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

ELISSE B. WALTER, COMMISSIONER

LUIS A. AGUILAR, COMMISSIONER

TROY A. PAREDES, COMMISSIONER

DANIEL M. GALLAGHER, COMMISSIONER

(56 Documents)

Commissioner Walter
Commissioner Paredes
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9331 / July 2, 2012

SECURITIES EXCHANGE ACT OF 1934
Release No. 67335 / July 2, 2012

INVESTMENT ADVISERS ACT OF 1940
Release No. 3427 / July 2, 2012

INVESTMENT COMPANY ACT OF 1940
Release No. 30126 / July 2, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14676

In the Matter of

Eric David Wanger and Wanger Investment Management, Inc.

Respondents.

ORDER MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, SECTIONS 203(e), 203(f), AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940

I.

On December 23, 2011, the Securities and Exchange Commission ("Commission") instituted proceedings 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(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 Eric David Wanger ("Respondent Wanger" or "Wanger") and Wanger Investment Management, Inc. ("Respondent Wanger Investment Management" or "Wanger Investment Management").

II.

Respondent Wanger and Respondent Wanger Investment Management have submitted Offers of Settlement ("Offers"), which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and over the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Section 8A of the Securities Act of 1933, Section 21C of the Securities Exchange Act of 1934, Sections 203(e), 203(f), and 203(k) of the Investment Advisers Act of 1940, and Section 9(b) of the Investment Company Act of 1940 ("Order"), as set forth below.

III.

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

Respondents

1. Eric David Wanger ("Wanger"), age 48, is a resident of Chicago, Illinois and was the owner, chief compliance officer, and president of an investment adviser, Wanger Investment Management, Inc. He is the sole managing member of the general partner to the Wanger Long Term Opportunity Fund II, LP and served as its sole portfolio manager from January 2002 into December 2011. From January 2007 through January 2009, he also served as a director of AltiGen Communications, Inc.

2. Wanger Investment Management, Inc. ("Wanger Investment Management") is an investment adviser based in Chicago, Illinois. Wanger Investment Management registered with the Commission on April 6, 2009. On November 28, 2011, Wanger Investment Management filed a Form ADV-W Notice of Withdrawal from Registration as an Investment Adviser and Wanger Investment Management's registration ceased December 31, 2011. It serves as adviser to the Wanger Long Term Opportunity Fund II, LP.

Other Relevant Entities

3. AltiGen Communications, Inc. ("AltiGen") is a Delaware corporation headquartered in San Jose, California that designs, manufactures, and markets phone systems and call center products that use the Internet and public telephone networks. During the relevant period, its common stock was registered with the Commission pursuant to Section 12(b) of the Exchange Act and was traded on the NASDAQ under the symbol ATGN. On or about March 3,

2010, AltiGen announced that it would delist from the NASDAQ. On or about November 2, 2010, it filed a Form 15 Certification and Notice of Termination of Registration Under Section 12(g) of the Exchange Act or Suspension of Duty to File Reports Under Sections 13 and 15(d) of the Exchange Act.

4. The Wanger Long Term Opportunity Fund II, LP (the "Fund") is an investment fund that seeks long-term capital appreciation by investing in small and microcap companies. It is not registered with the Commission.

Background

5. Wanger formed the Fund on January 1, 2002. The initial investment in the Fund at that time amounted to approximately $2,000,000, consisting of money from family and friends. At its highest point, in April 2008, the Fund had a net asset value ("NAV") of approximately $14.5 million.

6. Beginning in November 2007, Wanger stated that he wanted to grow the Fund to $100 million, but he was only able to raise approximately $3.5 million from November 2007 through April 2008.

7. The Fund began acquiring shares of AltiGen in 2006. During the relevant period, one of the Fund's largest holdings was stock in AltiGen.

8. Wanger used one of the Fund's external brokers ("Broker") for the vast majority of the Fund's orders. Wanger relied on Broker's expertise and resources to execute orders for the Fund.

9. Wanger and Broker regularly discussed the best way for the Fund to buy shares for any particular day. Wanger and Broker exchanged instant messages regarding, among other things, their strategy to accumulate AltiGen shares given the stock's thinly-traded history.

10. Wanger instructed Broker in writing through various instant messages that he wanted "best execution," he was "price sensitive," and "not to trash the market." In response, Broker informed Wanger that he would purchase AltiGen stock for the Fund using his expertise, which was to be "stealthy" and to buy stock with "no market impact."

11. While the Fund was accumulating AltiGen shares, Wanger and Broker talked about suspicious end-of-the-day trading by others in AltiGen stock. Wanger understood that trading at the end of the day to raise the price of a thinly-traded stock was disruptive to investors and companies. He also understood that there could be a short-term benefit to the Fund's performance numbers when the price of AltiGen stock increased at the end of the day and, particularly, at the end of a month or quarter.

Wanger and Wanger Investment Management Marked
the Close on Fifteen Different Occasions

12. "Marking the close" involves the placing and execution of orders shortly before the close of trading on any given day to artificially affect the closing price of a security.

13. From January 31, 2008 through September 30, 2010, Wanger, as owner, president and chief compliance officer of Wanger Investment Management, repeatedly marked the close by placing bids in certain thinly-traded securities held by the Fund that were the last trade of the day of the final trading session of a month or quarter.

14. Specifically, Wanger marked the close on at least fourteen occasions on ten separate days, at month and quarter ends, in 2008, 2009, and 2010. He also marked the close on June 20, 2008, the date he transferred AltiGen securities from his own account to the Fund's account as part of an improper transaction as alleged in paragraphs 30-37 below. In addition, he attempted to mark the close on at least three other occasions.

15. Wanger marked the close in shares of AltiGen ("ATGN") (at least nine times), Clicksoftware Technologies Ltd., ("Clicksoftware" or "CKSW") (at least twice), Derma Sciences, Inc., ("Derma Sciences" or "DSCI") (at least twice) and Woodbridge Holdings Corp ("Woodbridge" or "WDGH") (at least once) to artificially improve the Fund's reported monthly and quarterly performance.

16. Wanger marked the close on the following dates in the following securities:

Trade Date	Security	Last Sale Prior to or During Wanger's Trade Activity	Closing Price Obtained by Wanger
01/31/08	ATGN	$1.60	$1.63
03/31/08	ATGN	$1.42	$1.65
04/30/08	ATGN	$1.44	$1.56
05/30/08	ATGN	$1.33	$1.45
06/20/08	ATGN	$1.37	$1.38
09/30/08	ATGN	$0.93	$0.99
09/30/08	DSCI	$0.54	$0.56

10/31/08	ATGN	$.68	$0.69
10/31/08	CKSW	$2.85	$2.90
02/27/09	ATGN	$0.84	$0.85
02/27/09	DSCI	$0.47	$0.54
03/31/09	CKSW	$3.68	$3.72
03/31/09	WDGH	$0.40	$0.62
05/28/10	ATGN	$0.72	$0.76
09/30/10	ATGN	$0.60	$0.75

17. Wanger did not use Broker to place the orders for the trades that marked the close. Rather, he placed the orders for the trades for the Fund himself.

18. In addition, Wanger's trading style in connection with the marking the close transactions differed from the trading style he had instructed Broker to follow.

19. Wanger's manipulative trading improperly inflated the Fund's monthly reported performance by amounts ranging from approximately 3.60% to 5,908.71%, and artificially increased the Fund's NAV by amounts ranging from approximately .24% to 2.56%.

20. From January 1, 2008 through September 30, 2010, the value of AltiGen as a share of the Fund's portfolio ranged from a low of approximately 8.99% in March 2010 to a high of approximately 14.91% in December 2008. AltiGen shares accounted for approximately 10% or more of the Fund's month-end value in thirty-one of the thirty-three months in this time period.

21. During the periods in which he marked the close in the following securities, they accounted for the following portions of the Fund's total portfolio: i.) Clicksoftware ranged from a low of approximately 7.41% to a high of approximately 11.5%; ii.) Derma Sciences ranged from a low of approximately 3% to a high of approximately 4.12%; and iii.) Woodbridge represented approximately .7% of the portfolio on March 31, 2009.

22. Wanger and Wanger Investment Management provided Fund investors and prospective investors with figures that reflected performance results and their proportionate share of the Fund's NAV that were improperly inflated as a result of Wanger's manipulative trading.

Wanger and Wanger Investment Management provided the artificially inflated results directly to investors and prospective investors through a variety of means, including the Wanger Investment Management website, mailings, e-mail, and oral presentations.

23. Wanger and Wanger Investment Management included the artificially inflated performance results in marketing materials, which they distributed to prospective and existing Fund investors in order to solicit additional investments in the Fund.

24. Wanger communicated directly with Fund investors or their representatives regarding the Fund's performance.

25. For example, Wanger responded to inquiries from Fund investors and their representatives about the Fund's performance in the spring of 2008, with statements such as "despite a truly awful market, we finished the quarter down only a bit more than 3%. . . Thanks for your continued faith in us." However, Wanger did not inform existing or prospective investors or their representatives that the Fund's performance during the first quarter of 2008 was artificially inflated due to his marking the close transactions. Among these, the orders he placed at the end of the day on March 31, 2008 artificially increased the Fund's NAV by nearly 2%, without which the reported performance for the month would have been approximately 30% lower than reported.

26. Wanger and Wanger Investment Management received $2,269.81 in additional management fees from the Fund as a result of the marking the close transactions and did not fulfill their obligations to obtain the best prices for shares purchased by the Fund.

27. Wanger also marked the close of AltiGen stock on June 20, 2008 in an attempt to obtain a higher valuation of AltiGen stock he transferred from his personal account to the Fund's account as alleged in paragraphs 30 thru 37 below.

28. By marking the closing price of certain stocks held in the Fund's portfolio to artificially inflate the Fund's performance results and by communicating the inflated performance results to existing and prospective investors, Wanger and Wanger Investment Management engaged in a scheme to defraud and engaged in a practice that operated as a fraud.

29. Wanger and Wanger Investment Management also made material misrepresentations and omissions when they reported the artificially inflated performance results to existing and potential investors.

Wanger and Wanger Investment Management Engaged in
<u>Improper Transactions with the Fund</u>

30. Section 206(3) of the Advisers Act provides that it is unlawful for an investment adviser, "acting as principal for his own account, knowingly to sell any security to or purchase any security from a client . . . without disclosing to such client in writing before the completion

of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction."

31. In 2008 and 2009, Wanger, acting through Wanger Investment Management, directed the transfer of funds from the Fund's brokerage accounts to Wanger Investment Management's bank accounts to pay investment adviser operating expenses and payroll in amounts totaling approximately $300,000 and approximately $200,000, respectively. These transfers were not specifically authorized by the Fund.

32. In June 2008 and June 2009, Wanger and Wanger Investment Management partially repaid the Fund by engaging in at least two improper principal securities transactions.

33. On or about June 20, 2008, Wanger transferred 37,344 shares of AltiGen, and other securities, from his personal account to the Fund's account.

34. Wanger marked the closing price of AltiGen stock on June 20, 2008, which could have had the effect of increasing the price the Fund paid for the securities had the AltiGen shares remained in the Fund's account with a transfer date of June 20, 2008.

35. In July 2008, these AltiGen securities and certain of the other securities were transferred back to Wanger's personal account.

36. In June 2009, Wanger transferred AltiGen stock and another security from his personal account to the Fund again. The transferred securities were 37,344 AltiGen shares valued at approximately $47,053 and 29,000 Woodbridge shares valued at approximately $33,060 (approximately $80,113 total).

37. Wanger and Wanger Investment Management did not provide the Fund with written disclosure or obtain the Fund's consent prior to engaging in the principal securities transactions with the Fund described in paragraphs 30 to 36 above, as required by Section 206(3) of the Advisers Act.

<u>Wanger and Wanger Investment Management's Failure to Timely File Forms 4</u>

38. Wanger served as a member of the AltiGen Board of Directors from January 2007 through January 2009.

39. The Fund was a 10% owner of AltiGen stock from at least July 2008 into December 2010.

40. During this time, Wanger failed to timely file the requisite Forms 4 with the Commission regarding at least eight personal transactions in AltiGen securities.

41. Wanger Investment Management also failed to timely file the requisite Forms 4 for the Fund regarding at least forty transactions in AltiGen securities.

42. Section 16(a) of the Exchange Act and Rule 16a-3 thereunder require directors and persons owning more than 10% of a company's stock to file a Form 4 within two business days of the acquisition or disposition of the security.

43. AltiGen filed a Form 8-K, dated January 8, 2009, stating:

> In late 2008, we were informed by Eric Wanger, a Board member, that he had failed to timely file his Forms 3, 4 and/or 5, in connection with a significant number of purchases of AltiGen common stock during the period beginning on January 23, 2007 and ending on September 30, 2008. In response, the company, with the assistance of outside counsel, reviewed Mr. Wanger's trading activities and discovered that certain of the purchases of AltiGen's common stock by Mr. Wanger, or entities affiliated with Mr. Wanger, in April of 2007, March of 2008, June of 2008 and September through November of 2008, constituting approximately 25 separate trades in the aggregate amount of approximately $100,000, violated AltiGen's blackout period set forth in our insider trading policy. The Board was informed of these matters and has carefully reviewed them.
>
> On January 8, 2009, our Board decided to not nominate Mr. Wanger for re-election to the Board.

44. Wanger resigned from the AltiGen Board on January 26, 2009.

45. In connection with the conduct described above, Respondents Wanger and Wanger Investment Management acted recklessly, or at least, negligently.

Violations

46. As a result of the conduct described above, Wanger willfully violated Sections 17(a)(1) and 17(a)(3) of the Securities Act, and 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.

47. As a result of the conduct described above, Wanger Investment Management willfully violated Section 17(a)(1), 17(a)(2) and 17(a)(3) of the Securities Act, and 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.

48. As a result of the conduct described above, Wanger willfully violated Section 16(a) of the Exchange Act and Rule 16a-3 thereunder, which require timely and accurate filings of Forms 4 with the Commission.

49. As a result of the conduct described above, Wanger Investment Management willfully aided and abetted and caused the Fund's violations of Section 16(a) of the Exchange Act and Rule 16a-3 thereunder, which require timely and accurate filings of Forms 4 with the Commission.

50. As a result of the conduct described above, Wanger and Wanger Investment Management willfully violated Section 206(3) of the Advisers Act, which states that it is unlawful for an investment adviser, "acting as principal for his own account, knowingly to sell any security to or purchase any security from a client . . . without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction."

51. As a result of the conduct described above, Wanger and Wanger Investment Management willfully violated Sections 206(1), 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, which prohibit fraudulent conduct by an investment adviser.

52. As a result of the conduct described above, Wanger willfully aided and abetted and caused Wanger Investment Management's violations of Sections 206(1), 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, which prohibit fraudulent conduct by an investment adviser.

IV.

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

Accordingly, pursuant to Section 8A of the Securities Act, Section 21C of the Exchange Act, Sections 203(e), 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 Wanger shall cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, Sections 10(b) and 16(a) of the Exchange Act and Rules 10b-5 and 16a-3 thereunder, and Sections 206(1), 206(2), 206(3), and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

B. Respondent Wanger 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.

with the right to apply for reentry after one (1) year to the appropriate self-regulatory organization, or if there is none, to the Commission.

C. Any reapplication for association by the Respondent Wanger 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 Wanger, 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 Wanger shall, within 15 days of the entry of this Order, pay a civil money penalty in the amount of $75,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Such payment shall be: (A) made by 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 Securities and Exchange Commission, Office of Financial Management, 100 F St., NE, Stop 6042, Washington, DC 20549; and (D) submitted under cover letter that identifies Eric David Wanger 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 Robert J. Burson, Division of Enforcement, Securities and Exchange Commission, 175 W. Jackson Blvd., Suite 900, Chicago, IL, 60604.

E. Respondent Wanger Investment Management shall cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, Sections 10(b) and 16(a) of the Exchange Act and Rules 10b-5 and 16a-3 thereunder, and Sections 206(1), 206(2), 206(3), and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

F. Respondent Wanger Investment Management is censured.

G. Respondent Wanger Investment Management shall, within 15 days of the entry of this Order, pay disgorgement of $2,269.81 and prejudgment interest of $121.94 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. Payment shall be: (A) made by 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 Securities and Exchange Commission, Office of Financial Management, 100 F St., NE, Stop 6042, Washington, DC 20549; and (D) submitted under cover letter that identifies Wanger Investment Management as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Robert J. Burson, Division of Enforcement, Securities and Exchange Commission, 175 W. Jackson Blvd., Suite 900, Chicago, IL, 60604.

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. 67330 / July 2, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14933

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

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondent Apogee Technology, Inc., and any successor under Exchange Act Rules 12b-2 and 12g-3 or new corporate name ("Respondent" or "Apogee") because it has not filed any periodic reports for any period ended after June 30, 2011.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENT

1. Apogee (CIK No. 823876) is a Delaware corporation located in Norwood, Massachusetts that develops and markets drug delivery systems. Apogee has a class of securities that is registered with the Commission pursuant to Section 12(g) of the Exchange Act and is currently quoted under the symbol ATCS on OTC Link (formerly, "Pink Sheets") operated by OTC Markets Group Inc. Apogee's fiscal year ends on December 31 and it is required to file periodic and other reports with the Commission as a smaller reporting company. On April 16, 2010, the Commission instituted administrative proceedings pursuant to Section 12(j) of the Exchange Act to determine whether the registration of Apogee's securities should be suspended or revoked. The Division of Enforcement alleged in those prior administrative proceedings that Apogee was delinquent in its required periodic filings with the Commission. That matter was settled in August 2010 when Apogee agreed to make all then-delinquent periodic filings

by August 16, 2010, which it did. The Commission had also previously filed a civil injunctive action against Apogee and others on May 19, 2009, alleging that the defendants engaged in a scheme to inflate Apogee's reported revenue. A judgment by consent was entered against Apogee in that action on May 22, 2009. Among other things, the judgment enjoined Apogee from future violations of Section 17(a) of the Securities Act of 1933 ("Securities Act") and Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act, and Rules 10b-5, 12b-20, 13a-1 and 13a-13 thereunder.

B. DELINQUENT PERIODIC FILINGS

2. Respondent is delinquent in its periodic filings with the Commission. In particular, Apogee failed to file a Form 10-K for the 2011 fiscal year, and failed to file Forms 10-Q for the third quarter of the 2011 fiscal year and the first quarter of the 2012 fiscal year.

3. Apogee's Form 10-Q for the quarter ended September 30, 2011 was due on November 14, 2011. On November 15, 2011, Apogee timely filed a Form 12b-25 announcing that it was unable to timely file its Form 10-Q for the quarter ended September 30, 2011 because the report "cannot be filed without unreasonable effort [or] expense" and representing that it would be filed on or before the fifth calendar day following the prescribed due date, which would have been November 21, 2011. To date, Apogee has not filed this Form 10-Q.

4. Apogee's Form 10-K for the fiscal year ended December 31, 2011 was due on March 30, 2012. To date, Apogee has not filed this Form 10-K.

5. Apogee's Form 10-Q for the quarter ended March 31, 2012 was due on May 15, 2012. To date, Apogee has not filed this Form 10-Q.

6. Section 13(a) of the Exchange Act and the rules promulgated thereunder require issuers of securities registered pursuant to Section 12 of the Exchange Act to file with the Commission current and accurate information in periodic reports. Specifically, Rule 13a-1 requires issuers to file annual reports (Form 10-K) and Rule 13a-13 requires issuers to file quarterly reports (Form 10-Q).

7. As a result of its failure to make the required periodic filings described above, Respondent failed to comply with Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder.

III.

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

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

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

IV.

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

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

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

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

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

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

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

July 2, 2012

IN THE MATTER OF Apogee Technology, Inc. File No. 500-1	:	ORDER OF SUSPENSION OF TRADING

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Apogee Technology, Inc. ("Apogee") because it has not filed any periodic reports since the period ended June 30, 2011.

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, and any equity securities of any entity purporting to succeed to this issuer.

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, and any equity securities of any entity purporting to succeed to this issuer, is suspended for the period from 9:30 a.m. EDT on July 2, 2012, through 11:59 p.m. EDT on July 16, 2012.

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. 67334 / July 2, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14934

In the Matter of	
Objex, Inc., Online Power Supply, Inc., Orca Technologies, Inc., Orion Research Group, Inc., and PRTX, Inc., Respondents.	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents Objex, Inc., Online Power Supply, Inc., Orca Technologies, Inc., Orion Research Group, Inc., and PRTX, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Objex, Inc. (CIK No. 1124859) is a dissolved Colorado corporation located in Colorado Springs, Colorado with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Objex 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 October 2, 2000.

2. Online Power Supply, Inc. (CIK No. 1101152) is a Nevada corporation located in Englewood, Colorado with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Online 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, 2002, which reported a net loss of over $3.86 million for the prior nine months. The company has also violated an August 28, 2003 permanent injunction issued by the U.S. District Court for the District of Colorado enjoining it from violations of Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder. On May 14, 2004, the company filed a Chapter 11 petition in the U.S. Bankruptcy Court for the District of Colorado, which was converted to Chapter 7 and was terminated on May 23, 2011. As of July 2, 2012, the company's stock ("OPWR") was traded on the over-the-counter markets.

3. Orca Technologies, Inc. (CIK No. 1004932) is an expired Utah corporation located in Bothell, Washington with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Orca 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 31, 1999, which reported a net loss of over $5 million for the prior nine months.

4. Orion Research Group, Inc. (CIK No. 1093429) is a permanently revoked Nevada corporation located in Minden, Nevada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Orion Research 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 $2,666 for the year ended December 31, 1999.

5. PRTX, Inc. (CIK No. 1410516) is a void Delaware corporation located in Kirkland, Washington with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). PRTX 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, 2008, which reported a net loss of $25,100 since the company's April 27, 2007 inception.

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

Commissioner Walter
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
July 3, 2012

In the Matter of A-Power Energy Generation Systems, Ltd., File No. 500-1	ORDER OF SUSPENSION OF TRADING

It appears to the Securities and Exchange Commission ("Commission") that there is a lack of current and accurate information concerning the securities of A-Power Energy Generation Systems, Ltd. ("A-Power") because, among other things, it: (1) has not filed any periodic reports since the period ended December 31, 2009; and (2) failed to disclose that its independent auditor resigned after A-Power's management informed the auditor that it did not intend to regain current filing status with the Commission.

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 A-Power is suspended for the period from 9:30 a.m. EDT on July 3, 2012, through 11:59 p.m. EDT on July 17, 2012.

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. 67338 / July 3, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14935

In the Matter of **A-Power Energy Generation Systems, Ltd.,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondent A-Power Energy Generation Systems, Ltd. ("A-Power").

II.

After an investigation, the Division of Enforcement alleges that:

A. Respondent

A-Power Energy Generation Systems, Ltd. (CIK No. 0001399233) is a British Virgin Islands corporation with its principal executive offices located in the People's Republic of China ("PRC"). On January 18, 2008, A-Power merged with its parent, Chardan South China Acquisition Corporation, through a reverse merger and was the surviving entity. It claims to be the largest provider of distributed power generation systems in China and claims to have the largest wind turbine manufacturing facility in China. It is a foreign private issuer that is required to file annual reports on Form 20-F with the Commission. At all relevant times, its common stock has been registered pursuant to Section 12(b) of the Exchange Act. Its stock was listed and began trading on NASDAQ on January 22, 2008, under the symbol APWR and traded as high as $31.89 on June 20, 2008. On June 27, 2011, NASDAQ halted trading in A-Power's stock following the resignation of its independent auditor. The trading halt converted into a suspension on September 26, 2011.[1] A-Power's stock did not trade from June 28, 2011 through September 23, 2011. On September 26, 2011, A-Power's stock resumed trading in the over the counter market and closed at $0.31 with a trading volume of 2.8 million shares. On April 13, 2012, NASDAQ announced the delisting of A-Power's common stock, which closed at $0.27. That day, A-Power had five market makers, a trading volume of 304,388 shares, and a market capitalization of $12.5 million (46,363,638 total shares outstanding).

B. A-Power's Reporting Violations

1. A-Power failed to file an annual report on Form 20-F for the year ended December 31, 2010 containing audited financial statements because its former independent auditor resigned before the completion of its audit and A-Power has been unable to have another auditor complete the audit.

2. Section 13(a) of the Exchange Act and the rules promulgated thereunder require issuers of securities registered pursuant to Section 12 of the Exchange Act to file with the Commission current and accurate information in periodic reports. Rule 13a-1 requires issuers to file annual reports.

3. As a result of the foregoing, Respondent failed to comply with Section 13(a) and Rule 13a-1 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 to revoke the registration of each class of securities registered pursuant to Section 12 of the Exchange Act of A-Power.

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[1] NASDAQ informed A-Power that it concluded, pursuant to Listing Rules 5101 and 5250(c), that continued listing of A-Power's securities on NASDAQ was unwarranted because of circumstances surrounding the resignation of its independent auditor, resignations of several of its directors, and because it had not timely filed its annual report with the Commission. A-Power appealed this determination to a NASDAQ Listing Qualifications Panel and was granted until December 31, 2011 to complete its audit and file its Form 20-F for the year ended December 31, 2010.

IV.

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

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

If respondent fails to file the directed Answer, or fails to appear at a hearing after being duly notified, the Respondent 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 201.310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 220(f), 201.221(f) and 201.310].

This Order shall be served forthwith upon Respondent personally or by certified, registered, or Express Mail, or by other means permitted by the Commission's 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
July 5, 2012

In the Matter of **Qiao Xing Universal Resources, Inc., and Qiao Xing Mobile Communication Co., Ltd.** **File No. 500-1**	**ORDER OF SUSPENSION OF TRADING**

It appears to the Securities and Exchange Commission ("Commission") that there is a lack of current and accurate information concerning the securities of Qiao Xing Universal Resources, Inc. ("XING"), a British Virgin Islands corporation with headquarters and operations in the People's Republic of China. Those securities now trade in the over-the-counter market under the symbol XINGF since trading in them was suspended by the NASDAQ Stock Market Inc. ("NASDAQ") on May 10, 2012.

Questions have arisen regarding the accuracy and completeness of information contained in XING's public filings with the Commission concerning, among other things, the effectiveness of XING's internal control over financial reporting. It appears to the Commission that relevant information has not been disclosed about XING, including the following: (1) its CFO resigned; (2) its independent auditor resigned; and (3) its US counsel resigned.

It also appears to the Commission that there is a lack of current and accurate information concerning the securities of Qiao Xing Mobile Communication Co., Ltd. ("QXM"), a British Virgin Islands corporation with headquarters and operations in the People's Republic of China, which now trades in the over-the-counter market under the symbol QXMCF since it was suspended by the New York Stock Exchange ("NYSE") on May 18, 2012.

It appears to the Commission that relevant information has not been disclosed about QXM, including the following: (1) the Chairman of its Audit Committee resigned; and (2) its outside independent auditor resigned.

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

Therefore, IT IS ORDERED, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed companies is suspended for the period from 9:30 a.m. EDT on July 5, 2012, through 11:59 p.m. EDT on July 18, 2012.

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. 67350 / July 5, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14936

In the Matter of Qiao Xing Universal Resources, Inc., and Qiao Xing Mobile Communication Co., Ltd. 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 Qiao Xing Universal Resources, Inc. ("XING"), and Qiao Xing Mobile Communication Co., Ltd. ("QXM").

II.

The Division of Enforcement alleges that:

A. Respondents

1. **Qiao Xing Universal Resources, Inc.** (CIK No. 0001051846) is a British Virgin Islands ("BVI") corporation with its principal executive offices located in the People's Republic of China ("PRC"). The company was formed on December 6, 1994. Until April 6, 2009, it made and sold telecommunication terminals and equipment. From then until the present, it has been in the mineral resources industry and claims to be a leading player in the molybdenum-mining industry. XING's stock traded on NASDAQ until it was halted on April 16, 2012, and suspended on May 10, 2012. XING's stock is currently traded in the over-the-counter market under the symbol XINGF and closed at $0.18 a share on May 10, 2012.

2. **Qiao Xing Mobile Communication Co., Ltd.** (CIK No. 0001386607) is also a BVI corporation with its principal executive offices located in the PRC. It was formed on January 31, 2002. It manufactures and sells mobile handsets. Its common stock was listed on the NYSE from May 3, 2007 until its trading was halted on May 2, 2012. The NYSE issued a delisting letter on May 17, 2012, and suspended trading in QXM's stock on May 18, 2012. QXM's stock now trades in the over-the-counter market under the symbol QXMCF and closed at $0.15 a share on May 18, 2012. QXM is a controlled company as defined by the NYSE, because XING owns more than 50% of its voting power.

B. Reporting Violations

1. XING has failed to file an annual report on Form 20-F for the year ended December 31, 2011 containing audited financial statements because its former independent auditor resigned before the completion of its audit. It has not filed a periodic report since July 15, 2011.

2. QXM has failed to file an annual report on Form 20-F for the year ended December 31, 2011 containing audited financial statements because its former independent auditor resigned before the completion of its audit. It has not filed a periodic report since June 30, 2011.

3. Section 13(a) of the Exchange Act and the rules promulgated thereunder require issuers of securities registered pursuant to Section 12 of the Exchange Act to file with the Commission current and accurate information in periodic reports. Rule 13a-1 requires issuers to file annual reports.

4. As a result of the foregoing, Respondents failed to comply with Section 13(a) and Rule 13a-1 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 to revoke the registration of each class of securities registered pursuant to Section 12 of the Exchange Act of XING and QXM.

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 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 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 201.310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 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's 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. 67361 / July 6, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14938

In the Matter of SUPERIOR BANCORP, Respondent.	ORDER INSTITUTING PROCEEDINGS, MAKING FINDINGS, AND REVOKING REGISTRATION OF SECURITIES PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934

I.

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

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, Respondent consents to the entry of this Order Instituting Proceedings, Making Findings, and Revoking Registration of Securities Pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Order"), as set forth below.

III.

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

A. Superior is a Delaware corporation located in Birmingham, Alabama. At all times relevant to this proceeding, the common stock of Superior was registered under Exchange Act Section 12. It is currently quoted on OTC Link operated by OTC Markets Group, Inc.

B. Superior has failed to comply with Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder because it has not filed any periodic reports with the Commission since the period ended September 30, 2010.

IV.

Section 12(j) of the Exchange Act provides as follows:

The Commission is authorized, by order, as it deems necessary or appropriate for the protection of investors to deny, to suspend the effective date of, to suspend for a period not exceeding twelve months, or to revoke the registration of a security, if the Commission finds, on the record after notice and opportunity for hearing, that the issuer of such security has failed to comply with any provision of this title or the rules and regulations thereunder. No member of a national securities exchange, broker, or dealer shall make use of the mails or any means of instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security the registration of which has been and is suspended or revoked pursuant to the preceding sentence.

In view of the foregoing, the Commission finds that it is necessary and appropriate for the protection of investors to impose the sanction specified in Respondent's Offer.

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

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

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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.

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 67365 / July 6, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14940

In the Matter of OptiSystems Solutions, Ltd., Paradise Tan, Inc. (n/k/a General Red International), and Power Smoothie Café Franchising, Inc., Respondents.	ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents OptiSystems Solutions, Inc., Paradise Tan, Inc. (n/k/a General Red International), and Power Smoothie Café Franchising, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. OptiSystems Solutions, Ltd. (CIK No. 1038371) is an Israeli corporation located in Or Yehuda, Israel with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). OptiSystems 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 $2.75 million for the prior twelve months.

2. Paradise Tan, Inc. (n/k/a General Red International, Inc.) (CIK No. 1185218) is a forfeited Texas corporation located in Beijing, China with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Paradise Tan 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 $244,966 for the prior nine months. As of July 3, 2012, the company's stock (symbol "GRED") was traded on the over-the-counter markets.

3. Power Smoothie Café Franchising, Inc. (CIK No. 1404750) is a dissolved Florida corporation located in Coral Springs, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Power Smoothie 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, 2008, which reported a net loss of $121,362 for the prior three months.

B. DELINQUENT PERIODIC FILINGS

4. 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.

5. 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.

6. 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

Commissioner Aguilar not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 67368 / July 9, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14941

In the Matter of Manuel M. Bello, 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 Manuel M. Bello ("Respondent").

II.

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

III.

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

1. Bello is the President and Chief Executive Officer of Ayuda Funding Corporation, which wholly owns Ayuda Equity Funding, LLC ("Ayuda"), and is the owner of AmeriFund Capital Holdings, LLC ("AmeriFund"). During the relevant period, neither Ayuda nor AmeriFund was registered with the Commission in any capacity. From 1986 through 2000, Bello was a registered representative associated with broker-dealers registered with the Commission. Bello, age 46, is a resident of Kinnelon, New Jersey.

2. On July 6, 2012, a final judgment was entered by consent against Bello, permanently enjoining him from future violations of Section 5 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. Manuel M. Bello, et al., Civil Action Number 2:12-CV-03794-JLL-MAH in the United States District Court for the District of New Jersey.

3. The Commission's Complaint alleged that Ayuda and AmeriFund, which are controlled by Bello, induced certain affiliates of issuers to transfer ownership of millions of shares of publicly traded stock as collateral for loans based on a false promise to return identical shares posted by borrowers as collateral upon repayments of the loans. The Complaint further alleged that Ayuda and AmeriFund, at Bello's direction, sold the pledged shares (in unregistered transactions for which no exemption applied) before or soon after funding the loans. The Complaint also alleged that Bello acted as an unregistered broker or 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 Bello's Offer.

Accordingly, it is hereby ORDERED pursuant to Section 15(b)(6) of the Exchange Act that Respondent Bello 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 Aguilar not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 67368 / July 9, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14941

In the Matter of **Manuel M. Bello,** **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 Manuel M. Bello ("Respondent").

II.

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

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III.

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

1. Bello is the President and Chief Executive Officer of Ayuda Funding Corporation, which wholly owns Ayuda Equity Funding, LLC ("Ayuda"), and is the owner of AmeriFund Capital Holdings, LLC ("AmeriFund"). During the relevant period, neither Ayuda nor AmeriFund was registered with the Commission in any capacity. From 1986 through 2000, Bello was a registered representative associated with broker-dealers registered with the Commission. Bello, age 46, is a resident of Kinnelon, New Jersey.

2. On July 6, 2012, a final judgment was entered by consent against Bello, permanently enjoining him from future violations of Section 5 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. Manuel M. Bello, et al., Civil Action Number 2:12-CV-03794-JLL-MAH in the United States District Court for the District of New Jersey.

3. The Commission's Complaint alleged that Ayuda and AmeriFund, which are controlled by Bello, induced certain affiliates of issuers to transfer ownership of millions of shares of publicly traded stock as collateral for loans based on a false promise to return identical shares posted by borrowers as collateral upon repayments of the loans. The Complaint further alleged that Ayuda and AmeriFund, at Bello's direction, sold the pledged shares (in unregistered transactions for which no exemption applied) before or soon after funding the loans. The Complaint also alleged that Bello acted as an unregistered broker or 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 Bello's Offer.

Accordingly, it is hereby ORDERED pursuant to Section 15(b)(6) of the Exchange Act that Respondent Bello 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

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 67370 / July 9, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14943

In the Matter of Quill Industries, Inc. (n/k/a Eagle Worldwide Inc.), Rocky Point Pharmaceuticals, Inc., Sentosa Financial Investments, Ltd., Western Futures Fund LP, Western Futures Fund II LP, Wichita River Oil Corp., Woods Cross Holding Corp., and WSC Group, Inc., Respondents.	ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents Quill Industries, Inc. (n/k/a Eagle Worldwide Inc.), Rocky Point Pharmaceuticals, Inc., Sentosa Financial Investments, Ltd., Western Futures Fund LP, Western Futures Fund II LP, Wichita River Oil Corp., Woods Cross Holding Corp., and WSC Group, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Quill Industries, Inc. (n/k/a Eagle Worldwide Inc.) (CIK No. 1065188) 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). Quill Industries is

delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10 registration statement on August 21, 1998, which reported a net loss of over $2.6 million between the company's June 1, 1998 inception and June 30, 1998. Quill Industries filed annual reports for the years ended 2007 through 2011, but they were unaudited, and accordingly, materially deficient.

2. Rocky Point Pharmaceuticals, Inc. (CIK No. 853465) is a revoked Nevada corporation located in Salt Lake City, Utah with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Rocky Point Pharmaceuticals is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 2006.

3. Sentosa Financial Investments, Ltd. (CIK No. 1372905) is a forfeited Delaware corporation located in Dallas, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Sentosa Financial Investments 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, 2007, which reported a net loss of $139 between the company's inception on July 20, 2006 and March 31, 2007.

4. Western Futures Fund LP (CIK No. 812025) is a cancelled Illinois limited partnership located in Chicago, Illinois with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Western Futures Fund 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 $82,000 for the prior three months.

5. Western Futures Fund II LP (CIK No. 857075) is a cancelled Delaware limited partnership located in Chicago, Illinois with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Western Futures Fund II 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, 1991, which reported a net loss of over $378,000 for the prior twelve months.

6. Wichita River Oil Corp. (CIK No. 857566) is a Delaware corporation located in Metairie, Louisiana with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Wichita River Oil 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 $1.4 million for the prior nine months. On March 30, 2011, Wichita River Oil filed a Chapter 7 bankruptcy petition in the U.S. Bankruptcy Court for the Northern District of Texas, and the case was terminated on June 15, 2011.

7. Woods Cross Holding Corp. (CIK No. 934852) is a void Delaware corporation located in Woods Cross, Utah with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Woods Cross Holding is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a

Form 10 registration statement with the Commission on October 2, 2008, which reported a net loss over $4,000 for the twelve-month period ended June 30, 2008.

8. WSC Group, Inc. (CIK No. 108618) is a dissolved New York corporation located in Dallas, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). WSC Group 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 October 31, 1992, which reported a net loss of $80,000 for the prior twelve months. On November 3, 1981, a permanent injunction was entered against WSC Group, enjoining the company from aiding or abetting violations of the antifraud provisions of the Exchange Act.

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. 67369 / July 9, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14942

In the Matter of **SEI Holdings, Inc. (n/k/a Stoneleigh Realty Investors, LLLP), Voorhees Acquisition Corp., Wellstead Industries, Inc., Werdston Holding, Inc., Wingate Government Mortgage Partners II LP, Wingate Housing Partners, Ltd., and Winthrop Interim Partners I L.P.,** **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 SEI Holdings, Inc. (n/k/a Stoneleigh Realty Investors, LLLP), Voorhees Acquisition Corp., Wellstead Industries, Inc., Werdston Holding, Inc., Wingate Government Mortgage Partners II LP, Wingate Housing Partners, Ltd., and Winthrop Interim Partners I L.P.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. SEI Holdings, Inc. (n/k/a Stoneleigh Realty Investors, LLLP) (CIK No. 1321508) is a Florida Limited Liability Limited Partnership located in Jupiter, Florida with a class of securities registered with the Commission pursuant to Exchange Act

Section 12(g). SEI 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 February 29, 2008, which reported a net loss of over $61,000 for the prior nine months.

2. Voorhees Acquisition Corp. (CIK No. 1293323) is a Delaware corporation located in Garden City, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Voorhees 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 March 31, 2006, which reported a net loss of over $1,900 between the company's inception on May 6, 2004 and March 31, 2006.

3. Wellstead Industries, Inc. (CIK No. 769626) is a void Delaware corporation located in Boston, Massachusetts with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Wellstead Industries 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, erroneously filed under cover of Form NTN-10Q, which reported a net loss of $830,000 for the prior nine months.

4. Werdston Holding, Inc. (CIK No. 1374137) 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). Werdston Holding is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10 registration statement on September 21, 2006, which reported a net loss of $421 for the period between the company's inception on March 28, 2006 and June 30, 2006.

5. Wingate Government Mortgage Partners II LP (CIK No. 847324) is a Massachusetts limited partnership located in Boston, Massachusetts with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Wingate Government Mortgage Partners II 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.

6. Wingate Housing Partners, Ltd. (CIK No. 701745) is a California limited partnership located in Boston, Massachusetts with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Wingate Housing Partners 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 $65,000 for the prior six months.

7. Winthrop Interim Partners I Limited Partnership (CIK No. 718535) is a forfeited Maryland limited partnership located in Cambridge, Massachusetts with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Winthrop Interim Partners I is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 1999, which reported a net loss of over $25,000 for the prior nine 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

Commissioner Aguilar not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9333 / July 9, 2012

SECURITIES EXCHANGE ACT OF 1934
Release No. 67377 / July 9, 2012

INVESTMENT ADVISERS ACT OF 1940
Release No. 3428 / July 9, 2012

INVESTMENT COMPANY ACT OF 1940
Release No. 30131 / July 9, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14680

In the Matter of

CALHOUN ASSET MANAGEMENT, LLC, and KRISTA LYNN WARD A/K/A KRISTA LYNN KARNEZIS

Respondents.

ORDER MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, SECTIONS 203(e), 203(f), AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940

I.

On December 29, 2011, the Securities and Exchange Commission ("Commission") instituted proceedings against Calhoun Asset Management, LLC ("Calhoun") 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(e) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act"), and Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act"), and against Krista Lynn Ward a/k/a Krista Lynn Karnezis ("Ward") 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.

II.

Calhoun and Ward (collectively, "Respondents") have submitted Offers of Settlement ("Offers") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and over the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Section 8A of the Securities Act of 1933, Section 21C of the Securities Exchange Act of 1934, Sections 203(e), 203(f), and 203(k) of the Investment Advisers Act of 1940, and Section 9(b) of the Investment Company Act of 1940 ("Order"), as set forth below.

III.

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

A. SUMMARY

1. This matter concerns materially false and misleading statements made by Calhoun, the investment adviser to two funds of funds, and Ward, its principal. Ward raised the assets managed by Calhoun by grossly exaggerating Calhoun's assets under management. Ward also made misleading statements about Calhoun's due diligence process, and filed numerous false Forms ADV with the Commission. In addition to making false and misleading statements, Ward failed to maintain records to support the performance that Calhoun claimed in its marketing materials.

B. RESPONDENTS

2. Calhoun is an Illinois limited liability company located in Chicago, Illinois, that was registered with the Commission as an investment adviser from August 31, 2007 until it withdrew its registration on April 22, 2010. Calhoun was the investment adviser to a master fund, "Calhoun Master Fund SPC, Ltd.," a Cayman Islands company, and two feeder funds: "Calhoun Multi-Series Fund LP (f/k/a Triumph Multi-Series Fund)," a Delaware limited partnership, and "Calhoun Fund SPC, Ltd. (f/k/a Calhoun Market Neutral Fund)," a Cayman Islands company. Calhoun has no disciplinary history.

3. Ward, age 41, resides in Park Ridge, Illinois. Ward was the managing member, sole owner, and sole full-time employee of Calhoun. Ward has no disciplinary history.

C. OTHER RELEVANT ENTITIES

4. Skore Financial Management, LLC a/k/a Taipan Wealth Advisors LLC a/k/a FQ Advisors, LLC ("Skore") was an Illinois limited liability company located in Chicago, Illinois, that was registered with the Commission as an investment adviser from

January 7, 2002 until February 14, 2011, when its registration was cancelled. Skore was dissolved as a corporate entity on September 11, 2009. Prior to Skore's dissolution, Ward was its CEO and Chief Compliance Officer. Skore has no disciplinary history.

5. Skore Investment Advisory Services, LLC ("SIAS") is a Nevis, West Indies corporation. SIAS is not registered with the Commission. SIAS is the investment adviser to "Triumph Offshore Fund," an offshore fund-of-funds open only to insurance companies. Ward is the managing member of SIAS.

D. BACKGROUND

The Calhoun Hedge Funds

6. In 2006, Ward started two hedge funds – Triumph Multi-Series Fund, a Delaware limited partnership (later renamed Calhoun Multi-Series Fund LP) (the "CMSF Fund"), and Calhoun Market Neutral Fund, a Cayman Islands company (later renamed Calhoun Fund SPC, Ltd.) (the "Calhoun Fund") (together, the "Funds"). The CMSF Fund offered limited partnership interests to investors, while the Calhoun Fund offered several different classes of shares of stock.

7. Calhoun managed the two Funds, and Ward was the managing member and sole full-time employee of Calhoun. Ward set up the CMSF Fund and the Calhoun Fund to each be a fund of funds, investing only in other hedge funds. The stated strategy of the Funds was to seek long term capital growth and positive returns through the selection of investment managers across a widely diversified pool of strategies.

8. Ward attracted capital to the Funds by aggressively marketing herself as an experienced hedge fund manager, despite having no experience in portfolio management. In an effort to promote the Funds, Ward attended various asset management conferences, distributed marketing materials, and established an Internet website. She solicited some investments for the Funds directly from individuals she met at conferences.

E. THE VIOLATIVE CONDUCT

False and Misleading Statements to Orizon

9. In 2006, Ward entered into discussions with Orizon Investment Counsel, LLC, an asset management firm registered with the Commission as an investment adviser, in an attempt to attract new investors. During these discussions, Ward told executives at Orizon that she had several hundred million dollars under management.

10. On the due diligence questionnaire filled out by Ward (on behalf of Calhoun and SIAS) and given to Orizon in 2006, in response to the "current assets under management" question, Ward wrote that she had "[a]pproximately $237 million under advisement." In the following question on the questionnaire, which asks about "the growth of assets under management over the last five years," Ward stated that her assets under

management grew from $27 million in 1999 to $200 million. At the time she filled out the questionnaire, however, Ward had never had more than $3 million under management.

11. Orizon entered into an Advisory Fee Sharing Agreement with Calhoun in September 2006 (the "Orizon Agreement"). The Orizon Agreement contemplated that Orizon would recommend certain of its advisory clients to invest in the CMSF Fund. Orizon communicated to its advisory clients that Calhoun had a substantial amount of assets under management, based on what Ward had told Orizon. Orizon also gave a copy of the due diligence questionnaire filled out by Ward to some of its advisory clients.

12. Approximately twenty of Orizon's advisory clients purchased limited partnership interests in the CMSF Fund, making Orizon the largest source of investors in Calhoun's Funds. Ward's representations that she had hundreds of millions of dollars under management were instrumental in convincing Orizon to recommend that its clients invest in the CMSF Fund.

Calhoun's Marketing Materials

13. Ward created various marketing materials in an attempt to attract investors. Ward distributed the marketing materials to prospective investors at conferences and through third parties, and made them available on an Internet website. These marketing materials contain various misrepresentations and unsupported performance claims.

14. The marketing materials refer to a 10-year track record with 11+% average annual returns. Ward, however, did not maintain documentation supporting this track record. Ward only maintained records dating back to 2007, and her recordkeeping was scattered and disorganized.

15. The marketing materials also contain misrepresentations about performance returns. In a PowerPoint presentation Ward provided to prospective and current investors, via Orizon and through her marketing activities, Ward included a full-page chart of monthly and annual performance returns from 1999 through 2009. The legend at the bottom of the page states that "[t]hese returns represent our flagship fund, Calhoun Fund SPC, Ltd." Calhoun Fund SPC, Ltd., however, did not commence operations until January 1, 2007 – and therefore the fund had no performance return data from 1999 through 2006.

16. Calhoun's marketing materials state that Ward "Grew [Skore] from $0 to $313M" – suggesting that Skore had over $300 million under management. Skore, however, never had any assets under management.

False and Misleading Statements Regarding Due Diligence

17. Calhoun touted its due diligence capabilities in marketing materials, written by Ward and provided to prospective and current investors, which described the criteria for selecting managers: past performance; diversification in relation to other managers; assets under management; absence of significant conflicts of interest; overall integrity and reputation; percentage of business time devoted to investment activities; and fees charged.

18. Calhoun also described a network of sources for identifying prospective managers. Calhoun represented that its due diligence included regular monitoring and performance reviews of managers, conducted at least monthly, along with periodic visits to managers. In materials available on its Internet website and authored by Ward, Calhoun stated that "we take every precaution necessary to complete **thorough due diligence and research** on every manager we recommend" (emphasis in original).

19. Calhoun's actual due diligence, however, was virtually nonexistent. Indeed, Ward did not even perform the due diligence herself, instead outsourcing the due diligence to a third party, Second City Alternatives, LLC ("Second City"). Once Ward outsourced the due diligence to Second City, Ward did not perform any due diligence services, nor did she oversee Second City. According to Ward, Second City breached its agreement to perform the due diligence, did not provide any due diligence reports, and only substantiated its services with some handwritten notes.

False and Misleading Statements on Forms ADV

20. On the Forms ADV she filed with the Commission, Ward repeatedly misrepresented Calhoun's assets under management. Ward first registered Calhoun as an investment adviser on August 31, 2007. On Calhoun's Form ADV, which Ward herself completed and electronically signed in her capacity as the managing member of Calhoun, Ward stated that Calhoun had $30 million in assets under management. In reality, at the time, Calhoun had less than $6 million under management.

21. On February 18, 2009, Ward filed an amendment to Calhoun's Form ADV. Ward herself completed and electronically signed the amendment in her capacity as the "owner" of Calhoun. Ward represented that Calhoun had $79.8 million in assets under management. In reality, at the time, Calhoun had approximately $7 million under management. Ward never amended the Form ADV to reflect Calhoun's actual assets under management.

22. Ward also misrepresented Skore's assets under management throughout its existence. From 2004 through 2008, in Forms ADV which Ward herself completed and electronically signed, Ward reported figures for Skore's assets under management ranging from $24 million to $335 million. In reality, Skore never had any assets under management.

F. VIOLATIONS

23. As a result of the conduct described above, Calhoun and Ward 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;

24. As a result of the conduct described above, Calhoun willfully violated, and Ward willfully aided and abetted and caused Calhoun's violations of, Section 203A of the

Advisers Act by registering with the Commission as an investment adviser despite being prohibited from doing so;

25. As a result of the conduct described above, Calhoun willfully violated, and Ward willfully aided and abetted and caused Calhoun's violations of, Section 204 of the Advisers Act and Rule 204-2(a)(16) thereunder by failing to keep all documents that are necessary to form the basis for, or demonstrate the calculation of, the performance or rate of return of any or all managed accounts that it used in advertisements or other communications distributed to 10 or more persons;

26. As a result of the conduct described above, Calhoun and Ward willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder by making false or misleading statements to, or otherwise defrauding, investors or prospective investors in a pooled investment vehicle; and

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

IV.

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

Accordingly, pursuant to Section 8A of the Securities Act, Section 21C of the Exchange Act, Sections 203(e), 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 Calhoun 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 203A, 204, 206(4), and 207 of the Advisers Act and Rules 204-2(a)(16) and 206(4)-8 promulgated thereunder.

B. Respondent Calhoun shall pay a civil money penalty, on a joint and several basis with Respondent Ward, of $50,000.00 to the United States Treasury. Payment shall be made in the following installments: $25,000.00 on or before August 15, 2012; $10,000.00 on or before October 31, 2012; $10,000.00 on or before December 31, 2012; and $5,000.00 on or before March 30, 2013. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of the civil penalty, plus any additional interest accrued pursuant to 31 U.S.C. 3717, shall be due and payable immediately, without further application. Payments shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Securities and Exchange Commission, Office of Financial Management, 100 F St., NE, Stop 6042, Washington, DC 20549; and (D) submitted under cover letter that identifies Calhoun Asset Management, LLC as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Timothy L. Warren, Division of Enforcement, Securities and Exchange Commission, 175 W. Jackson Blvd., Suite 900, Chicago, IL, 60604.

C. Respondent Ward 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 203A, 204, 206(4), and 207 of the Advisers Act and Rules 204-2(a)(16) and 206(4)-8 promulgated thereunder.

D. Respondent Ward be, and hereby is:

i. barred from association with any broker, dealer, investment adviser, municipal securities dealer, or transfer agent, provided however, that for a period of up to eight months from the entry of this Order, Ward may, solely for the purposes of completing the wind down of Calhoun, making final payments and distributions to investors in the funds Calhoun manages, and preserving value for those investors in the interim, (a) participate in advisory activities and (b) continue to be associated with Calhoun while Calhoun acts as an investment adviser;

ii. prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter;

with the right to apply for reentry after five (5) years to the appropriate self-regulatory organization, or if there is none, to the Commission.

E. 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.

F. Respondent Ward shall pay a civil money penalty, on a joint and several basis with Respondent Calhoun, of $50,000.00 to the United States Treasury. Payment shall be made in the following installments: $25,000.00 on or before August 15, 2012; $10,000.00 on or before October 31, 2012; $10,000.00 on or before December 31, 2012; and $5,000.00 on or before March 30, 2013. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of the civil penalty, plus any additional interest accrued pursuant to 31 U.S.C. 3717, shall be due and payable immediately, without further application. Payments shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Securities and Exchange Commission, Office of Financial Management, 100 F St., NE, Stop 6042, Washington, DC 20549; and (D) submitted under cover letter that identifies Krista Lynn Ward a/k/a Krista Lynn Karnezis as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Timothy L. Warren, Division of Enforcement, Securities and Exchange Commission, 175 W. Jackson Blvd., Suite 900, Chicago, IL, 60604.

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. 66144A / July 10, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14689

In the Matter of Kay Berensen-Galster, Respondent.	AMENDED ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 17A 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 17A of the Securities Exchange Act of 1934 ("Exchange Act") against Kay Berensen-Galster ("Respondent" or "Galster").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over her and the subject matter of these proceedings, and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Amended Order Instituting Administrative Proceedings Pursuant to Section 17A 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. Kay Berensen-Galster, age 59, is a resident of Salt Lake City, Utah. Galster was the President and part-owner of National Stock Transfer, Inc. ("National"), a suspended Utah corporation with its principal place of business in Salt Lake City, Utah. As President, Galster operated and was familiar with National's business. National became registered with the Commission as a transfer agent on March 29, 1983.

2. On November 9, 2011, a judgment was entered by consent against Galster, permanently enjoining her from aiding and abetting future violations of Sections 17(a)(3) and 17A(d) of the Exchange Act and Rules 17Ad-2, 17f-1, 17f-2(a), 17Ac2-1(c), 17Ac2-2, 17Ad-6, 17Ad-7, 17Ad-10, 17Ad-13, 17Ad-15(c), 17Ad-17 and 17Ad-19 thereunder, in the civil action entitled Securities and Exchange Commission v. National Stock Transfer, Inc., et al., Civil Action Number 2:11-cv-798, in the United States District Court for the District of Utah.

3. The Commission's Complaint alleged that, for at least five years, National violated many of the transfer agent provisions of the federal securities laws, including, among other things, that National, as aided and abetted by Galster, failed to report lost or stolen securities in a timely manner, failed to maintain certain records, failed to maintain control books for all of its issuers and failed to file its annual report with the Securities and Exchange Commission. During the time period covered by the Complaint, National acted as the transfer agent for at least 58 issues of common and preferred stock..

IV.

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

Accordingly, it is hereby ORDERED pursuant to Section 17A(c)(4)(C) of the Exchange Act that Respondent Galster be, and hereby is:

> barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization.

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

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

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Commissioner Paredes not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 66647A / July 10, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14811

In the Matter of

Roger Greer,

Respondent.

AMENDED ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 17A 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 17A of the Securities Exchange Act of 1934 ("Exchange Act") against Roger Greer ("Greer" 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 Amended Order Instituting Administrative Proceedings Pursuant to Section 17A 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. Greer, age 56, is a resident of Salt Lake City, Utah. Greer was the owner of National Stock Transfer, Inc. ("National"), a suspended Utah corporation with its principal place of business in Salt Lake City, Utah. As the owner, Greer operated and was familiar with National's business. His sister Kay Berensen-Galster replaced him in 2007, after Greer was convicted of a third degree felony for possession of child pornography. National became registered with the Commission as a transfer agent on March 29, 1983.

2. On January 31, 2012, a default and final judgment was entered against Greer, permanently enjoining him from aiding and abetting future violations of Sections 17(a)(3) and 17A(d) of the Exchange Act and Rules 17Ad-2, 17f-1, 17f-2(a), 17Ac2-1(c), 17Ac2-2, 17Ad-6, 17Ad-7, 17Ad-10, 17Ad-13, 17Ad-15(c), 17Ad-17 and 17Ad-19 thereunder, in the civil action entitled Securities and Exchange Commission v. National Stock Transfer, et al., Civil Action Number 2:11-cv-798, in the United States District Court for the District of Utah.

3. The Commission's Complaint alleged that, for at least five years, National violated many of the transfer agent provisions of the federal securities laws, including, among other things, that National, as aided and abetted by Greer, failed to report lost or stolen securities in a timely manner, failed to maintain certain records, failed to maintain control books for all of its issuers and failed to file its annual report with the Commission. During the time period covered by the Complaint, National acted as the transfer agent for at least 58 issues of common and preferred stock.

IV.

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

Accordingly, it is hereby ORDERED pursuant to Section 17A(c)(4)(C) of the Exchange Act that Respondent Greer be, and hereby is:

> barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization.

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

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

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. 67384 / July 10, 2012

INVESTMENT ADVISERS ACT OF 1940
Release No. 3429 / July 10, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14944

In the Matter of

BRIAN M. CAMPBELL,

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 AND NOTICE OF HEARING

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 Brian Campbell ("Respondent" or "Campbell").

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENT

1. From prior to 2001 through 2009, Respondent was the Managing Director of Pamrapo Service Corporation, a wholly-owned subsidiary of a New Jersey-based bank that provided investment services to the bank's customers. From approximately September 2001

through April 2009, Respondent was also a registered representative of Prime Capital Services, Inc. ("Prime Capital"), a broker-dealer registered with the Commission since 1986. Moreover, from approximately January 2002 through April 2009, Respondent was an associated person of Asset & Financial Planning, Ltd., ("Asset Planning"), an investment adviser registered with the Commission since 1984. Respondent, 43 years old, is a resident of Bayonne, New Jersey.

B. THE RESPONDENT'S CRIMINAL CONVICTION

2. On March 22, 2011, after a jury trial, Campbell was convicted of mail fraud and embezzlement in violation of 18 U.S.C. Sections 981, 982, 1341, 1957 and 2 and 28 U.S.C. Section 2461 before the United States District Court of the District of New Jersey, in United States v. Campbell, Crim. No. 10-00372-DRD-1. On November 11, 2011, Campbell was sentenced to a prison term of six months followed by three years of supervised release and ordered to make restitution in the amount of approximately $300,000. An order of forfeiture in the amount of $571,104.86 was also entered against Campbell on November 21, 2011.

3. The criminal indictment for which Campbell was convicted charged that Campbell, in 2007 and 2008, engaged in mail fraud and embezzlement by stealing a total of 33 commission checks (totaling approximately $571,000) intended for his employer, Pamrapo Service Corporation, and diverting them to his own personal bank account.

III.

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

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

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

C. What, if any, remedial action is appropriate in the public interest against Respondent pursuant to Section 203(f) of the Advisers Act.

IV.

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

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

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

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

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 210 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice.

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 67393 / July 10, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14945

In the Matter of **Mitchell Segal, Esq.** **Respondent.**	**ORDER INSTITUTING PUBLIC ADMINISTRATIVE PROCEEDINGS AND IMPOSING TEMPORARY SUSPENSION PURSUANT TO RULE 102(e)(3) OF THE COMMISSION'S RULES OF PRACTICE**

I.

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

II.

The Commission finds that:

A. RESPONDENT

1. Mitchell Segal, Esq., age 56, is and has been an attorney licensed to practice law in the State of New York and a sole practitioner with the professional association of the Law Offices of Mitchell S. Segal, PC, in Great Neck, New York.

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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, temporarily suspend from appearing or practicing before it any attorney . . . who has been by name . . . [p]ermanently enjoined by any court of competent jurisdiction, by reason of his or her misconduct in an action brought by the Commission, from violating or aiding and abetting the violation of any provision of the Federal securities laws or of the rules and regulations thereunder.

B. THE PERMANENT INJUNCTION AGAINST SEGAL

2. The Commission's complaint alleged, among other claims, that Segal and others violated Section 5 of the Securities Act of 1933 ("Securities Act") by "offering and selling securities when no registration statement had been filed or was in effect as to such securities and when no exemption from registration was available. The complaint further alleged that Segal violated, and aided and abetted in the violation of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), by "obtaining and furnishing false documents . . . to support a legal opinion letter that was provided to Alternative Green Technologies, Inc.'s transfer agent so that the transfer agent would issue millions of shares of purportedly unrestricted AGTI stock in an unregistered offering."

3. On April 11, 2012, the U.S. District Court for the Southern District of New York entered a final judgment against Segal, permanently enjoining him from future violations of Section 5 of the Securities Act of 1933 ("Section 5") and Section 10(b) of the Securities Exchange Act of 1934 ("Section 10(b)"). United States Securities and Exchange Commission v. Alternative Green Technologies, Inc., Mitchell Segal, *et al.*, 11 Civ. 9056 (DAB). Specifically, the judgment permanently restrained and enjoined Segal from violating directly or indirectly, or aiding and abetting in the violation of, Section 10(b) [15 U.S.C. § 78j(b)] and Rule 10b-5 promulgated thereunder [17 C.F.R. § 240.10b-5], by using any means or instrumentality of interstate commerce to employ any device, scheme or artifice to defraud, to make any untrue statement or omission of material fact or to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person. The judgment restrains and enjoins Segal from violating Section 5 [15 U.S.C. § 77e], by buying, selling or causing the sale of unregistered securities, in the absence of any applicable exemption. The judgment also prohibits Segal from acting as an officer or director of any issuer that has a class of securities registered pursuant to Section 12 of the Exchange Act, 15 U.S.C. § 781 or that is required to file reports pursuant to Section 15(d) of the Exchange Act, 15 U.S.C. § 780(d). The court permanently barred Segal from participating in any offering of penny stock as defined by Rule 3a51-1 under the Exchange Act [17 C.F.R. § 240.3a51-1]. Finally, the court ordered AGTI and Segal to pay disgorgement of ill-gotten gains, prejudgment interest thereon, and a civil penalty pursuant to Section 20(d) of the Securities Act [15 U.S.C. § 77t(d)] and Section 21(d)(3) of the Exchange Act [15 U.S.C. § 78u(d)(3)], the amounts of which will be determined by the court upon motion of the Commission.

III.

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

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

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

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

This Order shall be served upon Mitchell Segal, Esq. personally or by certified mail at his last known address.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

Release No. 34-67405; File No. S7-30-11

RIN 3235-AL19

Extension of Interim Final Temporary Rule on Retail Foreign Exchange Transactions

AGENCY: Securities and Exchange Commission.

ACTION: Interim final temporary rule; extension.

SUMMARY: The Securities and Exchange Commission ("Commission") is amending interim final temporary Rule 15b12-1T under the Securities Exchange Act of 1934 ("Exchange Act") to extend the date on which the rule will expire from July 16, 2012 to July 16, 2013.

DATES: *Effective Date*: July 16, 2012. The expiration date of interim final temporary Rule 15b12-1T (17 CFR 240.15b12-1T) is extended to July 16, 2013.

FOR FURTHER INFORMATION CONTACT: Joanne Rutkowski, Branch Chief, Bonnie Gauch, Senior Special Counsel, and Leila Bham, Special Counsel, Division of Trading and Markets, at (202) 551-5550, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: The Commission is extending the expiration date for Rule 15b12-1T under the Exchange Act.

I. DISCUSSION

Section 742 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")[1] amended the Commodity Exchange Act ("CEA") to provide that a person

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1 Public Law 111–203, 124 Stat. 1376 (2010).

for which there is a Federal regulatory agency,[2] including a broker or dealer ("broker-dealer") registered under section 15(b) (except pursuant to paragraph (11) thereof) or 15C of the Exchange Act,[3] shall not enter into, or offer to enter into, a foreign exchange ("forex") transaction[4] with a person who is not an "eligible contract participant"[5] ("ECP") except pursuant to a rule or regulation of a Federal regulatory agency allowing the transaction under such terms and conditions as the Federal regulatory agency shall prescribe ("retail forex rule").[6] A Federal

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2 7 U.S.C. 2(c)(2)(E)(i), as amended by § 742(c) of the Dodd-Frank Act, defines a "Federal regulatory agency" to mean the Commodity Futures Trading Commission ("CFTC"), the Securities and Exchange Commission, an appropriate Federal banking agency, the National Credit Union Association, and the Farm Credit Administration.

3 7 U.S.C. 2(c)(2)(B)(i)(II).

4 7 U.S.C. 2(c)(2)(B)(i)(I). Transactions described in CEA section 2(c)(2)(B)(i)(I) include "an agreement, contract, or transaction in foreign currency that . . . is a contract of sale of a commodity for future delivery (or an option on such a contract) or an option (other than an option executed or traded on a national securities exchange registered pursuant to section 6(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78f(a))."

5 Section 1a(18) of the CEA defines "eligible contract participant" generally to mean certain regulated persons; entities that meet a specified total asset test (*e.g.*, a corporation, partnership, proprietorship, organization, trust, or other entity with total assets exceeding $10 million) or an alternative monetary test coupled with a non-monetary component (*e.g.*, an entity with a net worth in excess of $1 million and engaging in business-related hedging; or certain employee benefit plans, the investment decisions of which are made by one of four enumerated types of regulated entities); and certain governmental entities and individuals that meet defined thresholds. 7 U.S.C. 2(c)(2)(E)(i). The CFTC has adopted rules further clarifying the definition of "eligible contract participant" in the CEA. *See* 17 CFR 1.3(m). *See also Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant,"* Exchange Act Release No. 66868 (April 27, 2012), 77 FR 30596 (May 23, 2012). Because transactions that are the subject of this release are commonly referred to as "retail forex transactions," this release uses the term "retail customer" to describe persons who are not ECPs.

6 *See* 7 U.S.C. 2(c)(2)(B)(i)(II) and 7 U.S.C. 2(c)(2)(E)(ii)(I). On September 10, 2010, the CFTC adopted a retail forex rule for persons subject to its jurisdiction. *See Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries*, 75 FR 55410 (September 10, 2010). The CFTC had proposed its rules regarding retail forex transactions prior to the enactment of the Dodd-Frank Act. *See Regulation of Off-*

regulatory agency's retail forex rule must treat all forex agreements, contracts, and transactions and their functional or economic equivalents, similarly.[7] Any retail forex rule also must prescribe appropriate requirements with respect to disclosure. recordkeeping, capital and margin, reporting, business conduct, and documentation, and may include such other standards or requirements as the Federal regulatory agency determines to be necessary.[8]

The prohibition in CEA section 2(c)(2)(B) took effect on July 16, 2011. Beginning on that date, broker-dealers, including broker-dealers also registered with the CFTC as futures commission merchants ("BD-FCMs"), for which the Commission is the "Federal regulatory agency," were no longer able to engage in off-exchange retail forex futures and options transactions with a customer except pursuant to a retail forex rule issued by the Commission.[9] On July 13, 2011, the Commission adopted interim final temporary Rule 15b12-1T, which temporarily permits a broker-dealer to engage in a "retail forex business," as defined in the rule, in compliance with the Exchange Act, the rules and regulations thereunder, and the rules of the self-regulatory organizations of which the broker-dealer is a member, insofar as they are

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Exchange Retail Foreign Exchange Transactions and Intermediaries, 75 FR 3282 (January 20, 2010). The Federal Deposit Insurance Corporation ("FDIC") and the Office of the Comptroller of the Currency ("OCC") have adopted similar rules. *See Retail Foreign Exchange Transactions*, 76 FR 40779 (July 12, 2011); *Retail Foreign Exchange Transactions*, 76 FR 41375 (July 14, 2011). The Board of Governors of the Federal Reserve System (the "Board") has proposed rules for bank holding companies. *See Retail Foreign Exchange Transactions*, 76 FR 46652 (August 3, 2011).

7 7 U.S.C. 2(c)(2)(E)(iii)(II).

8 7 U.S.C. 2(c)(2)(E)(iii)(I).

9 *See* 7 U.S.C. 2(c)(2)(B)(i)(II)(cc) (giving the CFTC jurisdiction over retail forex transactions with FCMs that, among other things, are not registered broker-dealers) and 7 U.S.C. 2(c)(2)(C)(i)(I)(aa). In addition, a commenter noted that the CFTC "does not have jurisdiction over retail foreign exchange activities conducted by broker-dealers, including entities that are dually registered as broker-dealers with the SEC and as futures commission merchants ('FCMs') with the CFTC." SIFMA/ISDA Letter at 1.

applicable to retail forex transactions.[10] We explained at the time that our action was intended to preserve potentially beneficial market practices that, for example, may serve to minimize a retail customer's exposure to the risk of changes in foreign currency rates in connection with the customer's purchase or sale of a security. We also discussed in the Interim Release that there may be potentially abusive practices such as lack of disclosure about fees and forex pricing, and insufficient capital or margin requirements occurring in the retail forex market, and sought comment on these practices and steps we should take to seek to prevent them. [11] Rule 15b12-1T, by its terms and without further Commission action, would have expired on July 16, 2012.

The Commission received comments on the Interim Release, which are summarized below.[12]

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10 *See Retail Foreign Exchange Transactions*, Exchange Act Release No. 64874 (July 13, 2011), 76 FR 41676 (July 15, 2011) (adopting 17 CFR 240.15b12-1T) ("Interim Release").

11 Our Office of Investor Education Advocacy has published an Investor Bulletin providing information about retail forex investing, including information about the risks involved in that trading. *See Investor Bulletin: Foreign Currency Exchange (Forex) Trading for Individual Investors* (July 2011), available at http://www.sec.gov/investor/alerts/forextrading.pdf. The CFTC and the North American Securities Administrators Association also have published an alert regarding risks of fraud in forex markets. *See Foreign Exchange Currency Fraud: CFTC/NASAA Investor Alert*, available at http://www.cftc.gov/ConsumerProtection/FraudAwarenessPrevention/ForeignCurrencyTrading/cftcnasaaforexalert. We recently brought an enforcement action against the CEO of a purported foreign currency trading firm alleging fraud by that person. *See SEC v. Jeffery A. Lowrance, et al.,* Case No. CV-11-3451, press release, complaint and litigation release, available at http://www.sec.gov/news/press/2011/2011-147.htm.

12 The comments are available at http://www.sec.gov/comments/s7-30-11/s73011.shtml. In addition to other specific requests for comment, the Commission requested comment in the Interim Release as to whether Rule 15b12-1T should be extended, and if so for how long.

- Nine commenters asked the Commission to preserve their ability to engage in retail forex transactions.[13]
- One commenter stated that the Commission should rescind the rule and allow the ban to take effect or, in the alternative, to limit the scope of the rule to a narrowly defined class of forex transactions, specifically hedging and the facilitation of settlement of foreign securities.[14] The commenter further stated that in adopting Rule 15b12-1T, the Commission did not provide notice of and opportunity for comment on the rule, and did not include a "concrete assessment or quantification of the need" for the relief granted by this rule.
- Another commenter provided data on the returns of retail forex accounts at futures commission merchants and retail foreign exchange dealers, and offered recommendations that the commenter believed would improve retail forex transactions and identified areas of retail forex that the commenter believed warrants further study.[15] This commenter also

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13 *See* email comments from Raul Gonzalez, dated July 17, 2011, James Peck, dated July 17, 2011, Bob Flowers, dated July 17, 2011, James M. Beatty, dated July 17, 2011, Angela Li, dated July 17, 2011, Mark A. McDonnell, dated July 21, 2011, Mark Smith, dated July 23, 2011, John Baur, dated July 27, 2011, and Ronald Covington, dated October 23, 2011.

14 *See* Letter from Dennis M. Kelleher, President and CEO, and Stephen W. Hall, Securities Specialist, Better Markets, Inc. to Ms. Elizabeth Murphy, Secretary, Commission, dated September 12, 2011 ("Better Markets Letter"). We understand the commenter's reference to transactions entered into to facilitate the settlement of foreign securities to mean the conversion trades discussed *infra*, in the text accompanying notes 19 and 20.

15 Letter from Justin Hughes, CFA and Managing Member, Philadelphia Financial Management of San Francisco to Ms. Elizabeth Murphy, Secretary, Commission, dated August 2, 2011 ("Philadelphia Financial Letter"). *See also* letter from P. Georgia Bullitt, Michael A. Piracci and F. Mindy Lo, Morgan Lewis to Joseph Furey, Bonnie L. Gauch and Adam Yonce, Commission, dated July 28, 2011 ("Morgan Lewis Letter").

suggested that currency exchange-traded funds ("currency ETFs") would provide an alternative means for effectively hedging against currency risk.[16]

- One commenter provided data from five large broker-dealers showing that the notional amount of foreign exchange conversion trades at those broker-dealers accounts for approximately 90% of those firms' foreign exchange transactions. The firms' data further indicated that 99% of customer accounts have entered into a conversion trade, though not all trades within an account may be conversion trades.[17]
- One group of commenters urged the Commission to adopt a final rule based on the approach followed in the interim final temporary rule, with certain modifications.[18] These commenters maintained that it is in the best interests of retail customers to have the opportunity to conduct forex activity as part of their broader investing activity, through their broker-dealers, with the assistance of personnel who have expertise in forex.

More recently, in April 2012, a group of commenters asked the CFTC, as well as other Federal regulatory agencies (including the Commission), to take the view that forex transactions that are solely incidental to, and that are initiated for the sole purpose of, permitting a customer to complete a transaction in a foreign security, so-called "conversion trades," are not prohibited

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16 *See* Philadelphia Financial Letter. *See also* Better Markets Letter. While certain forex transactions, in particular portfolio hedges or currency transactions that are part of a diversified investment strategy, may have close substitutes in currency ETFs, currency conversions that facilitate securities transactions (discussed in more detail below) may not have such close substitutes.

17 *See* Morgan Lewis Letter.

18 *See* Letter from Kenneth E. Bentsen, Jr., Executive Vice President Public Policy and Advocacy, SIFMA and Robert Pickel, Executive Vice Chairman, ISDA, to Ms. Elizabeth Murphy, Secretary, Commission, dated October 17, 2011 ("SIFMA/ISDA Letter"). *See also* Memorandum from SIFMA and ISDA to Marc Menchel, Gary Goldsholle, Matthew Vitek, Rudy Verra, Glen Garofalo, FINRA, dated February 23, 2012.

retail forex transactions for purposes of section 2 of the CEA.[19] These commenters maintain that Congress did not intend to include within the scope of the CEA section 2 prohibition currency transactions effected in connection with securities transactions, stating that "[s]uch transactions do not involve speculation in the underlying currencies and, to the contrary, will result in an exchange of currencies to be used to settle the relevant securities transactions."[20] We anticipate that the interpretation will be addressed in the context of the CFTC's and SEC's joint rulemaking to further define terms such as "swap" and "security-based swap" under Title VII of the Dodd-Frank Act ("Products Definition Release").[21] We further anticipate that the rulemaking will be finalized in the near future and the CFTC will provide at that time its views of whether conversion trades are excluded from the prohibition under CEA section 2.

The ABA/GFMA Letter and the CFTC response affect the scope, substance, and timing of our consideration of further rulemaking for retail forex transactions. If the CFTC were to adopt the interpretation put forth by the ABA/GFMA, conversion trades, which commenters have asserted comprise the overwhelming majority of retail forex transactions conducted through broker-dealers,[22] would not fall within the scope of the prohibition. The potential for such

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19 *See* Letter from Phoebe A. Papageorgiou, Senior Counsel, American Bankers Association, and James Kemp, Managing Director, Global Foreign Exchange Division, to Thomas J. Curry, Comptroller, OCC, Robert E. Feldman, Executive Secretary, FDIC, Jennifer J. Johnson, Secretary, the Board, David Stanwick, Secretary, CFTC, and Elizabeth Murphy, Secretary, Commission, dated April 18, 2012 ("ABA/GFMA Letter").

20 *Id.* at 2.

21 *See also Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping*, Securities Act Release No. 9204 (April 29, 2011), 76 FR 29818 (May 23, 2011) (proposing release).

22 *See* Morgan Lewis Letter.

interpretation means that further rulemaking could well confront a very different set of transactions than contemplated in April 2012, one focused not on conversion trades, but rather on apparently less common and more diverse retail forex transactions identified by commenters, such as hedging transactions and direct investments.[23] It also means that further rulemaking would need to consider whether there are classes of conversion trades not excluded under any final interpretation that may be adopted by the CFTC that must be addressed separately. We expect to consider these types of transactions and an appropriate regulatory approach to them in considering whether and what permanent rules we should adopt in this area.

Extending the expiration of Rule 15b12-1T to July 16, 2013 will provide the Commission additional time to consider carefully these issues. The extension will help to ensure that we have sufficient time to take such action as we may determine appropriate in this area, particularly in light of the diverse classes of transactions – beyond the conversion trades that have been the focus of comments to date – that any further rulemaking may need to consider.[24] We recognize that commenters' views differed as to whether and to what extent we should permit broker-dealers to continue to engage in some or all retail forex transactions. As discussed above, some commenters urged us to permit the statutory prohibition simply to take effect, thereby preventing potential abuses of retail customers by broker-dealers and BD-FCMs. A number of retail customers asked us to permit them to have continued access to retail forex transactions through broker-dealers. Some commenters stated that we should make certain revisions to Rule 15b12-

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23 *See* SIFMA/ISDA Letter (Annex A, Part I).

24 If the Commission adopts permanent rules for retail forex transactions by broker-dealers before July 16, 2013, the Commission will consider whether it is appropriate to terminate the effectiveness of Rule 15b12-1T as part of that rulemaking.

1T, while others favored the rule as written, stating that existing broker-dealer regulations adequately address retail forex activities.

In considering commenters' views, we believe, on balance, that we should extend the expiration date of the rule to permit further assessment by the Commission in this area, which would be informed by any potential CFTC interpretation regarding conversion trades. Our view is influenced by investors' views that we should permit them to conduct retail forex transactions with broker-dealers. We also are mindful that while futures commission merchants that are not also broker-dealers could continue to engage in retail forex transactions in compliance with CFTC rules, a futures commission merchant that is also a broker-dealer would be prohibited from engaging in retail forex transactions if we do not extend Rule 15b12-1T. For these reasons, we are extending the expiration date of Rule 15b12-1T to July 16, 2013 to prevent retail customers who transact retail forex transactions through a broker-dealer from being potentially disadvantaged by the prohibition for retail forex transactions taking effect.[25] Given the limited nature of this extension, the pending request for a CFTC interpretation regarding conversion trades, the need to further understand the implications of the CFTC's interpretation, and the scope of comments we are seeking before any further action is taken, we are not modifying the interim final temporary rule other than to extend the expiration date of Rule 15b12-1T to July 16, 2013. Absent further action by the Commission, Rule 15b12-1T as amended will expire on July 16, 2013 at 11:59 p.m. Eastern Time.

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25 While retail customers could of course open an account with a futures commission merchant (that is not also registered as a broker-dealer) to engage in retail forex transactions, as explained below, this could create certain inefficiencies and additional costs. *See* discussion in the Economic Analysis section below.

II. REQUEST FOR COMMENT

The Commission requests comment regarding all aspects of the interim final temporary rule and the current market practices involving retail forex transactions, as well as any investor protection or other concerns that commenters believe should be addressed by Commission rulemaking. The Commission particularly requests comment from broker-dealers, including BD-FCMs, that are currently engaged or plan to engage in a retail forex business, retail customers that engage in forex transactions, and ECPs. The Commission welcomes information from all affected parties about the current scope and nature of retail forex transactions. This information, together with input from market participants and other regulators, as well as comments received on the Interim Release, will help inform the Commission's consideration of the appropriate regulatory framework, if any, for retail forex transactions before or beyond the expiration of the interim final temporary rule.

The Commission seeks comment on the need for further Commission rulemaking, should the CFTC determine that certain conversion trades are not subject to the CEA prohibition with respect to retail forex transactions.[26] We specifically seek to better understand the other types of retail forex transactions in which broker-dealers may engage, such as forex transactions to hedge portfolio currency risk or to diversify a portfolio, that would not be excluded from the prohibition under section 2 of the CEA by the requested interpretation. We also request information about what mechanisms broker-dealers use currently to comply with existing disclosure, recordkeeping, capital and margin, reporting, business conduct and documentation rules with respect to each type of retail forex transaction in which they engage. What policies and procedures and supervisory controls, for example, have broker-dealers implemented to

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[26] *See* 7 U.S.C. 2(c)(2)(E)(ii)(I).

address those transactions? We also seek comment on what mechanisms broker-dealers use currently to comply with other existing regulatory requirements with respect to retail forex transactions.

If commenters believe further rulemaking is needed, please explain why, and provide us with a discussion of the types of transactions for which rules are needed and the circumstances under which such transactions are entered into. If commenters believe further rulemaking is not needed, please explain why not. The Commission seeks comment on the extent to which broker-dealers' retail forex activities may be affected, and any impact on retail customers of broker-dealers, in the event the Commission does not adopt any further rules in this area.

The Commission also seeks comment on the retail forex activities of BD-FCMs, and whether the Commission should adopt tailored rules for these intermediaries. We seek comment on the nature of BD-FCM retail forex activities, including the type of transactions in which they engage, and which part of the dually registered entity may engage in these activities or transactions. We also request comment on the mechanisms BD-FCMs use currently to comply with existing disclosure, recordkeeping, capital and margin, reporting, business conduct and documentation rules with respect to each type of retail forex transaction in which they engage. In connection with this specific request for comment, please identify whether the relevant requirements are Exchange Act Rules, CEA Rules, or rules of a particular self-regulatory organization ("SRO") of which the BD-FCM is a member. The Commission also seeks comment on the extent to which the retail forex activities of BD-FCMs may be affected, and any impact on retail customers of BD-FCMs, in the event the Commission does not adopt any further rules in this area.

Some commenters have suggested that if broker-dealers were prohibited from engaging in retail forex activities, currency ETFs would be a reasonable substitute for broker-dealer customers seeking to hedge their currency exposures.[27] The Commission requests comment on whether and how currency ETFs could meet the needs of retail customers in this regard. The Commission also requests information about how currency ETFs (and any other financial product or service that commenters believe could serve as a substitute for forex) could be used more generally to meet the risk mitigation and any other needs of retail customers that currently are addressed using retail forex transactions. Would currency ETFs (or other financial products) hedge currency risks in connection with foreign securities transactions in the same manner or differently than retail forex transactions? How would the transaction and other costs associated with currency ETFs and retail forex transactions compare? We further seek comment on what the associated benefits and costs would be of retail customers using currency ETFs or some other product or service, as a substitute for retail forex. We also seek comment on the liquidity of such alternative products or services, the ease or difficulty of accessing and using those products or services, and any additional risks involved in using those products or services.

The Commission also seeks comment on whether Rule 15b12-1T should be extended beyond July 16, 2013, and if so, why and for how long, or whether it should be adopted as a final rule.

III. ECONOMIC ANALYSIS

A. Introduction

Section 3(f) of the Exchange Act requires the Commission, whenever it engages in rulemaking under the Exchange Act and is required to consider or determine whether an action is

[27] *See* Philadelphia Financial Letter at 8, and Better Markets Letter at 3.

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.[28] In addition, Section 23(a)(2) of the Exchange Act requires the Commission, when making rules under the Exchange Act, to consider the impact such rules would have on competition.[29] Section 23(a)(2) of the Exchange Act 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.[30]

We understand that under the current regulatory regime, retail customers typically enter into foreign exchange transactions with broker-dealers for a number of reasons. Industry participants have told us that the most common transaction is a foreign exchange conversion trade, in which a currency trade is made in connection with a foreign securities transaction.[31] Commenters have also told us that retail customers enter into forex transactions with broker-dealers as part of a hedging strategy. For instance, retail customers may engage in forex transactions through broker-dealers in order to hedge currency risk in securities or in a portfolio generally held in the customer's brokerage account; they may also engage in these transactions in order to obtain exposure to foreign markets as part of their investment strategy.[32]

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28 *See* 15 U.S.C. 78c(f).

29 *See* 15 U.S.C. 78w(a)(2).

30 *See id.*

31 Morgan Lewis Letter. As explained above, the ABA/GFMA Letter requests an interpretation that would exclude conversion trades from the prohibition under CEA section 2.

32 SIFMA/ISDA Letter at 4, Annex A at 1 – 2.

Congress prohibited the retail forex transactions described in CEA section 2 except pursuant to rules adopted by the relevant Federal regulatory agencies allowing the transactions. As we noted in the Interim Release, some of these transactions, in particular hedging transactions and securities conversion trades, may be beneficial to investors.[33] At the same time, as discussed in the Interim Release, the Commission is aware of potentially abusive practices that may be occurring in the retail forex market. Such practices may include, for example, lack of disclosure about fees and forex pricing, and insufficient capital or margin requirements.[34]

As discussed above, on April 18, 2012, a group of commenters asked the CFTC, as well as other Federal regulatory agencies (including the Commission), to take the view that forex transactions that are solely incidental to, and are initiated for the sole purpose of, permitting a client to complete a transaction in a foreign security, through "conversion trades," would not be subject to the retail forex prohibition under section 2 of the CEA.[35] An interpretation by the CFTC that conversion trades are not subject to the statutory prohibition could significantly affect the costs and benefits of any action by the Commission with regard to retail forex transactions going forward. Commenters have stated that conversion trades comprise the vast majority of retail forex transactions engaged in by broker-dealers,[36] but also note that there are other types of forex transactions in which broker-dealers engage with retail customers.[37] Because the request for the interpretation is still pending, however, the Commission will continue to consider

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33 *See* Interim Release at 41684.

34 *See id.*

35 *See* ABA/GFMA Letter.

36 *See* Morgan Lewis Letter.

37 *See* SIFMA/ISDA Letter, Annex A.

conversion trades as retail forex transactions that would be prohibited but for Rule 15b12-1T, for purposes of our economic analysis.

Extending Rule 15b12-1T maintains the regulatory framework that currently exists for broker-dealers, and does not create any new regulatory obligations. Furthermore, the rule preserves the ability of broker-dealers to provide, among other services, hedging and conversion trades to retail customers while the Commission considers what further appropriate steps to take, if any. [38]

The Commission has previously considered and discussed in the Interim Release its economic analysis of Rule 15b12-1T.[39] The Commission solicited comment on its economic analysis in the Interim Release, and received one comment that addressed but did not support its economic analysis.[40] As stated in the Interim Release, we adopted Rule 15b12-1T as an interim final temporary rule to allow the existing regulatory framework for retail forex transactions to continue for a defined period, to avoid potentially unintended consequences from broker-dealers immediately discontinuing their retail forex business, and to provide the Commission sufficient time to determine the appropriate regulatory framework regarding retail forex transactions.[41] Furthermore, investors who commented on the rule asked the Commission to preserve their

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38 To the extent that conversion trades are not excluded from the prohibition in CEA section 2, extension of the Rule 15b12-1T would also have the benefit of allowing customers to continue to engage in those transactions as part of their brokerage activities while the Commission considers any further action.

39 For a detailed description of the costs and benefits of Rule 15b12-1T, *see also* Interim Release at 41684.

40 Better Markets Letter. *But see* SIFMA/ISDA Letter.

41 *See* Interim Release at 48683.

ability to engage in retail forex transaction through their broker-dealers. In addition, we included an economic analysis of the rule in the Interim Release.[42]

As mentioned above, based on data a commenter provided of five broker-dealers, in terms of notional amount, foreign exchange conversion trades would account for approximately 90% of foreign exchange transactions done through broker-dealers, and 99% of all broker-dealer customer accounts are involved in conversion trades, though not all trades within an account may be conversions.[43] Commenters have told us that certain forex transactions, particularly certain portfolio hedges, may have close substitutes in currency ETFs.[44] It does not appear that currency ETFs would necessarily function as effectively in mitigating the currency risk of particular securities transactions, because the precise timing and amount of a securities transaction may not be readily matched to a currency ETF, as conversion trades are customer-specific and typically designed to facilitate particular securities transactions, whereas currency ETFs generally are designed to provide broad exposure to exchange rate movements. The contracts used to complete forex conversions do have close substitutes in exchange-traded currency futures, as both involve the exchange of currency at a future date. However, as with currency ETFs, the precise timing and amount of a securities transaction may not be easily matched to exchange-traded futures contracts, which have standardized maturity dates and notional amounts. Off-exchange forwards, on the other hand, can be easily customized to match a particular transaction. Additionally, exchange-traded futures are not as effective at mitigating risks between the trade

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42 *See id.* at 41684.

43 Morgan Lewis Letter.

44 *See* Philadelphia Financial Letter. *See also* Better Markets Letter.

and settlement dates, since mark-to-market margin requirements expose the investor to additional cash flow risk.

The Commission understands that conversion trades can be replicated at futures commission merchants. However, as a practical matter, this would require the customer to maintain multiple accounts, which could increase transaction costs and reduce efficiency relative to conversion trades performed within a broker-dealer.

B. Alternatives Considered

The Commission considered certain alternatives to extending Rule 15b12-1T. One alternative would be to let Rule 15b12-1T expire on its original expiration date, and so preclude broker-dealers from engaging in certain types of retail forex business other than, potentially, conversion trades, at least until such time as the Commission were to adopt final rules in this area. The benefit of this alternative would be that the abuses Congress sought to address through Dodd-Frank Act Section 724 would be addressed through this complete prohibition. The cost of this alternative would be that an outright prohibition on retail forex activity would interfere with certain business activities engaged in by broker-dealers that are potentially beneficial for their customers, in particular the potential benefit to customers relating to conversion trades. We note in this alternative approach, retail customers of broker-dealers would be required to open an account with a futures commission merchant or other financial service provider merely to engage in currency transactions intended to mitigate risks in connection with brokerage transactions in foreign securities. While this shifting to services to another intermediary would impose additional costs, retail customers may, however, benefit from the protection of rules to which those intermediaries are subject.[45]

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45 *See supra* note 6.

The Commission has not adopted this alternative at this time for the reasons discussed above, and in particular because of concerns that we not disrupt potentially beneficial market practices, such as conversion trades that may serve to minimize a retail customer's exposure to the risk of changes in foreign currency rates in connection with the customer's purchase or sale of a security. In addition, we have not adopted this alternative because the CFTC's interpretation regarding conversion trades is not yet settled.

The Commission also considered adopting Rule 15b12-1T as a final, permanent rule. While the direct costs and benefits of this alternative would be minimal (as it would simply continue the existing regulatory requirements for broker-dealers engaging in retail forex transactions), it nevertheless could have broader impacts on the markets given that other regulators have now adopted or proposed final rules with various specific requirements relating to retail forex that impose different requirements on market intermediaries than those the Commission imposes on broker-dealers under Rule 15b12-1T.[46] The lack of comparable rules across the various intermediaries engaging in a retail forex business could lead to regulatory arbitrage or regulatory gaps. The Commission is considering alternatives, including proposing rules pertaining to retail forex that are more tailored than Rule 15b12-1T and that would be more closely aligned with those of the other regulators but has deferred a determination pending the resolution by the CFTC of the pending request in the ABA/GFMA Letter concerning the treatment of conversion trades.

C. Benefits

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[46] *Id.*

Rule 15b12-1T was designed to preserve retail customers' access to the forex markets through broker-dealers and so promote efficiency by, for example, permitting retail customers to continue to enter into forex transactions in connection with trades in foreign securities, as part of their brokerage activities until such time as the Commission allows Rule 15b12-1T to expire or adopts final, permanent rules in this area. Without the Commission acting to extend Rule 15b12-1T, broker-dealers would be required to exit certain types of retail forex business, which could require retail customers to engage in forex transactions through a futures commission merchant or other service provider. This could be economically inefficient. In particular, to the extent that access to the foreign exchange markets through broker-dealers provides hedging and conversion opportunities for foreign investments, economic benefits may accrue to retail customers.[47] To the extent that the CFTC takes the view that some or all conversion trades remain subject to the retail forex prohibition, and as noted in the Interim Release, the benefits of these trades may not be as easily or efficiently replicated outside of the broker-dealer.[48] Furthermore, by continuing to preserve a channel for broker-dealers' retail customers to access forex transactions through broker-dealers, the extension of the interim final temporary rule will continue to prevent any loss of competition in the retail forex market that could result if broker-dealers were required to exit the business. Moreover, extending the term of the rule will likely, for the period of the extended term, maintain the status quo for broker-dealers with respect to other regulated intermediaries offering retail forex services, whose regulators have adopted (or have proposed to adopt) rules targeted to retail forex with which those intermediaries must comply.[49] Extending the term of

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47 *See* Interim Release at 41684.

48 *See id.*

49 *See supra* note 6.

the rule would not necessarily promote competition between broker-dealers and the other regulated intermediaries, as broker-dealers would continue to offer retail forex services under Rule 15b12-1T which, in general, imposes requirements that arguably could be viewed as less burdensome that those that have become (or are proposed to become) applicable to other regulated intermediaries. Competition among broker-dealers would most likely not be affected by extending the term of the rule.

Because the regulatory requirements for broker-dealers operating in the retail forex market will remain unchanged, extending the expiration date of Rule 15b12-1T will impose no new burden on competition. Similarly, since the rule preserves an existing regulatory structure, the Commission does not expect that extending the term of the rule would result in any potential impairment of the capital formation process.

D. Costs

Because Rule 15b12-1T preserves the regulatory regime that had been in place prior to the effective date of Section 742(c) of the Dodd-Frank Act, the extension of the rule imposes no new regulatory burdens beyond those that already existed for broker-dealers engaged in a retail forex business. The Commission recognizes that broker-dealers will face regulatory costs and requirements associated with operating in the retail forex market, but these costs and requirements are those they already shouldered from engaging in the business.[50] As discussed

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50 As described in the Interim Release, these costs include costs related to disclosure, recordkeeping and documentation, capital and margin, reporting, and business conduct. A broker-dealer that currently engages in forex transactions with retail customers, for example, incurs costs associated with establishing, maintaining, and implementing policies and procedures to comply with regulatory requirements; preparing disclosure documents; establishing and maintaining forex-related business records; and preparing filings with the Commission, which may include legal and accounting fees. Interim Release at 41684.

above and in the Interim Release, the Commission is aware of potentially abusive practices that may be occurring in the retail forex market.[51] To the extent that such practices continue, customers may bear the costs associated with these abuses. We are monitoring potential fraud involved in forex within our jurisdiction,[52] and our staff has also alerted investors to the risks of retail forex trading.[53] The Commission believes, on balance, that the cost of market disruption that may occur if the Commission does not extend Rule 15b12-1T, particularly with respect to conversion transactions that may not be easily replicated outside of the broker-dealer,[54] justifies the cost of maintaining the current regulatory regime while the Commission considers proposing rules in light of additional developments, including the recent request for the CFTC's interpretation regarding conversion trades.[55]

E. Conclusion

Because the extension of Rule 15b12-1T will not affect the regulatory requirements for broker-dealers operating in the retail forex market, this extension will impose no new burden on competition. Similarly, because the rule's extension does not alter the existing regulatory structure, the Commission does not expect any potential impairment of the capital formation process. To the extent that potentially abusive practices continue in the retail forex market, the

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52 For instance, we recently brought an enforcement action against the CEO of a purported foreign currency trading firm, alleging fraud by that person. *See SEC v. Jeffery A. Lowrance, et al.*, Case No. CV-11-3451, press release, complaint and litigation release, available at http://www.sec.gov/news/press/2011/2011-147.htm.

53 *See Investor Bulletin: Foreign Currency Exchange (Forex) Trading for Individual Investors* (July 2011), available at http://www.sec.gov/investor/alerts/forextrading.pdf.

54 *See* Interim Release at 41684.

55 *Id.*

market will continue to bear the costs associated with any such abuses and the resultant inefficient provision of services across the market. Because extending Rule 15b12-1T does not alter the existing regulatory structure or regime, the Commission does not expect any potential impairment of the capital formation process, especially as the rule's extension allows retail customers to continue to have access through broker-dealers to hedging transactions, conversion trades, and other forex transactions, without the need to shift business and open new accounts at other market intermediaries.

IV. Paperwork Reduction Act

Rule 15b12-1T does not impose any new "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA"),[56] or create any new filing, reporting, recordkeeping, or disclosure reporting requirements for broker-dealers that are or plan to be engaged in a retail forex business. In the Interim Release, the Commission requested comment on its conclusion that there are no collections of information.[57] The Commission received no comments relating to the PRA analysis. Accordingly, the Commission maintains its PRA analysis set forth in the Interim Release for purposes of this extension.

V. OTHER MATTERS

A. Administrative Procedure Act

The Administrative Procedure Act generally requires an agency to publish notice of a proposed rulemaking in the Federal Register.[58] This requirement does not apply, however, if the agency "for good cause finds . . . that notice and public procedure are impracticable,

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56 44 U.S.C. 3501 *et seq.*

57 *See* Interim Release at 41683-84.

58 *See* 5 U.S.C. 553(b).

unnecessary, or contrary to the public interest."[59] The Administrative Procedure Act also generally requires that an agency publish an adopted rule in the Federal Register 30 days before it becomes effective.[60] This requirement, however, does not apply if the agency finds good cause for making the rule effective sooner.[61] The Commission finds that there is good cause to extend the expiration date of Rule 15b12-1T to July 16, 2013, without notice and comment and not to delay the effective date of the extension. The Commission further finds that notice and solicitation of comment on the extension is impracticable, unnecessary, or contrary to the public interest.[62]

As discussed above, on April 18, 2012, a group of commenters asked the CFTC, as well as other Federal regulatory agencies (including the Commission), to find that forex transactions that are solely incidental to, and are initiated for the sole purpose of, permitting a client to complete a transaction in a foreign security, so-called "conversion trades," would not be subject to the retail forex prohibition under section 2 of the CEA.[63] We anticipate that the CFTC will address this request in the context of the Products Definition Release. An interpretation by the CFTC that conversion trades are not subject to the statutory prohibition could affect the need for, or the extent and reach of, any Commission rulemaking for retail forex transactions generally. Commenters have stated that conversion trades comprise the vast majority of retail

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[59] *Id.*

[60] *See* 5 U.S.C. 553(d).

[61] *Id.*

[62] *See* 5 U.S.C. 553(b) and (d).

[63] *See* ABA/GFMA Letter.

forex transactions engaged in by broker-dealers,[64] and permitting conversion trades by broker-dealers was one of the reasons we adopted Rule 15b12-1T.[65] As we previously have noted, there are other types of forex transactions broker-dealers engage in which may be potentially beneficial for retail customers, such as using forex to hedge portfolio currency risk or to provide portfolio diversification.[66] The potential CFTC interpretation means that further rulemaking could well confront a very different set of transactions than contemplated in April 2012, one focused not on conversion trades, but rather on these other types of forex transactions. It also means that further rulemaking would need to consider whether there are classes of conversion trades not excluded under any final interpretation that may be adopted by the CFTC that must be addressed separately. Accordingly, if the CEA is interpreted so that certain conversion trades would not be prohibited, we would want to consider what, if anything, we believe is appropriate with respect to proposing and adopting a permanent rule in this area in light of the diverse classes of transactions – beyond the conversion trades that have been the focus of comments to date – that any such rule may need to consider. Accordingly, in view of these very recent developments, the Commission has determined that it would be impracticable to publish notice of the proposed extension.

In making this finding of good cause,[67] the Commission has decided to maintain the current regulatory regime in order to avoid disruption for investors engaging in retail forex

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[64] *See* Morgan Lewis Letter.

[65] *See* Interim Release at 41684.

[66] *See id.* *See also* SIFMA/ISDA Letter (Annex A, Part I).

[67] This finding also satisfies the requirements of 5 U.S.C. 808(2), allowing the rules to become effective notwithstanding the requirement of 5 U.S.C. 801 (if a federal agency finds that notice and public comment are "impractical, unnecessary or contrary to the

transactions through broker-delaers, until such time as the Commission makes any final decision with regard to permanent rulemaking in this area, in light of any potential interpretation by the CFTC. In particular, the Commission considered that not extending the expiration date, or allowing the extension to be delayed, would cause disruption to the markets and potentially harm investors, as retail forex transactions, including conversion trades, would, as of July 16, 2012, the original expiration date of Rule 15b12-1T, be prohibited. For the same reasons, the Commission finds good cause not to delay the effective date of this extension for 30 days.

In the event that the Commission determines to propose a permanent rule to replace Rule 15b12-1T, the Commission will provide notice and solicit comment on that proposal.

B. Regulatory Flexibility Act Certification

In the Interim Release, the Commission certified that pursuant to 5 U.S.C. 605(b), Rule 15b12-1T would not have a significant economic impact on a substantial number of small entities. As explained in the Interim Release, although Rule 15b12-1T applies to broker-dealers that may engage in retail forex transactions, which may include small businesses, any costs or regulatory burdens incurred as a result of the rule are the same as those incurred by small broker-dealers prior to the effective date of Section 742 of the Dodd-Frank Act.[68] We also noted that the rule would impose no new regulatory obligations, costs, or burdens on such broker-dealers. Thus, there would not be a significant economic impact on a substantial number of small entities. In the Interim Release, we requested comment on our conclusion that Rule 15b12-1T should not have a significant economic impact on a substantial number of small entities. The Commission received no comments addressing this issue. In light of this, as well as the fact that we are

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public interest," a rule "shall take effect at such time as the federal agency promulgating the rule determines").

68 *See id.* at 41684-85.

making no change to Rule 15b12-1T apart from extending its expiration date, we hereby certify pursuant to 5 U.S.C. 605(b) that extending Rule 15b12-1T will not have a significant economic impact on a substantial number of small entities.

VI. STATUTORY AUTHORITY AND TEXT OF RULE AND AMENDMENT

Pursuant to section 2(c)(2) of the Commodity Exchange Act, as well as the Exchange Act as amended, the Commission is amending Exchange Act Rule 15b12-1T.

List of Subjects in 17 CFR Part 240

Brokers, Consumer protection, Currency, Reporting and recordkeeping requirements. In accordance with the foregoing, the Securities and Exchange Commission is amending Title 17, chapter II, of the Code of Federal Regulations as follows:

TEXT OF THE RULE AND AMENDMENT

PART 240 - GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The general authority citation for Part 240 continues 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; 12 U.S.C. 5221(e)(3); and 7 U.S.C. 2(c)(2)(E), unless otherwise noted.

* * * * *

§ 240.15b12-1T [Amended]

2. Revise paragraph (d) of § 240.15b12-1T to read as follows:

§ 240.15b12-1T Brokers or dealers engaged in a retail forex business.

* * * * *

(d) This section will expire and no longer be effective on July 16, 2013.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

July 11, 2012

Commissioner Paredes
Commissioner Gallagher
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9335 / July 11, 2012

SECURITIES EXCHANGE ACT OF 1934
Release No. 67406 / July 11, 2012

INVESTMENT ADVISERS ACT OF 1940
Release No. 3430 / July 11, 2012

INVESTMENT COMPANY ACT OF 1940
Release No. 30135 / July 11, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14404

In the Matter of

Belsen Getty, LLC, Terry M. Deru, and Andrew W. Limpert,

Respondents.

ORDER MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, 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 ANDREW W. LIMPERT

I.

On May 31, 2011, the Securities and Exchange Commission ("Commission") issued an 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 against Belsen Getty, LLC ("Belsen Getty"), Terry M. Deru ("Deru"), and Andrew W. Limpert ("Limpert" or "Resondent"). Respondent has submitted an Offer of Settlement ("Offer") which the Commission has determined to accept.

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II.

Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over 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 Section 8A of the Securities Act of 1933, 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 Andrew W. Limpert ("Order") as set forth, below.

III.

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

Summary

These proceedings arise out of the fraudulent conduct and violations of the Securities Act of 1933 ("Securities Act"), the Securities Exchange Act of 1934 ("Exchange Act") and the Investment Advisers Act of 1940 ("Advisers Act") by (1) a registered investment adviser, Belsen Getty; (2) its owner and managing member, Deru; and, (3) its former principal, Limpert.

In November 2006, Deru and Limpert became involved in founding Nine Mile Software, Inc. ("Nine Mile"), a software company. Deru and Limpert were major shareholders in Nine Mile, and Limpert became Chairman of the Board. Deru and Limpert invested personal monies and also obtained start-up money for Nine Mile by selling restricted Nine Mile stock to Belsen Getty clients and others. Nine Mile, which was not named in this action, commenced an initial public offering of its common stock in November 2007. The vast majority of the offering was sold to Belsen Getty clients, based on advice from Deru or Limpert. In October and November 2008, Belsen Getty used its discretionary trading authority to trade Nine Mile stock on behalf of clients without informing the clients of risk or conflicts. The trades were made to create the illusion of active trading in Nine Mile stock, as Belsen Getty was the only participant in the market at the time and acted on both the buy and sell sides of all transactions.

Belsen Getty, through Deru and Limpert, also recommended to its clients other high-risk investments in which Deru and Limpert had a financial interest. In recommending these investments, there were numerous instances of failure to disclose conflicts, breaches of fiduciary duty, and misrepresentations or omissions to clients.

A. RESPONDENT

1. Limpert was a former member, direct owner and control person of Belsen Getty from 2004 until December 2008, at which time he sold his interest in Belsen Getty. He was an investment adviser representative. Limpert was the Chairman of the Board of Nine Mile until May

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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.

6, 2011 and is the CFO and director of ProFire Energy, Inc. ("ProFire"), both publicly traded companies. Limpert was an officer and director of Prime Resource, Inc. ("Prime Resource"), an entity formerly owned by Deru and his brother, Scott Deru, when it was a public company during approximately 2002 to 2007. Limpert, 41 years old, is a resident of American Fork, Utah. Limpert participated in an offering of Nine Mile stock, which is a penny stock.

B. OTHER RELEVANT ENTITIES AND INDIVIDUALS

2. 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 was headquartered in Bountiful, Utah. From approximately 2002 to 2007, Belsen Getty was owned and controlled by Prime Resource, Inc. ("Prime Resource"), a public company. Prime Resource later transferred all of its substantial assets to a private entity, Prime Advisors, LLC ("Prime Advisors"), a holding company that was owned by Deru and his brother, Scott Deru. 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 exercised discretionary trading authority over its client accounts. On September 26, 2011, Belsen Getty closed operations and terminated its advisory relationship with its clients.

3. Deru was the managing member and Chief Compliance Officer of Belsen Getty. He was 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, 57 years old, is a resident of Layton, Utah. Deru participated in an offering of Nine Mile stock, which is a penny stock.

4. Nine Mile, incorporated in Nevada on November 30, 2006, was engaged in the business of developing and marketing specialized software for the financial and brokerage industry. Nine Mile was headquartered in Layton, Utah. It had a reporting obligation pursuant to Section 15(d) of the Exchange Act. Nine Mile stock was a penny stock: it did not fit within any of the exceptions from the definition of a penny stock established by Section 3(a)(51) of the Exchange Act and Rule 3a51-1 thereunder. In particular, Nine Mile was not a Regulation NMS stock and traded below five dollars per share during the relevant period. In addition, at all relevant times Nine Mile had net tangible assets of less than $2 million and average revenue of less than $6 million per year during the relevant period and to date. According to an 8-K filed in August 2011, Nine Mile entered into a reverse merger with SaveDaily, Inc. and changed its business and name to SaveDaily, Inc. on August 23, 2011.

5. Damon Deru was the CEO and a Director of Nine Mile until Nine Mile entered into a reverse merger with SaveDaily, Inc. on August 23, 2011. 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. BACKGROUND

6. 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.

7. 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 $499,991 and issued a total of 714,288 shares at $0.70 per share. The vast majority of IPO shares 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, the majority 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.

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, at the time it was formed, was the majority owner with sixty percent ownership interest. Limpert and Damon Deru were the only other managing members, each with a twenty percent ownership interest.

9. Belsen Getty, through Deru, recommended Axxess to Belsen Getty clients and raised $4,070,694 from approximately 88 investors (all Belsen Getty clients) through two private offerings, one in 2005 and one in 2007-08. Limpert recommended Axxess to at least one client.

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. Deru controlled 60% of the voting shares of the company and managed the company and used investor funds with little input from Limpert and Damon Deru. Instead, Deru hired his 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.

12. In addition, Deru used investor funds to loan himself and his personal entity, Northpark Development, LLC, over $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 either of the two loans and did not obtain consent from any members. To date, these loan amounts remain outstanding. 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.

13. Belsen Getty, through Deru and Limpert, failed to disclose these material facts about Axxess to investors.

14. 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.

15. 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 of Prime Advisors, the parent company to Belsen Getty, as required by Item 2(d). 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. 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.[2]

16. Belsen Getty, through Deru as Chief Compliance Officer 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.

17. 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.

18. 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

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2 Item numbers are to the Form ADV prior to Part II's amendment effective October 12, 2010.

this failure, Belsen Getty, through Deru, failed to adapt or revise its policies. Limpert failed to ensure written policies and procedures were adequate and enforced, even though he read and reviewed the policies and procedures.

19. 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.

20. 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. Belsen Getty, through Deru and Limpert, 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.

21. Belsen Getty did 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 placed their own interests ahead of Belsen Getty clients and failed to disclose the facts giving rise to these conflicts of interest. Deru and Limpert were responsible for complying with the Advisers Act but failed to do so.

22. 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.

D. VIOLATIONS

23. Based on the above-described conduct:

(a) Respondent Limpert 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;

(b) Respondent Limpert willfully violated Sections 206(1) and 206(2) of the Advisers Act, which prohibit any investment adviser to employ any device, scheme, or artifice to defraud any client or prospective client or to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;

(c) Respondent Limpert willfully aided and abetted and caused Belsen Getty's violations of Section 206(4) of the Advisers Act and Rule 206(4)-7 promulgated thereunder, which require that registered investment advisers adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules thereunder;

(c) Respondent Limpert willfully aided and abetted and caused Belsen Getty's violations of Section 204A of the Advisers Act and Rule 204A-1 promulgated thereunder, which require that investment advisers registered with the Commission adopt and implement written policies and procedures reasonably designed to prevent the misuse of material non-public information by the investment adviser and associated persons; and,

(d) Respondent Limpert willfully aided and abetted and caused Belsen Getty's violations of Section 204(a) of the Advisers Act and Rule 204-2(a)(7) promulgated thereunder, which require registered investment advisers to maintain and preserve certain books and records, including 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."

IV.

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

Accordingly, pursuant to Section 8A of the Securities Act, 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 of 1940, it is hereby ORDERED that:

1. Respondent Limpert 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, Sections 206(1), 206(2), 204(a), 204A and 206(4) of the Advisers Act and Rules 204-2(a)(7), 204A-1 and 206(4)-7 promulgated thereunder.

2. Respondent Limpert be, and hereby is:

(a) barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization;

(b) prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter; and,

(c) 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.

3. 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.

4. Respondent shall pay disgorgement of $51,255.80, prejudgment interest of $10,445.18 and civil penalties of $51,255.80, for a total amount of $112,956.78, to the Securities and Exchange Commission. Payment shall be made in the following installments: (1) $28,239.21 upon entry of the Order; (2) $28,239.19 on or before 180 days from the entry of the Order; (3) $28,239.19 on or before 270 days from the entry of the Order; and, (4) $28,239.19 on or before 360 days from the entry of the 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 shall be due and payable immediately, without further application. If timely payment of disgorgement is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. If payment of a civil penalty is not timely made, additional interest shall accrue pursuant to 31 U.S.C. § 3717. 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 Securities and Exchange Commission, Office of Financial Management, 100 F St., NE, Stop 6042, Washington, DC 20549; and (D) submitted under cover letter that identifies Andrew W. Limpert 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 Daniel J. Wadley, Trial Counsel, Securities and Exchange Commission, Salt Lake Regional Office, 15 West South Temple Street, Suite 1800, Salt Lake City, Utah 84101.

5. Such civil money penalty may be distributed pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002, as amended ("Fair Fund distribution"). Regardless of whether any such Fair Fund distribution is made, amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondent agrees that in any Related Investor Action, he shall not argue that he is entitled to, nor shall he benefit by, offset or reduction of any award of compensatory damages by the amount of any part of Respondent's

payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Respondent agrees that he shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the United States Treasury or to a Fair Fund, as the Commission directs. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against Respondent by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Paredes, Commissioner Gallagher not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9336 / July 11, 2012

SECURITIES EXCHANGE ACT OF 1934
Release No. 67407 / July 11, 2012

INVESTMENT ADVISERS ACT OF 1940
Release No. 3431 / July 11, 2012

INVESTMENT COMPANY ACT OF 1940
Release No. 30136 / July 11, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14404

In the Matter of

Belsen Getty, LLC, Terry M. Deru, and Andrew W. Limpert,

Respondents.

ORDER MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER 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 AS TO TERRY M. DERU AND BELSEN GETTY, LLC

I.

On May 31, 2011, the Securities and Exchange Commission ("Commission") issued the 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 against Terry M. Deru ("Deru"), Belsen Getty, LLC ("Belsen Getty") (collectively, "Respondents") and Andrew W. Limpert ("Limpert"). Respondents have submitted Offers of Settlement ("Offers") which the Commission has determined to accept.

II.

Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order 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 as to Belsen Getty, LLC and Terry M. Deru ("Order") as set forth, below.

III.

On the basis of this Order and the Offers of Deru and Belsen Getty, the Commission finds[1] that:

Summary

These proceedings arise out of the fraudulent conduct and violations of the Securities Act of 1933 ("Securities Act"), the Securities Exchange Act of 1934 ("Exchange Act") and the Investment Advisers Act of 1940 ("Advisers Act") by (1) a registered investment adviser, Belsen Getty; (2) its owner and managing member, Deru; and, (3) its former principal, Limpert.

In November 2006, Deru and Limpert became involved in founding Nine Mile Software, Inc. ("Nine Mile"), a software company. Deru and Limpert were major shareholders in Nine Mile, and Limpert became Chairman of the Board. Deru and Limpert obtained start-up money for Nine Mile by selling restricted Nine Mile stock to Belsen Getty clients and others. Nine Mile, which was not named in this action, commenced an initial public offering of its common stock in November 2007. The vast majority of the offering was sold to Belsen Getty clients, based on advice from Deru or Limpert. In October and November 2008, Belsen Getty used its discretionary trading authority to trade Nine Mile stock on behalf of clients without informing the clients of risk or conflicts. The trades were made to create the illusion of active trading in Nine Mile stock, as Belsen Getty was the only participant in the market at the time and acted on both the buy and sell sides of all transactions.

Belsen Getty, through Deru and Limpert, also recommended to its clients other high-risk investments in which Deru and Limpert had a financial interest. In recommending these investments, there were numerous instances of failure to disclose conflicts, breaches of fiduciary duty, and misrepresentations or omissions to clients.

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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.

A. RESPONDENTS

1. Deru was the managing member and Chief Compliance Officer of Belsen Getty. He was an investment adviser representative, and a direct owner and control person of Belsen Getty. Deru was an officer and director of Prime Resource, Inc. ("Prime Resource"), an entity formerly owned by Deru and his brother, Scott Deru, when it was a public company during approximately 2002 to 2007. Deru, 57 years old, is a resident of Layton, Utah. Deru participated in an offering of Nine Mile stock, which is a penny stock.

2. 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 was headquartered in Bountiful, Utah. From approximately 2002 to 2007, Belsen Getty was owned and controlled by Prime Resource, a public company. Prime Resource later transferred all of its substantial assets to a private entity, Prime Advisors, LLC ("Prime Advisors"), a holding company that was owned by Deru and his brother, Scott Deru. 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 exercised discretionary trading authority over its client accounts. On September 26, 2011, Belsen Getty closed operations and terminated its advisory relationship with its clients.

B. OTHER RELEVANT ENTITIES AND INDIVIDUALS

3. Limpert was a former member, direct owner and control person of Belsen Getty from 2004 until December 2008, at which time he sold his interest in Belsen Getty. He was an investment adviser representative. Limpert was the Chairman of the Board of Nine Mile until May 6, 2011 and is CFO and director 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 American Fork, Utah. Limpert participated in an offering of Nine Mile stock, which is a penny stock.

4. Nine Mile, incorporated in Nevada on November 30, 2006, was engaged in the business of developing and marketing specialized software for the financial and brokerage industry. Nine Mile was headquartered in Layton, Utah. It had a reporting obligation pursuant to Section 15(d) of the Exchange Act. Nine Mile stock was a penny stock: it did not fit within any of the exceptions from the definition of a penny stock established by Section 3(a)(51) of the Exchange Act and Rule 3a51-1 thereunder. In particular, Nine Mile was not a Regulation NMS stock and traded below five dollars per share during the relevant period. In addition, at all relevant times Nine Mile had net tangible assets of less than $2 million and average revenue of less than $6 million per year during the relevant period and to date. According to an 8-K filed in August 2011, Nine Mile entered into a reverse merger with SaveDaily, Inc. and changed its business and name to SaveDaily, Inc. on August 23, 2011.

5. Damon Deru was the CEO and a Director of Nine Mile until Nine Mile entered into a reverse merger with SaveDaily, Inc. on August 23, 2011. 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. BACKGROUND

6. 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.

7. 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 $499,991 and issued a total of 714,288 shares at $0.70 per share. The vast majority of IPO shares were sold to Belsen Getty clients.

8. 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.

9. 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 block orders for the trades using Belsen Getty's trading account, then the advisers allocated the block trades into or out of individual client accounts.

10. The buy and sell sides of the transactions in Nine Mile were not identical (e.g., wash trades), but the total number of trades 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.

11. 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.

12. After the trades were placed, Nine Mile stock began to be publicly quoted and traded within the range of $0.74 and $0.84 per share. The price of the last trade initiated by Belsen Getty was $0.82. 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.

13. 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.

14. Belsen Getty, through Deru and Limpert, recommended Axxess to Belsen Getty clients and raised $4,070,694 from approximately 88 investors (all Belsen Getty clients) through two private offerings, one in 2005 and one in 2007-08.

15. 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. Deru controlled 60% of the voting shares of the company and managed the company and used investor funds with little input from Limpert and Damon Deru. Deru hired his 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.

16. 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.

17. In addition, Deru used investor funds to loan himself and his personal entity, Northpark Development, LLC, over $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 either of the two loans and did not obtain consent from any members. To date, these loan amounts remain outstanding.

18. Belsen Getty, through Deru and Limpert, failed to disclose these material facts about Axxess to investors.

19. 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.

20. In March 2008 Belsen Getty, through Deru, recommended to a 63-year-old Belsen Getty client, that he purchase Flooring Zone, Inc. 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 in selling his own personal restricted stock, 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.

21. Deru also caused at least six additional Belsen Getty clients to purchase Flooring Zone/ProFire stock without informing the clients and/or without disclosing material facts, including that Deru was selling personal, restricted stock, 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 failed to disclose in writing to these clients that Deru was acting as principal for his own account and failed to obtain the clients' consents prior to completion of these transactions.

22. 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.

23. 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, the parent company to Belsen Getty, as required by Item 2(d). 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.[2]

24. 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.

25. 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.

26. 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

2 Item numbers are to the Form ADV prior to Part II's amendment effective October 12, 2010.

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 and procedures were adequate and enforced, even though he read and reviewed the policies and procedures.

27. 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.

28. 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.

29. Belsen Getty did 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.

30. 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.

D. VIOLATIONS

31. Based on the above-described conduct:

(a) Respondents Deru and Belsen Getty 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;

(b) Respondents Deru and Belsen Getty willfully violated Sections 206(1) and 206(2) of the Advisers Act, which prohibit any investment adviser to employ any device, scheme, or artifice to defraud any client or prospective client or to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;

(c) Respondent 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;

(d) Respondents Deru and Belsen Getty 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";

(e) Respondent 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 require that registered investment advisers adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules thereunder;

(f) Respondent 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;

(g) Respondent Belsen Getty willfully violated Section 204(a) of the Advisers Act, and Rule 204-2(a)(7) 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";

(h) Respondent Deru willfully aided and abetted and caused Belsen Getty's violations of Section 206(4) of the Advisers Act and Rule 206(4)-7 promulgated thereunder, which require that registered investment advisers adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules thereunder;

(i) Respondent Deru willfully aided and abetted and caused Belsen Getty's violations of Section 204A of the Advisers Act and Rule 204A-1 promulgated thereunder, which require that investment advisers registered with the Commission adopt and implement written policies and procedures reasonably designed to prevent the misuse of material non-public information by the investment adviser and associated persons; and,

(j) Respondent Deru willfully aided and abetted and caused Belsen Getty's violations of Section 204(a) of the Advisers Act and Rule 204-2(a)(7) promulgated thereunder, which require registered investment advisers to maintain and preserve certain books and records, including 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."

IV.

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

Accordingly, pursuant to Section 8A of the Securities Act of 1933, Sections 15(b) and 21C of the Exchange Act of 1934, Sections 203(e) as to Belsen Getty, 203(f) as to Deru and 203(k) of the Investment Advisers Act of 1940, and Section 9(b) of the Investment Company Act of 1940, it is hereby ORDERED that:

1. Respondent Deru 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, Sections 206(1), 206(2), 206(3), and 207 of the Advisers Act and Sections 204(a), 204A and 206(4) of the Advisers Act and Rules 204-2(a), 204A-1 and 206(4)-7 promulgated thereunder.

2. Respondent Deru be, and hereby is:

(a) barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization;

(b) prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter; and,

(c) 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.

3. 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.

4. Respondent Deru shall pay disgorgement of $93,536.72, prejudgment interest of $19,060.24 and civil penalties of $65,000.00, for a total amount of $177,596.96, to the Securities and Exchange Commission. Payment shall be made in the following installments: (1) $44,399.24 upon entry of the Order; (2) $24,399.24 on or before 180 days from the entry of the Order; (3) $24,399.24 on or before 270 days from the entry of the Order; and, (4) $84,399.24 on or before 360 days from the entry of the 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 shall be due and payable immediately, without further application. If timely payment of disgorgement is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. If payment of a civil penalty is not timely made, additional interest shall accrue pursuant to 31 U.S.C. § 3717. 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 Securities and Exchange Commission, Office of Financial Management, 100 F St., NE, Stop 6042, Washington, DC 20549; and (D) submitted under cover letter that identifies Terry M. Deru 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 Daniel J. Wadley, Trial Counsel, Securities and Exchange Commission, Salt Lake Regional Office, 15 West South Temple Street, Suite 1800, Salt Lake City, Utah 84101.

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

6. Respondent Belsen Getty 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 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 promulgated thereunder.

7. Respondent Belsen Getty's registration be, and hereby is, revoked.

8. Respondent Belsen Getty is hereby censured.

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. 67418 / July 12, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14946

In the Matter of Alternative Energy Sources, Inc., Arlington Hospitality, Inc., Consolidated Oil & Gas, Inc., CSMG Technologies, Inc., CytoGenix, Inc., Dakotah, Incorporated, and DelSite, Inc., Respondents.	ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934

I.

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

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Alternative Energy Sources, Inc. ("AENS") [1] (CIK No. 1175867) is a dissolved Missouri corporation located in Kansas City, Missouri with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). AENS is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 2008, which reported a net loss of $3,575,545 for the prior nine months. As of July 9, 2012, the common stock of AENS was quoted on OTC Link (formerly

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

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

2. Arlington Hospitality, Inc. ("HOSTQ") (CIK No. 778423) is a void Delaware corporation located in Arlington Heights, Illinois with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). HOSTQ 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, 2005, which reported a net loss of $1,484,668 for the prior three months. On August 31, 2005, HOSTQ filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Northern District of Illinois, which was closed on September 2, 2011. As of July 9, 2012, the common stock of HOSTQ 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. Consolidated Oil & Gas, Inc. ("CSLG") (CIK No. 1346736) is a Nevada corporation located in Humble, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). CSLG is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2007, which reported a net loss of $578,919 for the prior nine months. On January 28, 2005, the Commission revoked the Exchange Act Section 12(g) registration of each class of CSLG's securities pursuant to Exchange Act Section 12(j). *Consolidated Oil & Gas, Inc., et al.*, Admin. Proc. File No. 3-11690, Securities Act of 1933 Rel. No. 8527 (Jan. 28, 2005). On March 10, 2006, CSLG filed a Form 10-SB to re-register its common stock. As of July 9, 2012, the common stock of CSLG was quoted on OTC Link, had eight market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

4. CSMG Technologies, Inc. ("CTGI") (CIK No. 1015002) is a Texas corporation located in Corpus Christi, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). CTGI is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 2008, which reported a net loss of $7,107,972 for the prior nine months. As of July 9, 2012, the common stock of CTGI was quoted on OTC Link, had eight market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

5. CytoGenix, Inc. ("CYGX") (CIK No. 1005302) is a defaulted Nevada corporation located in Houston, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). CYGX 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, 2009, which reported a net loss of $203,193 for the prior three months. As of July 9, 2012, the common stock of CYGX was traded on the over-the-counter markets.

6. Dakotah, Incorporated ("DKTH") (CIK No. 859944) is a South Dakota corporation located in Webster, South Dakota with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). DKTH 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 $7,141,907 for the prior nine months. As of July 9, 2012, the common stock of DKTH was quoted on OTC Link, had four

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

7. DelSite, Inc. ("DSIIQ") (CIK No. 718007) is a Texas corporation located in Irving, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). DSIIQ is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 2008, which reported a net loss of $4,533,000 for the prior nine months. On April 2, 2009, DSIIQ filed a Chapter 7 petition in the U.S. Bankruptcy Court for the Northern District of Texas, which was closed on March 12, 2012. As of July 9, 2012, the common stock of DSIIQ was quoted on OTC Link, had six market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

B. DELINQUENT PERIODIC FILINGS

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

9. Exchange Act Section 13(a) and the rules promulgated thereunder require issuers of securities registered pursuant to Exchange Act Section 12 to file with the Commission current and accurate information in periodic reports, even if the registration is voluntary under Section 12(g). Specifically, Rule 13a-1 requires issuers to file annual reports, and Rule 13a-13 requires 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
July 12, 2012

In the Matter of

Alternative Energy Sources, Inc.,
Arlington Hospitality, Inc.,
Consolidated Oil & Gas, Inc.,
CSMG Technologies, Inc.,
Dakotah, Incorporated, and
DelSite, Inc.,

File No. 500-1

ORDER OF SUSPENSION OF TRADING

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

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Arlington Hospitality, Inc. because it has not filed any periodic reports since the period ended March 31, 2005.

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

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Dakotah, Incorporated 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 DelSite, Inc. because it has not filed any periodic reports since the period ended September 30, 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 July 12, 2012, through 11:59 p.m. EDT on July 25, 2012.

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. 67423 / July 12, 2012

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3393 / July 12, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14947

In the Matter of **STANLEY NG, C.P.A.,** **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 ORDER OF SUSPENSION PURSUANT TO RULE 102(e)(2) OF THE COMMISSION'S RULES OF PRACTICE**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted against Stanley Ng, CPA, ("Ng" or "Respondent") pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") and also deems it appropriate to issue an order of forthwith suspension of Ng pursuant to Rule 102(e)(2) of the Commission's Rules of Practice [17 C.F.R. §201.102(e)(2)].[1]

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, Respondent consents to the Commission's

1 Rule 102(e)(2) provides in pertinent part: "Any ... person who has been convicted of a felony or a misdemeanor involving moral turpitude shall be forthwith suspended from appearing or practicing before the Commission."

jurisdiction over him and the subject matter of these proceedings and 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 Order of Suspension Pursuant to Rule 102(e) of the Commission's Rules of Practice ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds[2] that:

1. This matter concerns insider trading by Ng, who in late 2007 and 2008 disclosed material nonpublic information that he obtained in the course of his employment at Marvell Technology Group, Ltd. ("Marvell") to Winifred Jiau ("Jiau") and Son Ngoc Nguyen ("Nguyen"). Jiau and Nguyen, in turn, traded Marvell securities based on the material nonpublic information.

2. By virtue of his conduct, Ng violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

3. Stanley Ng, age 43 and a resident of Cupertino, California is a Certified Public Accountant ("CPA") licensed in California (although his license is currently inactive). From 2002 through 2011, Ng worked in the finance department of Marvell, serving as the company's "SEC Reporting Manager" from 2002 until September 2010. Ng has already pleaded guilty to one count of conspiracy to commit securities fraud and wire fraud before the United States District Court for the Southern District of New York in U.S. v. Ng, S4 11-cr-161 (JSR), and has been sentenced to two years of probation, ordered to forfeit $6,464 (based on the illegal trading profits of his direct tippees) and fined $2,000.

4. Jiau, age 44, is currently incarcerated in a federal correctional facility in California after being convicted in June 2011 of securities fraud and conspiracy to commit securities fraud and wire fraud, and sentenced to a 48-month term of imprisonment by the United States District Court for the Southern District of New York in U.S. v. Jiau, 11-cr-161 (JSR). Jiau is also the subject of a permanent antifraud injunction, which was entered against her by the United States District Court for the Southern District of New York in SEC v. Longoria, et al., 11-cv-753 (JSR).

5. Nguyen, age 39, is a resident of San Jose, California. Nguyen pleaded guilty to one count of conspiracy to commit securities fraud and wire fraud before the United States District Court for the Southern District of New York in U.S. v. Nguyen, S3 11-cr-161 (JSR), and was sentenced to one year of probation and ordered to forfeit $6,464 in illegal trading profits.

6. Marvell is a Bermuda corporation headquartered in Santa Clara, California. Marvell is a global provider of semiconductors and microprocessor integrated circuits. Marvell's securities are registered with the Commission pursuant to Section 12(b) of the Exchange Act and its stock trades on the NASDAQ under the symbol "MRVL."

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[2] 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.

7. In late 2007 and 2008, Ng, Jiau and Nguyen participated in a scheme to exchange material nonpublic information for the purpose of executing securities trades while in possession of material nonpublic information. Ng agreed to provide Jiau with material, nonpublic information regarding the financial performance of his employer, Marvell. In exchange, Jiau and Nguyen agreed to provide Ng with stock tips.

8. On May 17 and May 27, 2008, Ng spoke to Jiau by telephone and provided her with inside information regarding Marvell's performance for its first fiscal quarter, which had ended on May 3, 2008 and for which Marvell would publicly announce results on May 29, 2008. Specifically, Ng informed Jiau that Marvell would announce quarterly revenues of $804 million, a gross profit margin of 51.6%, and earnings per share would be $0.11. These results were significantly better than market analysts' expectations at the time.

9. On May 29, 2008, prior to Marvell's announcement of its quarterly results, Jiau purchased 875 shares of Marvell stock while in possession of material nonpublic information that she had received from Ng.

10. That same day Ng also had a telephone conversation with Nguyen during which Ng provided Nguyen with material nonpublic information regarding Marvell's quarterly earnings.

11. Later that day (and before Marvell announced its quarterly results), Nguyen purchased 1,000 shares of Marvell stock while in possession of material nonpublic information that he had received from Ng.

12. After market-close on May 29, 2008, Marvell released its quarterly results for the first quarter of 2008, including revenues of $804 million, a gross profit margin of 52% and earnings per share of $0.11, almost exactly as Ng had stated. These results, which were significantly better than market analysts expected, caused the stock price to increase 23% (from $14.08 per share at market-close on May 29 to $17.36 per share at market-close on May 30).

13. The increase in Marvell's stock price resulted in combined profits of $6,464 for Jiau and Nguyen. (Ng did not share in the insider trading profits of Jiau or Nguyen.)

14. By providing the information regarding Marvell's quarterly earnings to Jiau and Nguyen, Ng violated the duty he owed to Marvell to keep all material nonpublic information concerning the company confidential, as well as a specific company policy which prohibits the tipping of material nonpublic information to persons outside Marvell.

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

IV.

In view of the foregoing, the Commission finds that Ng has been convicted of a felony within the meaning of Rule 102(e)(2) and deems it appropriate to impose the sanctions agreed to in Ng's Offer.

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

A. Pursuant to Section 21C of the Exchange Act, Ng shall 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. Ng is forthwith suspended from appearing or practicing before the Commission pursuant to Rule 102(e)(2) of the Commission's Rules of Practice.

C. Pursuant to Section 21C(f) of the Exchange Act Ng, is barred from acting as an officer or director of any issuer that has a class of securities registered pursuant to Section 12 of the Exchange Act [15 U.S.C. § 78l] or that is required to file reports pursuant to Section 15(d) of the Exchange Act [15 U.S.C. § 78o(d)].

D. Ng shall, within 180 days of the entry of this Order, pay disgorgement of $6,464 and prejudgment interest of $984.23, for a total of $7,448.23, to the Securities and Exchange Commission to be remitted to the United States Treasury. Ng's obligations to pay disgorgement in the amount of $6,464 and pre-judgment interest in the amount of $984.23 will be credited dollar for dollar by the amount of the forfeiture order of $6,464 entered against Ng in criminal case number 11-CR-0161 (JSR) in the United States District Court of the Southern District of New York. Thus, within 180 days of the entry of this Order, Ng shall pay $984.23 to the Securities and Exchange Commission to be remitted to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. Payment shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check, bank money order, or by credit or debit card via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to Enterprise Services Center, Accounts Receivable Branch, 6500 South MacArthur Boulevard, Oklahoma City, Oklahoma 73169; and (D) submitted under cover letter that identifies Ng as the Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Sanjay Wadhwa, Associate Director, Division of Enforcement, Securities and Exchange Commission, New York Regional Office, 3 World Financial Center, Suite 400, New York, New York 10281.

E. Ng shall, within 180 days of the entry of this Order, pay a civil money penalty in the amount of $6,464 to the Securities and Exchange Commission to be remitted 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, bank money order, or by credit or debit card via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to Enterprise Services Center, Accounts Receivable Branch, 6500 South MacArthur Boulevard, Oklahoma City, Oklahoma 73169; and (D) submitted under cover letter that identifies Ng as the Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Sanjay Wadhwa, Associate Director, Division of Enforcement, Securities and Exchange Commission, New York Regional Office, 3 World Financial Center, Suite 400, New York, New York 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. 67426 / July 12, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14949

In the Matter of **Charles M. Vaughn,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND NOTICE OF HEARING**

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 Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") against Charles M. Vaughn ("Vaughn" or "Respondent").

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENT

1. From August 2001 through March 2008, Vaughn was the sole owner and principal of CM Vaughn, LLC, an unregistered broker based in multiple locations in and around Atlanta, Georgia. Vaughn, 43 years old, was a resident of Ellijay, Georgia when he operated CM Vaughn, LLC.

B. RESPONDENT'S CRIMINAL CONVICTION

2. On October 24, 2011, Vaughn entered a guilty plea in U.S. District Court for the Northern District of Georgia to one count of wire fraud in violation of Title 18 United States Code, Sections 1343 and 2, in United States v. Charles Michael Vaughn, Crim. Case No. 1:11-CR-310-RWS. On February 7, 2012, Vaughn was sentenced to a term of one hundred (100) months in prison and three (3) years of supervised release, and ordered to pay restitution in the amount of $8,833,686.41. Vaughn began serving his prison sentence on March 28, 2012.

3. As alleged in Vaughn's negotiated plea agreement, between July 2004 and October 2007, Vaughn induced more than 50 individuals to invest in a purported pooled investment fund called CM Vaughn Emerging Ventures Fund ("Emerging Ventures Fund" or "Fund"). As further alleged in the plea agreement, Vaughn represented to investors that the Fund earned annual returns from 15 to 50 percent, and stated that investors' funds were "insured." The plea agreement also alleges that Vaughn represented that the Fund was subject to a "stop loss" policy where, if the investments dropped below a certain value, Vaughn would terminate all investment activity in order to prevent further losses. However, as alleged in the plea agreement, rather than actually investing investor funds in the Emerging Ventures Fund, Vaughn misappropriated such funds to finance various private companies he owned and/or operated and also to pay his personal expenses and to repay earlier investors. Finally, the plea agreement alleges that Vaughn hid his actions by generating statements reflecting fictitious investment gains and account balances.

C. OPERATION OF CM VAUGHN, LLC

4. CM Vaughn, LLC solicited investors in the Emerging Ventures Fund through Vaughn, providing Fund information on the firm's letterhead. The Fund purportedly invested in exchange-listed stocks. Investors in the Fund opened individual accounts at CM Vaughn, LLC, through which the firm purportedly purchased their interests in the Fund. Finally, CM Vaughn, LLC purportedly charged Fund investors "commissions and trade fees" associated with the Fund's purported underlying stock trading.

III.

In view of the foregoing, the Commission deems it necessary and appropriate in the public interest that public administrative proceedings be instituted to determine:

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

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

IV.

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

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

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

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

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 210 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

Commissioner Aguilar
Commissioner Gallagher
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 3432 / July 17, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14950

In the Matter of CENTAUR MANAGEMENT CO. LLC Respondent.	ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTIONS 203(e) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") against Centaur Management Co. LLC ("Respondent" or "Centaur Management").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over Respondent and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 203(e) 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 Respondent's Offer, the Commission finds that

Summary

From January 1, 2006 until April 2, 2009 (the "Relevant Period"), Centaur Management, a registered investment adviser, directed its client, Argent Classic Convertible Arbitrage Fund L.P. ("Argent Classic"), to provide Centaur Management with approximately $15 million in interest-free loans. The loans were made bi-weekly in amounts between $133,000 and $1,500,000. During the Relevant Period, the outstanding balance on the loans ranged from $361,354 to $3,872,146. Centaur Management used these loans to fund the payroll for employees who provided management and accounting services, not only for Argent Classic, but also for up to fourteen related funds (the "Related Funds").[1] No interest was paid on the vast majority of the loans from Argent Classic, and thus, Centaur Management deprived Argent Classic of the use of its capital.

Centaur Management failed to disclose adequately the loan practice to the Argent Classic investors. The loans were described in Argent Classic's audited financial statements as payroll receivables, but were not disclosed as loans directed by Centaur Management, that they were interest-free, or that they were being used to cover payroll expenses for funds other than Argent Classic.

As a result, Centaur Management violated Section 206(2) and Section 206(4) of the Advisers Act, and Rule 206(4)-8 promulgated thereunder.

Respondent

1. **Centaur Management Co. LLC**, formerly known as Argent Management Co. LLC (collectively "Centaur Management"), is a Delaware limited liability company with offices in Norwalk, Connecticut, and was registered with the Commission as an investment adviser from December 2005 until October 2011. Centaur Management belonged to a family of investment advisers and funds, which, during the Relevant Period, included five investment advisers managing twenty-three funds. From December 1995 through June 2009, Centaur Management provided investment advice to, and made investment decisions for, Argent Classic and at least five other funds. Centaur Management received fees from Argent Classic for providing investment advice to Argent Classic.

Other Relevant Entities

2. **Argent Classic Convertible Arbitrage Fund L.P.**, a Delaware limited partnership which invested in convertible securities, was formed in December 1995 by Centaur Management, its only general partner, and was closed in March 2009. At its peak in May 2007, Argent Classic had approximately $118 million of partners' capital. Argent Classic was one of the largest client funds that Centaur Management advised.

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[1] The majority of the Related Funds have since been closed.

Facts

The Interest-Free Loans

3. From December 2005 through March 2009, Centaur Management was the registered investment adviser for several funds. In its role as registered investment adviser, Centaur Management earned and collected management and performance fees from each fund.

4. During this period, Centaur Management determined to defer the collection of fees from certain funds. As a result of the decision to defer these fees, Centaur Management was required to seek alternative sources to meet its ongoing payroll obligations. Those payroll obligations constituted payroll expenses incurred directly by Centaur Management and payroll expenses incurred by Argent Classic and the Related Funds.

5. During the Relevant Period, Centaur Management obtained the money to meet its payroll expenses, including payroll for the Related Funds, by borrowing the funds from Argent Classic through a series of bi-weekly cash loans in amounts ranging from $133,000 to $1,500,000. In total, Centaur Management took at least 75 loans from Argent Classic.

6. Centaur Management paid no interest to Argent Classic on the loans it took, except for the last loan repayment made in April 2009 when the practice of borrowing monies from Argent Classic was discontinued.[2] Consequently, Centaur Management circumvented the conventional costs of borrowing at the expense of its client, Argent Classic.

7. Although ultimately repaid, most of the loans obtained from Argent Classic remained outstanding for at least two months, and several loans remained outstanding for over a year. Centaur Management's practice of taking interest-free loans from Argent Classic constituted an unauthorized use of Argent Classic's assets by Centaur Management. The practice deprived Argent Classic of the use of its capital.

8. As a direct result of these outstanding loans, during several periods in 2006 and 2007, Centaur Management owed Argent Classic as much as $3,872,146. In multiple periods during 2008, the amount owed to Argent Classic by Centaur Management totaled over 8% of the partners' capital in Argent Classic as a result of the significant withdrawals of partners' capital and declining value of the Fund occasioned by the sharp contraction in the markets.

9. By borrowing from Argent Classic at an interest rate of zero, Centaur Management benefitted by avoiding paying interest of approximately $172,438.[3]

10. As the investment adviser to Argent Classic, Centaur Management owed a fiduciary duty to its client. Centaur Management breached that fiduciary duty by inappropriately using

[2] Interest of $13,841 was included with the last repayment amount of $680,478.

[3] The calculation of this amount is based on the net amount of loans from Argent Classic to Centaur Management offset by the performance and management fees owed to Centaur Management by Argent Classic.

Argent Classic funds to make no-interest loans and thus depriving Argent Classic of the use of those funds. As a result, Centaur Management willfully[4] violated Section 206(2) of the Advisers Act, which prohibits fraudulent conduct by an investment adviser.[5]

Non-Disclosure of the Loans

11. Centaur Management, the general partner of Argent Classic and its registered investment adviser, failed to disclose adequately the interest-free loans and the terms of such loans to Argent Classic's investors. Argent Classic's audited financial statements described the money owed to Argent Classic from Centaur Management merely as "payroll receivables," without further explanation. In addition, Argent Classic's Agreement of Limited Partnership, Subscription Agreement, and Private Offering Summary omitted any mention of the loan practice. Centaur Management also failed to report that the interest-free loans were being used to cover payroll expenses for the Related Funds.

12. As a result of the above, Centaur Management willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-8 promulgated thereunder, which, in pertinent part, prohibit an investment adviser to a pooled vehicle from making any false or misleading material statements of facts or omitting to state material facts to any investor or prospective investor in the pooled investment vehicle.

IV.

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

Accordingly, pursuant to Sections 203(e) and 203(k) of the Advisers Act, it is hereby ORDERED that:

A. Respondent Centaur Management cease and desist from committing or causing any violations and any future violations of Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 promulgated thereunder.

B. Respondent Centaur Management is censured.

C. Respondent shall, within thirty days of the entry of this Order, pay disgorgement of $172,438 and prejudgment interest of $41,884 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. Payment shall be: (A) made by wire transfer, United States postal money order, certified check,

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[4] A willful violation of the securities laws means merely "'that the person charged with the duty knows what he is doing.'" *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). 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)).

[5] Proof of scienter is not required to establish a violation of Section 206(2) of the Advisers Act. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963).

bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) if paid by money order or check, such payment shall be hand-delivered or overnight mailed to Enterprise Services Center, HQ Bldg, Room 181, AMZ-341, 6500 South MacArthur Blvd, Oklahoma City, OK 73169; and (D) submitted under cover letter that identifies Centaur Management as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Laura B. Josephs, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549-5010A.

D. Respondent shall, within thirty days of the entry of this Order, pay a civil money penalty in the amount of $150,000 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. § 3717. Such payment shall be: (A) made by 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) if paid by money order or check, such payment shall be hand-delivered or overnight mailed to Enterprise Services Center, HQ Bldg, Room 181, AMZ-341, 6500 South MacArthur Blvd, Oklahoma City, OK 73169; and (D) submitted under cover letter that identifies Centaur Management as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Laura B. Josephs, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549-5010A.

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR PART 241

Release No. 34-67448; File No. S7-06-12

Commission Guidance Regarding Definitions of Mortgage Related Security and Small Business Related Security

AGENCY: Securities and Exchange Commission.

ACTION: Interpretation; solicitation of comment.

SUMMARY: The Securities and Exchange Commission (the "Commission") is publishing interpretive guidance with respect to sections 3(a)(41) (the definition of "mortgage related security") and 3(a)(53)(A) (the definition of "small business related security") of the Securities Exchange Act of 1934 (the "Exchange Act"), in light of section 939(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Section 939(e) strikes provisions in sections 3(a)(41) and 3(a)(53)(A) of the Exchange Act that reference credit ratings issued by nationally recognized statistical rating organizations ("NRSROs"), and inserts new text that provides that in order to satisfy these definitions a security must meet "standards of credit-worthiness as established by the Commission." Because more time is needed to develop and establish standards of creditworthiness for purposes of these definitions, the Commission is providing a transitional interpretation that will be applicable on and after July 20, 2012, and until such time as final Commission rules establishing new standards of creditworthiness become effective. The Commission also is seeking comment on potential standards of creditworthiness that could be established to replace the use of NRSRO credit ratings in the definitions of the terms "mortgage related security" and "small business related security."

DATES: Effective Date: July 20, 2012.

Comments: Comments should be received on or before [insert date 30 days after publication in the Federal Register].

FOR FURTHER INFORMATION CONTACT: Michael A. Macchiaroli, Associate Director, at (202) 551-5525; Thomas K. McGowan, Deputy Associate Director, at (202) 551-5521; Randall W. Roy, Assistant Director, at (202) 551-5522; Mark M. Attar, Branch Chief, at (202) 551-5889; Carrie A. O'Brien, Special Counsel, at (202) 551-5640; and Rachel B. Yura, Attorney-Adviser, at (202) 551-5729, Office of Financial Responsibility, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-7010.

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/interp.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-06-12 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 S7-06-12. 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/interp.shtml). Comments also are available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available.

SUPPLEMENTARY INFORMATION:

I. INTRODUCTION

Section 3(a)(41) of the Exchange Act defines the term "mortgage related security" as, among other things, a security that is rated in one of the two highest rating categories by at least one NRSRO.[1] Section 3(a)(53)(A) of the Exchange Act defines the term "small business related security" as, among other things, a security that is rated in one of the four highest rating categories by at least one NRSRO.[2] A "rating category" refers to a distinct level in an NRSRO's rating scale represented by a unique symbol, number, or score. For example, a rating scale consisting of AAA, AA, A, BBB, BB, B, CCC, CC, C, and D has ten rating categories, with the AAA and AA categories being the two highest categories and the AAA through BBB categories being the four highest categories. Securities rated in the two highest categories of such a rating scale are sometimes colloquially referred to as "highly rated" and securities rated in the four highest categories as "investment grade."

Section 939(e) of the Dodd-Frank Act strikes the text in sections 3(a)(41) and 3(a)(53)(A) of the Exchange Act that reference NRSRO credit ratings and in its place inserts text providing that a "mortgage related security" and a "small business related security" means

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1 See 15 U.S.C. 78c(a)(41).

2 See 15 U.S.C. 78c(a)(53)(A).

a security that "meets standards of creditworthiness as established by the Commission."[3] The effective date of these amendments to the Exchange Act is July 20, 2012.[4]

The Commission previously discussed and requested comment on section 939(e) of the Dodd-Frank Act and potential standards of creditworthiness that could be used for purposes of the terms "mortgage related security" and "small business related security."[5] The Commission is continuing to work on rule proposals to establish standards of creditworthiness to implement section 939(e) of the Dodd-Frank Act. However, as explained below, these definitions are referenced in numerous statutes and regulations – the majority of which are not Commission authorizing statutes or regulations administered by the Commission. Consequently, the new standards of creditworthiness established by the Commission under section 939(e) of the Dodd-Frank Act will impact different types of persons and transactions, including persons and transactions for which the Commission does not have oversight authority. This impact adds a layer of complexity to the process of developing and establishing a standard or standards of creditworthiness for each definition. The considerations involved in undertaking this difficult task include seeking to accommodate, to the extent practicable, the varied uses of the definitions of "mortgage related security" and "small business related security" in statutes and regulations without lowering protections for investors, disrupting the markets for these securities, increasing risk to financial institutions, or imposing undue burdens and costs to market participants.

Furthermore, as explained below, the Commission and other Federal agencies are continuing their efforts to remove references to credit ratings in regulations they administer as

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3 See Pub. L. No. 111-203 § 939(e).

4 See Pub. L. No. 111-203 § 939(g).

5 See Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934, Exchange Act Release No. 64352 (Apr. 27, 2011), 76 FR 26550 (May 6, 2011).

mandated by section 939A of the Dodd-Frank Act.[6] In the case of some proposed amendments under section 939A, commenters – as explained below – have raised concerns that replacing the benchmark of credit ratings with another standard could, among other things, be harmful to investors, increase risk to financial institutions, distort financial markets, and increase burdens and costs.

For these reasons, the Commission needs additional time to analyze and understand the potential impact that could result from the establishment of new standards of creditworthiness in the definitions of the terms "mortgage related security" and "small business related security." At the same time, under section 939(e) of the Dodd-Frank Act, the use of NRSRO credit ratings in sections 3(a)(41) and 3(a)(53)(A) of the Exchange Act will be stricken from the statutory text on July 20, 2012. Absent further guidance from the Commission, this change could create uncertainty among market participants that rely on these definitions and potentially negatively impact the market for mortgage related securities and small business related securities. In this regard, the Commission does not believe that, in the absence of established standards of creditworthiness by the Commission, Congress intended for the statutory definitions to become unworkable or to create market uncertainty regarding the status or meaning of these definitions. Consequently, the Commission is issuing this transitional interpretation to ensure that the markets can continue to function while the Commission continues its work on rule proposals to establish standards of creditworthiness to implement section 939(e) of the Dodd-Frank Act.

Therefore, until new standards of creditworthiness are established by final rules, the Commission is providing a transitional interpretation that will be applicable beginning on July 20, 2012 with respect to section 3(a)(41) (the definition of "mortgage related security") and

6 See Pub. L. No. 111-203 § 939a.

section 3(a)(53)(A) (the definition of "small business related security") of the Exchange Act. Specifically, for purposes of these sections, the Commission interprets the terms "standards of creditworthiness as established by the Commission" to mean that on and after July 20, 2012, and until such time as final Commission rules establishing new standards of creditworthiness are effective:

- The standard of creditworthiness for purposes of the definition of the term "mortgage related security" in section 3(a)(41) of the Exchange Act is a security that is rated in one of the two highest rating categories by at least one NRSRO; and
- The standard of creditworthiness for purposes of the definition of the term "small business related security" in section 3(a)(53)(A) of the Exchange Act is a security that is rated in one of the four highest rating categories by at least one NRSRO.

The Commission is not interpreting any other provisions of sections 3(a)(41) and 3(a)(53)(A) of the Exchange Act herein.

II. BACKGROUND

A. Use of the Definitions of these Securities

1. Mortgage Related Security

Congress defined the term "mortgage related security" in section 3(a)(41) of the Exchange Act as part of the Secondary Mortgage Market Enhancement Act of 1984 ("SMMEA").[7] SMMEA was intended to encourage private sector participation in the secondary mortgage market by, among other things, relaxing certain regulatory requirements for "private-label issuers"[8] to sell mortgage-backed securities.[9] For example, SMMEA: (1) pre-empted

7 Pub. L. No. 98-440, § 101, 98 Stat. 1689 (1984).

8 Most mortgage-backed securities are issued or guaranteed by the Government National Mortgage Association ("Ginnie Mae"), a U.S. government agency, or the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac"), U.S. government-

certain state investment laws to permit state regulated institutions to invest in private-label mortgage-backed securities to the same extent as agency securities;[10] (2) granted authority for certain depository institutions to invest in these securities;[11] and (3) required states to exempt private-label mortgage-backed securities from state registration to the same extent as agency securities, unless the state specifically deemed otherwise.[12] A security that qualifies as a mortgage related security under section 3(a)(41) of the Exchange Act receives the benefits intended by SMMEA.[13]

Currently, section 3(a)(41) of the Exchange Act defines the term "mortgage related security" as a "security that is rated in one of the two highest rating categories by at least one [NRSRO]" and that: (1) represents ownership of one or more promissory notes, or interests therein, which notes are directly secured by a first lien on a single parcel of real estate upon which is located a dwelling or mixed residential and commercial structure, or on a residential manufactured home or one or more parcels of real estate upon which is located one or more commercial structures and were originated by a savings or banking institution or other similar institution approved for insurance by the Secretary of the U.S. Department of Housing and Urban

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sponsored enterprises. These securities are commonly referred to as "agency" mortgage-backed securities. Ginnie Mae, backed by the full faith and credit of the U.S. government, guarantees that investors receive timely payments. Fannie Mae and Freddie Mac also provide certain guarantees and, while not backed by the full faith and credit of the U.S. government, have special authority to borrow from the U.S. Treasury. Some private institutions, such as brokerage firms, banks, and homebuilders, also securitize mortgages, known as "private-label" mortgage-backed securities.

9 The legislation was aimed at encouraging participation in the secondary mortgage market by investment banks, investment entities, mortgage bankers, private mortgage insurance companies, pension funds and other investors, depositary institutions, and federal credit unions. See Kenneth G. Lore & Cameron L. Cowan, Mortgage-Backed Securities; Developments and Trends in the Secondary Market 2-39 (2001), at 1-14. See also Edward L. Pittman, Economic and Regulatory Developments Affecting Mortgage Related Securities, 64 Notre Dame L. Rev. 497, 499 (1989).

10 See 15 U.S.C. 77r-1.

11 See 12 U.S.C. 1464(c)(1), 12 U.S.C. 1757, and 12 U.S.C. 24.

12 See 15 U.S.C. 77d. For further discussion of SMMEA, see also Protecting Investors: A Half Century of Investment Company Regulation, Division of Investment Management (May 1992).

13 See Pittman, p. 514.

Development; or (2) is secured by one or more promissory notes, or interests therein, and provides for payments of principal in relation to payments, or reasonable projections of payments, on notes, or interests therein, meeting such requirements.[14]

Table 1 identifies examples of Federal statutes and regulations that refer to the term "mortgage related security" as defined under the Exchange Act and indicates the type of entity that is subject to the statute or regulation.

Table 1

Citation	Entities Subject to Requirement
11 U.S.C. 101(47)	Participants in bankruptcy proceedings
12 U.S.C. 24	National banking associations
12 U.S.C. 1464	Federal savings associations
12 U.S.C. 1757	Federal credit unions
12 U.S.C. 1787	Federal credit unions
12 U.S.C. 1821	Depository institutions insured by the Federal Deposit Insurance Corporation
12 U.S.C. 4520	Fannie Mae and any affiliate thereof or Freddie Mac and any affiliate thereof
12 U.S.C. 4617	Fannie Mae and any affiliate thereof or Freddie Mac and any affiliate thereof
15 U.S.C. 77r-1	Any person, trust, corporation, partnership, association, business trust, or business entity created pursuant to or existing under the laws of the United States or any State
15 U.S.C. 78g	Broker-dealers
15 U.S.C. 78k	Broker-dealers
12 C.F.R. 1.2	National banks, District of Columbia banks, and federal branches of foreign banks, State banks that are members of the Federal Reserve System and foreign branches of national banks
12 C.F.R. Part 3, Appendix A	National banking associations
12 C.F.R. Part 208, Appendix A	State banks that are members of the Federal Reserve System
12 C.F.R. Part 225, Appendix A	Bank holding companies
12 C.F.R. Part 325, Appendix A	Depository institutions insured by the Federal Deposit Insurance Corporation
12 C.F.R. 567.1	Savings associations
12 C.F.R. 567.6	Savings associations
12 C.F.R. 703.2	Federal credit unions
12 C.F.R. 703.16(d)	Federal credit unions
12 C.F.R. 704, Appendix C	Corporate credit unions
12 C.F.R. Part 1750, Appendix A to Subpart B	Fannie Mae and any affiliate thereof and Freddie Mac and any affiliate thereof
17 C.F.R. 230.424	Persons filing a prospectus or prospectus

[14] See 15 U.S.C. 78c(a)(41).

Citation	Entities Subject to Requirement
	supplement relating to an offering of mortgage related securities on a delayed basis
17 C.F.R. 240.15c3-1	Broker-dealers

Numerous State laws also contain references to the definition of the term "mortgage related security" in section 3(a)(41) of the Exchange Act.[15] The entities subject to these laws include insurance companies, banks, and trusts.[16]

2. Small Business Related Security

Congress defined the term "small business related security" in section 3(a)(53)(A) as part of the Riegle Community Development and Regulatory Improvement Act of 1994 (the "CDRI").[17] Among other things, the CDRI removed limitations on purchases of certain small business-related securities by national banks.[18] The CDRI was designed to increase small business access to capital by removing impediments in existing law to the securitizations of small business loans.[19] The CDRI created a framework for small business related securities similar to the SMMEA framework for mortgage related securities with the goal of stimulating the flow of funds to small businesses.

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15 See, e.g., ALA. CODE §§ 10A-10-1.10 and 11-81-21; ARIZ. REV. STAT. ANN. § 44-1843; ARK. CODE ANN. § 23-42-503; COLO. REV. STAT. ANN. § 11-59.5-101; CONN. GEN. STAT. §§ 36a-459a and 38a-905; D.C. CODE §§ 31-1372.03 and 31-1372.04; HAW. REV. STAT. § 412:10-502; KAN. STAT. ANN. § 40-2a25; LA. REV. STAT. ANN. 6:611; ME. REV. STAT. 10, § 969-A; ME. REV. STAT. 30-A, § 4722; MD. CODE ANN., INS § 9-229.1; MICH. COMP. LAWS § 500.901; MISS. CODE ANN. § 81-27-5.101; MO. ANN. STAT. § 362.170; N.H. REV. STAT. ANN §§ 392:25 and 392-B:20; N.J. STAT. ANN. § 17:9-41; N.Y. MUN. HOME RULE LAW § 10; N.Y. INS. LAW §§ 1401, 1404, and 1409; N.C. GEN. STAT. ANN. § 53-342; OHIO REV. CODE ANN. §§ 3907.141 and 3925.081; OKLA. STAT. ANN. 6, § 806; OKLA. STAT. ANN. 71, § 1-201; 7 PA. CONS. STAT. ANN. §§ 315 and 502; S.C. CODE ANN. §§ 38-12-220, 38-12-230, 38-12-430, and 38-12-440; TEX. FIN. CODE ANN. §§ 34.101, 184.101, and 443.004; and UTAH CODE ANN. § 61-1-11.

16 Id.

17 Pub. L. No. 103-325, § 202, 108 Stat. 2198 (1994).

18 See Conf. Rep. on H.R. 3474, 140 Cong. Rec. H6685, H6690 (Aug. 2, 1994).

19 Id. See also Remarks of Sen. Domenici, Vol. 140 Cong. Record, p. S11039 (Aug. 2, 1994).

Currently, section 3(a)(53)(A) defines the term "small business related security" as "a security that is rated in one of the four highest rating categories by at least one [NRSRO]" and that either: (1) represents an interest in one or more promissory notes or leases of personal property evidencing the obligation of a small business concern and originated by an insured depository institution or other similar institution which is supervised and examined by federal or state authority or certain other regulated types of issuers; or (2) is secured by an interest in one or more promissory notes or leases of personal property (with or without recourse to the issuer or lessee) and provides for payments of principal in relation to payments, or reasonable projections of payments, on notes or leases of the type described in the preceding clause.[20]

Table 2 identifies examples of Federal statutes and regulations that use the term "small business related security" and indicates the type of entity that is subject to the statute or regulation.

Table 2

Citation	Entities Subject to Requirement
12 U.S.C. 24	National banking associations
12 U.S.C. 1464	Federal savings associations
12 U.S.C. 1757	Federal credit unions
15 U.S.C. 77r-1	Any person, trust, corporation, partnership, association, business trust, or business entity created pursuant to or existing under the laws of the United States or any State
15 U.S.C. 78g	Broker-dealers
15 U.S.C. 78k	Broker-dealers
12 C.F.R. 1.2	National banks, District of Columbia banks, and federal branches of foreign banks, State banks that are members of the Federal Reserve System and foreign branches of national banks
12 C.F.R. 1.3	National banking associations
12 C.F.R. 703.2	Federal credit unions
12 C.F.R. 703.16	Federal credit unions
12 C.F.R. 704.2	Corporate credit unions
12 C.F.R. 704.5	Corporate credit unions

20 See 15 U.S.C. 78c(a)(53)(A).

Several State laws also contain references to the definition of the term "small business related security" in section 3(a)(53)(A) of the Exchange Act.[21] Banks and trust companies are subject to these laws.[22]

3. Use of the Definitions by the Commission and Other Agencies

As identified in the tables set forth above, rules administered by the Commission and other Federal agencies reference the terms "mortgage related security" and "small business related security," as those terms are defined in Exchange Act Sections 3(a)(41) and 3(a)(53)(A), respectively. Since the Dodd-Frank Act was adopted, several Federal agencies have proposed to continue to rely on the Exchange Act definitions of these terms. For example, the Office of the Comptroller of the Currency (the "OCC") proposed to retain rule provisions applicable to national banks that reference the statutory definitions of the terms "mortgage related security" and "small business related security" in the Exchange Act.[23] Similarly, the National Credit Union Administration (the "NCUA") also proposed to continue to reference the Exchange Act definitions of the terms "mortgage related security" and "small business related security" in its rules.[24] However, the NCUA stated in its proposal that in the time period before the Commission moves to specify "standards of creditworthiness" for mortgage related securities and small business related securities, a Federal credit union is prohibited from purchasing such security

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21 See, e.g., LA. REV. STAT. ANN. § 6:611; MISS. CODE. ANN. 81-27-5.101; TEX. FIN. CODE ANN. § 34.101; and TEX. FIN. CODE ANN. § 184.101.

22 Id.

23 See Alternatives to the Use of External Credit Ratings in the Regulations of the OCC, 76 FR 73526, 73529 (Nov. 29, 2011), Docket OCC-2011-0019.

24 See Removing References to Credit Ratings in Regulations; Proposing Alternatives to the Use of Credit Ratings, 76 FR 11164, 11166 (Mar. 1, 2011).

unless the Federal credit union has specific evidence that the Commission considers that security to meet the requirements of section 3(a)(41) or section 3(a)(53)(A), as applicable.[25]

B. Regulatory Initiatives to Remove References to Credit Ratings

1. Introduction

The use of NRSRO credit ratings in statutes and regulations has been criticized as fostering undue reliance by investors on credit ratings.[26] In addition, concerns have been raised that using NRSRO credit ratings in statutes and regulations impedes competition in the credit rating industry by giving NRSROs an unfair advantage over credit rating agencies that do not operate as NRSROs because entities subject to the statutes and regulations, or seeking favorable treatment under the statutes and regulations, must use NRSRO credit ratings.[27]

The Commission has for many years studied the issue of using NRSRO credit ratings in its rules and is engaged in an extensive rulemaking initiative to remove references to NRSRO credit ratings from its rules that commenced prior to enactment of the Dodd-Frank Act. The development of alternatives to NRSRO credit ratings raises complex issues as indicated by comments received by the Commission and other Federal agencies.

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25 Id.

26 Id.; see also H.R. Rep. No. 111-517, Joint Explanatory Statement of the Committee of Conference, Title IX, Subtitle C "Improvement to the Regulation of Credit Rating Agencies," at 871-72 (Conf. Rep.) (Jun. 29, 2010) (noting that "[t]o reduce reliance on ratings, the report amends several statutes to remove references to credit ratings, credit rating agencies and NRSROs") and Principles for Reducing Reliance on CRA Ratings, Financial Stability Board (Oct. 2010) ("The 'hard wiring' of CRA ratings in standards and regulations contributes significantly to market reliance on ratings. This in turn is a cause of the 'cliff effects' of the sort experienced during the recent crisis, through which CRA rating downgrades can amplify procyclicality and cause systemic disruptions. It can be also one cause of herding in market behaviour, if regulations effectively require or incentivise large numbers of market participants to act in similar fashion. But, more widely, official sector uses of ratings that encourage reliance on CRA ratings have reduced banks', institutional investors' and other market participants' own capacity for credit risk assessment in an undesirable way.").

27 See, e.g., Introduction of the Consumer Protection and Regulatory Enhancement Act, 155 Cong. Rec. E1965, E1965-67 (Jul. 23, 2009) (statement of Rep. Bachus).

2. Regulatory Initiatives

In 1975, the Commission adopted the term "nationally recognized statistical rating organization" as part of amendments to the "net capital rule" for broker-dealers (Rule 15c3-1).[28] The Commission's initial regulatory use of the term was intended to provide a method for determining net capital charges on different grades of debt securities under Rule 15c3-1.[29] The Commission eventually inserted references to NRSRO credit ratings in other rules under the Securities Act of 1933 (the "Securities Act"), the Exchange Act, and the Investment Company Act of 1940 (the "Investment Company Act").[30] In addition, credit ratings by NRSROs have been used as benchmarks in Federal and State legislation, rules administered by other Federal agencies, and foreign regulatory schemes.[31]

Concerns about the use of NRSRO credit ratings in statutes and regulations have prompted the Commission to study whether this use should be eliminated and whether there are practical alternatives to NRSRO credit ratings that could be used as benchmarks in regulations. For example, in 1994, the Commission published a concept release soliciting comment on whether references to NRSRO credit ratings should be eliminated from its rules.[32] Commenters generally supported the continued use of NRSRO credit ratings.[33] As summarized by the

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28 See Adoption of Uniform Net Capital Rule and an Alternative Net Capital Requirement for Certain Brokers and Dealers, Exchange Act Release No. 11497 (Jun. 26, 1975), 40 FR 29795 (Jul. 16, 1975), and 17 CFR 240.15c3-1. The net capital rule prescribes minimum net capital requirements for broker-dealers and it uses NRSRO credit ratings to determine the amount of the charge to capital ("haircut") a broker-dealer must apply to certain types of debt instruments. See 17 CFR 240.15c3-1.

29 See 17 CFR 240.15c3-1.

30 See, e.g., Report on Review of Reliance on Credit Ratings: As Required by Section 939A(c) of the Dodd Frank Wall Street Reform and Consumer Protection Act, Commission Staff (Jul. 2011).

31 See, e.g., Report to Congress on Credit Ratings, Board of Governors of the Federal Reserve System (Jul. 2011); References to Credit Ratings in FDIC Regulations, Federal Deposit Insurance Corporation (Jul. 2011); and Stocktaking on the use of credit ratings, the Joint Forum (Jun. 2009).

32 See Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34616 (Aug. 31, 1994), 59 FR 46314 (Sep. 7, 1994).

33 See Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934, Exchange

Commission, one commenter noted that the use of NRSRO credit ratings provides an objective, simple standard.[34] Some commenters suggested that internal models could be used for purposes of determining net capital charges under the Commission's broker-dealer net capital rule.[35]

In 2003, the Commission again sought comment on whether to eliminate the use of NRSRO credit ratings from Commission rules, and, if so, what alternative benchmarks could be used to meet the Commission's regulatory objectives.[36] Commenters raised concerns about alternatives to credit ratings, highlighting the challenge of replacing credit ratings, though some commenters stated that alternatives such as internally developed credit ratings could be used.[37]

In July 2008, the Commission proposed amendments to remove references to NRSRO credit ratings from its rules under the Securities Act, Exchange Act, and Investment Company Act.[38] Commenters again raised concerns about alternatives to credit ratings.[39] In October 2009,

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Act Release No. 39457 (Dec. 17, 1997), 62 FR 68018 (Dec. 30, 1997).

34 Id.

35 Id.

36 See Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws, Exchange Act Release No. 47972 (Jun. 4, 2003), 68 FR 35258 (Jun. 12, 2003). See also Report of the Role and Function of Credit Rating Agencies in the Operations of the Securities Markets as Required by Section 702(b) of the Sarbanes-Oxley Act of 2002, Commission (Jan. 2003).

37 The comment letters are available on the Commission's Internet website at the following address: http://www.sec.gov/rules/concept/s71203.shtml. See, e.g., letter dated Jul. 28, 2003 from Gregory V. Serio, Superintendent, New York Insurance Department, Chair, NAIC Rating Agency Working Group, National Association of Insurance Commissioners (stating that replacing NRSRO credit ratings "could be costly and complicated"); letter dated Jul. 25, 2003 from Steven C. Nelson, Director of Taxable Money Market Research, Fidelity Investments Money Management, Inc. (stating that replacing NRSRO credit ratings in Rule 2a-7 under the Investment Company Act ("Rule 2a-7") "would not provide sufficient protection for investors" in money market funds and "could lead to significant risk inequality across money market funds"); letter dated Jul. 24, 2003 from Charles M. Nathan, Chair, Committee on Securities Regulation and Nicolas Grabar, Committee on Securities Regulation, Association of the Bar of the City of New York (stating that with respect to replacing NRSRO credit ratings in Rule 2a-7 that a "change to a more subjective standard could disrupt the market in unpredictable and undesirable ways."); and letter dated Jul. 28, 2003 from Raymond W. McDaniel, Moody's Investors Service (suggesting internally generated credit ratings as an alternative).

38 See References to Ratings of Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 58070 (Jul. 1, 2008), 73 FR 40088 (Jul. 11, 2008).

39 The comment letters are available on the Commission's Internet website at the following addresses: http://www.sec.gov/comments/s7-18-08/s71808.shtml (Securities Act rules);

the Commission adopted several of the proposed amendments and re-opened for comment the remaining amendments.[40] Commenters to the October 2009 re-proposal continued to raise concerns about alternatives to NRSRO credit ratings.[41]

The Dodd-Frank Act – enacted in 2010 – includes section 939A.[42] This section requires Federal agencies to "review any regulation issued by such agency that requires the use of an assessment of the creditworthiness of a security or money market instrument and any references to or requirements in such regulations regarding credit ratings."[43] Once the agency has completed that review, the statute provides that the agency "remove any reference to or

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http://www.sec.gov/comments/s7-19-08/s71908.shtml (Investment Company Act rules); and http://www.sec.gov/comments/s7-17-08/s71708.shtml (Exchange Act rules). See, e.g., letter dated Sep. 5, 2008 from Jeffrey T. Brown, Senior Vice President, Charles Schwab & Co., Inc. (stating that replacing NRSRO credit ratings "may be destabilizing and inject risk and uncertainty into the operations of broker-dealers, investment advisers and money market mutual funds."); letter dated Sep. 4, 2008 from Deborah A. Cunningham, Chief Investment Officer, Federated Investors and Boyce I. Greer, President, Fixed Income & Asset Allocation, Fidelity, on behalf of the Securities Industry and Financial Markets Association (stating that replacing NRSRO credit ratings would "be to the detriment of all investors"); letter dated Sep. 10, 2008 from Ronald W. Forbes and Rodney D. Johnson, The Independent Directors of The BlackRock Liquidity Funds (stating that replacing NRSRO credit ratings would "impose significant and unrealistic new burdens on money market fund boards"); letter dated Sep. 12, 2008 from Keith F. Higgins, Chair, Committee on Federal Regulation of Securities, and Vicki O. Tucker, Chair, Committee on Securitization and Structured Finance, Business Law Section, American Bar Association (stating that replacing NRSRO credit ratings would "eliminate all objective indicia of credit quality and will provide greater opportunity for abuse.").

40 See References to Ratings of Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 60789 (Oct. 5, 2009), 74 FR 52358 (Oct. 9, 2009) (adopting release). In the adopting release, the Commission amended Exchange Act Rule 3a1-1 (17 CFR 240.3a1-1), Exchange Act Rules 300, 301(b)(5) and 301(b)(6) of Regulation ATS (17 CFR 242.300, 242.301(b)(5) and 242.301(b)(6)), Form ATS-R (17 CFR 249.638) and Form PILOT (17 CFR 249.821). The Commission also adopted amendments to Rules 5b-3 and 10f-3 under the Investment Company Act (17 CFR 270.5b-3 and 17 CFR 270.10f-3). See also References to Ratings of Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 60790 (Oct. 5, 2009), 74 FR 52374 (Oct. 9, 2009) (re-opening comment for net capital rule purposes and various Exchange Act rules).

41 The comment letters are available on the Commission's Internet website at the following address: http://www.sec.gov/comments/s7-17-08/s71708.shtml. See, e.g., letter dated Dec. 9, 2009 from Steven G. Tepper, Arnold & Porter LLP, letter dated Dec. 8, 2009 from Sean C. Davy, Managing Director, Corporate Credit Markets Division, Securities Industry and Financial Markets Association, and letter dated Dec. 8, 2009 from Karrie McMillan, General Counsel, Investment Company Institute (stating that the removal of ratings from Commission rules would result in "serious unintended consequences.").

42 See Pub. L. No. 111-203 § 939A.

43 See Pub. L. No. 111-203 § 939A(a)(1)-(2).

requirement of reliance on credit ratings, and to substitute in such regulations such standard of creditworthiness" as the agency determines to be appropriate.[44]

In response to section 939A of the Dodd-Frank Act, the Commission proposed amendments in 2011 to remove references to NRSRO credit ratings in its rules and forms under the Securities Act, the Exchange Act, and the Investment Company Act. In particular, in February 2011, the Commission proposed to remove references to credit ratings in rules and forms promulgated under the Securities Act and the Exchange Act related to offerings of securities or issuer disclosure.[45] In March 2011, the Commission proposed amending certain rules and forms under the Investment Company Act, including Rule 2a-7 governing the operations of money market funds.[46] Further, in April 2011, the Commission proposed to amend additional rules and one form under the Exchange Act applicable to broker-dealer financial responsibility, distributions of securities, and confirmations of transactions.[47] In that same release, the Commission also requested comment on potential standards of creditworthiness for

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44 See Pub. L. No. 111-203 § 939A(b); see also Report on Review of Reliance on Credit Ratings: As Required by Section 939A(c) of the Dodd Frank Wall Street Reform and Consumer Protection Act, Commission Staff (Jul. 2011).

45 See Security Ratings, Securities Act Release No. 9186 (Feb. 9, 2011), 76 FR 8961 (Feb. 16, 2011). See also Security Ratings, Securities Act Release No. 9245 (Jul. 27, 2011), 76 FR 46603 (Aug. 3, 2011) (adopting amendments to Rules 134 (17 CFR 230.134), 138 (17 CFR 230.138), 139 (17 CFR 230.139), 168 (17 CFR 230.168), Form S-3 (17 CFR 239.13), Form S-4 (17 CFR 239.25), Form F-3 (17 CFR 239.33), and Form F-4 (17 CFR 230. 34) under the Securities Act, rescinded Form F-9 (17 CFR 239.39) and adopted amendments to the Securities Act and Exchange Act forms and rules that referred to Form F-9 to eliminate those references, and amended Schedule 14A (17 CFR 240.14a-101) under the Exchange Act).

46 See References to Credit Ratings in Certain Investment Company Act Rules and Forms, Securities Act Release No. 9193 (Mar. 3, 2011), 76 FR 12896 (Mar. 9, 2011). In particular, the Commission requested public comment on proposed amendments to rules 2a-7 (17 CFR 270.2a-7) and 5b-3 (17 CFR 270.5b-3) under the Investment Company Act, to Forms N-1A (17 CFR 239.15A and 17 CFR 274.11A), N-2 (17 CFR 239.14 and 17 CFR 274.11a-1) and N-3 (17 CFR 239.17a and 17 CFR 274.11b) under the Investment Company Act and the Securities Act, and Form N-MFP (17 CFR 274.201) under the Investment Company Act.

47 See Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934, 76 FR 26550. In particular, the Commission requested public comment on proposed amendments to Exchange Act Rule 15c3-1 (17 CFR 240.15c3-1), 15c3-3 (17 CFR 240.15c3-3), 17a-4 (17 CFR 240.17a-4), 101 and 102 of Regulation M (17 CFR 242.101 and 242.102), and 10b-10 (17 CFR 240.10b-10), and one Exchange Act form – Form X-17A-5, Part IIB (17 CFR 249.617) – to remove references to credit ratings and, in certain cases, substitute alternative standards of creditworthiness.

purposes of Exchange Act sections 3(a)(41) and 3(a)(53)(A), in order to consider how to implement section 939(e) of the Dodd-Frank Act.[48] Commenters to the various Commission proposals identified above continued to raise concerns about alternatives to NRSRO credit ratings.[49] Other Federal agencies have proposed and, in some cases, adopted amendments to regulations that they administer that contain references to NRSRO credit ratings.[50] Commenters have raised a number of concerns with respect to these proposals.[51]

As noted above, in its April 2011 proposal to amend rules under the Exchange Act, the Commission sought comment on potential standards of creditworthiness for purposes of sections 3(a)(41) and 3(a)(53)(A) of the Exchange Act.[52] One specific alternative that the Commission discussed and requested comment on was whether a more subjective standard of creditworthiness – modeled on the "minimal amount of credit risk" standard proposed with respect to the broker-dealer net capital rule – would be a practical and workable standard of creditworthiness for purposes of the definition of "mortgage related security" in section 3(a)(41) of the Exchange Act

48 Id.

49 See comment letters to the proposals available on the Commission's Internet website at the following addresses: (1) http://www.sec.gov/comments/s7-18-08/s71808.shtml (letters commenting on Security Ratings, 76 FR 8961); (2) http://sec.gov/comments/s7-07-11/s70711.shtml (letters commenting on References to Credit Ratings in Certain Investment Company Act Rules and Forms, 76 FR 12896); and (3) http://sec.gov/comments/s7-15-11/s71511.shtml (letters commenting on Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934, 76 FR 26550). See, e.g., letter dated Apr. 25, 2011 from Dennis M. Kelleher, President & CEO of Better Markets, Inc., commenting on References to Credit Ratings in Certain Investment Company Act Rules and Forms, 76 FR 12896 ("In theory, incorporating alternative standards of credit-worthiness into the Commission's rules can be accomplished in one of two ways: Either incorporating by reference some reliable, external measure of credit-worthiness other than credit ratings, or setting forth in the rules the actual standards of credit-worthiness that market participants must apply...As a practical matter, a reliable and objective shorthand measure of credit risk, which could be incorporated by reference into the Commission's regulations, is not currently available.").

50 See, e.g., Alternatives to the Use of External Credit Ratings in the Regulations of the OCC, Department of the Treasury, Office of the Comptroller of the Currency, 76 FR 73526 (Nov. 29, 2011).

51 See, e.g., comments submitted in response to Alternatives to the Use of External Credit Ratings in the Regulations of the OCC, 76 FR 73526, available at http://www.regulations.gov/#!searchResults;a=OCC;rpp=25;po=0;dktid=OCC-2011-0019.

52 See Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934, 76 FR at 26566.

and "small business related security" in section 3(a)(53)(A) of the Exchange Act.[53] Four comment letters addressed this general request for comment.[54] One commenter suggested that using the same standard of creditworthiness as proposed for the net capital rule would be too subjective and that a more objective standard is needed.[55] According to this commenter, a standard that is too subjective could create uncertainty in the markets, which in turn would reduce liquidity and "limit buyside demand, distribution and secondary trading, thereby further harming the ability of non-Agency securitization to fund mortgage credit."[56] Another commenter stated that using the single standard proposed for the net capital rule – the "minimal amount of credit risk" standard – may not work given that the definition of "mortgage related security" refers to a security that is rated in the two highest categories by an NRSRO and the definition of "small business related security" refers to a security that is rated in the four highest categories.[57] The commenter suggested potential alternative standards based on the characteristics of assets underlying the securities.[58] A third commenter acknowledged the "challenge facing the Commission here is an especially important one, since the alternative

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53 Id.

54 See letter dated Jun. 6, 2011 from Chris Barnard (the "Barnard Letter"); letter dated Jul. 5, 2011 from Dennis M. Kelleher, President & CEO, and Stephen W. Hall, Securities Specialist, Better Markets, Inc. (the "Better Markets Letter"); letter dated Sep. 23, 2011 from Richard A. Dorfman, Managing Director, Head of Securitization, and Christopher B. Killian, Vice President, Securitization Group, Securities Industry and Financial Markets Association (the "SIFMA Letter"); and letter dated Dec. 20, 2011 from Kurt N. Schacht, Managing Director, Standards and Financial Market Integrity, and Linda L. Rittenhouse, Director, Capital Markets Policy, CFA Institute (the "CFA Letter").

55 See the SIFMA Letter.

56 Id.

57 See the CFA Letter.

58 Id. ("With respect to objective measures that could be used to determine whether securities qualify as mortgage-related securities or small business-related securities, we suggest consideration of the following factors: Average loan-to-value for borrowers in secured borrowings; Term to maturity of the security; Regional concentrations of loans within the pools; Loan category concentration of loans within the pools, such as loans secured with either commercial or residential real estate, commercial and industrial loans, or small business credit card loans; Average debt-to-equity ratios for the loan pools supporting small business-related securities; Guarantees for bond guarantors.").

standards of credit-worthiness ultimately adopted will undoubtedly have an impact on a huge number of investors."[59] The commenter supported using the "minimal amount of credit risk" standard provided that an appropriate set of factors were incorporated into the test.[60] The fourth commenter supported the "minimal amount of credit risk" standard without elaboration.[61]

III. SOLICITATION OF COMMENT

The Commission solicits comment on section 939(e) of the Dodd-Frank Act and potential standards of creditworthiness that could be used for the definition of the terms "mortgage related security" in section 3(a)(41) of the Exchange Act and "small business related security" in section 3(a)(53)(A) of the Exchange Act in order to assist the Commission in developing proposed standards of creditworthiness to replace NRSRO credit ratings. The Commission seeks comment from all interested parties, including: (1) persons that are subject to, or rely on, Federal or State statutes and/or regulations that use these definitions; (2) Federal and State agencies that oversee persons that are subject to, or rely on, Federal or State statutes and/or regulations that use these definitions; (3) Federal and State agencies that administer regulations that use these definitions; (4) persons that participate in the markets for mortgage related securities and/or small business related securities, including issuers, underwriters, investors, and NRSROs; (5) originators of mortgages and/or small business loans that are securitized into mortgage related securities and/or small business related securities; and (6) any other interested persons, including persons that will need to rely on the standards of creditworthiness the Commission establishes to replace the use of NRSRO credit ratings.

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59 See the Better Markets Letter.

60 Id.

61 See the Barnard Letter.

The Commission invites commenters to provide their views and recommendations on all aspects of section 939(e) of the Dodd-Frank Act, including identifying approaches for developing new standards and creditworthiness to be used in the definitions and the benefits, costs, and competitive impacts of such approaches. To supplement the April 2011 proposing release and its formal solicitation of comments,[62] the Commission seeks comments on the following questions and topics:

1. To help the Commission obtain relevant market information, commenters are invited to provide data and statistics on the nature of the market for "mortgage related securities" as defined in section 3(a)(41) of the Exchange Act, including the size of the market in terms of the number and aggregate principal amount of issuances per year.
2. To help the Commission obtain relevant market information, commenters are invited to provide data and statistics on the nature of the market for "small business related securities" as defined in section 3(a)(53)(A) of the Exchange Act, including the size of the market in terms of the number and aggregate principal amount of issuances per year.
3. With respect to establishing a standard of creditworthiness to be used in the definition of the term "mortgage related security," would any of the proposals or final rules by the Commission and other Federal agencies under section 939A of the Dodd-Frank Act serve as a model to develop a practical and workable new standard of creditworthiness in section 3(a)(41) of the Exchange Act? If so, identify the proposal and explain how it may accommodate the varied uses of the definition of the term "mortgage related security" in statutes and regulations as well as how it may impact protections for investors, the market for these securities, risk to the financial system, and burdens and costs to market

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62 See Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934, 76 FR 26550.

participants. Are there other approaches that could serve as models for developing a practical and workable new standard of creditworthiness in section 3(a)(41) of the Exchange Act? If so, identify the approach and explain how it would meet the Commission's objective.

4. With respect to establishing a standard of creditworthiness to be used in the definition of "small business related security," would any of the proposals or final rules by the Commission and other Federal agencies under section 939A of the Dodd-Frank Act serve as a model to develop a practical and workable new standard of creditworthiness in section 3(a)(53)(A) of the Exchange Act? If so, identify the proposal and explain how it may accommodate the varied uses of the definition of the term "small business related security" in statutes and regulations as well as how it may impact protections for investors, the market for these securities, risk to the financial system, and burdens and costs to market participants. Are there other approaches that could serve as models for developing a practical and workable new standard of creditworthiness in section 3(a)(53)(A) of the Exchange Act? If so, identify the approach and explain how it would meet the Commission's objective.

5. Should the new standards of creditworthiness in sections 3(a)(41) and 3(a)(53)(A) of the Exchange Act be modeled on Commission proposals under section 939A of the Dodd-Frank Act that would replace the use of NRSRO credit ratings with definitional standards? For example, as discussed above, the Commission proposed to remove references to NRSRO credit ratings in the net capital rule for purposes of determining whether lower haircuts apply to certain debt instruments.[63] In place of credit ratings, the

[63] See Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934, 76 FR at 26552-54.

Commission proposed a new standard of creditworthiness; namely, that the debt instrument has only "a minimal amount of credit risk" as determined by the broker-dealer pursuant to written policies and procedures the broker-dealer establishes, maintains, and enforces to assess creditworthiness. Would such a definitional approach be a practical and workable standard of creditworthiness for sections 3(a)(41) and 3(a)(53)(A) of the Exchange Act? In this regard, the Commission seeks comment in response to the following questions:

a. Would there need to be different creditworthiness definitions for the terms "mortgage related security" and "small business related security" given that the current standard in section 3(a)(41) of the Exchange Act is a security that is rated in one of the two highest rating categories by at least one NRSRO and the current standard in section 3(a)(53)(A) of the Exchange Act is a security that is rated in one of the four highest rating categories by at least one NRSRO? For example, should the standard of creditworthiness for purposes of the definition of the term "mortgage related security" require a more stringent level of creditworthiness than the standard of creditworthiness in the definition of the term "small business related security"? If so, should the Commission use the "minimal amount of credit risk" standard proposed for the net capital rule for a small business related security and a different, more stringent standard of creditworthiness for a mortgage related security?

b. Under the Commission's net capital rule proposal, the broker-dealer holding the security would be required to determine whether the security has a "minimal amount of credit risk." As noted above, the statutes and regulations using the definitions of "mortgage related security" and "small business related security" implicate a range of market participants. Consequently, who could be responsible for making the determination that a security meets the definitional creditworthiness standard used for purposes of sections 3(a)(41) and 3(a)(53)(A) of the Exchange Act? For example, could the issuer or underwriter represent that the security meets the definitional standard? If so, should the representation be made as of a point in time (e.g., at or before issuance of the security) and/or would it need to be updated throughout the term of the debt security? Alternatively, if the investor in the security is subject to oversight and inspection by a Federal or State agency, could the investor be required to make the determination (subject to review by the agency) as to whether the security meets the definitional standard of creditworthiness in order to obtain favorable treatment under an applicable statute or regulation using the definition of "mortgage related security" or "small business related security"? Could the issuer or underwriter be required to make the representation that the security meets the definitional standard at issuance and, thereafter, the investor be responsible for determining on an on-going basis whether the security continues to meet the definitional standard? Issuers, underwriters, and investors may have incentives to determine that a security meets the definitional standard in order to get favorable treatment under statutes and regulations using the terms "mortgage related security" or "small business related security." Given this potential conflict, could a third-party be required to verify that the security meets the definitional standard? If so, what type of entity could perform the verification and who would be responsible for compensating the third-party for this work?

c. The following examples of different possible definitional standards are designed to provide context to assist commenters in responding to the questions above:

Mortgage Related Security

Example 1

For purposes of section 3(a)(41) of the Act (15 U.S.C. 78c(a)(41)), a "mortgage related security" means a security that has virtually no credit risk, including virtually no vulnerability to changes in business or economic circumstances.

Example 2

For purposes of section 3(a)(41) of the Act (15 U.S.C. 78c(a)(41)), a "mortgage related security" means a security that the issuer or underwriter of the security represents has virtually no credit risk, including virtually no vulnerability to changes in business or economic circumstances.

Example 3

For purposes of section 3(a)(41) of the Act (15 U.S.C. 78c(a)(41)), a "mortgage related security" means a security that the issuer or underwriter of the security represents at the time of issuance has virtually no credit risk, including virtually no vulnerability to changes in business or economic circumstances, and thereafter has virtually no credit risk, including virtually no vulnerability to changes in business or economic circumstances.

Example 4

For purposes of section 3(a)(41) of the Act (15 U.S.C. 78c(a)(41)), a "mortgage related security" means a security that the issuer or underwriter of the security represents has virtually no credit risk, including virtually no vulnerability to changes in business or economic circumstances. The representation of the issuer or underwriter must be verified by an independent third party that is in the business of performing credit analysis.

Small Business Related Security

Example 1

For purposes of section 3(a)(53)(A) of the Act (15 U.S.C. 78c(a)(53)), a "small business related security" means a security that has only a minimal amount of credit risk.

Example 2

For purposes of section 3(a)(53)(A) of the Act (15 U.S.C. 78c(a)(53)), a "small business related security" means a security that the issuer or underwriter of the security represents has only a minimal amount of credit risk.

Example 3

For purposes of section 3(a)(53)(A) of the Act (15 U.S.C. 78c(a)(53)), a "small business related security" means a security that the issuer or underwriter of the security represents at the time of issuance has only a minimal amount of credit risk and thereafter has only a minimal amount of credit risk.

Example 4

For purposes of section 3(a)(53)(A) of the Act (15 U.S.C. 78c(a)(53)), a "small business related security" means a security that the issuer or underwriter of the security represents has only a minimal amount of credit risk. The representation of the issuer or underwriter must be verified by an independent third party that is in the business of performing credit analysis.

d. Provide additional examples of definitions that could be used as standards of creditworthiness. For any example provided, explain why it would be a practical and workable standard for purposes of the definitions of mortgage related security and small business related security.

6. Rather than using a definitional standard, could the new standards of creditworthiness in sections 3(a)(41) and 3(a)(53)(A) of the Exchange Act be based on objective criteria? For example, could the criteria be based on structural characteristics of securities that meet the current definitions of the terms "mortgage related security" and "small business related security" such as the features, underlying asset pool quality, and the performance

of the underlying assets after issuance that are typical of such securities? If so, what characteristics could be used to develop the criteria? In this regard, the Commission seeks comment in response to the following questions:

a. What are the typical features of mortgage related securities that meet the current standard of creditworthiness in section 3(a)(41) of the Exchange Act (i.e., rated in the top two rating categories by at least one NRSRO)?

b. What are the characteristics of the loans underlying mortgage related securities that meet the current standard of creditworthiness in section 3(a)(41) of the Exchange Act (i.e., rated in the top two rating categories by at least one NRSRO)? Would the characteristics of a "qualified mortgage," as that term is defined under the Truth in Lending Act section 129C(b)(2), meet the current standard of creditworthiness in section 3(a)(41)? Could the criteria for a mortgage related security be tied to that definition? Could the criteria be tied to the definition of a "qualified residential mortgage," as is used in section 15G of the Exchange Act?[64] If so, explain how.

c. What is typical of the level of performance of the loans underlying mortgage related securities that meet the current standard of creditworthiness in section 3(a)(41) of the Exchange Act (i.e., rated in the top two rating categories by at least one NRSRO)?

d. What are the typical features of small business related securities that meet the current standard of creditworthiness in section 3(a)(53)(A) of the Exchange Act (i.e., rated in the top four rating categories by at least one NRSRO)?

64 On April 29, 2011, the Commission, together with the Office of Comptroller of the Currency, Treasury, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Department of Housing and Urban Development, published a joint notice of public comment to implement the risk retention requirements of Section 15G, including the proposed requirements for a qualified residential mortgage. See Credit Risk Retention, Exchange Act Release No. 64148 (Mar. 30, 2011), 76 FR 24090 (Apr. 29, 2011). The proposed definition has been the subject of significant comment.

e. What are the characteristics of the loans underlying small business related securities that meet the current standard of creditworthiness in section 3(a)(53)(A) of the Exchange Act (i.e., rated in the top four rating categories by at least one NRSRO)?

f. What is typical of the level of performance of the loans underlying small business related securities that meet the current standard of creditworthiness in section 3(a)(53)(A) of the Exchange Act (i.e., rated in the top four rating categories by at least one NRSRO)?

7. Could the requirements of Regulation AB or the proposed shelf eligibility requirements described below serve, in whole or in part, as a standard for creditworthiness for a mortgage related security? In 2010, the Commission proposed to eliminate the provision for shelf eligibility for mortgage related securities regardless of the form that can be used for registration of the securities.[65] Under the proposal, offerings of mortgage related securities would only be eligible for shelf registration on a delayed basis if, like other asset-backed securities, they meet the proposed criteria for eligibility for shelf registration that would be contained in new proposed Form SF-3. Note that the proposed requirements for shelf eligibility would replace, in part, the requirement that the securities be investment grade rated.[66] Could the standards distinguish between issuers that meet the shelf eligibility requirements and those that do not? If so, why and how should the conditions differ? Could we require that a mortgage related security be

65 See Asset-Backed Securities, Securities Act Release No. 9117 (Apr. 7, 2010), 75 FR 23328 (May 3, 2010).

66 In July 2011, in light of the Dodd-Frank Act and comments received, the Commission re-proposed the shelf eligibility requirements that would replace the investment grade ratings criteria. See Re-proposal of Shelf Eligibility Conditions for Asset-Backed Securities and Other Additional Requests for Comment, Release No. 33-9244 (Jul. 26, 2011), 76 FR 47948 (Aug. 5, 2011).

required to be registered on existing Form S-3 or, if adopted, Form SF-3? Commentators should be specific in their responses and provide data and statistics, if possible.

IV. CONCLUSION

For the foregoing reasons, the Commission is providing a transitional interpretation that will be applicable on and after July 20, 2012, and until such time as final Commission rules establishing new standards of creditworthiness are effective. The Commission's interpretation herein does not address any other provisions of the definitions of "mortgage related security" or "small business related security" in sections 3(a)(41) and 3(a)(53)(A) of the Exchange Act, respectively.

List of Subjects

17 CFR Part 241

Securities.

Amendment to the Code of Federal Regulations

For the reasons set forth above, the Commission is amending title 17, chapter II of the Code of Federal Regulations as set forth below:

PART 241 - INTERPRETIVE RELEASES RELATING TO THE SECURITIES EXCHANGE ACT OF 1934 AND GENERAL RULES AND REGULATIONS THEREUNDER

Part 241 is amended by adding Release No. 34-67448 to the list of interpretive releases as follows:

Subject	**Release No.**	**Date**	**Fed. Reg. Vol. .and Page**
Commission Guidance Regarding Definitions of Mortgage Related Security and Small Business Related Security	34-67448	July 17, 2012	75 FR [INSERT FR PAGE NUMBER]

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Dated: July 17, 2012

Commissioner Aguilar
Commissioner Gallagher
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 67454 / July 18, 2012

INVESTMENT ADVISERS ACT OF 1940
Release No. 3433 / July 18, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14951

In the Matter of **Kimon P. Daifotis,** **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 Kimon P. Daifotis ("Respondent" or "Daifotis").

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. Daifotis was Chief Investment Officer for Fixed Income of Charles Schwab Investment Management ("CSIM") until his position was eliminated in July 2008. He was also an officer of Schwab Investments, Senior Vice President of CSIM, and oversaw the portfolio management of the Schwab YieldPlus Fund ("YieldPlus"). Daifotis was an employee of CS&Co. and performed services for CSIM. Daifotis was listed on CRD as associated with CS&Co. Daifotis currently remains unemployed. He has Series 3, 7 and 63 licenses. Daifotis, 52 years old, is a resident of Corte Madera, California.

2. On July 17, 2012, a final judgment was entered by consent against Daifotis, permanently enjoining him from future violations of Section 17(a)(2) of the Securities Act of 1933, and Section 34(b) of the Investment Company Act of 1940, in the civil action entitled Securities and Exchange Commission v. Daifotis, et al., Civil Action Number 3:11-CV-0137, in the United States District Court for the Northern District of California.

3. The Commission's complaint alleged that Daifotis committed securities law violations in connection with the offer, sale and management of YieldPlus. According to the complaint, Daifotis misled or failed to adequately inform investors about the risks of investing in YieldPlus. The complaint also charged that Daifotis misleadingly described YieldPlus as only slightly riskier than a money market fund, falsely claimed that the Fund primarily held very short maturity bonds, misleadingly failed to disclose YieldPlus's substantial holdings of securities backed by "Alt-A" mortgages, and falsely stated that the level of redemptions that the Fund was experiencing were "very, very, very slight" or otherwise minimal in mid-August 2007.

IV.

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

Accordingly, it is hereby ORDERED pursuant to Section 15(b)(6) of the Exchange Act and Section 203(f) of the Advisers Act that Respondent Daifotis 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

barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock, with the right to apply for reentry after three (3) years to the appropriate self-regulatory organization, or if there is none, to the Commission.

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 67460 / July 18, 2012

INVESTMENT ADVISERS ACT OF 1940
Release No. 3435 / July 18, 2012

INVESTMENT COMPANY ACT OF 1940
Release No. 30142 / July 18, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14955

In the Matter of **Noonan Capital Management, LLC and Timothy George Noonan,** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, SECTIONS 203(e), 203(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940 AND NOTICE OF HEARING**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act"), and Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act") against Noonan Capital Management, LLC ("Noonan Capital") and Timothy George Noonan ("Noonan") (collectively "Respondents").

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Noonan Capital, LLC is a Commission-registered and Georgia-based investment adviser. Noonan Capital has been operating since in or about February 2009 and has been registered with the Commission since March 2009. While Noonan Capital represented in its initial Form ADV (filed on February 27, 2009) and in its most recently amended Form ADV (filed on July 13, 2009) that it was a Georgia limited liability company, it did not and has not taken the necessary legal steps required to become such an entity. In its July 13, 2009 amended Form ADV, Noonan Capital also represented that it provided advisory services to twenty-three accounts with $39.4 million in assets under management ("AUM"). Noonan Capital's client accounts were custodied at Charles Schwab and Co. ("Schwab") from the time Noonan Capital first began operations to in or about early 2011.

2. Timothy George Noonan, age 53, has been, for all relevant times, the sole owner, chief compliance officer, manager and employee of Noonan Capital. Although now expired, Noonan formerly held the securities licenses Series 7 and Series 66. From January 2002 until February 2009, Noonan was a registered representative with Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch"). Prior to working at Merrill Lynch, Noonan was in sales and business development, primarily in the technology staffing sector. Noonan has no prior regulatory disciplinary history.

B. NOONAN CAPITAL MISAPPROPRIATED CLIENT ASSETS BY CHARGING EXCESSIVE "ADVISORY FEES"

1. In Noonan Capital's Form ADV, Part 2, Fee Schedule filed with the Commission on March 9, 2009 and, then again, on March 12, 2009 ("Fee Schedule"), Noonan Capital represented that its advisory fees from its clients' accounts were to be payable quarterly and in advance based on the value of the accounts' portfolio on the last business day of the prior quarter. Those advisory fees were to be calculated as a percentage of the AUM in the clients' accounts as follows:

First $250,000:	1.5% per year
Next $250,000:	1.25% per year
Next $500,000:	1% per year

2. Although Noonan Capital and Noonan did not provide Part 2 of the Forms ADV to clients, Noonan Capital and Noonan represented to clients that they would be charged advisory fees at the rates set forth in those filings. Additionally, Noonan Capital and Noonan represented to and agreed with one of Noonan Capital's largest clients – who had accounts containing approximately $1 million in AUM – that Noonan Capital would not charge **any** advisory fees until that client's accounts grew by approximately 50%, an event that never occurred.

3. Based on the Fee Schedule and/or Noonan's oral representations to clients, Noonan Capital should have charged the twenty-two clients a total of $92,212

between April 2009 and January 2011. Instead, Noonan Capital and Noonan charged these clients advisory fees totaling $183,908, resulting in total overcharges of approximately $91,696 in advisory fees.

4. In at least some client accounts, Noonan Capital and Noonan's improper fee requests resulted in the sale of money market funds to satisfy their requests.

5. As a result of these misappropriations, on an annualized basis, some clients paid "fees" of up to 7%, which was far in excess of the 1.0 to 1.5% they should have been charged.

C. NOONAN CAPITAL AND NOONAN MISREPRESENTED NOONAN CAPITAL'S ASSETS UNDER MANAGEMENT AND FAILED TO WITHDRAW ITS REGISTRATION FROM THE COMMISSION

1. Noonan Capital and Noonan repeatedly misrepresented Noonan Capital's AUM in the Forms ADV filed with the Commission. In its initial Form ADV filed with the Commission on February 27, 2009, Noonan Capital invoked Rule 203A-2(d), a registration prohibition exemption, thereby effectively representing that the firm expected to have $25 million in assets under management within 120 days. On March 12, 2009, Noonan Capital filed an amended Form ADV again representing that the firm expected to have $25 million in assets under management. And, on July 13, 2009, Noonan Capital filed an amended Form ADV in which the firm claimed that it was eligible to remain registered with the Commission because it had $39.4 million in assets under management, comprised of $9.4 million in twenty-two discretionary accounts and $30 million in one non-discretionary account.

2. In fact, Noonan Capital never had more than approximately $9 million in AUM. Noonan Capital's and Noonan's representations concerning its AUM in its July 2009 Form ADV were false at the time it was submitted.

3. At no time did Noonan Capital file any amendment to its Form ADV reflecting a corrected AUM of under $25 million or seek to withdraw from registration. Noonan Capital further failed to file its required annual amendments to its Form ADV for the fiscal years ending December 31, 2009, 2010, and 2011.

D. NOONAN CAPITAL FAILED TO CREATE OR MAINTAIN PROPER BOOKS AND RECORDS AND FAILED TO PROVIDE A BROCHURE OR PART 2 OF ITS FORM ADV TO ITS CLIENTS

1. Noonan Capital did not create or maintain required balance sheets, income statements, and supporting documents as required under certain rules of the Advisers Act.

2. Neither Noonan Capital nor Noonan ever provided to any client Part 2 of Form ADV or any brochure containing the information required by Part 2.

E. VIOLATIONS

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

2. As a result of the conduct described above, Noonan Capital and Noonan willfully violated Sections 206(1) and 206(2) of the Advisers Act, which prohibit fraudulent conduct by an investment adviser.

3. As a result of the conduct described above, Noonan Capital willfully violated, and Noonan willfully aided and abetted and caused Noonan Capital's violation of Section 203A, which, during the relevant time, generally prohibited an adviser regulated or required to be regulated in the state in which it had its principal office and place of business from registering with the Commission, unless it had assets under management in excess of $25 million or advised a registered investment company.

4. As a result of the conduct described above, Noonan Capital and Noonan 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."

5. As a result of the conduct described above, Noonan Capital willfully violated, and Noonan willfully aided and abetted and caused Noonan Capital's violation of Section 204 of the Advisers Act and Rules 204-1(a), 204-2(a)(6), 204-3(a), and 204-3(b)(1) and (2) thereunder. Section 204 of the Advisers Act requires every registered investment adviser to make and keep "such reports as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors." Such records are subject to periodic examinations by the Commission. Rule 204-1(a) promulgated thereunder requires registered investment advisers to amend their Form ADV "at least annually, within 90 days of the end of [its] fiscal year . . . [or] more frequently, if required by the instructions to Form ADV." Rule 204-2(a)(6) promulgated thereunder requires registered investment advisers to make and keep true, accurate, and current certain books and records relating to its investment advisory business, including, trial balances, financial statements, and internal audit working papers relating to the business of the investment adviser. Rules 204-3(a), and 204-3(b)(1) and (2) promulgated thereunder requires registered investment advisers to deliver a brochure to each client or prospective client that contains all information required by Part 2 of Form ADV.

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 Noonan Capital pursuant to Section 203(e) of the Advisers Act including, but not limited to, disgorgement and civil penalties pursuant to Section 203 of the Advisers Act;

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

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

E. Whether, pursuant to Section 21C of the Exchange Act and Section 203(k) of the Advisers Act, Noonan Capital and Noonan should be ordered to cease and desist from committing or causing violations of and any future violations of Sections 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 203A, 204, 206(1), 206(2), and 207 of the Advisers Act and Rules 204-1, 204-2, 204-3(a), 204-3(b)(1) and (2) thereunder, whether Noonan Capital and Noonan should be ordered to pay a civil penalty pursuant to Section 21B(a) of the Exchange Act, Section 203(i) of the Advisers Act, and Section 9(d) of the Investment Company Act; and whether Noonan Capital and Noonan should be ordered to pay disgorgement pursuant to Section 21C(e) of the Exchange Act, Section 203 of the Advisers Act, and Section 9 of the Investment Company 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

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Walter
Commissioner Aguilar
Disapproved

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 242

[Release No. 34-67457; File No. S7-11-10]

RIN 3235-AK51

Consolidated Audit Trail

AGENCY: Securities and Exchange Commission

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission ("Commission") is adopting Rule 613 under the Securities Exchange Act of 1934 ("Exchange Act" or "Act") to require national securities exchanges and national securities associations ("self-regulatory organizations" or "SROs") to submit a national market system ("NMS") plan to create, implement, and maintain a consolidated order tracking system, or consolidated audit trail, with respect to the trading of NMS securities, that would capture customer and order event information for orders in NMS securities, across all markets, from the time of order inception through routing, cancellation, modification, or execution.

EFFECTIVE DATE: [insert date 60 days from publication in the Federal Register]

FOR FURTHER INFORMATION CONTACT: Rebekah Liu, Special Counsel, at (202) 551-5665; Jennifer Colihan, Special Counsel, at (202) 551-5642; Carl Tugberk, Special Counsel, at (202) 551-6049; or Leigh Duffy, Special Counsel, at (202) 551-5928, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-7010.

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I. Executive Summary

In today's high-speed electronic markets, trading is widely dispersed across a variety of market centers, including exchanges, alternative trading systems ("ATSs"), such as dark pools and electronic communication networks ("ECNs"), and over-the-counter broker-dealers acting as market makers or block positioners. In their capacity as SROs, the Financial Industry Regulatory Authority ("FINRA") and some of the exchanges currently maintain their own separate audit trail systems for certain segments of this trading activity, which vary in scope, required data elements and format. In performing their market oversight responsibilities, SRO and Commission staffs today must rely heavily on data from these various SRO audit trails.

As discussed more fully in part II.A below, there are shortcomings in the completeness, accuracy, accessibility, and timeliness of these existing audit trail systems. Some of these shortcomings are a result of the disparate nature of the systems, which make it impractical, for example, to follow orders through their entire lifecycle as they may be routed, aggregated, re-routed, and disaggregated across multiple markets. The lack of key information in the audit trails that would be useful for regulatory oversight, such as the identity of the customers who originate orders, or even the fact that two sets of orders may have been originated by the same customer, is another shortcoming.

Though SRO and Commission staff also have access to sources of market activity data other than SRO audit trails, these systems each suffer their own drawbacks. For example, data obtained from the electronic blue sheet ("EBS")[1] system and equity cleared reports[2] comprise only trade executions, and not orders or quotes. In addition, like data from existing audit trails, data from these sources lacks key elements important to regulators, such as the time of execution, and, in the case of equity cleared reports, the identity of the customer. Furthermore,

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1 EBSs are trading records requested by the Commission and SROs from broker-dealers that are used in regulatory investigations to identify buyers and sellers of specific securities. See Securities Exchange Act Release No. 44494 (June 29, 2001), 66 FR 35836 (July 9, 2001) (File No. S7-12-00) (adopting Rule 17a-25). See also Securities Exchange Act Release Nos. 26235 (November 1, 1988), 53 FR 44688 (November 4, 1988) (approving the Chicago Board Options Exchange's ("CBOE") rule for the electronic submission of transaction information); 26539 (February 13, 1989), 54 FR 7318 (February 17, 1989) (approving the National Association of Securities Dealers' (n/k/a FINRA) rule for the electronic submission of transaction information); and 27170 (August 23, 1989), 54 FR 37066 (September 6, 1989) (approving the Philadelphia Stock Exchange's (n/k/a NASDAQ OMX PHLX LLC) ("Phlx") rule for the electronic submission of transaction information).

To partially address some of the current limitations of the EBS system, and to provide the Commission, in the short term, with more detailed and timely trade information for large traders, the Commission recently adopted new Rule 13h-1 concerning large trader reporting. See Securities Exchange Act Release No. 61908 (July 27, 2011), 76 FR 46960 (August 3, 2011) ("Large Trader Release"). Rule 13h-1 requires "large traders" to identify themselves to the Commission and make certain disclosures to the Commission on Form 13H. As adopted, Rule 13h-1 requires certain broker-dealers to capture and report through EBS the time of execution for any trade involving a large trader and a Commission-issued large trader identifier that identifies the large trader. See also Section II.A.3., infra.

On April 20, 2012, the Commission, among other things, extended the time by which registered broker-dealers were required to comply with Rule 13h-1 to allow broker-dealers additional time to develop, test, and implement enhancements to their recordkeeping and reporting systems as required under Rule 13h-1. See Securities Exchange Act Release No. 66839, 77 FR 25007 (April 26, 2012) (Order Temporarily Exempting Broker-Dealers From the Recordkeeping, Reporting, and Monitoring Requirements of Rule 13h-1 Under the Securities Exchange Act of 1934 and Granting an Exemption for Certain Securities Transactions) ("Large Trader Extension").

2 The Commission uses the National Securities Clearing Corporation's ("NSCC") equity cleared report for initial regulatory inquiries. This report is generated on a daily basis by the SROs and is provided to the NSCC in a database accessible by the Commission, and shows the number of trades and daily volume of all equity securities in which transactions took place, sorted by clearing member. The information provided is end-of-day data and is searchable by security name and CUSIP number.

recent experience with implementing incremental improvements to the EBS system has illustrated some of the overall limitations of the current technologies and mechanisms used by the industry to collect, record, and make available market activity data for regulatory purposes.[3]

The Commission therefore believes that the regulatory data infrastructure on which the SROs and the Commission currently must rely generally is outdated and inadequate to effectively oversee a complex, dispersed, and highly automated national market system. In performing their oversight responsibilities, regulators today must attempt to cobble together disparate data from a variety of existing information systems lacking in completeness, accuracy, accessibility, and/or timeliness – a model that neither supports the efficient aggregation of data from multiple trading venues nor yields the type of complete and accurate market activity data needed for robust market oversight.

To address this problem and improve the ability of the SROs and the Commission to oversee the securities markets, on May 26, 2010, the Commission proposed Rule 613,[4] with the goal of creating a comprehensive consolidated audit trail[5] that allows regulators to efficiently and accurately track all activity in NMS securities throughout the U.S. markets. As proposed – and summarized in part II.B below – Rule 613 required SROs to jointly submit an NMS plan[6] that

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3 See Large Trader Extension, supra note 1.

4 See Securities Exchange Act Release No. 62174 (May 26, 2010), 75 FR 32556 (June 8, 2010) ("Proposing Release"). The comment file is on the Commission's website at: http://www.sec.gov/comments/s7-11-10/s71110.shtml.

5 In this release, "consolidated audit trail" means both a system capable of capturing a complete record of all transactions relating to an order, from origination to execution or cancellation, and the complete record for an order generated by such a system, as the context may require.

6 NMS plan is defined in Rule 600(b)(43) to mean "any joint self-regulatory organization plan in connection with: (i) [t]he planning, development, operation or regulation of a national market system (or a subsystem thereof) or one or more facilities thereof; or (ii) [t]he development and implementation of procedures and/or facilities designed to achieve

would govern the creation, implementation, and maintenance of a consolidated audit trail, including a central repository to receive and store consolidated audit trail data. In the proposed Rule, the Commission specified many requirements that the NMS plan, and by extension the consolidated audit trail, must meet, ranging from details of the data elements to be collected, to the timing of data transmissions, to specific standards for data formatting.

Among its various requirements, the proposed Rule mandated that the NMS plan developed by the SROs must in turn require each SRO and its members to capture and report specified trade, quote, and order activity in all NMS securities[7] to the central repository in real time, across all markets, from order inception through routing, cancellation, modification, and execution. The proposed Rule also mandated that the NMS plan require the creation of unique order identifiers to facilitate the ability of regulators to view cross-market activity, as well as unique customer identifiers to enhance the ability of regulators to reliably and efficiently identify the beneficial owner of the account originating an order or the person exercising investment discretion for the account originating the order, if different from the beneficial owner.

The Commission received 64 comment letters from 56 commenters in response to the proposed consolidated audit trail representing a wide range of viewpoints, as summarized in part

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compliance by self-regulatory organizations and their members with any section of [Regulation NMS] . . . ." 17 CFR 240.600(b)(43). Such NMS plan may be subject to modification prior to approval by the Commission pursuant to Rule 608 of Regulation NMS, as discussed in Section III.C.2.a.v., infra.

7 "NMS security" is defined in Rule 600(a)(46) of Regulation NMS to mean "any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options." 17 CFR 242.600(a)(46). NMS stock is defined in Rule 600(47) to mean "any NMS security other than an option." 17 CFR 242.600(a)(46). A listed option is defined in Rule 600(a)(35) of Regulation NMS to mean "any option traded on a registered national securities exchange or automated facility of a national securities association." 17 CFR 242.600(a)(35).

II.C below.[8] The commenters included national securities exchanges, a national securities association, technology providers, academics, broker-dealers, organizations representing industry participants, individual investors, and members of Congress.[9] Of the comment letters received, 13 expressed support for the proposal;[10] 36 expressed support, but suggested modifications to certain provisions of the proposal;[11] five solely suggested modifications to the proposal;[12] two opposed the proposal;[13] and seven neither supported nor opposed the substance of the proposal.[14] Concerns raised in these comment letters included: (1) the appropriateness of real-time reporting of required data to the central repository;[15] (2) the scope of the required data elements, including

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8 See Exhibit A for a citation key to the comment letters received by the Commission on the proposed rule. The Commission also received four comment letters that do not address the substance of the consolidated audit trail proposal. See Ericson Letter; Kondracki Letter; Grady Letter; Deep Liquidity Letter.

9 The Commission notes that, in some cases, commenters fell into more than one such category.

10 See Vannelli Letter; Beach Letter; Foothill Letter; Green Letter; Wealth Management Letter; McCrary Letter; Anastasopoulos Letter; Triage Letter; FTEN Letter; Middle Office Letter; Correlix Letter; Lettieri Letter; Bean Letter.

11 See ICI Letter; Thomson Reuters Letter; Scottrade Letter; Liquidnet Letter; FINRA/NYSE Euronext Letter; BOX Letter; Nasdaq Letter I; Nasdaq Letter II; TIAA-CREF Letter; GETCO Letter; BATS Letter; SIFMA Letter; SIFMA February 2012 Letter; CBOE Letter; Direct Edge Letter; Angel Letter; IAG Letter; Managed Funds Association Letter; Mansfield Letter; Marketcore Letter; Kumaraguru Letter; Ameritrade Letter; FINRA Letter; Wells Fargo Letter; Noetic Partners Letters; Knight Letter; FIF Letter; FIF Letter II; Albany Letter; Endace Letter; Ross Letter; FINRA Proposal Letter; Schumer Letter; FIA Letter; STA Letter; Van Bokkelen Letter.

12 See Belanger Letters; SIFMA Drop Copy Letter; Wachtel Letter; High Speed Letter (recommending next steps in the development of the consolidated audit trail).

13 See BondMart Letter; Leuchtkafter Letter.

14 See Broadridge Letter; FIX Letter; Know More Letter; Aditat Letter; iSys Letter; Kaufman Letter; Berkeley Letter.

15 See Scottrade Letter, p. 1; ICI Letter, p. 4-6; FINRA/NYSE Euronext Letter, p. 4; GETCO Letter, p. 2; BATS Letter, p. 1-2; SIFMA Letter, p. 3-8; SIFMA February 2012 Letter, p. 1; CBOE Letter, p. 4-5; Direct Edge Letter, p. 3; FINRA Letter, p. 10-13; Wells Fargo Letter, p. 3; Knight Letter, p. 2-3; Leuchtkafer Letter; Broadridge Letter, p. 3; FIF

the use of unique order identifiers and unique customer identifiers;[16] and (3) the burden and costs associated with the proposal.[17] In addition, a number of commenters offered alternative approaches and made suggestions regarding the creation, implementation, and maintenance of the consolidated audit trail.[18]

In consideration of the views expressed, suggestions for alternatives, and other information provided by those commenting on the proposed Rule, the Commission is adopting Rule 613 with significant modifications to the proposed requirements for the NMS plan submitted to the Commission for its consideration. In certain instances these modifications alter the data and collection requirements of the proposed Rule. In other instances, the adopted Rule has been altered to be less prescriptive, and hence less limiting, in the means SROs may use to meet certain requirements. Some of the more significant changes are as follows:

Letter, p. 4; SIFMA Drop Copy Letter, p. 1; Ross Letter, p. 1; FINRA Proposal Letter, p. 3; FIA Letter, p. 1-2.

16 See Ameritrade Letter, p. 3; Kumaraguru Letter, p. 1; FINRA Proposal Letter, p. 6-8, 13 and Appendix A.; Angel Letter, p. 2-3; Managed Funds Association Letter, p. 2; SIFMA Letter, p. 11-12, 14; SIFMA Drop Copy Letter, p. 2; Liquidnet Letter p. 6-7; FINRA Letter, p. 4, 7-9; CBOE Letter, p. 2; Knight Letter, p. 2; Scottrade Letter, p. 1; DirectEdge Letter, p. 3; FIF Letter, p. 2-3, 6-7; FIF Letter II, p. 2; BOX Letter, p. 2; Wells Fargo Letter, p. 3; Ross Letter, p. 1; ICI Letter, p. 3; Thomson Reuters Letter, p. 3; Endace Letter, p. 1-2; GETCO Letter, p. 4.

17 See Thomson Reuters Letter, p. 2; Liquidnet Letter, p. 1; CBOE Letter, p. 2, 4-5; Nasdaq Letter I, p. 2; Angel Letter, p. 1-2; IAG Letter, p. 3.; Kaufman Letter, attachment p. 3; Wells Fargo Letter, p. 3-4; Noetic Partners Letter, p. 2; Leuchtkafer Letter, p. 1-5; Broadridge Letter, p. 3; FINRA Proposal Letter, p. 2-3.; High Speed Letter, p. 1; Belanger Letter, p. 7-8; Correlix Letter, p. 2.; FTEN Letter, p. 13; SIFMA Letter, p.1-8, 15-16; FINRA/NYSE Euronext Letter, p 4, 7; FINRA Letter, p. 3, 10-13; Scottrade Letter, p. 1; ICI Letter, p. 4-6; GETCO Letter, p. 2; BATS Letter, p. 1-2; Direct Edge Letter, p. 3; Knight Letter, p. 2-3; Leuchtkafer Letter; Broadridge Letter, p. 3; FIF Letter, p. 4; SIFMA Drop Copy Letter, p. 1; Ross Letter, p. 1; SIFMA February 2012 Letter; FIA Letter, p. 1-2; Noetic Partners Letter II, p. 2; High Speed Letter, p. 1.

18 See FINRA Proposal Letter; Angel Letter, p. 3; BOX Letter, p. 2; BATS Letter, p. 2; CBOE Letter, p. 2-3; SIFMA Letter, p. 16-18; Wells Fargo Letter, p. 2; Knight Letter, p. 3; FIF Letter, p. 5-6; Schumer Letter, p. 1; FIF Letter, p. 1-3; FINRA Letter, p. 3, 6; FINRA/NYSE Euronext Letter, p. 8, 14; SIFMA Drop Copy Letter.

- Replacing Real-Time Reporting with a Requirement to Report Data by 8:00 AM of the Next Trading Day. The adopted Rule no longer requires that the NMS plan provide for the reporting of order event data[19] to the central repository in real time; rather, it provides that the NMS plan must require the reporting of order event data to the central repository by 8:00 a.m. Eastern Time on the trading day following the day such information has been recorded by the SRO or the member.[20] The NMS plan may accommodate voluntary submissions of order event data prior to 8:00 a.m. on the following trading day, but it may not mandate a reporting deadline prior to 8:00 a.m.

- Providing More Flexibility to Determine the Format of Data Reported to the Central Repository. The proposed Rule mandated that the NMS plan require the SROs and their members to collect and provide to the central repository the required order and event information in a uniform electronic format. The adopted Rule instead allows the SROs to determine the details of how market participants would transmit data to the central

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19 As used herein, the term "order event data" is used to refer to the information reported pursuant to Rule 613(c)(3) and identified in Rule 613(c)(7)(i) through (v), generally including: (1) the Customer-ID(s) for each customer, including the person giving a modification or cancellation instruction; (2) the CAT-Order-ID; (3) the CAT-Reporter-ID of the broker-dealer, national securities exchange, or national securities association receiving, originating, routing, modifying, cancelling or executing an order, and to which an order is being routed; (4) the identity and nature of the department or desk to which an order is routed, if routed internally at the broker-dealer; (5) the date an order was received, originated, routed, modified, cancelled, or executed; (6) the time an order was received, originated, routed, modified, cancelled, or executed; (7) material terms of an order and any changes of such terms, if modified; (8) the price and remaining size of an order, if modified; (9) execution capacity (principal, agency, riskless principal); (10) execution price and size; and (11) whether the execution was reported pursuant to an effective transaction reporting plan or the Plan for Reporting of Consolidated Options Last Sale Reports and Quotation Information ("OPRA"). See Section III.B.1.d., infra. Information reported pursuant to Rule 613(c)(4) and identified in Rule 613(c)(7)(vi) through (viii) is referred to as "supplemental data."

20 See Rule 613(c)(3); Sections II.A., III.B.1.e., infra.

repository (which might include multiple electronic formats, rather than a uniform electronic format), subject to a more general requirement that data must be transmitted in a manner that ultimately allows the central repository to make this data available to regulators in a uniform electronic format.[21]

- Eliminating the Requirement to Report Orders with a Unique Order Identifier. The proposed Rule mandated that each order reported to the central repository be tagged with a unique identifier that is the same throughout the order's entire lifecycle. In the adopted Rule, this requirement is replaced with a more general requirement that once all order events are transmitted to the central repository, the repository must be able to efficiently and accurately link together all lifecycle events for the same order, and make available to regulators this linked order data.[22]
- Extending the Compliance Period for Small Broker-Dealers. Under the adopted Rule, the NMS plan may provide that small broker-dealers be allowed up to three years, rather than two years as proposed, from the effectiveness of the NMS plan to provide the required data to the consolidated audit trail.[23]

In addition to the above modifications, the Commission has also added a number of new requirements to the adopted Rule in response to general concerns expressed by commenters regarding the process for the development and implementation of the NMS plan. Some of the more significant of these additions are as follows:

- Considering and Explaining Choices and Available Alternatives. The adopted Rule requires that the NMS plan describe and discuss any reasonable alternative approaches to

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21 See Rule 613(c)(2); Sections III.B.1.f., III.B.2., infra.

22 See Rule 613(j)(1); Section III.B.1.d.iv., infra.

23 See Rule 613(a)(3)(vi); Section III.B.1.c., infra.

the creation of the consolidated audit trail that were considered by the SROs and why the approach set forth by the NMS plan was selected.[24]

- Planning for Future System Efficiencies. The adopted Rule requires that the NMS plan provide a plan to eliminate existing rules and systems (or components thereof) that are rendered duplicative by the consolidated audit trail, including identification of such rules and systems (or components thereof). Further, to the extent that any existing rules or systems related to monitoring quotes, orders, and executions provide information that is not rendered duplicative by the consolidated audit trail, such plan must also include an analysis of (1) whether the collection of such information remains appropriate, (2) if still appropriate, whether such information should continue to be separately collected or should instead be incorporated into the consolidated audit trail, and (3) if no longer appropriate, how the collection of such information could be efficiently terminated. Finally, such plan must also discuss the steps the plan sponsors propose to take to seek Commission approval for the elimination of such rules and systems (or components thereof); and a timetable for such elimination, including a description of how the plan sponsors propose to phase in the consolidated audit trail and phase out such existing rules and systems (or components thereof).[25]

- Considering Input. The adopted Rule requires the NMS plan to address the process by which the plan sponsors solicited views of their members and other appropriate parties regarding the creation, implementation, and maintenance of the consolidated audit trail, provide a summary of the views of such members and other parties, and describe how the

24 See Rule 613(a)(1)(xii); Section III.C.2.a., infra.

25 See Rule 613(a)(1)(ix); Section III.C.2.a., infra.

plan sponsors took such views into account in preparing the NMS plan.[26] In addition, the adopted Rule also requires the NMS plan to provide for the establishment of an Advisory Committee whose function will be to advise the plan sponsors on the implementation, operation, and administration of the central repository.[27]

- Periodic Reviews of the Consolidated Audit Trail. To help assure the Commission that as financial markets evolve and new technologies emerge, the consolidated audit trail remains a useful regulatory tool, the adopted Rule mandates that the NMS plan must require the central repository's Chief Compliance Officer to regularly review the operations of the consolidated audit trail, and, in light of market and technological developments, make appropriate recommendations for enhancements to the consolidated audit trail.[28]

The Commission has also added certain requirements to the adopted Rule in response to specific concerns expressed by commenters with respect to the use of consolidated audit trail data. Some of the more significant of these additions are as follows:

- Enhancing Security and Privacy Requirements. Commenters have expressed concerns regarding the risk of failing to maintain appropriate controls over the privacy and security of consolidated audit trail data. Accordingly, the adopted Rule requires the NMS plan to include additional policies and procedures that are designed to ensure the rigorous protection of confidential information collected by the central repository.[29]

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26 See Rule 613(a)(1)(xi).

27 See Rule 613(b)(7). For a further discussion of the composition of the Advisory Committee, see Section III.B.3.b., infra.

28 See Section III.B.2., infra.

29 See Rule 613(e)(4).

- Addressing and Limiting Errors. Commenters have also expressed concerns about the potential for errors in the consolidated audit trail; the adopted Rule requires the SROs to provide in their NMS plan detailed information regarding anticipated error rates as well as the plan's proposed error correction process.[30]

The Commission generally believes that the collective effect of the modifications and additions described above will be to significantly expand the set of solutions that could be considered by the SROs for creating, implementing, and maintaining a consolidated audit trail and to provide the SROs with increased flexibility in how they choose to meet the requirements of the adopted Rule, relative to the alternatives that would have been available under the requirements of the proposed Rule. The Commission further believes that these changes address or mitigate the principal concerns raised by commenters – including concerns regarding the extent and cost of the systems changes required by the SROs and their members – while continuing to enable the SROs and the Commission to achieve significant benefits from the consolidated audit trail.[31] Each of the modifications and additions noted above is described and explained in detail in part III below.

Given these changes and the wide array of commenters' views on how to best create, implement, and maintain a consolidated audit trail, the Commission expects that the SROs will seriously consider various options as they develop the NMS plan to be submitted to the Commission for its consideration.[32] Indeed, some commenters recognized that a consolidated

30 See Rule 613(e)(6); Section III.B.2., infra.

31 See Section II.A., infra, for a discussion of the objectives of the consolidated audit trail.

32 See, e.g., FINRA Letter, p. 14 (advocating that SROs build off existing audit trails to develop a consolidated audit trail) and Nasdaq Letter I, p. 11-12 (arguing against building off existing audit trail systems and supporting the development of new system to establish a consolidated audit trail).

audit trail could be created, implemented, and maintained in a number of ways, and thus recommended that the Commission replace the specific systems requirements of the proposed Rule with more general "end-user" requirements, perform an analysis of how existing audit trail systems do and do not meet the needs of regulators, and perhaps even engage in a formal request-for-proposal ("RFP") process.[33]

In light of the expanded solution set that should be available under the changes described above and commenter views on the NMS plan development process, the adopted Rule now requires the SROs to provide much more information and analysis to the Commission as part of their NMS plan submission. These requirements have been incorporated into the adopted Rule as "considerations" that the SROs must address, and generally mandate that the NMS plan discuss: (1) the specific features and details of the NMS plan (e.g., how data will be transmitted to the central repository, when linked data will be available to regulators); (2) the SROs' analysis of NMS plan costs and impact on competition, efficiency, and capital formation; (3) the process followed by the SROs in developing the NMS plan (e.g., the requirement to solicit input from members of the SROs and other appropriate parties); and (4) information about the implementation plan and milestones for the creation of the consolidated audit trail.

These requirements are intended to ensure that the Commission and the public have sufficiently detailed information to carefully consider all aspects of the NMS plan ultimately submitted by the SROs, facilitating an analysis of how well the NMS plan would allow regulators to effectively and efficiently carry out their responsibilities. To help elicit the most appropriate information and analysis from the SROs in response to these requirements, the Commission is furnishing further details about how it envisions regulators would use, access,

33 See Nasdaq Letter I, p. 12; FIF Letter II, p. 2-3; STA Letter, p. 1-3; Direct Edge Letter, p. 2-3, 5.

and analyze consolidated audit trail data through a number of "use cases." These use cases and accompanying questions should help the SROs prepare an NMS plan that better addresses the requirements of the adopted Rule, as well as aid the Commission and the public in gauging how well the NMS plan will address the need for a consolidated audit trail.[34]

Because the Commission believes the adopted Rule permits a wider array of solutions to be considered by the SROs than the proposed Rule did and because the Commission and the public will be able to avail themselves of much more information and analysis in connection with the NMS plan submission, the Commission is also making significant modifications to the process by which it will consider the costs and benefits of the creation, implementation, and maintenance of a consolidated audit trail, as well as the potential impacts on efficiency, competition, and capital formation. In particular, the methodology that the Commission used in the Proposing Release to estimate the costs of creating, implementing, and maintaining a consolidated audit trail may be no longer suitable. As discussed in the Proposing Release, the approximately $4 billion cost estimate for the creation and implementation of a consolidated audit trail was primarily based on averages for the development from scratch of new, very large-scale market systems.[35] However, the Commission's rationale for this approach was predicated on some of the specific technical requirements of the proposed Rule, especially those related to the real-time collection and standard formatting of all data. As such, the approach assumed that the consolidated audit trail would not be able to build on existing trade, order, and audit trail systems. As noted above, these assumptions may no longer be valid since several of the specific technical requirements underlying the Proposing Release's approach have been substantially

34 See Section III.C.2.b., infra.

35 The methodology in the Proposing Release assumed that the scope of the required systems changes would be comparable to those made in connection with Regulation NMS. See Proposing Release, supra note 4, at 32597, n. 352.

modified. The Commission believes these changes would now permit a wider array of solutions to be considered by the SROs, including solutions that could capitalize on existing systems and standards.[36]

In light of these changes, the Commission believes that the economic consequences of the consolidated audit trail now will become apparent only over the course of the multi-step process for developing and approving an NMS plan that will govern the creation, implementation, and maintenance of a consolidated audit trail. In particular, the Commission believes that the costs and benefits of creating a consolidated audit trail, and the consideration of specific costs as related to specific benefits, is more appropriately analyzed once the SROs narrow the expanded array of choices they have under the adopted Rule and develop a detailed NMS plan. The Commission therefore is focusing its economic analysis in this Release on the actions the SROs are required to take upon approval of the adopted Rule – specifically the requirement that the SROs develop an NMS plan, utilizing their own resources and undertaking their own research, that addresses the specific details, cost estimates, considerations, and other requirements of the Rule.[37] A robust economic analysis of the next step – the actual creation and implementation of a consolidated audit trail itself – requires information on the plan's detailed features (and their associated cost estimates) that will not be known until the SROs submit their NMS plan to the Commission for its consideration. Accordingly, the Commission is deferring this analysis until such time as it may approve any NMS plan – that is, after the NMS plan, together with its detailed information and analysis, has been submitted by the SROs and there has been an opportunity for public comment.

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36 See, e.g, FINRA Letter, p. 14; SIFMA Letter, p. 16-18.

37 See Rule 613(a)(1).

To that end, the adopted Rule requires that the SROs: (1) provide an estimate of the costs associated with creating, implementing, and maintaining the consolidated audit trail under the terms of the NMS plan submitted to the Commission for its consideration; (2) discuss the costs, benefits, and rationale for the choices made in developing the NMS plan submitted; and (3) provide their own analysis of the submitted NMS plan's potential impact on competition, efficiency and capital formation. The Commission believes that these estimates and analyses will help inform public comment regarding the NMS plan and will help inform the Commission as it evaluates whether to approve the NMS plan. In this way, the Commission can develop estimates of the costs for the creation, implementation, and maintenance of the consolidated audit trail that benefit from cost data and information provided by the SROs.

The Commission notes that this approach is suited for the multi-step nature of the particular process for developing and approving an NMS plan that will govern the creation, implementation, and maintenance of a consolidated audit trail. Further, because the Commission is deferring its final analysis of the consolidated audit trail until after a detailed NMS plan has been submitted to the Commission for its consideration and the public has had an opportunity to comment, the adopted Rule has been modified to include a mandate that in determining whether to approve the NMS plan and whether the NMS plan is in the public interest, the Commission must consider the impact of the NMS plan on efficiency, competition, and capital formation of creating, implementing, and maintaining the NMS plan.[38] The Commission also will consider the costs and benefits of the creation, implementation, and maintenance of the consolidated audit trail pursuant to the details proposed in the NMS plan submitted to the Commission for its consideration.

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38 See Rule 613(a)(5).

As a result of the new requirements for SROs to provide additional information about costs and a number of other aspects of the NMS plan they submit, the Commission is extending the timeframe for the submission of the NMS plan from 90 days from the date of approval of Rule 613 to 270 days from the date of publication of the adopting release for Rule 613 ("Adopting Release") in the Federal Register. The Commission also is altering the timeframe within which SROs must submit proposed rule changes to require their members to comply with the requirements of the Rule and the NMS plan approved by the Commission[39] and the deadline for submitting the document required by Rule 613(i) regarding the possible expansion of the scope of the NMS plan.[40]

II. Introduction

A. Need for, and Objectives of, a Consolidated Audit Trail

The Commission believes that the Rule adopted today is an appropriate step in the creation of a consolidated audit trail which, when implemented, should substantially enhance the ability of the SROs and the Commission to oversee today's securities markets and fulfill their responsibilities under the federal securities laws. Rule 613 requires the submission of an NMS plan to create, implement, and maintain the first comprehensive audit trail for the U.S. securities markets, which will allow for the prompt and accurate recording of material information about all orders in NMS securities, including the identity of customers, as these orders are generated and then routed throughout the U.S. markets until execution, cancellation, or modification. This

39 The proposed Rule would have required SROs to submit such proposed rule changes on or before from 120 days from approval of the Rule. Because the adopted Rule permits the SROs up to 270 days from the date of publication of the Adopting Release in the Federal Register to submit NMS plans, the Commission believes that the more appropriate deadline for SROs to submit rule changes is 60 days from the date the Commission approves an NMS plan.

40 Specifically, the adopted Rule provides SROs six months, instead of two months, after effectiveness of the NMS plan to submit this document to the Commission.

information will be consolidated and made readily available to regulators in a uniform electronic format.

This section reviews the current status and limitations of existing, discrete audit trails and discusses how a consolidated audit trail could address those limitations and improve the ability of the SROs and the Commission to perform their regulatory functions. To perform this review, the Commission is, in part, drawing upon its own experiences in using existing audit trails to carry out its regulatory duties.[41] The Commission also is relying on information provided to the Commission from other regulators who use existing audit trail systems, broker-dealers and organizations representing industry participants, and those with expertise in data management and technology solutions that may be applicable to the adopted requirements.

1. Use and Limitations of Current Sources of Trading Data

It has become increasingly challenging for SROs and the Commission to oversee the U.S. securities markets across the multitude of trading venues, given the huge volume of orders and trades that are generated, routed, transformed, and then re-routed across dozens of venues every day. Among the challenges is the fact that there is no single, comprehensive audit trail available to regulators.[42] At present, the SROs and the Commission must use a variety of data sources, including EBS,[43] equity cleared reports,[44] and SRO audit trail data to help fulfill their regulatory obligations. As a result, among other issues, regulatory authorities face many challenges in obtaining, reconciling, and making effective use of even the limited order and execution data that is available, thereby hindering the conduct of market surveillance, investigation and enforcement

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41 See Proposing Release, supra note 4, at 32558-61.

42 See FINRA/NYSE Euronext Letter, p. 1-3; Nasdaq Letter I, p. 1-5.

43 See note 1, supra; Proposing Release, supra note 4, at 32557-58.

44 See note 2, supra.

activities, and market reconstructions and analyses.[45]

The ultimate effectiveness of core SRO and Commission regulatory efforts depends on the following four qualities of trade and order (collectively "market") data:

- Accuracy. Is the data about a particular order or trade correct?
- Completeness. Does the data represent all market activity of interest, or just a subset? Is the data sufficiently detailed to provide the required information?
- Accessibility. How is the data stored? How practical is it to assemble, aggregate, reconcile, and process the data? Can all appropriate regulators acquire the data they need?
- Timeliness. When is the data available to regulators? How long will it take to process before it can be used for regulatory analyses?

SROs generally use market data in the form of audit trails to identify potential misconduct in the markets they oversee, including attempts to manipulate market quotations, inflate trading or order volume artificially, or profit from non-public information. When these surveillance efforts identify suspicious trading activity, SROs have a responsibility to open investigations in which they assemble and review additional market data to assess the nature and scope of the potential misconduct. When an SRO detects persistent problems in the market it oversees, it may write new rules for its members to address the problems. To inform these

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45 The term "market reconstruction" is used to refer to the efforts by SRO and Commission staff to collect and process detailed trade and order data, often from multiple and varied data sources (e.g., market participants, trading venues, and other SROs) to recreate the sequence of events and market conditions that existed over a given period of time. A recent example of this occurred following the "Flash Crash" of May 6, 2010, with the market reconstruction analysis undertaken by Commission and the Commodity Futures Trading Commission ("CFTC") staff, which can be found in the "Findings Regarding the Market Events of May 6, 2010: Report of the Staffs of the CFTC and the SEC to the Joint Advisory Commission Emerging Regulatory Issues." See http://www.sec.gov/news/studies/2010/marketevents-report.pdf.

rulemaking efforts, SROs frequently gather and analyze significant amounts of market data. The effectiveness of such efforts is largely determined by the qualities of the data available.[46]

The qualities of such market data are also primary determinants of the Commission's ability to fulfill its statutory mission. The Commission uses market data in most of its investigations of potential securities law violations. In many of these investigations, market data analysis frames the issues for investigation and is a primary means of identifying relationships between individuals and entities whose activities may threaten the integrity of the securities markets or create substantial and unnecessary investor losses. The Commission also uses audit trails and other sources of market data to: (1) inform its priorities for examinations of broker-dealers, investment advisers and SROs; (2) supplement the data and information it collects during those examinations; and (3) determine the nature and scope of any potential misconduct the examinations identify. The Commission also relies heavily on market data to identify patterns of trading and order activity that pose risks to the securities markets and to inform regulatory initiatives, as well as to perform market reconstructions. In addition, the Commission relies on market data to improve its understanding of how markets operate and evolve, including with respect to the development of new trading practices, the reconstruction of atypical or novel market events, and the implications of new markets or market rules. As is the case for the SROs, the effectiveness of such efforts by the Commission is largely determined by the qualities of the data available.[47]

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46 The Commission recognizes that the accuracy of the data available may also be subject to occasional errors, including errors caused by rare and unexpected events.

47 The effectiveness of such efforts with respect to cross-market activities within the Commission's jurisdiction depends on the qualities of data from multiple sources, such as separate SRO audit trails used for equities and equity options. See Section II.A.1.c., infra. This dependency also exists with respect to market activities that involve other

As described in the following sections, each of the present sources of market data available to regulators suffers from deficiencies limiting its effective use.

a. The EBS System

The EBS system is currently the only available source of data that allows regulators to obtain the identity of customers of broker-dealers who have executed trades. The SROs and the Commission have depended on this system for decades to request trading records from broker-dealers. The EBS system, supplemented by the requirements of Rule 17a-25 under the Exchange Act,[48] is generally used by SRO and Commission staff to assist in the investigation of possible securities law violations, typically involving insider trading and market manipulations.[49] In its electronic format, the EBS system provides certain detailed execution information, upon request by SRO or Commission staff, for specific securities during specified timeframes. However, EBS data, which is currently sourced from the so-called back-office records of clearing brokers, are limited to executed trades and do not contain information on orders or quotes (and thus no information on routes, modifications, and cancellations). Also, in frequent cases where brokers utilize average-price accounts to execute and aggregate multiple trades for one or more customers, the details of each individual trade execution are typically lost when reported through

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products outside the Commission's jurisdiction, such as futures and certain swaps. See note 239, infra.

48 17 CFR 240.17a-25. Rule 17a-25 codified the requirement that broker-dealers submit to the Commission, upon request, information on their customer and proprietary securities transactions in an electronic format. The rule requires submission of the same standard customer and proprietary transaction information that SROs request through the EBS system in connection with their market surveillance and enforcement inquiries.

49 See Rule 17a-25; supra note 1, and accompanying text.

the EBS system because it is only the average aggregate price and volume of a series of executed trades that are transmitted to the clearing systems for processing.[50]

Furthermore, the EBS data currently includes only the dates, but not the times, of each trade execution (regardless of whether or not the trade represents an average-price series of executions).[51] Since there could be many broker-dealers trading a given security on a given day of interest, to reconstruct trading on the market for one security on one day could involve many, perhaps hundreds, of EBS requests. Consequently, EBS data, alone, are not generally useful for price or short sale manipulations analysis, order flow analysis, depth-of-book analysis, or any large-scale market reconstructions in which the timing of events is required to build a useful picture of the market.[52]

In addition, though the EBS system provides the names associated with each account in which a trade has been placed, these names are based on the separate records of each broker-dealer providing data to the EBS system, and the same party may be identified by a different name across multiple broker-dealers. Experience of staff at the Commission has shown[53] that it is difficult to perform cross-broker customer analysis of trading since the same customer may be known by different names depending on the account and broker-dealer through which it traded.

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50 See FIF Letter I, p. 3; SIFMA Letter, p. 18-19.

51 As adopted, Rule 13h-1 requires certain broker-dealers to capture and report through EBS the time of execution for any trade involving a large trader and a Commission-issued large trader identifier that identifies the large trader. See Large Trader Release and Large Trader Extension, supra note 1.

52 A 1990 Senate Report acknowledged the immense value of the EBS system, but noted that "it is designed for use in more narrowly focused enforcement investigations that generally relate to trading in individual securities. It is not designed for use for multiple inquiries that are essential for trading reconstruction purposes." See S. Rep. No. 300, 101st Cong., 2d Sess. 2-5 (1990), at 48.

53 See, generally, Sections II.A.1. and II.A.2., infra.

The EBS system also typically requires SRO and Commission staff needing EBS data to request the information from each broker-dealer, and complete responses from each broker-dealer may take days or weeks depending upon the scope of the request. As a result of these various limitations, the EBS system is generally only used by regulators in narrowly-focused enforcement investigations that generally involve trading in particular securities on particular dates or with specific broker-dealers.

b. Equity Cleared Reports

In addition to the EBS system and Rule 17a-25, the SROs and the Commission also rely upon the NSCC[54] equity cleared report for initial regulatory inquiries.[55] This report is generated on a daily basis by the SROs, is provided to the NSCC, and shows the number of trades and daily volume of all equity securities in which transactions took place, sorted by clearing member. The information provided is end-of-day data and is searchable by security name and CUSIP number.[56] This information is also provided to the Commission upon request. Since the information made available on the report is limited to the date, the clearing firm, and the number of transactions cleared by each clearing firm, its use for regulatory purposes is quite limited -- equity cleared reports basically serve as a starting point for certain types of investigations, providing a tool the Commission can use to narrow down the clearing firms to contact concerning transactions in a certain security.

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54 See note 2, supra, and accompanying text.

55 The Commission also uses the Options Cleared Report, with data supplied by the Options Clearing Corporation ("OCC"), for analysis of trading in listed options. The OCC is an equity derivatives clearing organization that is registered as a clearing agency under Section 17A, 15 U.S.C. 78q-1, of the Exchange Act, and operates under the jurisdiction of both the Commission and the CFTC.

56 A CUSIP number is a unique alphanumeric identifier assigned to a security and is used to facilitate the clearance and settlement of trades in the security.

c. SRO Audit Trails

In addition to EBS data and equity cleared reports, the SROs and the Commission rely on data collected through individual SRO audit trails. Most SROs maintain their own specific audit trails applicable to their members. For example, the National Association of Securities Dealers ("NASD")[57] established its Order Audit Trail System ("OATS")[58] in 1996, which required NASD (n/k/a FINRA) members to report certain trade and order data on Nasdaq-listed equity securities. OATS was later expanded to include OTC equity securities. Similarly, the NYSE implemented its Order Tracking System ("OTS")[59] in 1999 under which its members were required to report certain trade and order data on NYSE-listed securities. Beginning in 2000, several of the current options exchanges implemented the Consolidated Options Audit Trail

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57 In 2007, NASD and the member-related functions of NYSE Regulation, Inc., the regulatory subsidiary of New York Stock Exchange LLC ("NYSE"), were consolidated. As part of this regulatory consolidation, the NASD changed its name to FINRA. See Securities Exchange Act Release No. 56146 (July 26, 2007), 72 FR 42190 (August 1, 2007). FINRA and the National Futures Association ("NFA") are currently the only national securities associations registered with the Commission; however, the NFA has a limited purpose registration with the Commission under Section 15A(k) of the Exchange Act, 15 U.S.C. 78o-3(k). See also Securities Exchange Act Release No. 44823 (September 20, 2001), 66 FR 49439 (September 27, 2001).

58 See In the Matter of National Association of Securities Dealers, Inc., Order Instituting Public Proceedings Pursuant to Section 19(h)(1) of the Securities Exchange Act of 1934, Making Findings and Imposing Remedial Sanctions, Exchange Act Release No. 37538 (August 8, 1996), Administrative Proceeding File No. 3-9056 and Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and The Nasdaq Stock Market LLC ("Nasdaq"). See also Securities Exchange Act Release No. 39729 (March 6, 1998), 63 FR 12559 (March 13, 1998) (order approving proposed rules comprising OATS) ("OATS Approval Order").

59 See Securities Exchange Act Release No. 47689 (April 17, 2003), 68 FR 20200 (April 24, 2003) (order approving proposed rule change by NYSE relating to order tracking) ("OTS Approval Order").

System ("COATS").[60] In addition, many of the exchanges have created their own audit trails to assist in surveillance activities.

Recently, FINRA expanded its OATS requirements from covering only Nasdaq-listed and OTC equity securities to covering all NMS stocks.[61] To avoid duplicative reporting requirements, the NYSE, NYSE Amex LLC (n/k/a "NYSE MKT LLC") ("NYSE Amex"), and NYSE ARCA, Inc. ("NYSE Arca") subsequently replaced their OTS audit trail requirements for members who are also members of either FINRA or Nasdaq (and therefore subject to OATS requirements) with rules that allow these members to satisfy their reporting obligations by meeting the new OATS requirements.[62]

Although these developments with respect to the scope of FINRA's OATS rules reduce the number of audit trails with disparate requirements, they still do not result in a comprehensive audit trail that provides regulators with accurate, complete, accessible, and timely data on the overall markets for which regulators have oversight responsibilities. In particular, data collected by FINRA pursuant to FINRA's Rule 7400 series ("OATS data") does not provide a complete picture of the market because though OATS collects data from FINRA members with respect to

60 See In the Matter of Certain Activities of Options Exchanges, Administrative Proceeding File No. 3-10282, Securities Exchange Act Release No. 43268 (September 11, 2000) (Order Instituting Public Administrative Proceedings Pursuant to Section 19(h)(1) of the Securities Exchange Act of 1934, Making Findings and Imposing Remedial Sanctions) ("Options Settlement Order"). See, e.g., Securities Exchange Act Release No. 50996 (January 7, 2005), 70 FR 2436 (order approving proposed rule change by CBOE relating to Phase V of COATS).

61 See Securities Exchange Act Release No. 63311 (November 12, 2010), 75 FR 70757 (November 18, 2010) (SR-FINRA-2010-044) (order approving proposed rule change by FINRA relating to the expansion of OATS to all NMS stocks).

62 See Securities Exchange Act Release Nos. 65523 (October 7, 2011), 76 FR 64154 (October 17, 2011) (SR-NYSE-2011-49); 65524 (October 7, 2011), 76 FR 64151 (October 17, 2011) (SR-NYSEAmex-2011-74); 65544 (October 12, 2011), 76 FR 64406 (October 18, 2011) (SR-NYSEArca-2011-69).

orders and trades involving NMS stocks, OATS does not include trade or order activity that occurs on exchanges, or at broker-dealers that are not FINRA or Nasdaq members. Nor does OATS include exchange quotes, principal orders submitted by FINRA members registered as market makers, or options data.[63] In performing its own regulatory oversight of the markets, FINRA has chosen to create an internal process in which it augments the data it collects via OATS with trade execution data from other exchanges with which it has a regulatory services agreement. This process provides FINRA with a wider view of the markets than that provided

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[63] See FINRA Rule 7410(j) (defining "Order" for purposes of OATS, to mean "any oral, written, or electronic instruction to effect a transaction in an NMS stock or an OTC equity security that is received by a member from another person for handling or execution, or that is originated by a department of a member for execution by the same or another member, other than any such instruction to effect a proprietary transaction originated by a trading desk in the ordinary course of a member's market making activities." Additionally, Nasdaq, Nasdaq OMX BX, Inc. ("BX") and Phlx equities ("PSX") members that are registered as market makers in a certain security are similarly exempted from recording OATS audit trail data for the security in which they are registered to make a market. See Nasdaq and BX Rules 6951(i); PSX Rule 3401(i).

The Commission notes that members of Nasdaq, BX and PSX, that are not also members of FINRA, are required by those exchanges to record the audit trail data required by OATS; however, they are only required to report that data through OATS upon request by their respective exchanges. See Nasdaq and BX Rules 6955(b); PSX Rule 3405(b). Additionally, as of October 17, 2011, members of NYSE and NYSE Amex, who are not also FINRA members, are required to record their trade and order activity. These non-FINRA members are not required to report this data through OATS unless requested. See NYSE and NYSE Amex Equities Rules 7450(b); see, e.g., Securities Exchange Act Release Nos. 65523 (October 7, 2011), 76 FR 64154 (October 17, 2011); 65524 (October 7, 2011), 76 FR 64151 (October 17, 2011); 65544 (October 12, 2011), 76 FR 64406 (October 18, 2011) (notice of immediate effective of proposed rule change to adopt the FINRA Rule 7400 series, the OATS rules, and making certain conforming changes to the NYSE and NYSE Amex Equities rules). Members of NYSE Arca, who are not also FINRA members, were required to record their trade and order activity as of March 31, 2012. See NYSE Arca Equities Rule 7450(b); see Securities Exchange Act Release No. 65544 (October 12, 2011), 76 FR 64406 (October 18, 2011) (notice of immediate effective of proposed rule change to adopt the FINRA Rule 7400 series, the OATS rules, and making certain conforming changes to the NYSE Arca Equities rules). See also Securities Exchange Act 66094 (January 4, 2012), 77 FR 1545 (January 10, 2012) (notice of immediate effectiveness to extend the implementation date of the NYSE Arca Equities Rule 7400 Series, the OATS rules, for Equity Trading Permit Holders that are not FINRA members from January 31, 2012 to March 31, 2012).

by OATS alone, but linking data in this fashion does not yield fully accurate results.[64] For these reasons, the Commission believes that the augmented OATS data currently falls short of providing an efficient source of data for analyzing cross-market activities, or tracking an order through its entire cycle from generation through routing to execution, modification or cancellation.

OATS data also suffers from a lack of timeliness, partly as a result of the problems with the accuracy of the data as collected, and partly because of its lack of completeness. When FINRA receives an end-of-day OATS file from a member, it takes an hour for FINRA to acknowledge receipt of the report and approximately another 24 hours to determine if there is a syntax error[65] in the report.[66] During this time, FINRA performs over 152 validation checks on

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64 FINRA has represented to Commission staff that, as part of its own surveillance activities, FINRA acquires some of this order handling system data from non-FINRA members to supplement the data it receives from its members via OATS, but that matching data across the audit trails yields varying levels of success and accuracy due to the disparate methods used by the different order handling systems to collect and store data. FINRA represented that, during the period from November 28, 2011 to February 24, 2012, approximately 2% of reportable OATS data related to exchange orders could not be linked with matching exchange data. See Commission Staff Memorandum to File No. S7-11-10 regarding telephone conversations with FINRA, dated April 17, 2012 ("Commission Staff Memorandum"). Also, since this process only involves acquiring trade and order data from select sources, it still does not produce a complete record of all market activity. The Commission notes that, when considering data covering a time period of approximately 26 months, the percentage of reportable OATS data related to exchange orders that could not be linked with matching exchange data remained at approximately 2%. Id.

65 Common reasons given by FINRA for syntax rejections include: missing mandatory fields, invalid fields, and invalid field combinations (e.g., a Limit Price without a Time in Force Code). OATS will reject records as duplicates if more than one record is submitted with the same Order Receiving Firm Market Participant Identifier, Order Received Date, and Order Identifier or if more than one record contains all of the same information. http://www.finra.org/Industry/Compliance/MarketTransparency/OATS/FAQ/P085542 (last viewed on May 23, 2012).

66 See Commission Staff Memorandum, supra note 64. FINRA estimates that, from the period November 28, 2011 to February 24, 2012 approximately 0.10% of the intra-firm data reported daily by broker-dealers were rejected for errors. Id. The Commission notes

each order event reported to OATS. Thus, FINRA performs over 40 billion separate checks each day to ensure OATS data conforms to all applicable specifications.[67] Each of these checks can result in OATS data submissions being rejected and generating an error message.[68] As a result of these validation checks, almost 425,000 reports per day, on average, are rejected and must be corrected.[69] In addition to the 24 hours needed to identify errors within a report, it takes another two business days to determine whether a file that is syntactically correct nevertheless contains errors in content related to internally-inconsistent information about processing, linking, and routing orders. Once a member is advised of such errors, the member has up to five business days to re-submit a corrected file. However, error corrections are limited to only those that are required to remedy internal inconsistencies within a given member's submission. Cross-firm inconsistencies in which, for example, one member reports routing an order to a second member, but the second member does not report receiving or processing such an order, are identified as unmatched or unlinkable data records, but neither firm corrects these types of reporting errors. The net result yields an historical data record of market activity that contains a small but permanent number of incorrect or irreconcilable trade and order events.[70]

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that, when considering data covering a time period of approximately 26 months, the percentage of the intra-firm data reported daily by broker-dealers rejected for errors was more than double this amount. Id.

67 See FINRA Letter, p. 11. FINRA represented to Commission staff that many of the validation errors result from problems encountered in translating order information from broker-dealer formats into OATS format. See Commission Staff Memorandum, supra note 64.

68 Id.

69 Id.

70 FINRA estimates that during the period from November 28, 2011 to February 24, 2012 approximately 0.5% of each day's reportable events remained unmatched (i.e., multi-firm events, such as routes, that cannot be reconciled). See Commission Staff Memorandum, supra note 64. When considering data covering a time period of approximately 26

Given the time it takes to process each OATS file, and the nature of the process in which errors are detected, reported back to members, and then corrected, inter-firm surveillance by FINRA typically does not begin until 5 business days after receipt of OATS data. In addition, the final product of the FINRA process is available to FINRA, but is not stored in a market-wide database or a central repository that is readily accessible to other regulators. This is because SROs do not typically have access to the internal systems of another SRO, though they may share some sources of underlying data.[71]

Because the Commission does not have direct access to OATS data and other SRO audit trails and because each SRO only has direct access to its own audit trails, requests must be made to the Intermarket Surveillance Group ("ISG")[72] or SROs to conduct an analysis on order data. It can take days or weeks, depending on the scope of the information requested, to receive responses to requests. Once the responses to its requests for information are received, the Commission, or any SRO undertaking the same task, must commit a significant amount of time and resources to process and cross-link the data from the various formats used by different SROs before it can be analyzed and used for regulatory purposes. Whether or not this process is successful depends on the accuracy, completeness, and format of the data received, as well as how readily data from different SROs can be reliably linked. For example, staff at the Commission working on the analysis of the May 6, 2010 "Flash-Crash" found it was not possible

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months, the percentage of each day's reportable events remaining unmatched was more than double this amount. Id.

71 For example, FINRA has been given access to order audit trail information from certain SROs pursuant to Regulatory Services Agreements.

72 ISG is an international group of exchanges, market centers, and regulators that perform market surveillance in their respective jurisdictions. The organization provides a forum for its members to share information and coordinate regulatory efforts to address potential intermarket manipulation and trading abuses.

to use the data from existing audit trails to accurately or comprehensively reconstruct exchange and ATS equity limit order books for NMS securities as required to fully analyze the events of that day.[73]

A further difficulty in using existing audit trails to conduct cross-market surveillance is the lack of consistency in both format and content among the various audit trails. Not all SROs collect data using the OATS format. In addition, each options exchange maintains its own COATS audit trail in a different format and includes different supplemental data items in its audit trail. These differences make it difficult and labor intensive for regulators to view options trading activity across multiple markets, and the lack of any combined equity and options audit trail is a significant impediment to regulators performing cross-product investigations and analyses.

An additional shortcoming of existing SRO audit trails is the lack of customer identifiers. In general, existing SRO audit trails only identify the broker-dealer handling the order and not the account holder or the person exercising investment discretion for the account holder, if different. This limitation makes the process of identifying the customers involved in unusual trading patterns or market events very difficult. Even determining whether or not an unusual trading pattern exists is challenging if the data does not identify trades by a single customer at multiple broker-dealers. Requests therefore must be made to one or more broker-dealers to obtain information about the customer or customers behind an order. Multiple requests may be necessary before the information is obtained. EBS data may have to be requested as a supplement. A further challenge arises in any type of customer-based cross-market analysis because there is no standard convention for how customers are identified at different broker-

73 See Section II.A.2.b., infra.

dealers – the same party directing trades across multiple venues, or through different broker-dealers, can be known by many different names.

Not having customer information at the early stage of surveillance can also impair the accuracy, and thus efficacy, of certain surveillances. The patterns that emerge when trade and order activity is aggregated across all customers of a broker-dealer often exhibit characteristics that can be quite different from the (initially) unobservable patterns of trade and order activity of each individual customer at that broker-dealer. This could result in what are known as "false positive signals," in which market activities that initially are flagged as being potentially manipulative by a surveillance system are later found not to be potentially manipulative once more detailed customer data from the broker-dealer is requested and analyzed. In contrast, potentially manipulative activities may be missed by a surveillance system that cannot identify the customers behind each order or trade if those activities are otherwise obscured by non-manipulative activities of other customers of the same broker-dealer such that the aggregate patterns of trading do not appear potentially manipulative.

Given the various limitations described above, the Commission does not believe that existing audit trails, with their current features, provide regulators with an efficient or adequate method of monitoring and surveilling the market for NMS securities. The Commission notes, for example, that FINRA summarizes the current cross-market systems as follows: "The current systems in place to achieve effective cross-market surveillance, such as the ISG, are incomplete. For example, the ISG audit trail data has numerous shortcomings, including: (1) it does not capture quote/orders away from a market's inside market (i.e., those quotes/orders below the best bid or above the best offer); (2) it currently identifies participants of a trade only to the clearing broker, not down to the executing broker level; (3) data submitted by participants is not validated; (4) certain data fields are not mandatory; and (5) there are no service level agreements to ensure that participants submit timely and accurate information."[74]

2. Regulatory Improvements with a Consolidated Audit Trail

The NMS plan required by the Rule, if approved by the Commission, will improve the quality of audit trail data by, among other things: (1) identifying with a unique "Customer-ID" the account holder(s) with respect to an account at a registered broker-dealer and, if different, any person authorized to give the broker-dealer trading instructions for such account; (2) identifying the time of each key event in the life of an order according to synchronized business clocks; (3) requiring the reporting of comprehensive order lifecycle data; and (4) including all NMS securities in one audit trail. As discussed below, the Commission believes that these improvements should have the potential to result in the following: (1) improved market surveillance and investigations; (2) improved analysis and reconstruction of broad-based market events; and (3) improved market analysis. In addition, a consolidated audit trail has the potential to result in a reduction in disparate reporting requirements and data requests.

a. Improved Market Surveillance and Investigations

A consolidated audit trail will expand the data available for regulators to perform surveillance and investigations for illegal activities such as insider trading, wash sales, or manipulative practices. In particular, a consolidated audit trail will help surveillance and investigations by facilitating risk-based examinations, allowing more accurate and faster surveillance for manipulation, improving the process for evaluating tips, complaints, and referrals ("TCRs"), and promoting innovation in cross-market and principal order surveillance.

i. Risk-Based Examinations

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74 See FINRA/NYSE Euronext Letter, p. 3.

A consolidated audit trail will facilitate risk-based examinations. Risk-based examinations require access to accurate and timely data so that the scope of the examination can be properly set to cover the areas of identified risks. Regulators currently may request audit trail data directly from the broker-dealer, work with the broker-dealer to understand the format and definitions in the data, validate that information with a third party, and analyze the data to determine whether the initial assumptions concerning risk were valid. This effort requires significant resources from both the regulator and the broker-dealer, all of which may be wasted if the resulting analysis shows that the assumptions of risk justifying the examination of a particular subject were not founded. Thus, this resource-intensive process does not necessarily reveal the subjects most worthy of examination, and does not permit an effective pre-examination review of a subject's trading practices.

In contrast, a consolidated audit trail would permit regulators, for example, to identify risks and appropriate subjects for examinations relating to certain types of trading by creating and comparing metrics based on the complete (and possibly cross-market) activities of a broker-dealer or customer. Signals based on such metrics could, for example, identify outlier patterns in the ratio of order activity to execution, which may be an indication of potentially manipulative practices. Currently, this method is impractical because, as described above, it requires the consolidation of many audit trails that store data in non-uniform formats, participant information in SRO audit trails often does not consistently identify the executing broker-dealer, and there is no uniform method of identifying customers.

In sum, consolidated audit trail data that meets the minimum requirements for the NMS plan specified in the Rule would allow regulators to create a process that focuses much more of their resources on those firms for which specific activities over specific time periods warrant follow up. The subsequent examinations would thus be more precise, resulting in more efficient use of regulatory resources, potentially reducing the need for multiple document requests, and ultimately reducing the sometimes significant compliance burden on a broker-dealer or other subject.

ii. Market Manipulation

In addition to helping regulators focus their resources and better identify areas in which potentially manipulative trading activity may be occurring, a consolidated audit trail will greatly aid the analysis of the potential manipulation itself. The current methodology to analyze order and trade data requires a tremendous amount of time and resources to construct an accurate picture of when trades are actually executed. Typically, this includes: (1) broker-dealers and other registrants responding to multiple requests from the Commission and SROs; (2) SROs devoting regulatory resources to obtaining, analyzing, and reporting data requested by the Commission; and (3) Commission staff reconciling inconsistent order data provided by different SROs with respect to different markets.

In addition, while SRO audit trail data identifies the dates and times of trades by a particular broker-dealer, SRO audit trail data does not reveal the identities of the customers initiating the trades executed by the broker-dealers. Accordingly, to identify customers placing trades through a broker-dealer, regulatory staff must obtain EBS data and integrate such data with SRO audit trail data. This is a cumbersome process because there is no automated process to link the two data sources. To determine the exact execution time for trades by a particular customer, regulatory staff must obtain a third set of data from the broker-dealer's trading and order handling system. These processes can take many months. In some cases, the laborious process of assembling the data delays other critical investigative or analytical steps. In other cases, investigators or analysts forego the process of determining when trades occurred, limiting their analysis to more accessible information. As a result, SRO and Commission staffs may fail to ascertain the full scope of misconduct under investigation or the causes of unusual market events at issue.

Even more critically, the absence of reliable information about who initiated which orders makes detection of schemes that involve repeat instances of activity through accounts at multiple broker-dealers difficult. Schemes of this sort may be among the most harmful and difficult to police, but without a customer identifier that consistently and uniquely identifies responsibility for orders across all broker-dealers, no amount of technical sophistication and securities market insight can produce a data query or analysis to detect them.[75]

With the data provided by the consolidated audit trail, regulatory staff would be able to conduct such analyses in a much shorter period of time. In addition, the process of analysis with a consolidated audit trail would be inherently more reliable than the manual reconstruction process currently available, reducing the risk of inaccuracies. Furthermore, the ability to process

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75 Examples of schemes that typically rely on orders from accounts at multiple brokers include: (1) "network" insider trading schemes in which the participants cultivate multiple sources of non-public information and trade on the information they receive over an extended period of time and through accounts at a large number of broker-dealers; (2) wash trading; and (3) order layering. Unlike insider trading, for example, which is neither defined nor expressly prohibited in the Act, wash trading is specifically prohibited in the statute. The entering of matched orders for the purpose of creating the illusion of market activity or to artificially affect the price is one of the oldest and most difficult to detect manipulative practices. Technology that permits the routing of thousands of orders to different venues in micro seconds has made cross market surveillance for this activity extremely difficult. "Order layering" is similar to wash trading. In this practice, a market participant can enter numerous non-bona fide market moving orders, often in substantial size relative to a security's legitimate volume to create the false impression of buy or sell side pressure. When such orders induce others to execute against profitable limit orders, the market participants immediately cancel the pending orders that manipulated the price. As with wash sales, multiple traders can enter orders on different venues, impacting the NBBO and making the activity difficult to detect.

and meaningfully analyze audit trail data more quickly would allow regulatory staff to employ proactive methods of identifying potentially manipulative activities. The Commission therefore believes a consolidated audit trail would make the overall process of identifying and analyzing potentially manipulative trading practices much more focused, accurate, and efficient.[76]

The timely availability of data to regulators also impacts the efficacy of detecting (and possibly mitigating the effects of) some types of market manipulation. For example, some pernicious trading schemes are designed to generate large "quick-hit" profits in which participants attempt to transfer the proceeds from the activity to accounts outside of the reach of domestic law enforcement as soon as the offending transactions have settled in the brokerage account (typically three days after execution). If the SROs detect such schemes and promptly report them to the Commission, the Commission potentially could seek asset freezes that limit the transfer of funds until charges against the account holder are resolved. The Commission believes that a consolidated audit trail in which uniform data about market activities are efficiently collected and processed soon after such activities occur, and in which data are available to regulators in a timely manner, would more frequently and effectively allow regulators to use this approach.

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76 For example, implementation of a consolidated audit trail also will help regulators monitor reliance on the use of the safe harbor provision for issuer repurchases in Rule 10b-18 under the Exchange Act. 17 CFR 240.10b-18. Rule 10b-18 under the Exchange Act provides issuers with a safe harbor from liability for manipulation under Sections 9(a)(2) and 10(b) of the Exchange Act, and Rule 10b-5 under the Exchange Act, when they repurchase their common stock in the market in accordance with the Rule's manner, timing, price, and volume conditions. The data required to be included in the consolidated audit trail will assist regulators in monitoring issuer repurchases that rely on Rule 10b-18's safe harbor protections to ensure that they comply with all required criteria.

iii. Tips and Complaints

A consolidated audit trail also would significantly improve the processes used by the SROs and the Commission for evaluating tips and complaints about trading activity.[77] It is not uncommon for market participants or those with experience in market data to sometimes note atypical trading or quoting patterns in publicly-available market data. A consolidated audit trail would allow regulatory staff to quickly determine whether a particular instance of an atypical activity (regardless of how it was originally identified), such as an abnormally high level of quote traffic, is worthy of further investigation.

Today, such an analysis of TCRs is difficult and cumbersome. Even a preliminary review requires analysis by each exchange or ATS to identify the activity in question and to determine its scope. Regulators then must consolidate the analyses from each such market center to determine the identities of those responsible for the atypical activity in question. To the extent that the activity originates from several market participants, regulators must conduct additional analysis on each of those participants, and possibly other participants, to discover information that could identify the customer(s) originating the orders that created the atypical activity. Without a unique customer identifier included in the order and trade data, this may not be possible. The consolidated audit trail would significantly improve the multi-stage process, enabling regulatory staff to make efficient queries on orders and more quickly determine whether the TCR can be "closed" or if further analysis and investigation are warranted.

iv. Cross-Market and Principal Order Surveillance

Investigations of cross-market activity may be more efficient with a consolidated audit trail as such an audit trail may provide regulators with data not currently consolidated across

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77 The Commission receives an average of over 200 market-related TCRs each month.

markets and/or data not currently available to regulators such as broker-dealer principal orders, including market maker quotes. For example, in an attempt to manipulate the market, a broker-dealer could use numerous principal sell orders across multiple venues to give the misleading appearance of broad sell-side pressure, and then send a buy principal order at a favorable price to take advantage of the market momentum created by the misleading sell orders. This type of activity would be difficult to readily identify with current audit trails, but it could be the target of a routine surveillance of a consolidated audit trail. The Commission notes, for example, the statement of FINRA and NYSE Euronext that, "[p]articularly since the implementation of Regulation NMS in 2007, there has been a significant increase in market linkages, the result of which is that trading activity on one market can have a profound effect on other markets. This, in turn, has led to the realization that market manipulation, by its very nature, is facilitated cross-market where, for example, trading on one market is used to affect a security's price while trading on another market is used to take advantage of that price change."[78]

In addition, the consolidation of order data with direct access for all relevant regulators may create opportunities for regulators to develop entirely new methods of surveillance, and to keep existing forms of surveillance up to date as new market practices and new market technologies continue to rapidly evolve. In fact, as described more fully below, SROs are required by the Rule to incorporate the expanded audit trail data into their surveillance systems.[79]

b. Improved Analysis and Reconstruction of Broad-Based Market Events

A consolidated audit trail will significantly improve the ability of regulators to reconstruct broad-based market events so that they and the public may be informed by an

78 See FINRA/NYSE Euronext Letter, p. 2.

79 See Rule 613(f).

accurate and timely accounting of what happened, and possibly why. The sooner a reconstruction can be completed, the sooner regulators can begin reviewing an event to determine what, if any, regulatory responses might be required to address the event in an effective manner.

For example, on the afternoon of May 6, 2010, the U.S. equity and equity futures markets experienced a sudden breakdown of orderly trading, when broad-based indices, such as the Dow Jones Industrial Average Index and the S&P 500 Index, fell about 5% in just five minutes, only to rebound soon after (the "Flash Crash"). Many individual equities suffered even worse declines, with prices in over 300 stocks and exchange-traded funds falling more than 60%. In many of these cases, trades were executed at a penny or less in stocks that were trading at prices of $30 or more only moments earlier before prices recovered to their pre-Flash Crash levels.[80]

The Commission immediately formed an interdisciplinary team from across the Commission to analyze the events of May 6, 2010, identify possible causes, inform the public of what happened, and aid in formation of regulatory responses. The CFTC took similar steps. Within a few weeks, staff at the Commission and the CFTC released a joint preliminary report that described the event and, in general terms, the market conditions prior to and during the rapid decline.[81] However, at that time the staffs were unable to definitively identify the specific conditions or circumstances that could have caused, contributed to, or exacerbated the event. Though the SROs and the Commission quickly implemented a single-stock circuit breaker pilot program as an initial response, a more complete regulatory response required a full and robust analysis of additional data.

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80 See note 45, supra.

81 See "Preliminary Findings Regarding the Market Events of May 6, 2010: Report of the Staffs of the CFTC and the SEC to the Joint Advisory Commission Emerging Regulatory Issues." (May 18, 2010). See http://www.sec.gov/sec-cftc-prelimreport.pdf.

From the start of the investigation, many market participants had suggested that the sudden withdrawal of liquidity in the equity markets may have resulted in the rapid decline of prices as orders to immediately sell (many from retail investors) found no interest on the buy side (from market professionals).[82] To fully understand how such conditions could occur, Commission economists needed to analyze the order books for thousands of equities. Commission staff requested order book data from several exchanges that sell such data or could readily put such data together, but this data did not represent the whole market. Commission staff attempted to use order data from OATS and several SRO audit trails to reconstruct order books for thousands of equities traded on exchanges that do not maintain or could not provide order book data. Although it was possible to link the data from different sources to show trading activity for a particular stock over a specific period of time, the accuracy, completeness, and content of the combined data sets were not sufficient to allow for an accurate reconstruction of the order books. This hindered staff in determining what happened to liquidity before, during, and after the Flash Crash. Two major problems were the inability to identify and eliminate duplicate orders from the data and the inability to accurately sequence events across the multiple data sources.

As described in the final joint report issued by the staffs of the CFTC and the Commission on September 30, 2010, Commission staff were only able to create a comprehensive view of the order books by acquiring, processing, and aggregating four distinct data sets that each contained a subset of order book information from each of the four exchanges that could

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82 For detailed discussions and chronologies of the investigation into the events of May 6, 2010, see SEC (http://www.sec.gov/spotlight/sec-cftcjointcommittee.shtml) and CFTC (http://www.cftc.gov/PressRoom/Events/AdvisoryCommitteeMeetings/index.htm) webcasts and minutes of public meetings held with the Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues on May 24, 2010, June 22, 2010, August 11, 2010, November 5, 2010, and February 18, 2011.

provide such information: Nasdaq ModelView, NYSE Openbook Ultra, NYSE ARCABook, and BATS Exchange.[83] Given the enormous volume of data that needed to be processed (more than 5.3 billion records), even small changes to the integration and aggregation process took significant computer time to test and implement.

By early July 2010, staff at the CFTC had completed a very detailed analysis of the full order book of the S&P 500 E-Mini futures contract and were able to show how liquidity in that contract had been eroding for most of the day. The CFTC's detailed second-by-second analysis of trading during the Flash Crash itself revealed how buy-side depth in the S&P 500 E-Mini futures virtually evaporated as broad market indices rapidly fell 5%.[84] However, until a similar analysis could be completed in the equity markets, neither regulators nor the public would know whether an evaporation of liquidity was also present in the equity markets, and whether the timing of such an event preceded or followed the liquidity event in the futures market. Ultimately, it took Commission staff nearly five months to complete an accurate representation of the order books of the equity markets for May 6, 2010. Even then, the reconstruction was not fully complete and only contained an estimated 90% of trade and order activity for that day.[85] However, it was sufficiently comprehensive to allow staff to perform a robust analysis of the equity markets revealing how "the decline in full-depth buy-side liquidity for the E-Mini precede[d] that of the SPY and [the stocks composing] the S&P 500," and how "drops in [stock] prices [became] increasingly more severe with ever-larger drops in liquidity."[86]

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83 See note 45, supra, at p. 11.

84 Id.

85 Id.

86 Id. at p. 18, 80.

Had there been a consolidated audit trail in place on May 6, 2010, regulators would likely have been able to much more quickly and efficiently perform these types of detailed analyses. This in turn could have dramatically shortened the time during which regulators, as well as the public, remained uncertain about what actually happened during the Flash Crash.

c. Improved Market Analysis

In addition to the surveillance and reconstruction benefits described above, a consolidated audit trail would also significantly improve the ability of regulators to monitor overall market structure, so that both the Commission and the SROs can be better informed in their rulemakings. In January 2010 the Commission published a concept release on equity market structure that discusses how the markets have rapidly evolved from trading by floor-based specialists to trading by high-speed computers. The concept release poses a number of questions about the role and impact of high-frequency trading strategies and the movement of trading volume from the public national securities exchanges to dark pools.[87]

Over the past two years there has been considerable discussion about these topics by regulators, market participants, the media, and the general public. Nevertheless, numerous open questions remain because of a lack of consolidated market data, making certain types of market-wide analysis impractical. For example, existing research on high frequency trading cannot precisely identify high frequency traders. As a result, studies of high frequency trading have been limited in their ability to thoroughly examine such strategies and their impact on the market, leaving many open questions. Having more precise data on who is trading (and from which general patterns of order submission could be inferred) would help regulators better understand the impact of high frequency trading on markets. Similar analyses also could be

[87] See Securities Exchange Act Release No. 61358 (January 14, 2010), 75 FR 3594 (January 21, 2010) ("Concept Release on Equity Market Structure").

performed for other aspects of general market structure, such as those discussed in the concept release related to dark pools and internalization. In addition, having access to a consolidated audit trail will provide the Commission and SROs with better data to conduct retrospective analyses of rules and pilots. Informed analysis of these topics requires consolidating audit trails so that quotes and trades across multiple exchanges can be linked (either by customer type or by specific customer) with order flow and trades from the many dozens of over-the-counter venues.

d. Potential Reduction in Disparate Reporting Requirements and Data Requests

The Commission believes that a consolidated audit trail will reduce the burdens on SROs and broker-dealers associated with producing regulatory data. In particular, the consolidated audit trail may reduce burdens from ad hoc data requests.

The Commission believes that the creation of a consolidated audit trail may reduce the number and types of ad hoc requests made by regulators to market participants for data concerning their trading activities. In particular, regulators could use direct access to data in the consolidated audit trail for investigations or analyzing trends or broad market activities instead of requesting data from market participants. In addition, regulators could use this direct access to analyze the activities of a single trader across multiple markets, which today requires requests for data from multiple market participants. Regulators would therefore likely make fewer ad hoc requests. The Commission, however, does not believe that all ad hoc requests for data from market participants will be replaced by obtaining data from the consolidated audit trail. A detailed investigation of a particular firm may require types of data from that firm that are not stored in the consolidated audit trail, or that relate to periods prior to the implementation of the consolidated audit trail. In addition, in cases in which there are discrepancies, or even suspected discrepancies, between a firm's actual trading activities and what is stored in the consolidated audit trail's central repository, regulators are likely to request data directly from market participants for verification and investigative purposes.

3. Large Trader Reporting System Rule

The Commission believes that a consolidated audit trail will be able to build upon various aspects of the large trader reporting system that was recently adopted by the Commission.[88] Rule 13h-1, which establishes the large trader reporting system, requires large traders to identify themselves to the Commission and make certain disclosures to the Commission on Form 13H. Upon receipt of Form 13H, the Commission issues a unique identification number to the large trader, which the large trader then will be required to provide to those broker-dealers through which the large trader trades. Registered broker-dealers will be required to maintain specified transaction records for each large trader and to report that information to the Commission upon request. The Large Trader Rule requirements are designed to enable the Commission to promptly and efficiently identify significant market participants and collect data on their trading activity so that Commission staff can reconstruct market events, conduct investigations and bring enforcement actions as appropriate.

Several commenters noted that portions of the requirements of Rule 13h-1 overlapped with certain provisions of proposed Rule 613 and requested that the Commission harmonize the rules.[89] One commenter stated that the Commission should consider implementing only those portions of Rule 13h-1 that would not be affected by, or be redundant to, the implementation of the consolidated audit trail proposal.[90] Another commenter suggested that the Commission

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88 See note 1, supra.

89 See ICI Letter, p. 6-7; Liquidnet Letter, p. 4-5; SIFMA Letter, p. 18-19; CBOE Letter, p. 6 (questioning the need for a large trader reporting system if a consolidated audit trail is implemented).

90 See FINRA/NYSE Euronext letter, p. 7.

mandate compliance only with those aspects of Rule 13h-1 that would operate as part of the consolidated audit trail – the large trader identifier in particular – so they could be leveraged in the creation of the consolidated audit trail.[91] Yet another commenter believed that, upon implementation of the consolidated audit trail, it would not be necessary for large traders to identify themselves to their broker-dealers pursuant to Rule 13h-1, because the consolidated audit trail already would require broker-dealers to include a customer identifier for every order.[92] The commenter explained that, if customer information is collected as part of the consolidated audit trail, the Commission and SROs could run queries to identify customers with significant trading volume.[93]

The Commission believes that both Rules are necessary to enhance regulatory oversight of the markets and its members. Key aspects of Rule 13h-1 define the types of entities that are large traders, and who must register with the Commission and file and keep current certain background information on Form 13H. These aspects of Rule 13h-1 are not addressed by Rule 613 and would not be superseded by it. Rather, the information collected by the registration of large traders would further complement the data collected for a consolidated audit trail. To this end, Rule 613 requires that large trader identifiers also be reported to the central repository as part of any large trader's customer account information[94]

The Commission does note, however, that other aspects of Rule 13h-1 may be superseded by Rule 613. Specifically, the trade reporting requirements of Rule 13h-1 are built upon the existing EBS system. To the extent that, as described in Section II.A.2.iv.d., data reported to the

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91 See SIFMA Letter, p. 18.

92 See Liquidnet Letter, p. 5.

93 Id.

94 See Rule 613(j)(4).

central repository under Rule 613 obviates the need for the EBS system, the Commission expects that the separate reporting requirements of Rule 13h-1 related to the EBS system would be eliminated.[95]

B. Summary of Proposed Rule 613

Proposed Rule 613 would have required that the SROs propose an NMS plan that included provisions regarding: (1) the operation and administration of the NMS plan; (2) the creation, operation and oversight of a central repository; (3) the data required to be provided by SROs and their members[96] to the central repository; (4) clock synchronization; (5) compliance by national securities exchanges, FINRA, and their members with Rule 613 and the NMS plan; and (6) a plan for the possible expansion of the NMS plan to products other than NMS securities.

Specifically, proposed Rule 613 would have required the SROs to jointly file an NMS

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95 Though certain reporting requirements of Rule 13h-1 may eventually be unnecessary due to Rule 613, the Commission notes that Rule 13h-1 will be implemented much more expeditiously compared to the consolidated audit trail, and therefore will address the Commission's near-term need for access to more information about large traders and their activities.

96 Section 3(a)(3)(A) of the Exchange Act defines the term "member" to mean: "(i) any natural person permitted to effect transactions on the floor of the exchange without the services of another person acting as broker; (ii) any registered broker or dealer with which such a natural person is associated; (iii) any registered broker or dealer permitted to designate as a representative such a natural person; and (iv) any other registered broker or dealer which agrees to be regulated by such exchange and with respect to which the exchange undertakes to enforce compliance with the provisions of the [Exchange Act], the rules and regulations thereunder, and its own rules." Section 3(a)(3)(A) further provides that, "[f]or purposes of Sections 6(b)(1), 6(b)(4), 6(b)(6), 6(b)(7), 6(d), 17(d), 19(d), 19(e), 19(g), 19(h), and 21 of [the Exchange Act], the term 'member' when used with respect to a national securities exchange also means, to the extent of the rules of the exchange specified by the Commission, any person required by the Commission to comply with such rules pursuant to Section 6(f) of this title." Finally, Section 3(a)(3)(B) provides that "[t]he term 'member' when used with respect to a registered securities association means any broker or dealer who agrees to be regulated by such association and with respect to whom the association undertakes to enforce compliance with the provisions of [the Exchange Act]." See 15 U.S.C. 78c(a)(3)(A) and 15 U.S.C. 78c(a)(3)(B).

plan with the Commission to govern the creation, implementation, and maintenance of a consolidated audit trail and a central repository.[97] The NMS plan would have been required to provide for an accurate, time-sequenced record of an order's life, from receipt or origination, through cancellation or execution. In particular, the proposed Rule would have required the NMS plan to require that the SROs and their respective members collect and provide to the central repository data for each "reportable event," defined to include the receipt, origination, modification, cancellation, routing, and execution (in whole or in part) of an order, with respect to any NMS security. This data would have been required to be collected and provided to the central repository in a uniform electronic format on a real-time basis.

Under the proposed Rule, the data collected upon the receipt or origination of an order would have included: a unique order identifier; a unique customer identifier;[98] a unique identifier for the broker-dealer receiving or originating the order; the date and time of receipt or origination of the order; and the "material terms of the order."[99] For orders that are modified or cancelled,

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97 The proposed Rule would have explicitly required each national securities exchange and national securities association to be a sponsor of the NMS plan submitted pursuant to the Rule and approved by the Commission. See proposed Rule 613(a)(4). "Sponsor," when used with respect to an NMS plan, is defined in Rule 600(a)(70) of Regulation NMS to mean any self-regulatory organization which is a signatory to such plan and has agreed to act in accordance with the terms of the plan. See 17 CFR 242.600(a)(70).

98 Proposed Rule 613(j)(1) would have defined the term "customer" to mean the beneficial owner(s) of the account originating the order and the person exercising investment discretion for the account originating the order, if different from the beneficial owner(s).

99 The proposed Rule would have defined "material terms of the order" to include, but not be limited to: the NMS security symbol; security type; price (if applicable); size (displayed and non-displayed); side (buy/sell); order type; if a sell order, whether the order is long, short, or short exempt; if a short sale, the locate identifier, open/close indicator, time in force (if applicable), whether the order is solicited or unsolicited, and whether the account has a prior position in the security; if the order is for a listed option, option type (put/call), option symbol or root symbol, underlying symbol, strike price, expiration date, and open/close; and any special handling instructions. See proposed Rule 613(j)(3).

the data collected in real time would have included: the date and time the modification or cancellation was received or originated; the price and remaining size of the order; changes in the material terms of the order (if the order is modified); and the identity of the person giving the modification or cancellation.

For orders that are routed, data collected in real time would have included: the unique order identifier, the date and time the order was routed; the unique identifier of the broker-dealer or national securities exchange routing the order; the unique identifier of the broker-dealer or national securities exchange receiving the order; if routed internally at a broker-dealer, the identity and nature of the department and desk to which the order was routed; and the material terms of the order.

For orders received that were routed, data collected in real time would have included all the information for orders that are routed, except the identity and nature of the department and desk to which the order was routed, if routed internally at a broker-dealer; however, the date and time the order was routed would be replaced by the date and time the order was received.

For the execution of an order, data collected in real time would have included: the unique order identifier; the date and time of execution; the execution size and price; the unique identifier of the SRO or broker-dealer executing the order; the capacity of the broker-dealer executing the order (i.e., principal, agency, riskless principal); and whether the execution was reported pursuant to an effective transaction reporting plan or the OPRA Plan.[100]

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100 "The OPRA Plan" is the Plan for Reporting of Consolidated Options Last Sale Reports and Quotation Information filed with the Commission pursuant to, and meeting the requirements of, Rule 608 of Regulation NMS. The OPRA Plan governs the dissemination of trade and quotation information for listed options. In this capacity, it provides real-time quotation and transaction information to market participants. See 17638 (March 18, 1981), 22 SEC Docket 484 (March 31, 1981) (order approving the OPRA Plan).

Because certain information may not be readily available at the time of the reportable event, the proposed Rule would have required the NMS plan to require each SRO and its members to collect and provide to the central repository certain information, in a uniform electronic format, promptly after receipt of such information, but in no instance later than midnight of the day that the reportable event occurred or when the SRO or its member receives such information. Under the proposed Rule, this data would have included: the account number for any subaccounts to which the execution is allocated (in whole or part); the unique identifier of the clearing broker or prime broker, if applicable; the unique order identifier of any contra-side order; special settlement terms, if applicable; short sale borrow information and identifier; the amount of a commission, if any, paid by the customer, and the unique identifier of the broker-dealer(s) to whom the commission is paid; and, if the execution is cancelled, a cancelled trade indicator.

The proposed Rule would have required that the SROs jointly file an NMS plan with the Commission within 90 days after approval of the Rule. In addition, the SROs would have been required to select a plan processor within two months of the effectiveness of the NMS plan, as well as provide the Commission a document outlining how the SROs would propose to expand the audit trail to include non-NMS securities and additional transactions. The proposed Rule also would have required the SROs to file proposed rule changes to require their members to comply with the requirements of the proposed Rule and the NMS plan within 120 days of the effectiveness of the NMS plan. The SROs would have been required to begin reporting data to the central repository within one year after the effectiveness of the NMS plan, and their members would have been required to begin reporting data to the central repository within two years after the effectiveness of the NMS plan.

As proposed, the NMS plan would have been required to include specific plan provisions detailing: the plan governance structure, the processes of admission and withdrawal of plan sponsors, the percentage of votes required to effectuate amendments to the plan, the allocation of central repository costs among the plan sponsors, and the appointment of a Chief Compliance Officer ("CCO") of the central repository. The proposed Rule would have required all plan sponsors to develop and implement a surveillance system, or enhance existing surveillance systems, reasonably designed to make use of the information contained in the consolidated audit trail. This information would be available to the Commission and the SROs for regulatory and oversight purposes only. The proposed Rule also would have required the NMS plan to require information be collected in a convenient and usable standard electronic data format, directly available and searchable electronically without any manual intervention for a period of not less than five years. This information would have been required to be available immediately, or, if immediate availability was not reasonably and practically achieved, any search query would have to begin operating on the data not later than one hour after the search query was made. Additionally, the proposed Rule would have required the NMS plan to include policies and procedures, including standards, to be utilized by the plan processor to ensure the security and confidentiality of all information submitted to the central repository, and all SROs and their employees, as well as all employees of the central repository, would have been required to agree to use appropriate safeguards to ensure the confidentiality of such data. The proposed Rule also would have required SROs and their members to synchronize their business clocks that are used for the purposes of recording the date and time of any event that must be reported under the proposed Rule consistent with industry standards. Further, the proposed Rule would have required the central repository to collect and retain, on a current and continuing basis, and in a format compatible with the other information collected pursuant to the proposed Rule, the national best bid and national best offer ("NBBO") information for each NMS security. Transaction reports reported pursuant to an effective transaction reporting plan filed with the Commission pursuant to, and meeting the requirements of, Rule 601 of Regulation NMS under the Exchange Act,[101] and last sale reports reported pursuant to the OPRA Plan filed with the Commission pursuant to, and meeting the requirements of, Rule 608 of Regulation NMS under the Exchange Act also would have been required to be collected and retained.

C. Summary of General Comments on the Proposed Rule

The Commission requested comments on all aspects of the proposed Rule, including the potential costs and benefits.[102] In particular, the Commission encouraged commenters to identify, discuss, analyze, and supply relevant data regarding any such costs or benefits.[103] In response, commenters provided views and opinions regarding the regulatory usefulness of a consolidated audit trail; the overall costs of the proposed Rule, focusing on those requirements that commenters believed would be the most costly or burdensome to implement;[104] the process for creating and implementing a consolidated audit trail; and alternatives to the proposed Rule's

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101 The effective transaction reporting plans include the Consolidated Tape Association Plan ("CTA Plan") and the Joint Self-Regulatory Organization Plan Governing the Collection, Consolidation and Dissemination of Quotation and Transaction Information for Nasdaq-listed Securities Traded on Exchanges on an Unlisted Trading Privilege Basis ("UTP Plan").

102 See Proposing Release, supra note 4, at 32586 and 32594.

103 Id.

104 For comments on general costs of the proposed Rule, see, e.g., Thomson Reuters Letter, p. 2; Liquidnet Letter, p. 1; CBOE Letter, p. 2; Nasdaq Letter I, p. 2; Angel Letter, p. 1-2; IAG Letter, p. 3.; Kaufman Letter, attachment p. 3; Wells Fargo Letter, p. 4; Noetic Partners Letter, p. 2; Leuchtkafer Letter, p. 1-5; Broadridge Letter, p. 3; SIFMA Letter, p. 1-2, FINRA Letter, p. 3; FINRA Proposal Letter, p. 2.; High Speed Letter, p. 1; Belanger Letter, p. 7-8.

approach to creating, implementing, and maintaining a consolidated audit trail. These comments are discussed below.

1. Industry Support for a Consolidated Audit Trail

Commenters provided a wide range of opinions, and shared their concerns, regarding specific aspects of the proposed Rule.[105] However, many of the commenters and their representatives who are involved with regulating and operating securities markets – as well as many of the commenters who otherwise populate data for, or make use of, existing audit trail systems (such as broker-dealers) – expressed support for the creation of a single consolidated audit trail.

FINRA and NYSE Euronext, filed a joint letter, "vigorously support[ing] the establishment of a consolidated audit trail," and stating, among other things, that "the evolution of the U.S. equity markets and the technological advancements that have recently taken place have created an environment where a consolidated audit trail is now essential to ensuring the proper surveillance of the securities markets and maintaining the confidence of investors in those markets."[106]

The NASDAQ OMX Group, Inc. similarly states that "[m]arket developments and fragmentation of market centers with varying market structures and levels of transparency have created inefficiencies and potential gaps in cross-market regulation," and that "[c]omplete transparency is the only way to ensure fair and orderly markets."[107]

105 See Section II.C., infra, for a discussion of specific concerns raised by commenters.

106 See FINRA/NYSE Euronext Letter, p. 1. NYSE Euronext is the publicly traded parent of a number of subsidiaries, including three SROs, NYSE, NYSE Amex, and NYSE Arca.

107 See Nasdaq Letter I, p. 2. The NASDAQ OMX Group, Inc. is the publicly traded parent of a number of subsidiaries, including three SROs, Nasdaq, Phlx, and BX.

Other commenters also stated their general support for the creation of a consolidated audit trail. According to Direct Edge Holdings, LLC ("Direct Edge"), "[t]he proposed consolidated audit trail ('CAT') system would significantly enhance the capabilities of regulators to police trading across asset classes; replace existing audit trails and consolidate trading and execution data for the asset classes under the Commission's jurisdiction . . . enable regulators to create a more complete timeline of an order's lifecycle; and facilitate large-scale market reconstructions . . . ."[108]

Although CBOE expressed some concerns in its comment letter about the "breadth, expense, and timetable of the Proposal"[109] (concerns that were shared by other commenters),[110] it "recognizes there are potential benefits to be obtained from CAT, and agrees that a central repository with uniform data submitted by all markets could enhance SRO and SEC oversight of the markets."[111] CBOE further stated that, "[i]n particular, a CAT that contains a customer identifier on an order by order basis would enhance significantly the audit trails of the markets."[112]

BATS Exchange, Inc. ("BATS") expressed general support for the Commission's proposal, stating, "[o]ver the last several years, liquidity has dispersed across multiple interconnected venues, such that no one market center can claim a majority share of equity

108 See Direct Edge Letter, p. 1. Direct Edge is the parent of two SROs, EDGA Exchange, Inc. and EDGX Exchange, Inc.

109 See CBOE Letter, p. 2.

110 See, e.g., Scottrade Letter, p. 1; ICI Letter, p. 4-6; FINRA/NYSE Euronext Letter, p. 4; GETCO Letter, p. 2; BATS Letter, p. 1-2; SIFMA Letter, p. 3-8; Direct Edge Letter, p. 3; FINRA Letter, p. 10-13; Wells Fargo Letter, p. 3; Knight Letter, p. 2-3; Leuchtkafer Letter; Broadridge Letter, p. 3; SIFMA Proposal Letter, p. 1; FINRA Proposal Letter, p. 3.; Liquidnet Letter, p. 3 & p. 5-6; Ameritrade Letter, p. 2-3

111 Id.

112 Id.

securities transactions. However, regulatory tools have not evolved to keep pace with these changes, and the limited existing processes and data available to analyze inter-market trading are inadequate. As a consequence, regulators rely on inefficient processes to reconstruct inter-market trading activity, including ad hoc requests to members for trading data when a potential problem is identified."[113]

Liquidnet, Inc. ("Liquidnet"), an ATS, generally stated that, "[i]n the long run, a properly-designed system that provides for centralized reporting of data should be more cost-efficient than the current patchwork system for collecting audit trail data."[114] Liquidnet outlined seven specific benefits of a consolidated audit trail, ranging from "[reducing] the time that regulatory personnel must expend to request and collect data from market participants on a case-by-case basis," to "[reducing] the cost of reconstructing, analyzing, and reporting on significant market events such as those that occurred on May 6, 2010."[115]

The Securities Industry and Financial Markets Association ("SIFMA"), an industry group that represents, among other entities, hundreds of securities firms that could be impacted by the creation of a consolidated audit trail, "believes that a centralized and comprehensive audit trail would enable the SEC and securities self-regulatory organizations ('SROs') to perform their monitoring, enforcement, and regulatory activities more effectively."[116] SIFMA further states that, "[i]n the current era of electronic trading, regulators need efficient access to order and execution data from both broker-dealers and exchanges. Indeed, a consolidated audit trail is a

113 See BATS Letter, p. 1.

114 See Liquidnet Letter, p. 1.

115 Id. at p. 1-2.

116 See SIFMA Letter, p. 1-2.

much-needed improvement over today's fragmented audit trail platforms."[117] As did a number of other commenters,[118] SIFMA also expressed concerns about, and suggested alternatives to, some specific aspects of the proposed Rule, which will be further discussed below.

Finally, the Commission notes that members of the Financial Information Forum, whose participants include "trading and back office service bureaus, broker-dealers, market data vendors and exchanges," agree that "an enhanced audit trail system could increase the effectiveness of cross-market surveillance through better data availability and integration."[119]

When the perspectives of these commenters are combined with the Commission's own experiences (as described above in Section II.A.1.c.), a common theme emerges: there is substantial room for improvement in the collection of and access to trading data beyond what is available today from existing audit trails and other sources. The Commission agrees with many of the commenters that one of the main benefits of a consolidated audit trail will be to improve the efficiency and adequacy of a regulatory process of collecting and accessing audit trail data that directly affects and impacts a significant number, and wide variety, of market participants.

2. Commenters' Views on the Overall Costs of the Proposed Rule and the Resulting Framework of the Adopted Rule

With respect to general costs for the proposal, commenters expressed differing views. As discussed below, some commenters thought that the Commission overestimated the burdens of creating, implementing, and maintaining a consolidated audit trail, while others argued that the Commission had underestimated such burdens.

117 Id. at p. 2.

118 See, e.g., FINRA/NYSE Euronext Letter, p. 7, FINRA Letter, p. 3, FINRA Proposal Letter, p. 1-16, FTEN Letter, p.1, 4-5, Correlix Letter, p. 2-3; BOX Letter, p. 2; BATS Letter, p. 2.; CBOE Letter, p. 2; Angel Letter, p. 2; Wells Fargo Letter, p. 2; Knight Letter, p. 3; FIF Letter, p. 5-6; Schumer Letter, p. 1.

119 See FIF Letter, p. 1.

Nasdaq was among those commenters that stated that the Commission had overestimated the burdens. Specifically, Nasdaq stated that "innovative technology exists to meet many of the Commission's goals at significantly lower costs than estimated in the Proposing Release," and that SROs should be able to weigh the costs and benefits of various designs.[120] Other commenters also expressed similar opinions stating that a consolidated audit trail accomplishing the Commission's goals could be implemented for less than the preliminary estimates.[121] Two firms with experience in processing and analyzing market data, FTEN and Thomson Reuters, each noted that current technology could convert data from disparate systems into a uniform format, resulting in a less costly implementation of the consolidated audit trail.[122] FTEN stated that "currently available commercial systems are capable of immediately accomplishing CAT goals of real-time cross-market transparency, accountability and control with no implementation risk and for far less than the estimated multi-billion dollar price tag."[123] It further suggested that "[t]he SEC should leverage already deployed and commercially available solutions that are in production use today by major market participants . . . ." and an "iterative approach [that] would leverage existing systems to capture order and execution data in real-time from liquidity destinations (exchanges, ECNs, ATSs and dark pools) and 'map' the data back to original trade submissions by market participants without requiring integration with, or changes to, market participants systems or to liquidity destination systems and without modifying existing order

120 See Nasdaq Letter I, p. 2.

121 See Thomson Reuters Letter, p. 2; Noetic Partners Letter, p. 2; FTEN Letter, p. 1; Ross Letter; Correlix Letter, p. 2.; FINRA Proposal Letter, p. 2.; High Speed Letter, p. 1; Belanger Letter, p. 7-8; Aditat Letter, p. 2 (stating that FIX protocol is already used in the industry today, making it cheaper to create systems to handle consolidated audit trail data as the data already exists in a "suitable format").

122 See FTEN Letter, p. 13; Thomson Reuters Letter, p. 2-3.

123 See FTEN Letter, p. 1.

flow."[124] Similarly, another commenter recommended a technology solution that could handle the required data in milliseconds and that "significantly reduces disk space required, which can potentially save millions of dollars when dealing with multiple terabytes of data."[125] One commenter suggested an entirely different approach through the use of an "adaptive graph indexing-based architecture" as the basis for the consolidated audit trail platform, instead of using a central repository, and explained that this technology would keep trading data within each SRO.[126]

On the other hand, numerous commenters expressed general concerns about the costs of implementing a consolidated audit trail relative to the benefits to be gained. For example, one commenter stated that "there can be no doubt whether market regulators need a consolidated audit trail;" however, the commenter questioned whether a system as costly as the consolidated audit trail was necessary to detect violations such as frontrunning, spoofing, and layering, which are violations the Commission has rarely pursued in the recent past.[127]

As discussed above, many commenters expressed general support for the creation of a consolidated audit trail, but believed that, as proposed, the implementation would be too costly and that the Rule should be modified.[128] Concern about the proposed real-time requirements for

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124 Id. at p. 3.

125 See Know More Software Letter, p. 1.

126 See Belanger Letter, p. 4.

127 See Leuchtkafer Letter, p. 4. See also IAG Letter, p. 3.

128 See, e.g., SIFMA Letter, p. 2, 15-16; FINRA/NYSE Euronext Letter, p. 7; FINRA Letter, p. 3; Angel Letter, p. 2; CBOE Letter, p. 2-6 (suggesting several ways that the costs of the proposal could be reduced, including: leveraging existing SRO experience with audit trail systems and imposing uniformity across markets in those systems; requiring the submission of audit trail information through a batch process after the close of the trading day; deleting the requirement that all market maker quotes be submitted to the proposed consolidated audit trail; making clear that broker-dealers have no obligation to report

reporting data to the central repository was a common theme expressed by these commenters,[129] including those who maintained that a requirement to provide data on a real-time basis would be too burdensome due to the extensive systems changes that would be needed to comply with such a requirement.[130] Some of these commenters argued that a real-time reporting requirement would require many industry participants to build entirely new systems or undertake significant technological upgrades.[131] SIFMA, in particular, estimated that the cost per broker-dealer to implement real-time reporting could be millions of dollars and that the cost of capturing options quotes in real time alone could exceed the Commission's $2.1 billion estimate for the annualized cost of the audit trail.[132] SIFMA further argued that broker-dealers would incur costs associated not only with establishing and maintaining the infrastructure to support real-time reporting, but also due to regulatory risk if they are not able to achieve 100 percent compliance with the

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order information that has already been reported to an exchange; and revisiting the need for a large trader reporting system if that proposed rule is adopted.).

129 See Scottrade Letter, p. 1; ICI Letter, p. 4-6; FINRA/NYSE Euronext Letter, p. 4; GETCO Letter, p. 2; BATS Letter, p. 1-2; SIFMA Letter, p. 3-8; CBOE Letter, p. 4-5; Direct Edge Letter, p. 3; FINRA Letter, p. 10-13; Wells Fargo Letter, p. 3; Knight Letter, p. 2-3; Leuchtkafer Letter; Broadridge Letter, p. 3; FIF Letter, p. 4; SIFMA Drop Copy Letter, p. 1; Ross Letter, p. 1; FINRA Proposal Letter, p. 3; SIFMA February 2012 Letter; FIA Letter, p. 1-2.

130 See Section III.F.2., infra; see also, e.g., BATS Letter, p. 1-2; Broadridge Letter, p. 3; FIF Letter, p. 4-5; FINRA/NYSE Euronext Letter, p. 7; FINRA Letter, p. 3; ICI Letter, p. 4-5; Knight Letter, p. 2; Scottrade Letter, p. 1-2; SIFMA Letter, p. 3-6; SIFMA February 2012 Letter. Some commenters also questioned whether the costs to provide data on a real-time basis would outweigh the benefits. See Scottrade Letter, p. 1-2; FINRA/NYSE Euronext Letter, p. 4; GETCO Letter, p. 2; BATS Letter, p. 2; SIFMA Letter, p. 3-8; CBOE Letter, p. 4; FINRA Letter, p. 11-13; Wells Fargo Letter, p. 3; ICI Letter, p. 4-6; GETCO Letter, p. 2; Direct Edge Letter, p. 3; Leuchtkafer Letter; SIFMA Drop Copy Letter, p. 1; Ross Letter, p. 1; FINRA Proposal Letter, p. 3; SIFMA February 2012 Letter; FIA Letter, p. 2.

131 See Scottrade Letter, p. 1-2; ICI Letter, p. 4-5; SIFMA Letter, p. 4; Knight Letter, p. 2. See also Broadridge Letter, p. 3; FIF Letter, p. 4; FIA Letter, p. 2.

132 See SIFMA Letter, p. 4-6.

proposed Rule.[133] While SIFMA opposed a real-time reporting requirement, and encouraged the Commission to adopt a next day or later reporting requirement,[134] SIFMA also stated that "if the SEC determines to require reporting of certain data elements in real-time or near real-time, we believe such data should be limited to reporting of 'key business events.'"[135] SIFMA further stated that, "if the definition of real-time allowed for reporting within minutes (e.g. 10-15 minutes) of the events, it would be substantially less intrusive on order management systems and may allow for greater flexibility in designing reporting systems architecture and more standardized content for events such as order modifications . . . ."[136] SIFMA described how a reporting system using "drop copies"[137] could be "achievable in the relative near term," although it noted that its proposed process would not, among other things, include a unique Customer ID or a unique order identifier.[138]

Commenters also expressed general concerns regarding the costs of other aspects of the Proposed Rule. For example, Global Electronic Trading Company ("GETCO"), a market maker in equities and equity options, urged the Commission to consider whether quotation information already disseminated by SROs could be reported instead of requiring the SROs and their members to report all quotation information to reduce costs for the industry.[139] Another

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133 Id. at p. 5.

134 See SIFMA Letter, p. 3-4.

135 See SIFMA Drop Copy Letter.

136 Id.

137 A "drop copy" is an electronic copy of a message automatically generated by the existing order management and execution systems used by broker-dealers and SROs.

138 See SIFMA Drop Copy Letter.

139 See GETCO Letter, p. 3-4.

commenter, Wells Fargo Advisors, argued that the inclusion of a unique customer identifier would add "tremendous incremental cost to the [consolidated audit trail]."[140]

Many commenters provided suggestions and views on how the costs of creating and implementing a consolidated audit trail might be lowered. For example, financial technology firm, Correlix, Inc. ("Correlix"), stated that relying on existing infrastructure, where possible, could bring down the cost and amount of time it would take to implement the consolidated audit trail.[141] Correlix further stated that existing technology already is able to provide "a complete end-to-end history of message and order data from the market participant to the execution venue's matching engine and back to the originator," and that allows clients to run customized queries and reports on the data.[142]

A variety of commenters, including SROs and broker-dealers, also believed it would be more cost efficient to use the existing OATS infrastructure specifically as a basis for a consolidated audit trail, rather than to purchase or create an entirely new system.[143] Commenters further argued that existing audit trails could be expanded economically and quickly.[144]

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140 See Wells Fargo Letter, p. 3.

141 See Correlix Letter, p. 2-3.

142 Id.

143 As discussed in Section II.C.4, infra, both SIFMA and FINRA submitted several comment letters with increasing levels of detail on the extent to which existing infrastructures could be used to achieve different forms of the various reporting requirements of the proposed Rule. In one of its later comment letters, FINRA submitted a detailed blueprint describing how it would build a consolidated audit trail that it believed would meet the primary objectives of the proposed Rule in a relatively short timeframe and with minimum costs to the industry. See FINRA Proposal Letter; SIFMA Letter, p. 16-18. See also BOX Letter, p. 2; BATS Letter, p. 2.; CBOE Letter, p. 2-3; Angel Letter, p. 2-3; Wells Fargo Letter, p. 2; Knight Letter, p. 3; FIF Letter, p. 5-6; Schumer Letter, p. 1; FIA Letter, p. 3.

144 See, e.g., FINRA/NYSE Euronext Letter; FINRA Letter; Schumer Letter, p. 1.

In contrast, other commenters expressed the view that costs could be reduced not by using existing audit trail infrastructures, but rather by using new, innovative technology to create the consolidated audit trail.[145] Noetic Partners, a financial technology firm, explained that technologies are currently available to build a system that would capture "full-depth" data with "compression and near-line storage" in a system that would enable fast retrieval and analysis of data, and opined that, based on existing technology, a consolidated audit trail could be implemented for substantially less than the Commission's preliminary estimates.[146] This commenter stated that, based on available technology, a fully functional consolidated audit trail could be implemented in months, rather than years, at an initial cost of less than $100 million.[147]

An aggregate analysis of the many specific opinions described above suggests that commenters' views regarding the costs of creating, implementing, and maintaining a consolidated audit trail fall into one of two general categories. One set of commenters expressed the view that many, if not all, of the requirements of the proposed Rule could be met in a cost-effective fashion if current audit trail systems were replaced with new technologies and systems. However, another set of commenters expressed the view that a number of the requirements of the proposed Rule would be very costly to implement, and, instead, suggested that the most cost-effective method of creating a consolidated audit trail would be to relax some of the proposed requirements and build upon the infrastructure of existing audit trail systems.

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145 See Noetic Partners Letter II, p. 2; High Speed Letter, p. 1 (opining that estimated costs could be reduced if data were stored in an off-the-shelf cloud-based storage system or if a petabyte storage facility was built to store data and also estimating that "an integrated analysis system combining bespoke software for first-cut filtering of data from the repository, along with [commercial off-the-shelf software] for detailed analysis, could be developed for less than $10M"). See also Know More Software Letter, p. 1; Belanger Letter, p. 4; FTEN Letter, p. 1, 13.

146 See Noetic Partners Letter II, p. 2.

147 Id.

Therefore, as discussed above and in detail below,[148] in response to these comments, and specific comments discussed throughout this Release,[149] the Commission is adopting Rule 613 with substantive changes to some of the specific collection, reporting, and data requirements of the Rule.[150] The Commission believes that these changes significantly expand the solutions that could be considered by the SROs for creating, implementing, and maintaining a consolidated audit trail and provide the SROs with increased flexibility in how they choose to meet the requirements of the Rule compared with the requirements of the proposed Rule. For example, the Rule no longer requires real-time reporting[151] or only one unique order identifier;[152] thus, the Rule would accommodate an NMS plan based on the types of solutions proposed by SIFMA and FINRA. However, to guide the SROs in their development of the NMS plan, the Rule includes several specific considerations[153] that the Commission intends to use to evaluate the submitted NMS plan and consider its costs and benefits.

The changes from the Proposing Release provide the SROs with the flexibility to submit an NMS plan that provides creative solutions that harness innovative technology or that build on existing audit trail systems.

3. Comments on the Process for Creating a Consolidated Audit Trail

The Commission received comments regarding the process through which a consolidated audit trail should be created. As proposed, the Rule required that the SROs submit an NMS plan setting forth the details for the creation, implementation, and maintenance of a consolidated audit

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148 See Section I., supra.

149 See, generally, Section III., infra.

150 See Section I., supra, for a summary of the changes to proposed Rule 613.

151 See Rule 613(c)(3); Section I., supra; Section III.B.1.e., infra.

152 See Rule 613(j)(1); Section I., supra; Section III.B.1.d.iv., infra.

153 See Rule 613(a)(1)(i) through (xii); Section I., supra; Section III.C.2.a., infra.

trail within 90 days of approval of the Rule. A few commenters suggested that more time be allotted for the planning and design of the NMS plan.[154] FIF and the Security Traders Association ("STA") recommended extensive, "up-front business analysis,"[155] explaining that if conducted "during the CAT plan development process, [they] are confident that issues would emerge earlier in the process, leading to more efficient and cost-effective solutions."[156] These commenters believed that the business analysis would require many discussions involving the Commission, the SROs and teams comprising members of the securities industry.[157]

In this regard, several commenters suggested that the Commission undergo a RFP or request for information ("RFI") process to create and implement a consolidated audit trail.[158] Specifically, FIF urged the Commission to perform a RFP process "to determine the best technical solution for developing a consolidated audit trail."[159] FIF suggested that the Commission "should outline a set of goals and guiding principles they are striving to achieve as part of the adopted CAT filing and leave the determination of data elements and other technical requirements to [an] industry working group."[160] Similarly, Direct Edge suggested that Commission staff should form and engage in a working group to develop an RFP for publication by the Commission.[161] DirectEdge explained that an RFP process would facilitate the

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154 See FIF Letter II, p. 2-3; STA Letter, p. 2; Nasdaq Letter I, p. 6-7.

155 See FIF Letter II, p. 1, 3; STA Letter, p. 1, 3.

156 See FIF Letter II, p. 2; STA Letter, p. 1.

157 See FIF Letter II, p. 1; STA Letter, p. 1-2.

158 See FIF Letter, p. 1, 9; FIF Letter II, p. 1-2; STA Letter, p. 2; Direct Edge Letter, p. 2-3, 5.

159 See FIF Letter, p. 1.

160 See FIF Letter II, p. 2.

161 See Direct Edge Letter, p. 2-3, 5. See also STA Letter, p. 1-3 (recommending the use of working groups comprising the Commission, FINRA, exchanges, broker-dealers,

identification of the costs and benefits of the audit trail, as well as the consideration of a wider range of technological solutions.[162] Further, commenters, including Broadridge Financial Solutions, Inc., a technology provider,[163] also requested more specific information about the audit trail system to better assess the Commission's initial cost estimates and to determine the best approach to the consolidated audit trail.[164]

To gather the necessary information, commenters argued that the timeframe for submitting an NMS plan should be extended. FIF and STA opined that the time needed to perform the analysis to produce a "detailed blueprint for CAT"[165] would be closer to six months,[166] rather than the proposed 90 days.[167] As a basis for their suggestions, FIF provided a breakdown of the time and the types of work needed for FINRA's expansion of OATS to all NMS securities.[168] FIF noted that over one-third of the time required for the project was spent

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investors, vendors, and institutional asset managers to conduct business analysis and requisite discussions with the industry in planning a consolidated audit trail that meets the Commission's goals).

162 Id. at p. 3.

163 See Broadridge Letter, p. 2.

164 See Broadridge Letter, p. 2; FIF Letter, p. 8. See also Ross Letter, p. 1 (discussing examples of information security details to consider); Nasdaq Letter I, p. 6 (stating that the proposed Rule provided "incomplete technical information on which design and features make the most sense").

165 See FIF Letter II, p. 1-2; STA Letter, p. 2.

166 See FIF Letter II, p. 2; STA Letter, p. 2-3; see also Nasdaq Letter I, p. 7 (arguing for "scheduling flexibility at the initial stage" of designing the consolidated audit trail).

167 See proposed Rule 613(a)(1).

168 See FIF Letter II, p. 3. The commenter also provided the cost to the industry for the expansion of OATS to all NMS stocks - $48 million. The Commission notes that this is the cost for the project as a whole, not solely for the planning phase, and therefore is not entirely applicable to the cost of the creating and filing the NMS plan required by Rule 613.

on conducting business analysis, and that one-third of the time was spent on project development.[169]

In response to these comments, the Rule requires the SROs to provide more information and analysis to the Commission as part of their NMS plan submission than would have been required under the proposed Rule. As discussed in more detail below, these requirements have been incorporated into the Rule as "considerations" that the SROs must address, and they generally mandate that the NMS plan submitted to the Commission for its consideration discuss certain important features and details of the NMS plan, such as how data will be transmitted to the central repository, as well as an analysis of NMS plan costs and impact on efficiency, competition, and capital formation, the process followed by the SROs in developing the NMS plan, and information about the implementation plan and milestones for the creation of the consolidated audit trail.[170] These requirements are intended to ensure that the NMS plan is the result of a thorough and well-developed plan for creating, implementing, and maintaining the consolidated audit trail, and the Proposing Release highlighted the importance of these types of considerations. In Section III.C. below, the Commission also provides details about how it envisions regulators would use, access, and analyze consolidated audit trail data through a number of "use cases" to help the SROs prepare a sufficiently detailed NMS plan that addresses the requirements of the adopted Rule.[171]

Because of the additional information and analysis required to be included in the NMS plan, the Commission is extending the amount of time allowed for the SROs to submit the NMS plan. Rule 613(a)(1) provides that "[e]ach national securities exchange and national securities

169 The time remaining was spent on "testing and other activities." See FIF Letter II, p. 3.

170 See Section III.C.2.a., infra.

171 See Section III.C.2.b., infra.

association shall jointly file on or before 270 days from the date of publication of the Adopting Release in the Federal Register a national market system plan to govern the creation, implementation, and maintenance of a consolidated audit trail and central repository as required by this section." The Commission will publish the NMS plan submitted in accordance with Rule 608 of Regulation NMS under the Exchange Act[172] for public comment and will approve the NMS plan if the Commission determines it is necessary or appropriate in the public interest, for the protection of investors and the maintenance of fair and orderly markets, to remove impediments to, and perfect the mechanisms of, a national market system, or otherwise in furtherance of the purposes of the Act. [173] The Commission also will consider whether the NMS plan submitted for its consideration would achieve the objectives of the Rule.

4. Comments on Alternatives to the Proposed Consolidated Audit Trail

Several commenters, many of whom generally supported the concept of a consolidated audit trail, recommended alternatives for how a consolidated audit trail should be created, implemented, and maintained. In particular, the Commission received comments suggesting various ways that the OATS system could be modified to serve as the central repository for the consolidated audit trail. FINRA submitted a blueprint for a modified version of OATS that listed certain changes to address the Commission's proposed requirements for the creation, implementation, and maintenance of the consolidated audit trail.[174] The proposed modifications included, for example, the addition of data elements capturing whether an order was solicited,

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172 17 CFR 242.608.

173 17 CFR 242.608(b)(2).

174 See FINRA Proposal Letter.

customer account type, a large trader identifier,[175] and a unique identifier for branch office and registered representative to the data reported to OATS;[176] using OATS to capture order and quote data from all national securities exchanges and eventually OPRA; the inclusion of options, fixed income securities, security-based swaps, principal orders and orders originating in firm-controlled accounts for purposes of working a customer order in OATS; the use of CRD numbers to identify broker-dealers; an exchange data processing gateway for OATS to validate submissions from exchanges; full access to regulators of queryable consolidated audit trail data through the FINRA web portal;[177] and OATS' acceptance of limited drop-copy report information from broker-dealers on a 15-minute reporting basis.[178] However, FINRA's blueprint provided that the large trader identifier should be used initially to identify market participants, as the complexities of tracking retail accounts, the infrequent amount of trading by retail investors, and the large number of such investors make requiring a unique customer identifier difficult.[179]

Another commenter from the academic field believed that a modified version of OATS (including fields incorporating ultimate customer account information, a reduction in the time stamp standard to milliseconds or even microseconds, and standardized clock synchronization requirements), coupled with a requirement that exchanges must report to OATS, would allow OATS to fulfill the needs of the consolidated audit trail in a less costly manner than originally

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175 See FINRA Proposal Letter, p. 4, 6 (arguing against requiring the name and address of the beneficial owner of an account, as well as of the individual making the investment decision, and against requiring tax identification or social security numbers for individual investors).

176 Id. at p. 7 and Appendix B.

177 Id.

178 Id. at p. 3-4 (noting that this information would be available for query by regulators within one hour of receipt, would include a unique order identifier and MPID, and would be added on T+1 to the "order lifecycle" using OATS and TRF data).

179 Id. at p. 4.

proposed.[180] This commenter stated that the Commission's needs could be met by "a few tweaks to the existing trade reports and by extending OATS to cover all NMS stocks and executions at exchanges."[181]

Several commenters, including SROs and broker-dealers, generally believed that it would be more cost and time efficient to use a form of OATS as a basis for the consolidated audit trail than to purchase or create a new system.[182] For example, FINRA/NYSE Euronext stated that modifying existing systems would reduce both the time and cost to develop a consolidated audit trail, explaining that "the programming changes needed to comply with an entirely new system are substantially greater than expanding existing protocols,"[183] while BATS suggested that significant cost savings may be realized by building a consolidated audit trail that "leverages elements of OATS."[184] FINRA/NYSE Euronext also argued that existing audit trails could be

180 See Angel Letter, p. 3 (also noting, "While the OATS data are extremely useful for understanding market behavior and for searching for various violations, these data are not really needed for real time surveillance. Real time surveillance is generally focused on the question of whether or not some change needs to take place immediately . . . . The extensive OATS data regarding the handling of individual orders are more useful for economic analysis and enforcement activities and do not need to be reported in real time.")

181 Id.

182 See FINRA Proposal Letter; BOX Letter, p. 2; BATS Letter, p. 2.; CBOE Letter, p. 2-3; Angel Letter, p. 2-3; SIFMA Letter, p. 16-18; Wells Fargo Letter, p. 2; Knight Letter, p. 3; FIF Letter, p. 5-6; Schumer Letter, p. 1; FIA Letter, p. 1-3.

183 See FINRA/NYSE Euronext Letter, p. 7. See also FINRA Letter, p. 3 (stating that "the necessary components to an effective, comprehensive, and efficient consolidated audit trail are: (1) uniform data (both data content and data format); (2) reliable data; and (3) timely access to the data by SROs and the SEC. FINRA believes this can be achieved most effectively, efficiently, and expeditiously by expanding FINRA's existing OATS requirements to additional securities and non-FINRA member broker-dealers and by consolidating exchange data in a central repository to be used with OATS data").

184 See BATS Letter, p. 2.

expanded "economically and quickly,"[185] noting that use of such systems, such as FINRA's OATS, could make the central repository unnecessary.[186] Similarly, FINRA believed that using OATS as a foundation of the consolidated audit trail would make the consolidated audit trail easier to implement,[187] as opposed to building a new system, which could take years to establish and would likely result in "negative unintended consequences" during development.[188] FIF suggested leveraging FINRA's Trade Reporting and Compliance Engine as a basis for the coverage of debt securities.[189]

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185 See FINRA/NYSE Euronext Letter, p. 14; FINRA Letter.

186 Id.

187 See FINRA Letter, p. 6. Specifically, FINRA proposed enhancements to OATS and outlined a phased approach for implementation. It explained that, under its approach, implementation would begin with equity securities in the first two phases, followed by options in the third and fourth phases. FINRA further proposed that it could "establish an intraday abbreviated order submission capability based on SIFMA's drop-copy proposal." FINRA estimated the initial cost for the first two phases of the OATS enhancement would be between $100 to $125 million and the ongoing annual costs to be between $30 million and $40 million. While FINRA's proposal appears to include many of the elements required by Rule 613, the Commission notes that the proposal does not include a Customer-ID (which was similarly lacking in the SIFMA proposal), nor would all broker-dealers be required to report order information to the central repository (certain firms that route orders exclusively to another reporting firm that is solely responsible for further routing decisions would be exempt from reporting obligations; additionally, FINRA proposed retaining exemptive authority in certain limited situations to provide relief to small member firms that do not otherwise qualify for exclusion from the definition of an OATS Reporting Member). Further, FINRA's proposal would not collect customers' names, addresses and account numbers. See FINRA Proposal Letter, p. 10; 14-16; Appendix. The Commission believes a unique Customer-ID and customer account information are critical to the efficacy and usefulness of the consolidated audit trail, and therefore is requiring the NMS plan submitted for its consideration to include such information.

188 Id. This commenter also noted that OATS compliance rates have improved to over 99% since the system was first implemented, and emphasized that creating a new system would result initially in low compliance rates until users became familiar with the system. Id. at p. 11; see also FINRA/NYSE Euronext Letter, p. 8.

189 See FIF Letter, p. 6 (also providing thoughts on the functionalities of OATS that should be considered in creating the consolidated audit trail, such as OATS' ability to identify and reject duplicative reporting; to link reports between firms and Nasdaq exchanges

Two SROs, BOX and CBOE, recommended the joint use of both OATS and COATS.[190] BOX suggested an expansion of OATS and COATS to include customer information,[191] and CBOE stated that it believed that certain aspects of OATS and COATS could be combined, with the addition of customer and routing broker information, and new formats.[192] The Commission also received an alternative proposal from a commenter that was not based on OATS, but on a combination of automatically-generated drop-copies and the Financial Information eXchange ("FIX") protocol.[193] SIFMA urged reporting on a T+1 basis as it believed real-time reporting would require significant changes to existing order management and trading systems.[194] If T+1 reporting were not adopted, however, SIFMA's proposal suggested that certain data be provided to the central repository in near real time, such as data pertaining to "key business events" such as order receipt and origination, order transmittal, execution, modification, and cancellation. SIFMA's proposal listed the specific data elements to be reported for each event, but, to achieve quick implementation, did not include unique customer or order identifiers,

without using a unique customer identifier; its possible flexibility in incorporating additional order types; its current incorporation of quote data; and its current identification of index arbitrage and program trading, and ability to possibly add a large trader identification field "to enhance analysis of high volume, algorithm trading").

190 See BOX Letter, p. 2; CBOE Letter, p. 2.

191 See BOX Letter, p. 2.

192 See CBOE Letter, p. 2.

193 See SIFMA Drop Copy Letter. The FIX Protocol is a series of messaging specifications for the electronic communication of trade-related messages. It has been developed through the collaboration of banks, broker-dealers, exchanges, industry utilities and associations, institutional investors, and information technology providers from around the world. These market participants share a vision of a common, global language for the automated trading of financial instruments. See http://fixprotocol.org/what-is-fix.shtml (last viewed on May 30, 2012).

194 Id. at p. 1.

or an identifier for algorithmic orders.[195]

The Commission has considered the comments on alternative proposals, including those based on OATS, and has made significant modifications to the proposed Rule in light of such comments. Each of these modifications is discussed in detail in Section III. below. But the Commission notes more generally that, as adopted, Rule 613 does not prescribe a specific audit trail collection system or a particular method of data collection to be used for the central repository. In addition, the Commission believes that certain modifications to Rule 613, such as allowing data to be reported by 8:00 a.m. Eastern Time the following trading day, rather than in real time as proposed, provide the SROs with a wider range of options for how they choose to meet the requirements of the adopted Rule compared with the requirements of the proposed Rule. This wider range of options could more easily accommodate an OATS-based approach or other approaches for the creation of a consolidated audit trail, as suggested by commenters, consistent with the requirements of Rule 613.

The Commission notes, however, that OATS, in its current form, has certain limitations and does not include certain attributes that the Commission deems crucial to an effective and complete consolidated audit trail.[196] Some of the limitations of OATS that would need to be addressed to meet the requirements of Rule 613 include:

- At present, only FINRA members are required to report trade and order activity through OATS. The resulting exclusion of some exchange-based and other types of non-member activity could lead to significant gaps in the data as an order is generated, routed, re-routed, and finally executed, canceled, or modified;

195 Id. at p. 1-2.

196 See Section II.A.1.c., supra.

- OATS does not currently require the collection of market-making quotes submitted by registered market makers (in those stocks for which they are registered), resulting in further, significant gaps in the data;
- OATS is a part of a process by which FINRA collects data from its members for its own regulatory use. OATS is not a central repository and therefore does not presently provide other regulators with ready access to a central database containing processed, reconciled, and linked orders, routes, and executions ready for query, analysis, or download; and
- OATS does not presently collect options data, and does not afford regulators an opportunity to perform cross-product surveillance and monitoring;
- OATS does not collect information on the identities of the customers of broker-dealers from whom an order is received. As discussed above in Section I., the Commission believes that the integrated inclusion of such data elements into a single consolidated audit trail provides many important regulatory benefits.

III. Discussion

A discussion of each of the key provisions of Rule 613, as adopted, is set forth below.

A. NMS Plan

1. Description of the Rule

a. Implementation of the Consolidated Audit Trail through an NMS Plan

As proposed, the consolidated audit trail would have been created, implemented, and maintained through an NMS plan approved by the Commission. As proposed, Rule 613(a)(1) would have required each national securities exchange and national securities association to jointly file on or before 90 days from approval of the Rule an NMS plan to govern the creation, implementation, and maintenance of a consolidated audit trail and a central repository.[197] The Commission would then have been required to publish the NMS plan for public comment pursuant to Rule 608 of Regulation NMS under the Exchange Act,[198] and, following the period of public comment, would consider whether or not to approve the NMS plan. In the Proposing Release, the Commission stated its expectation that the exchanges and FINRA would "cooperate with each other and take joint action as necessary to develop, file, and ultimately implement a single NMS plan to fulfill this requirement."[199]

The Commission requested comment on this approach. Specifically, the Commission requested comment on whether requiring the exchanges and FINRA to jointly file an NMS plan that would contain the requirements for a consolidated audit trail was the most effective and efficient way to achieve the objectives of Rule 613, or whether the Commission should require the exchanges and FINRA to standardize or otherwise enhance their existing rules. The Commission further requested comment on which approach would be most efficient in improving the ability to monitor cross-market trading, or to undertake market analysis or reconstructions, and why.

Two commenters discussed how the consolidated audit trail should be created and implemented through an NMS plan.[200] One noted that the Rule should provide the SROs with sufficient flexibility to develop an NMS plan that meets the overarching goals of the

197 This Section III.A. discusses the use of a NMS plan to create, implement, and maintain a consolidated audit trail. Section III.C., infra, focuses on the process the SROs must follow when submitting the NMS plan to the Commission.

198 17 CFR 242.608. See Rule 613(a)(2).

199 See Proposing Release, supra note 4, at 32568.

200 See Thomson Reuters Letter, p. 2; CBOE Letter, p. 7.

Commission.[201] The second suggested that the Rule should "include only the elements needed for a [consolidated audit trail], and then leave it up to the SROs, [securities information processors] and involved vendors to develop the specifications for the data elements to be specified in the NMS plan, which would ultimately be subject to public comment and SEC approval."[202]

Other commenters objected in principle to the use of an NMS plan to create and implement the consolidated audit trail.[203] One commenter stated that implementing the consolidated audit trail through an NMS plan would be "difficult and inefficient," given the need "to respond and adapt quickly to new ways of trading and handling orders," and believed it would be difficult to jointly make necessary technology changes under an NMS plan because, based on the commenter's experience of collecting data for an existing audit trail, "technology changes and changes to technical specifications must be made regularly and promptly with respect to firm-specific reporting requirements, interpretations, and codes to keep up with complex and evolving trading and routing strategies."[204] Another commenter argued that an NMS plan is "unnecessary … given all of the governance issues with NMS plans" because "[t]he Commission can get most of what it needs with a few tweaks to the existing trade reports and by extending OATS to cover all NMS stocks and executions at exchanges."[205]

For the reasons discussed below, the Commission continues to believe that an NMS plan

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201 See Thomson Reuters Letter, p. 2.

202 See CBOE Letter, p. 7.

203 See FINRA Letter, p. 15; Angel Letter, p. 3.

204 See FINRA Letter, p. 15.

205 See Angel Letter, p. 3.

filed pursuant to Rule 608 of Regulation NMS[206] is the most effective mechanism to implement the consolidated audit trail, and is adopting Rule 613 with a number of modifications and clarifications to address the concerns of commenters.[207]

The Commission believes that the creation, implementation, and maintenance of the consolidated audit trail through an NMS plan will ensure that the SROs' expertise as the "front line" regulators of securities markets is drawn upon to develop the details of the consolidated audit trail, and to make appropriate adjustments as warranted to respond to changes in the securities markets and technology going forward. As such, under the Commission's approach, Rule 613 outlines a broad framework for the creation, implementation, and maintenance of the consolidated audit trail, including the minimum elements the Commission believes are necessary for an effective consolidated audit trail. Additionally, Rules 613(a)(1) and (a)(4), which require that each SRO jointly file and be a sponsor of the NMS plan, is being adopted as proposed. The Commission continues to believe that requiring all SROs to jointly file the NMS plan to establish the consolidated audit trail, as opposed to the flexibility provided by current Rule 608 of Regulation NMS under the Exchange Act,[208] which permits any two or more SROs to submit an NMS plan, is appropriate because such a requirement is expected to result in an NMS plan that is the product of negotiation and compromise among all of the SROs; in this regard, the NMS plan submitted to the Commission also may be more readily implemented as the NMS plan should take into consideration the capabilities of every SRO.

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206 See Rule 613(a). The proposed Rule provided that the NMS plan must be filed with the Commission pursuant to Rule 608. Adopted Rule 613(a)(2) clarifies that the NMS plan must also satisfy the requirements set forth in Rule 608(a). See Rule 608(a) of Regulation NMS; 17 CFR 242.608(a).

207 See Section III.C., infra.

208 17 CFR 242.608. See Rule 613(a)(2).

In response to the commenter that advocated granting additional flexibility to the SROs in developing the requirements of the NMS plan,[209] the Commission has made significant modifications to the Rule in several respects to increase the options available to SROs in developing the requirements of the NMS plan.[210] Furthermore, in instances where Rule 613 sets forth minimum requirements for the consolidated audit trail, the Rule provides flexibility to the SROs to draft the requirements of the NMS plan in a way that best achieves the objectives of the Rule. For example, Rule 613 requires the NMS plan submitted to the Commission for its consideration to require material terms of an order, such as order type, to be collected by the central repository.[211] However, the Rule does not enumerate specific order types or prescribe the format or nature of how this information would be represented. This would be left to the SROs developing the NMS plan and allows flexibility for the future, when new order types may be introduced and added, if appropriate.

Similarly, in response to the commenter stating that implementing the consolidated audit trail through an NMS plan would be "difficult and inefficient" given the need to respond and adapt quickly to new ways of trading and handling orders,[212] the Commission notes that, while the NMS plan submitted to the Commission for its consideration must contain the minimum necessary elements for the consolidated audit trail, and any amendments to an effective NMS plan initiated by plan sponsors will require approval by Commission order, the SROs should have flexibility to accommodate a variety of technological and other market developments without amending the NMS plan (e.g., through the issuance and updating of technical

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209 See Thomson Reuters Letter, p. 2.

210 See Section I., supra; Sections III.B., III.C., infra.

211 See Section III.B.1.d.i.(A)., infra.

212 See FINRA Letter, p. 15.

specifications that are reasonably and fairly implied by the NMS plan). Underscoring this need to ensure the consolidated audit trail is regularly updated to remain compatible with best market practices, the Commission, as discussed in Section III.C.2.a.i., also has added general requirements to Rule 613 with regards to SROs monitoring and planning for the technological evolution of the consolidated audit trail. Further, as noted in Section III.B.3 below, the NMS plan must include a governance structure for the central repository that is designed to ensure efficient decision-making.

The Commission has also considered the comment that recommended that the Commission should leave it to the SROs, securities information processors ("SIPs") and vendors to develop the specifications for the data elements in the NMS plan.[213] The Commission agrees in principle with the commenter, and believes that market participants other than SROs also could have valuable insights regarding the design of the specifications for the data elements, the central repository, and other aspects of the Rule. To address this concern, the adopted Rule requires the SROs to explain in the NMS plan the process by which they solicited views of their members regarding the creation, implementation, and maintenance of the consolidated audit trail, a summary of the views of such members, and how the plan sponsors took such views into account in preparing the NMS plan.[214] In addition, the Rule requires the NMS plan submitted to the Commission for its consideration to provide for the creation of an Advisory Committee to afford SRO members, and other interested parties as permitted by the NMS plan,[215] the

213 See CBOE Letter, p. 7.

214 See Rule 613(a)(1)(xi).

215 See Rule 613(b)(7)(i). Because members of the SROs will be required to report data pursuant to the NMS plan, the Rule provides that the plan must require that the Advisory Committee include representatives of the member firms of the SROs. However, the Commission believes that it is advisable for the SROs to consider including other interested parties such as SIPs, vendors, investors, and/or academics on the Advisory

opportunity to have input on the creation, implementation, and maintenance of the consolidated audit trail.[216] The Commission also notes that nothing in the Rule precludes the SROs, as plan sponsors, from consulting with others, including the SIPs and vendors, as they craft the NMS plan. Finally, pursuant to Rule 608(b)(1), the NMS plan will be published for public comment.[217] Thus, all interested persons, including market participants, regulatory authorities, and the general public, will have an opportunity to provide meaningful comments on the details and costs of the NMS plan submitted to the Commission, which the Commission will review and consider.

In response to the commenter that believed that the objectives of the consolidated audit trail could be achieved "with a 'few tweaks' to the existing trade reports and by extending OATS,"[218] the Commission notes, as described above, that existing trade reports and the current OATS process combined do not meet many of the requirements the Commission believes are essential for a consolidated audit trail. The Commission therefore believes that an NMS plan, as noted above, provides an effective mechanism for the SROs to create, implement, and maintain a consolidated audit trail meeting such requirements. However, it also notes that the adopted Rule does not preclude the infrastructure, nomenclature, format, or any other aspects of an existing order audit trail system, such as OATS, from being used for the consolidated audit trail, provided the NMS plan proposing to establish such an audit trail otherwise meets the requirements of Rule 613. The Commission stresses that existing order audit trails lack critical information such as the

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Committee. In addition, the Commission expects that the Advisory Committee would include the Commission's Chief Technology Officer as an observer. See Section III.B.3.b., infra.

216 See Rule 613(b)(7).

217 17 CFR 242.608(b)(1).

218 See Angel Letter, p. 3.

identity of the customer, data on principal orders or quotes, and a way to link orders across markets – information that the Commission believes is essential to the consolidated audit trail.[219]

B. Elements of the NMS Plan

As discussed above, the adopted Rule requires the SROs to submit an NMS plan to create, implement, and maintain a consolidated audit trail.[220] As adopted, the Rule permits the SROs to consider a wider array of solutions, in creating, implementing, and maintaining a consolidated audit trail. The Rule, however, also sets forth certain minimum requirements of the consolidated audit trail that must be included in the NMS plan submitted by the SROs to the Commission for its consideration. The Commission believes that it is important to set forth certain minimum requirements to ensure that the consolidated audit trail will be designed in a way that provides regulators with the accurate, complete, accessible, and timely market activity data they need for robust market oversight. The minimum audit trail requirements that must be included in the NMS plan submitted by the SROs are discussed below.

1. Recording and Reporting

a. Products and Transactions Covered

As proposed, Rule 613 would have applied to secondary market transactions in all NMS securities, which includes NMS stocks and listed options.[221] In the Proposing Release, the

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219 See Section II.A., supra. The Commission notes that, in the Proposing Release, it used the term "proprietary orders" to describe orders that were generated for the account of a broker-dealer. See Proposing Release, supra note 4, at 32570.

To avoid confusion with the proposed "Volcker Rule," which proposes new regulations with respect to "proprietary" trading by commercial banks and their affiliates, the Commission is using the term "principal orders" in this Release to describe orders that were generated for the account of a broker-dealer. See Securities Exchange Act Release No. 65545 (October 12, 2011), 76 FR 68846 (November 7, 2011) (File No. S7-41-11).

220 See Section I., supra.

221 See proposed Rule 613(c)(5).

Commission also addressed the possibility of expanding the scope of the consolidated audit trail over time. Specifically, proposed Rule 613(i) would have required the NMS plan to include a provision requiring each national securities exchange and national securities association to jointly provide to the Commission, within two months after effectiveness of the NMS plan, a document outlining how such exchanges and associations would propose to incorporate into the consolidated audit trail information with respect to equity securities that are not NMS securities, debt securities, primary market transactions in NMS stocks, primary market transactions in equity securities that are not NMS securities, and primary market transactions in debt securities. The document also would have been required to identify which market participants would be required to provide the additional data and to include an implementation timeline and a cost estimate for including such data in the consolidated audit trail.[222] The Commission requested comment on whether expanding the consolidated audit trail to include the products and transactions specified above was an appropriate approach to the eventual expansion of the consolidated audit trail, and, if so, an appropriate and realistic timetable for doing so.

Several commenters expressed opinions on the scope of the products and transactions proposed to be covered by the Rule and how their inclusion in the consolidated audit trail should be phased in under the Rule.[223] One commenter urged the Commission to consider including

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222 The Commission notes that any expansion of the consolidated audit trail to cover non-NMS securities would be effectuated through notice and comment.

223 See Liquidnet Letter, p. 2 (suggesting limiting the scope of the first phase of audit trail implementation to end-of-day-reporting to ensure that it can be completed in a timely and cost-effective manner; this commenter also recommended that the first phase apply the consolidated audit trail to all market participants, not just the SROs, as proposed). See also FIF Letter, p. 7 (suggesting that the consolidated audit trail cover just NMS stocks - then at a later date, all NMS securities, including options); FINRA Proposal Letter, p. 5 (suggesting several phases of expansion, beginning with NMS stocks and over-the-counter ("OTC") equity securities, and ultimately including standardized options, fixed income securities, conventional options, and security-based derivatives in the

additional asset classes in the scope of the products covered by the Rule, and specifically questioned the value of the consolidated audit trail without the inclusion of information on futures and other derivatives.[224]

The Commission also received comment on the proposed Rule's approach for considering a possible future expansion of the products and transactions covered by the consolidated audit trail. One commenter believed that its technology would allow development of a platform that would support multiple asset classes and expansion of the consolidated audit trail for use by other regulators.[225] Other commenters expressed general support for expanding the scope of products covered.[226] One specifically suggested expanding the scope of the Rule, for example, to include the "creation of instruments that underlie the securities that make up [mortgage-backed securities] and [asset-backed securities]."[227] Another suggested expanding the consolidated audit trail to all securities submitted to an exchange or clearing agency.[228] Yet another commenter, however, argued against allowing the exchanges, through the NMS plan, to

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consolidated audit trail); SIFMA Letter, p. 16-17 (believing that OATS could form the basis for the consolidated audit trail, stating that OATS should be modified to include non-Nasdaq-listed securities, listed options, quotes, street side and exchange-to-exchange routing and market making and recommending phasing in NMS stocks first, then any additional data elements, then listed options and, finally, non-NMS securities); FIF Letter II, p. 2 (suggesting that the consolidated audit trail have "multi-instrument capabilities, most importantly options and futures but also fixed income and other instruments).

224 See Broadridge Letter, p. 4.

225 See Nasdaq Letter II, p. 3.

226 See Liquidnet Letter, p. 2; FINRA Proposal Letter, p. 5; SIFMA Letter, p. 16-17; Marketcore Letter, p. 1.

227 See Marketcore Letter, p. 1.

228 See Ameritrade Letter, p. 3. See also Mansfield Letter, p. 1 (suggesting other data, including "metrics" and "market environmental information" to be included in the consolidated audit trail).

have primary responsibility for specifying the data requirements of non-exchange-traded asset classes, stating that exchanges lacked experience with these instruments.[229]

The Commission has considered the comments discussed above and is adopting the Rule as proposed with respect to the scope of the securities that must be covered at this time, but, as described below, acknowledges the importance of a mechanism for considering other types of products in the future. Specifically, the adopted Rule requires that consolidated audit trail data be collected for all NMS securities.[230] However, the Commission also is adopting the requirement that the NMS plan require the SROs to jointly submit a document outlining a possible plan for expansion of the consolidated audit trail, as proposed, but with three modifications from the proposed Rule.

Rule 613(i) requires that the SROs jointly provide the Commission a document outlining how the SROs could incorporate the following additional products into the consolidated audit trail: equity securities that are not NMS securities, debt securities, primary market transactions in equity securities that are not NMS securities, and primary market transactions in debt securities ("expansion document"). The adopted Rule also requires the expansion document to include details for each order and reportable event that may be required to be provided, which market participants may be required to provide the data, an implementation timeline and a cost estimate. The first modification from the proposed Rule is a technical change clarifying that Rule 613(i) is requiring the SROs to provide the Commission with a document that outlines how an expansion of the consolidated audit trail could be accomplished in the future and is not, at this time, requiring that the SROs commit to expanding the consolidated audit trail beyond secondary

229 See Direct Edge Letter, p. 4.

230 See Proposing Release, supra note 4, at 32568-70; Rule 613(c)(5).

market transactions in NMS securities.[231] However, the Commission notes that Rule 613(i) retains the requirement that SROs include an implementation timeline and a cost estimate; in this regard, the Commission expects that the SROs will address fully in the expansion document how any such expansion of the consolidated audit trail could be implemented in practice, and that such document would include sufficient detail for the Commission to ascertain how the SROs could proceed with such expansion. The Commission would expect to make the expansion document publicly available on its website and to solicit a wide range of comment on it to further inform and facilitate the expansion of the consolidated audit trail if appropriate, taking into account the relevant considerations contemplated by Rule 613(a)(1). In addition, the expansion document could inform the detailed plans that are to be prepared at least every two years by the CCO of the NMS plan.[232]

In addition, after considering the comments received relating to the potential expansion of the consolidated audit trail and how such an expansion might occur,[233] the Commission is making the second modification to the proposed Rule to extend the deadline for submitting the expansion document from two months to six months from the date of effectiveness of the NMS plan approved by the Commission. The Commission believes that the additional four months

231 See Rule 613(i). Specifically, Rule 613(i) now provides that the SROs provide a document outlining how such exchanges and associations "could" incorporate non-NMS securities into the consolidated audit trail, rather than how the exchanges and associations "would propose to" incorporate non-NMS securities; and that the exchanges and associations should provide details for each order and reportable event that "may" be required to be provided, and which market participants "may" be required to provide the data. As proposed, the comparable provision of Rule 613(i) required that the exchanges and associations should provide details for each order and reportable event that "would" be required to be provided, and which market participants "would" be required to provide the data.

232 See Section III.B.3.b., infra.

233 See Ameritrade Letter, p. 3; Liquidnet Letter, p. 2; Marketcore Letter, p. 1; FINRA Proposal Letter, p. 5; SIFMA Letter, p. 16-17.

will provide the time necessary after the approval of the NMS plan by the Commission for the SROs to consider how they might expand the consolidated audit trail to capture orders and trading in these additional securities and thus will aid the Commission in receiving an outline or plan from the exchanges and associations that has had the benefit of additional time for analysis and planning. Finally, given the extension of the deadline for submitting the expansion document and the importance of information regarding primary market information in NMS stocks relative to other types of transactions as discussed in Section III.B.1.a. below, the Commission is removing the requirement that the expansion document discuss all primary market transactions in NMS stocks and is, instead, as discussed later, requiring that a discussion of the feasibility, benefits, and costs of incorporating into the consolidated audit trail information about allocations in primary market transactions in NMS securities be addressed with the NMS plan submission.[234] However, the expansion document must still include a discussion of primary market transactions in equity securities that are not NMS securities.

The Commission agrees in principle with the commenters that advocated a phased approach to implementation.[235] The Commission, however, has determined not to modify the proposed scope of the Rule, which applies to orders in NMS securities. The Commission also adopts substantially its proposed implementation timeframes that apply if and when the NMS plan is approved,[236] except that the NMS plan may provide up to one additional year before

234 See Rule 613(a)(1)(vi). See also Section III.C.2.a.i., infra.

235 See note 222, supra.

236 See Rule 613(a)(3), which states that the NMS plan must require the plan sponsors: (i) within two months after effectiveness of the NMS plan to select a plan processor; (ii) within four months after effectiveness of the NMS plan to synchronize their business clocks and require the members of each such exchange and association to synchronize their business clocks; (iii) within one year after effectiveness of the NMS plan to provide to the central repository the data specified in Rule 613(c); (iv) within fourteen months after effectiveness of the NMS plan to implement a new or enhanced surveillance

small broker-dealers will be required to provide information to the central repository.[237]

The Commission continues to believe that the Rule's requirement to include secondary market transactions in all NMS securities (i.e., both listed equities and options) is a reasonable first step in the implementation of the consolidated audit trail. In addition, the Commission believes that applying the Rule solely to NMS securities should allow for a less burdensome implementation of the consolidated audit trail as compared to applying the Rule to a broader set of securities,[238] in large part because market participants already have experience with audit trails for transactions in these securities. And, as discussed in detail above,[239] there are many significant benefits of a consolidated audit trail that includes NMS securities (even if it is only limited to NMS securities).

With regards to a phased approach to implementation, the Commission notes that the data recording and reporting requirements would apply initially, as proposed, to the SROs but not to their members. This will allow members additional time to, among other things, implement the systems and other changes necessary to provide the required information to the central repository, including capturing customer and order information that they may not have previously been required to collect. Should the SROs determine that additional implementation phases might be appropriate (e.g., applying the Rule first to equities and then to listed options),

system(s) as required by Rule 613(f); (v) within two years after effectiveness of the NMS plan to require their members, except those members that qualify as small broker-dealers as defined in § 240.0–10(c), to provide to the central repository the data specified in Rule 613(c); and (vi) within three years after effectiveness of the NMS plan to require their members that qualify as small broker-dealers as defined in § 240.0– 0(c) to provide to the central repository the data specified in Rule 613(c).

237 See Section III.D., infra.

238 The Commission also believes that limiting the application of the Rule initially to only NMS securities should help ensure that the implementation schedule prescribed by the Rule is achievable. See Section III.D., infra.

239 See Section II.A.2, supra.

the Commission notes that the Rule does not preclude the SROs from proposing such phases, so long as the outer time parameters specified in the Rule, which the Commission is adopting as proposed, are met.[240]

The Commission agrees with commenters that the inclusion of additional products (even at a later date) could further enhance the ability of the SROs and the Commission to conduct effective market oversight for financial products currently trading in the marketplace.[241] The

240 See note 223, supra.

241 The Commission notes that the financial markets have become increasingly interrelated, with transactions occurring in the futures markets affecting transactions in the securities markets. To the extent that instruments other than NMS securities (e.g., futures on a securities index or security-based swaps) can be substitutes for trading in NMS securities, or are otherwise linked to such trading (e.g., as part of a strategy that involves multiple products), having access to an audit trail that includes these instruments would improve regulators' ability to more quickly detect potentially manipulative or other illegal activity that could occur across markets. The Commission recognizes, however, that any such expansion to include products not under the Commission's jurisdiction, and thus not contemplated by this Rule, would need to be coordinated with the CFTC or other applicable regulatory authorities, and would likely require a separate rulemaking, which would include a consideration of the costs and benefits of such an expansion. In this regard, the Commission believes that it could be beneficial to discuss with the CFTC, at the appropriate time, the possibility of including within the consolidated audit trail data relating to futures or swap products regulated by the CFTC that are based on securities. The Commission is therefore directing the Commission staff to work with the SROs, the CFTC staff, and other regulators and market participants to determine how other asset classes, such as futures, might be added to the consolidated audit trail. The information from such an expanded consolidated audit trail could benefit both the CFTC and the Commission.

An example of a non-NMS security is a security-based swap. The Commission notes that, separately, it has proposed rules requiring the reporting of security-based swap information to registered security-based swap data repositories ("SDR") or the Commission. See Securities Exchange Act Release No. 63446, File No. S7-34-10 (November 19, 2010), 75 FR 75208 (December 2, 2010) (proposing Regulation SBSR under the Exchange Act providing for the reporting of security-based swap information to registered security-based SDR or the Commission, and the public dissemination of security-based swap transaction, volume, and pricing information); see also Securities Exchange Act Release No. 63447, File No. S7-35-10 (November 19, 2010), 75 FR 77306 (December 10, 2010) (proposing rules governing the SDR registration process, duties, and core principles).

Commission also believes that it could be beneficial for the consolidated audit trail to be expanded over a reasonable period of time to include information on primary market transactions in equity and debt securities, as this data could be used to quickly assess potential violations of various rules under the Exchange Act such as, for example, Regulation M and Rule 10b-5.[242] For example, the primary market transaction data would allow regulators to more quickly identify whether any participant in an offering sold short prior to the offering in violation of Regulation M. The primary market transaction data would allow for identification of the cost basis for purchases by intermediaries and make it easier to assess whether subsequent mark-ups to investors in primary offerings are fair and reasonable and, if not, whether there has been a violation of the antifraud provisions of the federal securities laws, including Rule 10b-5.

The Commission considered the comment letter that agreed that "policing the market requires a comprehensive approach" but asserted the exchanges should not be primarily responsible for specifying requirements relating to asset-backed securities and other debt

242 See 17 CFR 242.100 et seq.; 17 CFR 240.10b-5. Rule 105 of Regulation M prohibits the short selling of equity securities that are the subject of a public offering for cash and the subsequent purchase of the offered securities from an underwriter or broker or dealer participating in the offering if the short sale was effected during a period that is the shorter of the following: (i) beginning five business days before the pricing of the offered securities and ending with such pricing; or (ii) beginning with the initial filing of such registration statement or notification on Form 1-A or Form 1-E and ending with the pricing. Thus, Rule 105 prohibits any person from selling short an equity security immediately prior to an offering and purchasing the security by participating in the offering.

Rule 10b-5 provides that "[i]t shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

instruments, including swap instruments that are not exchange-traded.[243] In response, the Commission notes the Rule requires the SROs to submit a document outlining a plan for the possible expansion of the NMS plan to non-NMS securities – namely debt securities and equity securities that are not NMS securities.[244] The Commission also notes that FINRA, the SRO responsible for oversight of trading in the over-the-counter market, would participate in the preparation of such expansion document, and expects that FINRA would provide substantial input as to how the consolidated audit trail might be expanded to include non-NMS securities. Because the consolidated audit trail will be jointly owned and operated by the SROs pursuant to the NMS plan, however, the Commission believes that the involvement of all of the SROs in any potential expansion process is appropriate.

The Commission also notes that any expansion of the consolidated audit trail to include transactions in non-NMS securities would be effected through public notice and comment, and take into account the relevant considerations contemplated by Rule 613(a)(1). Furthermore, adopted Rule 613(b)(7), discussed in more detail later in this Release,[245] requires the NMS plan to include an Advisory Committee, which includes members of the plan sponsors and other interested parties as set by the NMS plan,[246] that would be available to provide consultation on matters concerning the central repository, including the securities subject to the Rule. Therefore, the Commission believes that the participation of FINRA, the public, and the Advisory Committee should assist the SROs in devising a document outlining the expansion of the consolidated audit trail to other securities.

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243 See Direct Edge Letter, p. 4.

244 See Rule 613(i).

245 See Section III.B.3.b., infra.

246 See note 2145, supra.

The Commission continues to believe that the expansion document required by Rule 613(i) will provide valuable information to the Commission and help inform the Commission about the likely efficacy of expanding the scope of the consolidated audit trail to include information on equity securities that are not NMS securities, debt securities, primary market transactions in equity securities that are not NMS securities, and primary market transactions in debt securities. In addition, the expansion document will aid the Commission in assessing the feasibility and impact of the plan sponsors' proposed approach.

The Commission acknowledges that plan sponsors will incur costs to prepare the expansion document. For example, plan sponsors will be required to address, among other things, details for each order and reportable event for which data may be submitted; which market participants may be required to provide the data; an implementation timeline; and a cost estimate. Thus, the plan sponsors must, among other things, undertake an analysis of technological and computer system acquisitions and upgrades that would be required to incorporate such an expansion. The Commission, however, believes that it would be beneficial to receive a document outlining how the plan sponsors could incorporate into the consolidated audit trail securities in addition to NMS securities, such as over-the-counter equity and debt securities, as soon as practicable. This is because such an expansion document will aid the Commission in assessing both the feasibility of expanding the audit trail to these additional securities, possibly including, as commenters urged, instruments that underlie mortgage-backed securities and asset-backed securities, and the resulting potential benefits to the securities markets as a whole if the consolidated audit trail is expanded in the manner described in the document submitted by the plan sponsors pursuant to Rule 613(i).

b. **Orders and Quotations**

As proposed, Rule 613 would have required that information be provided to the central repository for every order in an NMS security originated or received by a member of an NMS exchange or FINRA. Proposed Rule 613(j)(4) would have defined "order" to mean: (1) any order received by a member of a national securities exchange or national securities association from any person; (2) any order originated by a member of a national securities exchange or national securities association; or (3) any bid or offer.[247] In sum, the Commission proposed that the Rule cover all orders (whether for a customer or for a member's own account), as well as quotations in NMS stocks and listed options.[248]

The Commission requested comment about the scope of its proposed definition of "order," including whether principal orders[249] should be included in the scope of the consolidated audit trail and whether there are any differences between orders and quotations that should be taken into account with respect to the information that would be required to be provided to the central repository. The Commission also requested comment on whether non-firm quotations should be included in the consolidated audit trail and marked to show that they are not firm.[250]

Commenters generally supported the inclusion of principal orders in the definition of "order,"[251] but some expressed concern about including market maker quotations in the consolidated audit trail.[252] In particular, these commenters thought that the volume of quotes

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247 See Proposing Release, supra note 4, at 32570; proposed Rule 613(j)(4).

248 Id.

249 See note 219, supra.

250 See Proposing Release, supra note 4, at 32571.

251 See FINRA Letter, p. 10; SIFMA Letter, p. 15; Liquidnet Letter, p. 3; FINRA Proposal Letter, p. 6.

252 See SIFMA Letter, p. 13; CBOE Letter, p. 5.

proposed to be collected was so large that it would require market participants to increase the capacity of their systems that would transmit data to the central repository, and thus recommended that market maker quotations be exempted from the Rule's reporting requirements.[253] One of these commenters specifically suggested that the Rule use the same approach as is currently used for the COATS – which contains order, quote (but only the top of market quote) and transaction data for all market participants.[254]

The Commission also received two comments regarding the inclusion of non-firm orders and quotes in the consolidated audit trail. One commenter, consistent with the proposed Rule, stated that only firm orders and quotes should be included.[255] Another commenter, however, believed that the proposed Rule did not go far enough, and stated that the Rule should require that information relating to indications of interest or similar communications be reported to, among other things, assist the SROs and the Commission in detecting "spoofing,"[256] where a market participant enters and quickly cancels limit orders or quotations with the intent of having those non-bona fide orders or quotations change the NBBO or create a misperception of the available market liquidity to induce others to change their trading decisions.

In addition to the comments regarding inclusion of principal and non-firm orders and quotes in the consolidated audit trail, some commenters suggested ways to narrow the definition of "order." One commenter would exempt "non-trading transfers of securities within a legal entity, such as internal journals of securities within a desk or aggregation unit," from the

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253 See SIFMA Letter, p. 13; CBOE Letter, p. 5.

254 See CBOE Letter, p. 5. See also Options Settlement Order, supra, note 60. See, e.g., Securities Exchange Act Release No. 50996 (January 7, 2005), 70 FR 2436 (order approving proposed rule change by CBOE relating to Phase V of COATS).

255 See Liquidnet Letter, p. 3.

256 See Ameritrade Letter, p. 3.

mandatory reporting requirements.[257] Another commenter – an options exchange – recommended that the Commission only require consolidated NBBO data to be reported with respect to options quotations, noting that there are millions of quotes per day on its exchange and that certain options, including out-of-the-money options, are subject to a high volume of quotation updates but generate limited trading activity.[258]

The Commission considered the comments regarding the scope of the quotes and orders that should be included in the Rule's definition of "order," and acknowledges that costs will be incurred by SROs and their members to record and report this information to the central repository and by the central repository to receive, consolidate, store and make accessible such information.[259] The Commission also acknowledges that requiring the recording and reporting of all quotes and orders may entail more costs, such as additional development time and storage capacity, than if the Commission did not require the recording and reporting of market maker quotes or out-of-the-money options. Nevertheless, because the Commission continues to believe that many of the benefits of a consolidated audit trail can only be achieved if all orders and quotations are included, the Commission is adopting the definition of "order" in Rule 613(j)(4) (renumbered as Rule 613(j)(8)), as proposed, to include orders received by a member of an exchange or FINRA from any person, any order originated by a member of an exchange or FINRA, and any bid or offer, including principal orders.[260]

The Commission believes it is important for the consolidated audit trail to capture

257 See SIFMA Letter, p. 15.

258 See BOX Letter, p. 3.

259 Such costs might include the costs to purchase or build new systems and/or costs to modify existing systems to record and report the required data. As discussed in Section I., supra, the NMS plan would include detailed information about costs for the public and the Commission to consider.

260 See Rule 613(j)(4).

information for all principal orders and market maker quotations because principal orders and market maker quotations represent a significant amount of order and transaction activity in the U.S. markets. Effective surveillance of their trading is critical to detecting a variety of types of potential misconduct such as manipulation and trading ahead. By providing regulators comprehensive information about principal orders and market maker quotations throughout the U.S. markets – information that is not available to regulators today using existing audit trails – the consolidated audit trail would allow regulators to efficiently surveil for manipulative and other illegal activity by market making and other proprietary trading firms. In addition, any comprehensive market reconstruction or other market analysis would need to take into account principal orders and market maker quotations – which, as noted above, constitute a large percentage of the orders and trades in today's markets – to provide a complete and accurate picture of market activity.

Furthermore, the Commission believes that including principal orders and market maker quotations in the consolidated audit trail would permit SROs to more efficiently monitor the market for violations of SRO rules. Such monitoring requires determination of the exact sequence of the receipt and execution of customer orders in relation to the origination and execution of principal orders or market maker quotations. For example, SROs would be able to use the consolidated audit trail data to more efficiently detect instances when a broker-dealer receives a customer order and then sends a principal order or quote update to an exchange ahead of the customer order, potentially violating the trading ahead prohibitions in SRO rules.[261]

In addition, information on principal orders or market maker quotations could be useful in investigating illegal "spoofing." The availability to regulators of comprehensive information

[261] See, e.g., FINRA Rule 5320; NYSE Arca Equities Rule 6.16.

about principal orders and market maker quotations would allow them to more efficiently and effectively identify the source of the orders or quotations and, thus, better determine whether the quoted price was manipulated or simply a response to market forces.

A further example where information on principal orders and market maker quotations would enhance regulatory efforts is in reviewing "layering" or other manipulative activity. Layering is a form of market manipulation where orders are placed close to the best buy or sell price with no intention to trade in an effort to falsely overstate the liquidity in a security. Layering attempts to manipulate the shape of the limit order book to move the price of a security or influence the trading decisions of others. Layering is often effected with principal orders, so inclusion of principal orders in the consolidated audit trail would aid regulators in the detection of this manipulative practice.[262]

The Commission considered the comment that recommended excluding certain quotations, such as those generated for out-of-the-money options, from the definition of "orders" required to be reported to the central repository.[263] The Commission, however, believes that such quotations must be included in the consolidated audit trail. Although there may be a high volume of quotations in out-of-the-money options with limited resulting trading activity, the Commission believes that having a record of those quotations is necessary to allow regulators to surveil high-speed quoting strategies for manipulative or other illegal behavior and to assess the impact of market making and other high-frequency quoting behaviors on the quality of the markets. Including these quotations is necessary for example, because the Commission may investigate allegations of a broker-dealer engaging in the practice of flooding the market with out-of-the-money option quotations for the purpose of manipulating the price of the option or

262 See Section II.A., supra.

263 See BOX Letter, p. 3.

related security, or to overload exchange execution systems. Based on the foregoing, to ascertain whether any illegal activity might be occurring through the misuse of quoting, the consolidated audit trail must require all bids and offers to be collected and reported to the central repository.

The Commission also considered the comment that asserted that "non-trading transfers of securities within a legal entity, such as internal journals of securities within a desk or aggregation unit" should be exempt from the reporting requirements of the Rule.[264] In response to this comment, the Commission notes that Rule 613 does not require the reporting of such transfers because they are not "orders," as defined under Rule 613(j)(8). However, Rule 613 does require the NMS plan to require the reporting of the internal routing of orders at broker-dealers.[265]

The Commission also considered the comment that recommended including indications of interest in the definition of "order."[266] The Commission, however, is not including indications of interest in the definition of "order" for purposes of the consolidated audit trail because the Commission believes that the utility of the information such data would provide to regulators would not justify the costs of reporting the information. Indications of interest are different than orders because they are not firm offers to trade, but are essentially invitations to negotiate. As such, the Commission believes that indications of interest are less likely to be used as a vehicle for illegal activity, such as manipulation or layering, because they would be less likely to induce a response from other market participants.

264 See SIFMA Letter, p. 15.

265 See Rule 613(c)(7)(ii)(F). The Commission notes that the NMS plan submitted by the plan sponsors would need to provide appropriate detail as to how orders routed within a single broker-dealer would be reported. For example, the NMS plan would need to address the routing of an order received by a customer-facing sales desk within a broker-dealer to a separate trading or market-making desk within the same broker-dealer that actually determines how to execute the order.

266 See Ameritrade Letter, p. 3.

c. Persons Required to Report Information to the Central Repository

Under proposed Rule 613(c)(5), each national securities exchange and its members would have been required to collect and provide to the central repository certain data for each NMS security registered or listed on a national securities exchange, or admitted to unlisted trading privileges on such exchange; and, under proposed Rule 613(c)(6), each national securities association and its members would have been required to collect and provide to the central repository certain data for each NMS security for which transaction reports would be required to be submitted to a national securities association. Proposed Rule 613(c)(7) would have required each national securities exchange, national securities association, and any member of such exchange or association to collect and provide to the central repository certain details, delineated in such Rule, for each order and each reportable event. The Commission requested comment on whether requiring SROs and their members to report the required order information to the central repository was appropriate.

Several commenters broadly objected to the requirement that all broker-dealers report consolidated audit trail information to the central repository and/or proposed alternatives to such a requirement.[267] One commenter suggested that introducing brokers should be permitted to rely on their clearing firms for reporting to the central repository, arguing that requiring separate reporting by introducing brokers and clearing firms "will only dilute the economic benefits realized by Introducing Brokers through such clearing arrangements and may result in increased costs to customers."[268] This commenter also stated that it does not believe there is appreciable

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267 See CBOE Letter, p. 5; TIAA-CREF Letter, p. 2; Wachtel Letter, p. 1; SIFMA Letter p. 13; FINRA Proposal Letter, p. 5-6; GETCO Letter, p. 3-4; Nasdaq Letter II, p. 3.

268 See TIAA-CREF letter, p. 2-3. Another commenter echoed this concern and recommended that the consolidated audit trail develop a means to avoid such duplicative

benefit to the Commission, FINRA or the markets in general in mandating reporting by introducing brokers.[269]

Similarly, another commenter urged the Commission to exclude broker-dealers from the consolidated audit trail reporting requirements if they route their orders exclusively to another reporting firm that is solely responsible for further routing decisions, on the basis that this would essentially result in duplicative reporting.[270] In addition, this commenter recommended the Commission exempt small broker-dealers from the reporting requirements if compliance would be unduly burdensome.[271] Another commenter, a small broker-dealer that manually handles orders, specifically suggested that the Commission adopt a provision similar to FINRA Rule 7470, which provides FINRA staff the authority to grant exemptions to broker-dealers that solely handle orders manually from OATS recording and data transmission requirements.[272]

Three commenters argued that broker-dealers should not be required to report quotation information to the central repository that is available from other market participants.[273] Specifically, one commenter argued that broker-dealers should not be required to report information to the central repository that has already been reported to an SRO (e.g., market maker quotes) because the SRO would also be reporting the information to the central

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reporting, explaining that this is a problem with the current OATS system. See Wells Fargo Letter, p. 2.

269 See TIAA-CREF letter, p. 2.

270 See FINRA Proposal Letter, p. 5-6.

271 Id.

272 See Wachtel Letter, p. 1. The Commission notes any exemptions granted by FINRA under FINRA Rule 7470 may not exceed a period of two years, unless extended. See FINRA Rule 7470. FINRA's authority to grant exemptions under FINRA Rule 7470 expires on July 10, 2015. See FINRA Rule 7470(c).

273 See CBOE Letter, p. 5-6; SIFMA Letter, p. 13; GETCO Letter, p. 3-4.

repository.[274] Another commenter stated that it "believes that, rather than requiring quote reporting by broker-dealers, only the exchanges and FINRA (through its Alternative Display Facility and proposed Quotation Consolidation Facility) should be required to report quotations," and added that "[t]he exchanges and FINRA are in a position to provide quotation information at a lower cost and with more accuracy."[275] Similarly, a third commenter urged the Commission to consider "whether surveillance systems could rely on quotation information disseminated by the SROs," instead of requiring all quotation data to be sent separately to the repository.[276]

The Commission considered the comments objecting to the requirement that broker-dealers report all consolidated audit trail information to the central repository. However, for the reasons discussed below, the Commission is adopting the requirements as proposed with regard to the obligation of members to report required data to the central repository.[277] Specifically, the Commission is adopting Rules 613(c)(5) and (6) as proposed. Rule 613(c)(5) provides that "[t]he national market system plan submitted pursuant to this section shall require each national securities exchange and its members to record and report to the central repository the information required by [Rule 613(c)(7)] for each NMS security registered or listed for trading on such exchange or admitted to unlisted trading privileges on such exchange," and Rule 613(c)(6)

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274 See CBOE Letter, p. 5-6 (stating its belief that "it would be redundant for both the market makers and the exchanges to all submit this information to the CAT. We recommend that the exchanges be permitted to submit information on market maker quotes to the CAT. Market makers who submit quotes to an exchange would have no obligation other than to correctly identify themselves to the exchange as the party submitting the quotation. The exchange could add the rest of the required information (participant identifier, unique order identifier, etc.) to the quote and transmit it to the CAT").

275 See SIFMA Letter, p. 13.

276 See GETCO Letter, p. 3-4. Another commenter proposed to develop a platform that would collect audit trail information from the SROs and other sources of information, and thus reduce the obligations on broker-dealers to report data. See Nasdaq Letter II, p. 3.

277 See Rules 613(c)(5) through (7).

provides that "[t]he national market system plan submitted pursuant to this section shall require each national securities association and its members to record and report to the central repository the information required by paragraph (c)(7) of this section for each NMS security for which transaction reports are required to be submitted to the association."

In essence, the Commission believes these provisions are appropriate because they require each party – whether a broker-dealer, exchange or ATS – that takes an action with respect to an order, and thus has the best information with respect to that action, to record and report[278] that information to the central repository.[279] For example, the broker-dealer originating an order – whether received from a customer or generated as a principal order – is in the best position to record the terms of that order, including the time of origination, as well as the unique customer and order identifiers. If the originating broker-dealer is required to record the time each order in a rapid series of principal orders is generated, for example, regulators will be able to more accurately reconstruct the sequence of those orders for purposes of conducting market surveillances for manipulative or other illegal activity, or for performing market reconstructions. In addition, requiring the originating broker-dealer to record the time an order was received from a customer could then help regulators more accurately determine whether the broker-dealer quickly traded ahead of the customer order. On the other hand, if the recording and reporting

[278] The Commission notes that the Rule does not preclude the NMS plan from allowing broker-dealers to use a third party to report the data required to the central repository on their behalf. In particular, the Commission recognizes that introducing brokers may wish to contract with clearing broker-dealers for this purpose and that the SROs may need to amend their rules to address the allocation of responsibility between the parties. In such cases, the Commission expects that the clearing contract, as mandated by the SRO's rules, as amended, would address the allocation of responsibility for the reporting of required data.

[279] The Commission has adopted Rule 613(c)(5) and (6) using the terms "record" and "report" the required audit trail data, rather than "collect" and "provide" the required audit trail data, as proposed. See also Section III.B.1.e., infra.

requirements initially applied only to the executing or routing broker-dealer, or the exchange in the case of market maker quoting, regulators would not know the precise time the order or quote was originated, and would not be able to implement or perform as efficiently effective surveillances, such as those discussed above. In addition, the lack of precise order origination time could interfere with the ability of regulators to perform accurate market reconstructions or analyses, particularly with respect to high frequency trading strategies. Thus, the Commission believes that every broker-dealer (and exchange) that touches an order must record the required data with respect to actions it takes on the order, contemporaneously with the reportable event, to ensure that all relevant information, including the time the event occurred, is accurately captured and reported to the consolidated audit trail.[280]

280 The Rule as adopted requires the NMS plan submitted to the Commission for its consideration to require broker-dealers and SROs to record and report to a central repository only the audit trail information for actions each took with respect to an order. For example, if a member receives an order from a customer, the member will be required to report its receipt of that order (with the required information) to the central repository. If the member then routes the order to an exchange for execution, the member will be required to report the routing of that order (with the required information) to the central repository. Likewise, the exchange receiving the routed order will be required to report the receipt of that order from the member (with the required information) to the central repository. If the exchange executes the order on its trading system, the exchange will be required to report that execution of the order (with the required information) to the central repository, but the member will not also be required to report the execution of the order. If the member executes the order in the OTC market, however, rather than routing the order to an exchange (or other market center) for execution, the member will be required to report the execution of the order (with the required information) to the central repository. In this regard, there is no duplicative reporting of audit trail information because each market participant is required to report only the audit trail data for the actions it has taken with respect to an order.

The Commission notes that, for orders that are modified or cancelled, Rule 613(c)(7)(iv) would require the broker-dealer who received the modification from a customer, for example, to report the order modification to the central repository. Thus, if broker-dealer A received a modification to a customer's order from the customer, broker-dealer A would be required to report such modification to the central repository. If broker-dealer A had already routed the customer's order to another broker-dealer ("broker-dealer B"), the customer's modification would also need to be reported by broker-dealer A to broker-

While a broker-dealer will be required to record any actions it takes with respect to an order because such recordation would capture information, particularly the time stamp, which is needed by regulators for the reasons discussed above, the Commission notes that nothing in the Rule precludes the NMS plan submitted to the Commission for its consideration from allowing an introducing broker or other broker-dealer to use a third party, such as a clearing broker-dealer, to report the data recorded by the introducing broker or other broker-dealer to the central repository.

The Commission acknowledges that SROs and their members will incur costs to record and report the audit trail data required by Rules 613(c)(5), 613(c)(6) and 613(c)(7).[281] The Commission also acknowledges that, in some instances, the information required to be recorded and reported by some market participants, for example, market makers, may indeed be available from other market participants (in the case of market makers, the exchanges) and that there might be additional costs for all market participants to record and report information. However, for the reasons noted above, the Commission believes that requiring every market participant that touches an order to record and report the required audit trail data to the central repository, and thus requiring these market participants to incur these costs is appropriate. The Commission believes that such costs will depend on the exact details of how information is to be recorded and reported to the central repository, including whether third-parties, such as clearing-brokers or exchanges, facilitate the transmission of such data. But because these costs depend on details

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dealer B. The receipt of the customer's modification by broker-dealer B would also need to be reported to the central repository, pursuant to Rule 613(c)(7)(iv). The same reporting obligations would apply if the modification were originated by broker-dealer A.

281 Such costs might include the costs to purchase or build new systems and/or costs to modify existing systems to record and report the required data. As discussed in Section I., supra, the NMS plan would include detailed information about costs for the public and the Commission to consider.

that are not being prescribed by the Commission, Rule 613 requires that the SROs must, in their proposal of the specific mechanisms by which data will be reported to the central repository, include cost estimates of their solution, as well as a discussion of the costs and benefits of the various alternatives considered but not chosen.[282] More so, as discussed above in Section I, once the Commission receives the submitted NMS plan, it will be able to use such plan-specific details and costs estimates, as well as public comment on the NMS plan, in determining whether to approve the NMS plan.

The Commission also considered the comment that small broker-dealers should be granted an exemption from the Rule,[283] and, as discussed in Section III.D., is adopting Rule 613(a)(3)(vi), which provides that the NMS plan shall require each SRO to require small broker-dealers to provide audit trail data to the central repository within three years after effectiveness of the NMS plan, as opposed to within two years as proposed.[284] The Commission believes that completely exempting small broker-dealers from reporting requirements would be contradictory to the goal of Rule 613, which is to create a comprehensive audit trail. In effect, an exemption to small broker-dealers from the requirements of the Rule would eliminate the collection of audit trail information from a segment of the broker-dealer community and would thus result in an audit trail that does not capture all orders by all participants in the securities markets for NMS securities. The Commission notes that illegal activity, such as insider trading and market manipulation, can be conducted through accounts at small broker-dealers just as readily as it can be conducted through accounts at large broker-dealers. In addition, granting an exemption to certain broker-dealers might create incentives for prospective wrongdoers to utilize such firms to

282 See Section III.C.2.iii., infra.

283 See Wachtel Letter, p. 1.

284 See Section III.D., infra.

evade effective regulatory oversight through the consolidated audit trail. The Commission recognizes, however, that small broker-dealers, particularly those that operate manual systems, might be particularly impacted because of their more modest financial resources and may need additional time to upgrade to an electronic method of reporting audit trail data to the central repository, and thus believes that allowing the NMS plan to permit such broker-dealers up to an extra year to begin reporting data to the central repository if the plan sponsors believe such an accommodation is reasonable, is appropriate. The Commission believes up to an additional year could allow small broker-dealers extra time to explore the most cost-effective and most efficient method to comply with the Rule. The Commission acknowledges that permitting small broker-dealers up to three years to begin reporting the required audit trail data to the central repository will delay the ability of regulatory authorities to obtain full information about all orders from all participants, which in turn will result in delaying the full regulatory benefit of the consolidated audit trail. However, the Commission believes that such an accommodation to small broker-dealers is reasonable, given the fact that small broker-dealers may face greater financial constraints in complying with Rule 613 as compared to larger broker-dealers.[285] The Commission also notes that many small broker-dealers are introducing broker-dealers and may be able to use their clearing broker-dealers to report the data to the central repository, thereby potentially reducing some of their costs.

d. Reportable Events and Consolidated Audit Trail Data Elements

As proposed, Rule 613 would have required SROs and their respective members to

285 If a clearing broker-dealer receives an order from a small broker-dealer during the period between the time the Rule is applicable to large broker-dealers and the time the Rule is applicable to small broker-dealers, the broker-dealer performing the clearing function for the small introducing broker will be subject to only the requirements of the Plan applicable directly to the clearing broker-dealer, while the small introducing broker will not be subject to the reporting requirements at that time.

provide certain information regarding each order and each "reportable event" to the central repository. A reportable event would have been defined in proposed Rule 613(j)(5) to include, but not be limited to, the receipt, origination, modification, cancellation, routing, and execution (in whole or in part) of an order.

For the reportable event of receipt and origination of an order, proposed Rule 613(c)(7)(i) would have required the reporting of the following data elements: (1) information of sufficient detail to identify the customer; (2) a unique customer identifier for each customer; (3) customer account information; (4) a unique identifier that would attach to an order at the time of receipt or origination by the member; (5) a unique identifier for the broker-dealer receiving or originating an order; (6) the unique identifier of the branch office and registered representative receiving or originating the order; (7) the date and time (to the millisecond) of order receipt or origination; and (8) the material terms of the order.

For the reportable event of routing of an order, proposed Rule 613(c)(7)(ii) would have required the reporting of the following information by the member or SRO that is doing the routing, each time an order is routed: (1) the unique order identifier; (2) the date on which an order was routed; (3) the exact time (in milliseconds) the order was routed; (4) the unique identifier of the broker-dealer or national securities exchange that routes the order; (5) the unique identifier of the broker-dealer or national securities exchange that receives the order; (6) the identity and nature of the department or desk to which an order is routed if a broker-dealer routes the order internally; and (7) the material terms of the order.

Rule 613(c)(7)(iii), as proposed, also would have required the collection and reporting by the SRO or member receiving a routed order of the following information: (1) the unique order identifier; (2) the date on which the order is received; (3) the time at which the order is received (in milliseconds); (4) the unique identifier of the broker-dealer or national securities exchange receiving the order; (5) the unique identifier of the broker-dealer or national securities exchange routing the order; and (6) the material terms of the order.

For the reportable events of modification or cancellation of an order, proposed Rule 613(c)(7)(iv) would have required the following data be collected and reported: (1) the date and time (in milliseconds) that an order modification or cancellation was originated or received; (2) the price and remaining size of the order, if modified; (3) the identity of the person responsible for the modification or cancellation instruction; and (4) other modifications to the material terms of the order.

For full or partial executions of an order, proposed Rule 613(c)(7)(v) would have required the following information to be collected and reported to the central repository: (1) the unique order identifier; (2) the execution date; (3) the time of execution (in milliseconds); (4) the capacity of the entity executing the order (whether principal, agency, or riskless principal); (5) the execution price; (6) the size of the execution; (7) the unique identifier of the national securities exchange or broker-dealer executing the order; and (8) whether the execution was reported pursuant to an effective transaction reporting plan or pursuant to the OPRA Plan.

The Commission received comments on the information proposed to be recorded and reported to the central repository for each reportable event (i.e., the consolidated audit trail data elements) but did not receive comments on the proposed definition of reportable event in proposed Rule 613(j)(5) (i.e., the events that trigger consolidated audit trail reporting requirements). However, the Commission is making clarifying changes to proposed Rule 613(j)(5) (renumbered as Rule 613(j)(9)) to define a "reportable event" as including the original receipt of a customer's order by a broker-dealer; the origination of an order by a broker-dealer (i.e., a principal order); and the receipt of a routed order. Thus, Rule 613(j)(9), as adopted, provides that "[t]he term reportable event shall include, but not be limited to, the original receipt or origination, modification, cancellation, routing, and execution (in whole or in part) of an order, and receipt of a routed order." The Commission believes these changes from the proposal are appropriate because they conform Rule 613(j)(9) to the provisions of Rule 613(c)(7). Specifically, Rule 613(c)(7) is structured around each "reportable event;" therefore, audit trail data is listed according to the data that must be reported upon "original receipt or origination" of an order (Rule 613(c)(7)(i)); "routing" of an order (Rule 613(c)(7)(ii)); "receipt of an order that has been routed" (Rule 613(c)(7)(iii)); "modification or cancellation" of an order (Rule 613(c)(7)(iv)); and "execution" of an order (Rule 613(c)(7)(v) and (vi)).

As noted above, the Commission received comments on the information proposed to be recorded and reported to the central repository with each reportable event (i.e., the consolidated audit trail data elements) and, in response, is adopting the Rule with certain modifications from the proposed Rule with respect to certain of the consolidated audit trail data elements. In so adopting the Rule, the Commission acknowledges that costs will be incurred by SROs and their members to record and report this information to the central repository and by the central repository to receive, consolidate, store and make accessible such information.[286] However, the Commission believes that the costs to SRO members for reporting this information, and the costs to the central repository for collecting and storing this information, will significantly depend on

286 In particular, the Commission acknowledges that certain elements are not collected by existing audit trails and thus SROs and members would incur additional costs to record and report such information. The Commission also acknowledges that there might be additional costs with respect to assigning customer identifiers, the broker-dealer identifiers and the order identifiers because such assignments might, depending on the NMS plan, require coordination amongst various different entities and possibly further systems changes.

the exact details of how this information will be gathered and transmitted by the various types of market participants covered by Rule 613. The Commission is therefore requiring the SROs to include as part of the NMS plan submitted to the Commission for its consideration pursuant to the Rule, details of how each of the different data elements would be recorded, reported, collected, and stored, as well as cost estimates for the proposed solution, and a discussion of the costs and benefits of alternate solutions considered but not proposed. The Commission also notes that the SROs are not prohibited from proposing additional data elements not specified in Rule 613 if the SROs believe such data elements would further, or more efficiently, facilitate the requirements of the Rule.

Once the SROs have submitted an NMS plan with these details, the Commission will be able to use this information to determine whether to approve the NMS plan. The Commission at this time is only directing the SROs to develop and submit a detailed NMS plan that includes each of the data elements. The Commission is not making a final determination of the nature and scope of the data elements to be included in the consolidated audit trail – as discussed above, these determinations will be made after the SROs submit the NMS plan, and the Commission and public have had an opportunity to consider the proposed data elements.

Rather, at this time the Commission is only making a more limited determination. The benefits the Commission and the public will receive from being able to consider the detailed costs and benefits of the specific set of data elements submitted to the Commission for its consideration pursuant to the Rule justify the costs of preparing the NMS plan with such data elements included.

A discussion of these consolidated audit trail data elements follows.

i. Material Terms of the Order

As proposed, Rule 613 would have required broker-dealers to report the material terms of the order upon origination or receipt of an order and upon routing, modification, and cancellation of an order.[287] Proposed Rule 613(j)(3) (renumbered as Rule 613(j)(7)) defined material terms of the order to include, but not be limited to, the following information: (1) the NMS security symbol; (2) the type of security; (3) price (if applicable); (4) size (displayed and non-displayed); (5) side (buy/sell); (6) order type; (7) if a sell order, whether the order is long, short, or short exempt;[288] (8) if a short sale, the locate identifier; (9) open/close indicator; (10) time in force (if applicable); (11) whether the order is solicited or unsolicited; (12) whether the account has a prior position in the security; (13) if the order is for a listed option, option type (put/call), option symbol or root symbol, underlying symbol, strike price, expiration date, and open/close; and (14) any special handling instructions.

The Commission requested comment on whether there are any items of information that are required to be recorded and reported by existing audit trail rules, or to be provided to the SROs or the Commission upon request, that were not proposed but should have been included in the Rule. One commenter suggested that two data elements be added to aid regulators in detecting the original source of orders that violate laws or are involved in market manipulations.[289] Specifically, this commenter recommended that the proposed Rule should

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287 See proposed Rules 613(c)(7)(i)(I), 613(c)(7)(ii)(G), 613(c)(7)(iii)(F) and 613(c)(7)(iv)(D).

288 A broker or dealer currently must mark all sell orders of any equity security as long, short, or short exempt. See Rule 200(g)(1) under the Exchange Act, 17 CFR 242.200(g)(1). A sell order may be marked short exempt only if the conditions of Rule 201(c) or (d) under the Exchange Act are met (17 CFR 242.201(c) and (d)). See Rule 200(g)(2) under the Exchange Act, 17 CFR 242.200(g)(2).

289 See Kumaraguru Letter, p. 1.

capture the identity of the individual who originated the order (in addition to identifying the firm) and the system he or she used to originate the order.[290] Another commenter questioned the need for information regarding whether an account has a prior position in a security.[291] The commenter expressed skepticism about the value of knowing, in real time, whether the customer has a prior position in the security, since the length of time the position has been held would not be captured. This commenter also questioned how the Commission's requirement that the prior position in a security be reported would work in the situation where a client has multiple accounts but it is the first time the client has opened a position in one of the accounts.[292] Another commenter provided specific information on the exact data elements that it could incorporate into the consolidated audit trail if it were chosen as the central processor under Rule 613.[293]

The Commission considered the views of the commenter that questioned the value of knowing whether a customer has a prior position in a security. The Commission also considered the commenter's concern about potential reporting complications for clients with multiple accounts, as well as general comments urging the Commission to reduce the burdens of the Rule, and is adopting proposed Rule 613(j)(3) (renumbered as Rule 613(j)(7)) with modifications to delete certain data elements.

After considering the commenters' views, and re-evaluating the necessity of requiring certain specific data elements, the Commission has determined not to require the locate identifier (if a short sale); whether the order is solicited or unsolicited; and whether the account has a prior position in the security. The Commission believes the consolidated audit trail can still achieve

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290 Id.

291 See Ameritrade Letter, p. 3.

292 Id.

293 See FINRA Proposal Letter, Appendix A.

significant benefits without requiring the routine recording and reporting of these specific data elements to the central repository.[294] While this information may be useful for certain investigations and market analyses, the Commission believes that this additional data could be readily obtained from a follow-up request to a broker-dealer if the other data required by proposed Rule 613(j)(3), particularly relating to the customer behind the order, is included in the consolidated audit trail. Thus, the Commission believes that it is unnecessary to require this additional data to be reported as a standard part of the consolidated audit trail. In effect, the Commission believes that the benefits of having these specific audit trail data elements are minimal. As such, the Commission does not believe the benefits to the Commission and the public to consider the detailed costs and benefits of such data elements justify the costs to SROs for including them in their NMS plan submission.

In response to the commenter who recommended that the proposed Rule should capture the identity of the individual who originated the order (in addition to identifying the firm) and the system he or she used to originate the order,[295] the Commission notes that Rule 613 defines "customer" as: "(i) the account holder(s) of the account at a registered broker-dealer originating the order; and (ii) any person from whom the broker-dealer is authorized to accept trading instructions for such account, if different from the account holder(s)."[296] The Rule does not require the identification of the individual registered representative who placed the order.[297] Further, the Commission does not believe that "the system he or she used to originate the order"

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294 See Section II.A.2., supra.

295 See Kumaraguru Letter, p. 1.

296 See Rule 613(j)(3); see also Section III.B.1.d.iii.(C).(2)., infra (discussing the definition of "customer" as applied to investment advisers).

297 See Section III.B.1.d.ii., infra, for a discussion of the proposed requirement to report the unique identifier of the registered representative receiving or originating an order.

is of significant enough regulatory value to require that information to be recorded and reported under Rule 613 at this time.

(A) Order Type

As proposed, the Rule would have required that members report the order type as an element of the material terms of an order. In the Proposing Release, the Commission explained that the proposed Rule does not specify the exact order types (e.g., market, limit, stop, pegged, stop limit) that could be reported under the Rule in recognition that order types may differ across markets and an order type with the same title may have a different meaning at different exchanges.[298] The Commission also noted that markets are frequently creating new order types and eliminating existing order types. Thus, the Commission preliminarily believed that it would not be practical to include a list of order types in the proposed Rule as part of the required information to be reported to the central repository.

The Commission received one comment in response to its request for comment on its proposed approach to handling order types. This commenter believed that the Commission did not think that order types were needed for the consolidated audit trail, and argued that this information is "essential for any attempts to use the order data to reconstruct the state of the limit order book at any point in time."[299] The Commission agrees that information about an order's type is important and notes that the Rule, as proposed, did require order types to be reported.[300] Thus, the Commission is adopting the Rule, as proposed, to require plan sponsors to include in the NMS plan submitted to the Commission for its consideration a requirement for

298 See Proposing Release, supra note 4, at 32575.

299 See Angel Letter, p. 2-3.

300 Order type information is important because it reflects the intention of the person originating an order with regard to how an order should be handled, and also provides information regarding the potential impact of orders on the market.

SROs and members to report the order type as an element of the material terms of an order. The Rule, however, does not provide an exhaustive list of order types, as the Commission continues to believe that it is not feasible to do so in its Rule, for the reasons stated in the Proposing Release.[301] Rather, the Commission believes the plan sponsors should be responsible for determining how to describe and categorize specific order types in the NMS plan or in the NMS plan's technical specifications, as there is more flexibility to amend such documents and the SROs would have the most familiarity with the variations among the order types on their markets. The Commission notes that specific order types may differ across markets, and even an order type with the same title may have a different meaning at different exchanges. Further, SROs regularly develop new order types to respond to changes in market structures and trading strategies, and any list of order types will likely need to be updated over time.

(B) Special Handling Instructions

The proposed Rule also would have required that that any special handling instructions be reported as part of the material terms of an order.[302] The Commission specifically requested comment in the Proposing Release on whether the Rule should require, as part of the disclosure of special handling instructions, the disclosure of an individual algorithm that may be used by a member or customer to originate or execute an order, and, if so, how such an algorithm should be identified. The Commission received one comment noting the importance of requiring the special handling instructions to be included in the consolidated audit trail.[303] This commenter believed that special handling instructions were important for reconstructing the limit order

301 See Proposing Release, supra note 4, at 32575.

302 See proposed Rule 613(j)(3).

303 See Angel Letter, p. 2-3.

book.[304] Regarding algorithms, commenters generally were not in favor of unique identifiers for algorithms.[305] One commenter urged against requiring customer information at the level of "individual strategy, trading desk, or particular algorithm [illegible]."[306] Another commenter stated that the proposed rule should not require that unique customer identifiers be affixed to computer algorithms.[307] This commenter pointed out that algorithms change daily, which would result in uncertainty about whether new identifiers are needed. Further, the commenter argued that firms would need to develop safeguards to ensure proprietary algorithms and trading strategies are not appropriated by competitors. This commenter suggested that, instead of requiring a unique customer identifier, the Commission could require that a "flag" be appended to orders generated by an algorithm.

The Commission agrees with the commenter that supported the proposed requirement that special handling instructions be reported[308] and is adopting this requirement as proposed.[309] The Commission believes that such information will be useful to regulators in attempting to recreate an SRO's limit order book for market reconstructions. When performing market reconstructions, it is important for regulators not only to have information regarding what orders were on the book, but the conditions or special instructions attached to those orders. Such information can be of key importance in determining the amount of accessible liquidity at any

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304 Id.

305 See Managed Funds Association Letter, p. 2; SIFMA Letter, p. 11; SIFMA Drop Copy Letter, p. 2.

306 See Managed Funds Association Letter, p. 2.

307 See SIFMA Letter, p. 11. SIFMA subsequently submitted an alternative proposal that did not include a flag for algorithms, citing lack of clarity in the Commission's definition of algorithmic order, and stating that the FIX standard lacks existing fields to flag such orders. Id. at 2.

308 See Angel Letter, p. 2-3.

309 See Rule 613(j)(7).

price point and whether or not certain orders were entitled to be executed at various price levels.

Additionally, the Commission considered the comments received regarding whether an individual algorithm should be reported and identified as part of an order's special handling instructions, and has determined not to adopt that requirement in recognition that algorithms change frequently and therefore it may be difficult to determine when and if new algorithm identifiers are necessary. The Commission also considered one commenter's concern regarding the proprietary nature of algorithms and the risk of competitors appropriating algorithms if they were required to be identified in the consolidated audit trail. However, the Commission notes that, because the disclosure of whether an order is a result of an algorithm that makes trading decisions based on a programmed investment strategy might be useful for the Commission and the SROs to sort or filter trade data to re-construct market events or to better evaluate potentially manipulative behavior or intent, the SROs may want to consider whether it would be feasible to include a "flag" or other indicator that would reveal whether an order was the result of an algorithmic trading calculation. Such a flag would not identify the actual algorithm used, but could instead indicate whether the order was the result of an algorithmic trade. Appending such a "flag" or indicator may aid regulatory authorities in their efforts to make preliminary assessments about market activity and better allow the SROs and the Commission to monitor the usage of algorithms over time. The Commission acknowledges that by not requiring that algorithms be recorded and reported to the central repository, the consolidated audit trail may not contain an audit trail data element that might prove useful to regulatory authorities. The Commission, however, believes that, should regulatory authorities need such information, regulators can submit a request for this information and obtain the information about whether the order was the result of an algorithm readily from the broker-dealer that handled the order.

ii. Unique National Securities Exchange, National Securities Association and Broker-Dealer Identifiers

The Commission proposed to require each member originating or receiving an order from a customer, and each national securities exchange, national securities association, and member that subsequently handles the order to report its own unique identifier to the central repository. Proposed Rule 613(c)(7)(i)(E) (renumbered as 613(c)(7)(i)(C)) would have provided that any member of an SRO, that originally receives from a customer or originates a principal order, shall collect and electronically report "the unique identifier of the broker-dealer receiving or originating the order." Similarly, proposed Rule 613(c)(7)(ii)(D) provided that the SRO or any member of such SRO that routes an order shall collect and electronically report "the unique identifier of the broker-dealer or national securities exchange routing the order." Proposed Rule 613(c)(7)(ii)(E) provided that the SRO or any member of such SRO routing an order shall collect and electronically report "the unique identifier of the broker-dealer or national securities exchange receiving the order." Proposed Rule 613(c)(7)(iii)(D) provided that the SRO or any member of such SRO that receives an order shall collect and electronically report "the unique identifier of the broker-dealer or national securities exchange receiving the order." Proposed Rule 613(c)(7)(iii)(E) provided that the SRO or any member of such SRO that receives an order shall collect and electronically report "the unique identifier of the broker-dealer or national securities exchange routing the order." Proposed Rule 613(c)(7)(iv)(E) required, for a modification or a cancellation of an order, the identity of the person giving such instruction. Proposed Rule 613(c)(7)(v)(F) provided that the SRO or any member of such SRO that executes an order in whole or part report "the unique identifier of the broker-dealer or national securities exchange executing the order." Further, the Commission proposed to require a member receiving an order from a customer to report, if applicable, "the unique identifier of the branch office and the registered representative receiving or originating the order."[310]

Commenters generally supported the proposed use of unique identifiers for exchanges and broker-dealers.[311] One commenter explained that cross-market surveillance efforts are unduly complicated if a single market participant has a different identifier for each market, and stated that the current market participant identifier ("MPID") system needed to be updated.[312] This commenter, however, questioned whether it was necessary for branch office and registered representative information to be included in the consolidated audit trail, stating that the information would increase the amount of data reported to the consolidated audit trail, but would be useful only in certain circumstances.[313] In another letter, the same commenter proposed to use Central Registration Depository ("CRD") numbers to uniquely identify broker-dealers.[314] Under this system, the commenter suggested that SROs would be required to link the CRD numbers to unique MPIDs to create a cross-referenced database, so that data could be searched and retrieved at the firm level (by CRD number) or by the unique market center identifiers used

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310 See Proposed Rule 613(c)(7)(i)(F).

311 See SIFMA Letter, p. 12; Liquidnet Letter, p. 6; FINRA Letter, p. 4; FINRA Proposal Letter, p. 6.

312 See FINRA Letter, p. 4 (explaining that "multiple firms can currently be represented by a single MPID that is used for market access arrangements and is assigned to another firm that has no direct relationship to the trading activity being reported under that MPID"). This commenter also supported the use of more specific "sub-identifiers" to allow regulators to distinguish between desks or trading units within a firm.

313 Id. at p. 9. FINRA also requested that the Commission reconsider the need for reporting the identification of the beneficial owner, the identification of the person exercising investment discretion, and the unique identifier of the branch office and registered representative. For further discussion of this comment, see note 170 supra and accompanying text.

314 See FINRA Proposal Letter, p. 6, 13. The CRD is the central licensing and registration system operated by FINRA which contains employment, qualification and disciplinary histories for securities industry professionals who do business with the public.

by firms for each transaction on a specific market center.[315] For activity not occurring on a national securities exchange, the commenter proposed continued reporting with MPIDs currently used for OATS reporting.[316] Another commenter supported the use of MPIDs as unique identifiers for broker-dealers, suggesting that the MPIDs of the firms originating each order should be added to the trade report, but stated that only FINRA and the Commission should be allowed to access this information.[317]

After considering commenters' views requesting additional flexibility with respect to the unique identifiers requirement for national securities exchanges, national securities associations, and members, the Commission has determined to adopt the Rule to require plan sponsors to include in the NMS plan submitted to the Commission for its consideration a requirement for such unique identifiers, substantially as proposed. The Commission, however, has made two technical changes to the Rule text from the proposal to: (1) add a defined term, "CAT-Reporter-ID," in adopted Rule 613(j)(2) to refer to these unique identifiers, and (2) expressly permit that a "code" be used that uniquely and consistently identifies the national securities exchange, national securities association, or member. Specifically, adopted Rule 613(j)(2) provides that "[t]he term CAT-Reporter-ID shall mean, with respect to each national securities exchange, national securities association, and member of a national securities exchange or national securities association, a code that uniquely and consistently identifies such person for purposes of providing data to the central repository."

In response to the commenters that stated that firms' current MPIDs or CRD numbers may work as a viable unique broker-dealer identifier, the Commission believes it is appropriate

315 See FINRA Proposal Letter, p. 6, 13.

316 Id. at p. 6.

317 See Angel Letter, p. 2.

to leave the decision of whether to specify an existing identifier, such as a firm's MPID or CRD number, or some other identifier such as one created under the unique legal entity identifier (LEI) standard under development by the International Standards Organization ("ISO") (ISO 17442),[318] as the unique broker-dealer identifier, to the plan sponsors to assess and propose in the NMS plan. Therefore, while the adopted Rule continues to require the NMS plan to require these unique identifiers, the Rule does not specify which identifier to use, nor does the Rule specify the process for assigning unique broker-dealer identifiers.[319] In this regard, the Commission expects the plan sponsors to establish a process, to be described in the NMS plan, by which every national securities exchange, and every member of a national securities exchange

318 This standard is being developed by Technical Committee 68 (TC68) of ISO, in whose meetings a Commission staff representative participates. Its final publication is subject to the resolution of specific issues on implementation, operating procedures, and the need to coordinate with a global legal entity identifier initiative conducted by the global regulatory community, in which a Commission staff representative is also participating.

319 One commenter requested the Commission consider how the Department of Treasury's newly-created Office of Financial Research ("OFR") would impact reporting requirements imposed by the consolidated audit trail. See SIFMA Letter, p. 22-23. The commenter noted that the collection powers granted to the OFR, as well as its authority to require standardized reporting of data, could affect how data is submitted to the consolidated audit trail. Id. at p. 22. The commenter suggested that any information that is provided to the consolidated audit trail should not be required to be provided to the OFR again or in a different format. Id. The Commission understands that the OFR has been participating in and encouraging efforts by interested parties to have a standard for assigning unique entity identifiers created by an internationally recognized standards body ("IRSB") and that the ISO has issued a draft ISO standard, ISO 17442, for the financial services industry that is proposed to provide a viable global solution for the accurate and unambiguous identification of legal entities engaged in financial transactions. See ISO Press Release "ISO Financial Services Standard Wins Industry Support Six Months Ahead of Publication," July 25, 2011. Because the ISO standard is still in draft form and issues of implementation, governance and operating procedures remain to be resolved, the Commission does not believe that it is appropriate for it to mandate the use of the ISO standard at this time. The Commission notes, however, that to the extent that unique entity identifiers become available from an IRSB, Rule 613 provides SROs with sufficient flexibility to submit, if they so chose, an NMS plan that makes use of those identifiers and requires all or some reporting parties to obtain such identifiers, assuming such identifiers otherwise meet the requirements of the Rule.

or national securities association, can obtain a CAT-Reporter-ID.

The Commission also is adopting, substantially as proposed, rules requiring the NMS plan submitted to the Commission for its consideration to require each SRO and its members to report the unique identifier of the broker-dealer or SRO for each reportable event in the life of an order to the central repository, except to make two technical changes: to include the new defined term, "CAT-Reporter-ID" and to require the CAT-Reporter-ID or Customer-ID, if applicable, of the person giving a cancellation or modification instruction.[320] Specifically, Rule 613(c)(7)(i)(C), as adopted, provides that any member of an SRO that originally receives from a customer or originates a principal order shall record and report "[t]he CAT-Reporter-ID of the broker-dealer receiving or originating the order." Rule 613(c)(7)(ii)(D) provides that any national securities exchange or any member of an SRO that routes an order shall record and report "[t]he CAT-Reporter-ID of the broker-dealer or national securities exchange routing the order." Rule 613(c)(7)(ii)(E) provides that any national securities exchange or member of an SRO that routes an order shall record and report "[t]he CAT-Reporter-ID of the broker-dealer, national securities exchange, or national securities association to which the order is being routed." Rule 613(c)(7)(iii)(D) provides that the SRO or any member of an SRO that receives a routed order shall record and report "[t]he CAT-Reporter-ID of the broker-dealer, national securities exchange, or national securities association receiving the order." Rule 613(c)(7)(iii)(E) provides that the SRO or any member of an SRO that receives a routed order shall record and report "[t]he CAT-Reporter-ID of the broker-dealer or national securities exchange routing the order." Rule 613(c)(7)(iv)(F) provides that the SRO or any member of an

320 See proposed Rule 613(c)(7)(iv)(E) (requiring the reporting of the identity of the person giving a modification or cancellation instruction for an order); adopted Rule 613(c)(7)(iv)(F) (requiring the CAT-Reporter-ID or Customer-ID of such person instead).

SRO that receives an instruction to modify or cancel an order shall record and report "[t]he CAT-Reporter-ID of the broker-dealer or Customer-ID of the person giving the modification or cancellation instruction." Rule 613(c)(7)(v)(F) provides that the national securities exchange or any member of an SRO that executes an order in whole or part shall record and report "[t]he CAT-Reporter-ID of the broker-dealer or national securities exchange executing the order." Rule 613(c)(7)(vi)(B) provides that, if an order is executed in whole or part, a member of an SRO shall record and report "[t]he CAT-Reporter-ID of the clearing broker or prime broker, if applicable."

The Commission notes that CAT-Reporter-IDs will be reported to the central repository for each reportable event that the member or SRO is reporting to the central repository. The requirement to report CAT-Reporter-IDs in this manner will help ensure that regulators can determine which market participant took action with respect to an order at each reportable event. The Commission does not believe that the CAT-Reporter-ID of each member or market that touches an order needs to be tagged to and travel with an order for the life of the order, as long as the CAT-Reporter-ID of the member or exchange taking the action is reported to the central repository, and an order identifier(s) is reported at every reportable event of the order. The Commission believes the details of how these data are reported to the central repository, and the specific methodologies used by the central repository to assemble time-sequenced records of the full life-cycle of an order, is best left to the expertise of the SROs as they develop the NMS plan to be submitted to the Commission for its consideration. Instead, as adopted, Rule 613 requires that data in the central repository be made available to regulators in a linked fashion so that each order can be tracked from origination through modification, cancellation, or execution, and that the parties routing or receiving routes, or otherwise performing such actions, are identified for every reportable event.

After considering the comment opposing the requirement to report to the central repository the unique identifier of the branch office and registered representative receiving or originating an order,[321] the Commission has reconsidered the requirement in proposed Rule 613(c)(7)(i)(F) and is not adopting this requirement.[322] While this audit trail data may be useful in the context of certain investigations or market analyses, upon further consideration, the Commission believes that this information need not be required by Rule 613 because it is not critical information to help identify the customer responsible for trading a security, nor to capturing the entire life of an order as it moves from origination to execution or cancellation. In addition, the Commission believes that a requirement that a unique identifier of the branch office and registered representative receiving or originating the order be reported may not provide enough information in an initial assessment of whether illegal or manipulative activity is occurring in the marketplace to warrant that this information be required in the audit trail created by Rule 613. Further, should regulators determine that the identity of the branch office and registered representative receiving or originating the order is needed to follow-up on a specific issue, they may request the information directly from the broker-dealer as broker-dealers are required to make and keep records identifying the registered representative that receives an order pursuant to Exchange Act Rules 17a-3(a)(6)(i)[323] and 17a-4(b)(1).[324] As such, the Commission does not believe the benefits of including this information in the consolidated audit trail justify the costs to SROs for requiring them to devise a methodology to identify the branch offices and

321 See note 313, supra.

322 See proposed Rule 613(c)(7)(i)(F).

323 17 CFR 240.17a-3(a)(6)(i).

324 17 CFR 240.17a-4(b)(1).

registered representatives receiving or originating an order, and a mechanism for reporting this type of data to the central repository.

iii. Unique Customer Identifier

(A) Proposed Rule

As proposed, Rule 613 would have required every SRO and broker-dealer to report a unique customer identifier to the central repository for any order originated by or received from such customer.[325] Specifically, proposed Rule 613(c)(7)(i)(B) (renumbered as Rule 613(c)(7)(i)(A)) would have required that a national securities exchange, national securities association or any member of such exchange or association that originally receives or originates an order to collect and electronically report "a unique customer identifier for each customer." In the Proposing Release, the Commission noted that the unique customer identifier should remain constant for each customer, and have the same format, across all broker-dealers.[326]

The Commission requested comment on possible ways to develop and implement unique customer identifiers. For example, the Commission solicited input about who should be responsible for generating the identifier; whether a unique customer identifier, together with the other information with respect to the customer that would be required to be provided under the proposed Rule, would be sufficient to identify individual customers; and whether there were any concerns about how the customer information would be protected. The Commission specifically requested comment on what steps should be taken to ensure that appropriate safeguards are implemented with respect to the submission of customer information, as well as the receipt, consolidation, and maintenance of such information in the central repository.

325 See Rule 613(j)(3) for a definition of "customer."

326 See Proposing Release, supra note 4, at 32573; proposed Rule 613(c)(7)(i)(B).

(B) Comments on Proposed Rule 613(c)(7)(i)(B)

The Commission received comments that supported the general notion that identifying customers in an audit trail would be beneficial for regulatory purposes.[327] One commenter stated that a customer identifier on an order-by-order basis would "enhance significantly the audit trails of the markets."[328] Similarly, another commenter agreed that identifying the customer would be useful to regulators for purposes of market surveillance and enforcement.[329] Another commenter noted that it "fully supports more granularity in an order audit trail, such as obtaining high-level customer identity information (e.g., large trader identification), so that patterns of trading across multiple market centers can be quickly and readily identified, and [the commenter] agrees that the timeframe needed to identify customers should be greatly reduced; however, [the commenter] question[s] the utility of receiving the identity of both the beneficial owner and the person exercising the investment discretion, if different, for each and every order reported to the consolidated audit trail."[330]

However, other commenters disagreed with the need for a unique customer identifier and the proposed Rule's requirements for reporting a unique customer identifier with every order. These commenters generally focused on the complexity and cost of the systems changes required to implement the unique customer identifier requirement for every customer;[331] the complexity in

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327 See CBOE Letter, p. 2; Managed Funds Association Letter, p. 2; FINRA Letter, p. 9; SIFMA Drop Copy Letter, p. 1; SIFMA Letter, p. 9.

328 See CBOE Letter, p. 2.

329 See Managed Funds Association Letter, p. 2.

330 See FINRA Letter, p. 9.

331 See SIFMA Drop Copy Letter, p. 1. See also SIFMA Letter, p. 9.

the process for assigning unique customer identifiers;[332] the alternative ways that a customer could be identified without requiring a unique customer identifier as proposed;[333] and the concerns about how the privacy of customers might be compromised if every customer was assigned a unique customer identifier.[334]

One commenter discussed the complexity and cost of the systems changes required to implement the unique customer identifier requirement, as set forth in the Rule.[335] This commenter, who did not believe the Commission should require a unique customer identifier for every customer, noted the "complexity of the technology development work involved" in adding this identifier to the audit trail.[336] The commenter added that the work required to update internal architecture to report customer identifiers would be "substantial" because broker-dealer systems and processes may access and maintain customer (and proprietary) identification information in different ways and at different levels of specificity, and that sales and trading systems would need to be modified to report the unique customer identifiers with every order. This commenter also noted the "significant costs" generally associated with requiring a unique customer identifier.[337]

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332 See Liquidnet Letter, p. 4; SIFMA Letter, p. 10-11; Knight Letter, p. 2; Scottrade Letter, p. 1; Direct Edge Letter, p. 3; FINRA Proposal Letter, p. 4.

333 See Angel Letter, p. 2; FIF Letter, p. 2; BOX Letter, 2.

334 See SIFMA Letter, p. 10; Wells Fargo Letter, p. 3; Ross Letter, p. 1; ICI Letter, p. 3; FIF Letter, p. 2.

335 See SIFMA Drop Copy Letter, p. 1. See also SIFMA Letter, p. 9.

336 Id.

337 See SIFMA Letter p. 9, 10.

A few commenters also submitted their views on the complexity of the process for assigning unique customer identifiers.[338] One commenter noted that the process for assigning unique customer identifiers that the Commission discussed in the Proposing Release (i.e., the generating unique customer identifiers based on the input by a broker-dealer of a customer's social security number or tax identification number) would not create an administrative burden on individuals and non-broker-dealer entities.[339] Another commenter, however, noted difficulties associated with implementing a centralized process for assigning, storing and utilizing standardized customer identifiers[340] and another commenter characterized the "implementation of a centralized customer identification system" as a "monumental task."[341] Another commenter believed that to satisfy the Rule's requirements, the industry would need to implement a completely new market-wide system to satisfy the unique customer identifier requirement, noting that this might not be feasible on the proposed timeline.[342] Another commenter characterized the collection of a unique customer identifier as a "significant project unto itself."[343] One commenter observed that given the large number of retail investors (some with multiple accounts), the complexities associated with tracking retail investors' accounts, and the relatively small and infrequent amount of trading by typical retail investors, the Rule should not require unique customer identifiers for every customer.[344] Another commenter urged the

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338 See Liquidnet Letter, p. 4; SIFMA Letter, p. 10-11; Knight Letter, p. 2; Scottrade Letter, p. 1; Direct Edge Letter, p. 3; FINRA Proposal Letter, p. 4; SIFMA Letter, p. 11.

339 See Proposing Release, supra note 4, at 32573; Liquidnet Letter, p. 4.

340 See SIFMA Letter, p. 10.

341 See Knight Letter, p. 2.

342 See Scottrade Letter, p. 1. See also Knight Letter, p. 2; Direct Edge Letter, p. 4.

343 See Direct Edge Letter, p. 3.

344 See FINRA Proposal Letter, p. 4.

Commission to specify whether the process required that a unique customer identifier be submitted at the time an order is originated or received and the procedure to be followed if an identifier is not available.[345]

A few commenters suggested alternative ways to identify a customer, rather than through a unique customer identifier.[346] One commenter suggested that customers could be identified by amending the current trade report.[347] Another commenter believed that "sophisticated analysis could identify trading activity that might be coordinated, without using an account identifier, and that regulators could then perform further analysis to determine who traded by using [EBS] and other methods already available to the staff."[348] Another commenter noted that a possible method for identifying customers could be by linking customer information in EBS to trading information in OATS.[349] Another commenter noted that "[i]t makes economical sense to use the current OATS and COATS audit trails and to expand those audit trails to include additional customer information, thereby providing a more complete audit trail for regulatory oversight for post trade analysis rather than building another audit trail system."[350]

Commenters also discussed the need for both a large trader identification number under Rule 13h-1under the Exchange Act, the Commission's Rule implementing the large trader

345 See SIFMA Letter, p. 11.

346 See Angel Letter, p. 2; FIF Letter, p. 2; BOX Letter, p 2.

347 See Angel Letter, p. 2. This commenter stated that "[i]t would be relatively simple and cheap to add four fields to each trade report that would contain the account numbers of the buyer and seller and the Market Participant Identifier (MPID) for the original order entry firms."

348 See FIF Letter, p. 2. This commenter recommended that the requirement for such unique customer identifiers be tabled until after regulators have experience using CAT without this identifier.

349 See FIF Letter, p. 2.

350 See BOX Letter, p. 2.

reporting system,[351] and a unique customer identifier under Rule 613.[352] One commenter stated that the Commission could alleviate some of the burdens of the proposed Rule, and increase the effectiveness of an identification system, if it required only large trader identification numbers to be reported instead of requiring a unique customer identifier for every customer.[353] This commenter believed that the Commission and the SROs are unlikely to be interested in routine transactions by small investors and would much more likely need accurate information about the orders of large traders because they are most likely to engage in transactions large enough to impact prices.[354] Another commenter noted that an alternative would be to only identify entities that have sponsored or direct access to market centers via a relationship with a sponsoring market participant and to identify customers whose trading activity would be required to be disclosed pursuant to Rule 13h-1.[355]

Certain commenters discussed concerns about how the privacy of customers might be compromised if every customer was assigned a unique customer identifier.[356] One commenter, noting the Commission's discussion in the Proposing Release that the unique customer identifiers could be based on a customer's social security number or taxpayer identification

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351 See Section II.A.3., supra.

352 See SIFMA Letter, p. 11; FINRA Proposal Letter, p. 6-7.

353 See SIFMA Letter, p. 11.

354 Id. See also FINRA Proposal Letter, Appendix B (setting forth a method for identifying large traders through the "registration of unique market participant identifiers rather than by requiring broker-dealers to provide the CAT processor with any large trader numbers assigned by the SEC in order reports, thereby minimizing the ability of market participants to reverse engineer a large trader's identity or trading strategy").

355 See FINRA Proposal Letter, p. 6-7.

356 See SIFMA Letter, p. 10; Wells Fargo Letter, p. 3; Ross Letter, p. 1; ICI Letter, p. 2; FIF Letter, p. 2.

number, believed that the Commission's approach raises "serious privacy concerns."[357] Another commenter noted that "there is a legitimate privacy concern with having the unique customer identifier available to the marketplace, and creating a means to protect that privacy would add tremendous incremental cost to the [consolidated audit trail]."[358] One commenter questioned how long and at what level customer information would be encrypted,[359] and another noted that "[t]he proposal needs to clarify who will have access to customer data and how confidentiality will be ensured."[360]

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357 See SIFMA Letter, p. 10 (noting that "in recent years, increased concerns about identity theft and client confidentiality have led the securities industry to move away from using social security identification numbers or taxpayer identification numbers as a way to monitor clients and customers. The SEC has affirmed that it would guard access to customer social security and taxpayer identification numbers with even more safeguards than it does other information in the central repository of the consolidated audit trail. Although the SEC has a strong record of protecting investor privacy, the very presence of potentially billions of unique customer identifiers tied to personal information in a central repository would create a substantial risk of misuse and identity theft. The risk of unique customer identifiers being stolen or misused would be magnified in a real-time reporting system").

358 See Wells Fargo Letter, p. 3. However, this commenter also noted that, "[w]hile the full panoply of privacy concerns that flow from having a unique order identifier being available to every participant in the order execution process may be difficult to assess, creating a system that has that unique identifier available for primarily the post trade review likely solves both the privacy and cost issues in a manner reasonable for both clients, market participants and regulators." Id.

359 See Ross Letter, p. 1 (asking at what level of security to encrypt customer data, and for how long to encrypt it for, as well as how long the Commission would need to decrypt the customer's name – whether on a real time or overnight basis, and noting that data encryption is expensive and could enlarge message sizes.) See also ICI, p. 3 (suggesting that the Commission expressly state who would have access, when they could access it, and how they could use it; and also recommending requiring that all data sent to the central repository be encrypted and that certain fields be "masked" or that reporting of information in such fields be delayed until end-of-day to reduce concerns about leaked information being used for frontrunning).

360 See FIF Letter, p. 2.

(C) Adopted Rule

(1) Need for a Unique Customer Identifier

The Commission recognizes that the implementation of the unique customer identifier requirement may be complex and costly, and the reporting of a unique customer identifier will require SROs and their members to modify their systems to comply with the Rule's requirements. The Commission, however, believes that unique customer identifiers are vital to the effectiveness of the consolidated audit trail. The inclusion of unique customer identifiers should greatly facilitate the identification of the orders and actions attributable to particular customers and thus substantially enhance the efficiency and effectiveness of the regulatory oversight provided by the SROs and the Commission. Without the inclusion of unique customer identifiers, many of the benefits of a consolidated audit trail as described above in Section II.2. would not be achievable.

For example, unique customer identifiers will make regulatory inquiries and investigations more efficient by eliminating delays resulting from the current need to send information requests to individual market participants in search of this key information, as well as reducing the burden on regulators and market participants of such requests.[361] The identity of the customer is often necessary to tie together potential manipulative activities that occur across markets and through multiple accounts at various broker-dealers. Existing audit trails, however, do not identify the customer originating the order and thus do not allow SRO and Commission

361 Because existing SRO audit trails do not require customer information to be reported, regulators must request that information identifying the customer, often from a multitude of sources, which can result in significant delays in investigating market anomalies or violative trading. Additionally, indirect access to an exchange (such as "sponsored access" arrangements) also has made it more difficult to use the current EBS system and Rule 17a–25 to identify the originating customer because the broker-dealer through whom an order is sent to an exchange may not know or have direct access to information identifying the customer who originally submitted the order.

regulatory staff to quickly and reliably track a person's trading activity wherever it occurs in the U.S. securities markets. A unique customer identifier connected to each order will allow the SROs and the Commission to more quickly identify the customer that originated each order and therefore potentially more quickly and efficiently stop manipulative behavior through the submission of orders. In certain cases this might limit the losses of parties injured by malfeasance who currently may suffer losses during the weeks or months that it can currently take for regulators to obtain customer information through written requests for information.

Further, unique customer identifiers will aid regulators in reconstructing broad-based market events. Specifically, having unique customer identifiers will aid regulators in determining how certain market participants behaved in response to market conditions and may even reveal the identity of the market participant(s) who caused or exacerbated a broad-based market event. More so, unique customer identifiers would enable regulators to disaggregate the market activity of different participants in ways that could help address many important questions related to equity and equity options market structure, ranging from more detailed analyses of the potential impacts of high frequency trading, to studies of market liquidity, to trend analyses of the trading costs and general efficiency by which investors use our public markets to acquire or dispose of their securities holdings.

The Commission has considered commenters' concerns about the complexity of the process for creating and assigning unique customer identifiers and understands and acknowledges that the process of creating and assigning unique customer identifiers may not be simple and may result in additional costs to SROs and their members.[362] The Commission also considered the commenters' views that there may be alternative ways to identify the customer

[362] See notes 331-334, supra, and accompanying text.

responsible for orders, and that, in the view of some commenters, every individual customer need not be identified for purposes of an audit trail. As noted above, the Commission believes that the identification of each customer responsible for every order is critical to the effectiveness of a consolidated audit trail and does not agree that the commenters' alternative means of identifying a customer would be as effective as the method proposed by Rule 613. For example, the Commission considered the comment that customers could be identified by amending the trade report, but this approach would fail to identify customers associated with orders that are not executed.[363] Additionally, account numbers are assigned by broker-dealers for their own customers only, and account numbers vary between broker-dealers. Thus, the identity of a customer from a specific account number would not be apparent to regulators without the time-consuming requests for information Rule 613 specifically is seeking to avoid. The use of unique customer identifiers would permit regulators to readily trace market activity by the same customer back to that unique customer identifier even if such market activity were affected across multiple accounts and broker-dealers.

The Commission also considered the recommendations of some commenters that the consolidated audit trail should use the large trader identifier instead of a unique customer identifier.[364] The Commission, however, does not believe that the commenters' approach will address the regulatory need to obtain information on and to identify the holders of accounts for all order activity in the market for NMS securities because the use of the large trader identifier alone would identify only those traders that self-report as "large traders" pursuant to Rule 13h-1 and are assigned a large trader unique identifier. Thus, under the commenters' suggested approach, only a very small portion of customers – the very largest traders in the market – would

363 See Angel Letter, p. 2.

364 See SIFMA Letter, p. 9-11; FINRA Proposal Letter, p. 4 and 6.

be assigned a unique identifier for purposes of the consolidated audit trail. Smaller traders, however, also can be perpetrators of illegal activity, or otherwise impact the market. Accordingly, the Commission believes that information on all customers is necessary to achieve the goal of Rule 613.

Despite the wide and disparate array of views from commenters on the costs, complexities, and most efficient methodologies to generate and collect unique customer identifiers, the Commission believes that the potential benefits of including this information in the consolidated audit trail justify the costs to the SROs in requiring that they develop and include a detailed framework for unique customer identification as part of the NMS plan to be submitted for consideration by the Commission and the public. Therefore, the Commission is adopting the Rule substantially as proposed to provide that the NMS plan must require every member to report a unique customer identifier to the central repository upon origination or receipt of an order as required by Rule 613(c)(7)(i)(A). The Commission, however, is changing the term "unique customer identifier," as used in the proposed Rule, to the term "Customer-ID." Adopted Rule 613(j)(5) defines the term "Customer-ID" to mean, "with respect to a customer, a code that uniquely and consistently identifies such customer for purposes of providing data to the central repository."[365]

Given the complexity and the various existing options for identifying a customer, the Commission believes that the plan sponsors, by engaging in a detailed process that combines their own expertise with that of other market participants, are in the best position to devise a methodology for, and estimate the costs of, including customer identifiers in the consolidated audit trail. Once the NMS plan was submitted, the Commission and the public would then be

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365 For purposes of the following discussion, the Commission will use the terms "unique customer identifier" and "Customer-ID" interchangeably.

able to consider the details and costs of such a framework.

The Commission notes that the Rule does not specify the process for assigning the unique customer identifiers, or the format for such identifiers; rather, the Rule contemplates that the plan sponsors have the flexibility to determine the precise way to assign or "code" these identifiers. In this regard, the Commission expects the plan sponsors to establish a process by which every broker-dealer can, in a cost-effective manner, obtain a unique customer identifier, or Customer-ID, for each of their customer(s).[366] The Commission also expects the plan sponsors to establish a process by which unique customer identifiers are reported to the central repository, and how this information is linked to the name and address of customers as stored in the central repository. The Commission further notes that Rule 613 does not specify that unique customer identifiers must be attached to every reportable event as orders are routed from one market or broker-dealer to another, or that these identifiers are reported at the same time and fashion as other customer-identifying information. Rather, the Commission is relying on the SROs, and other market participants,[367] to develop a proposal that maximizes efficiency and security, and that data in the central repository be made available to regulators in a linked fashion so that each order, and all subsequent reportable events, can be readily traced back to one or more customers through their unique identifiers.

In response to the commenter that questioned what should happen if a unique customer identifier was not available,[368] the Commission notes that the Rule does not set out a process for

366 Under the Rule, each customer would be assigned a unique customer identifier, or Customer-ID. However, an order may have more than one Customer-ID if the account holder differs from the person from whom the broker-dealer is authorized to take trading instructions or if more than one person is an account holder for the account or is authorized to give trading instructions for the account.

367 See Rule 613(a)(1)(xi).

368 See SIFMA Letter, p. 11.

addressing a situation where a unique customer identifier is not available to a broker-dealer and/or customer. Instead, the Commission believes that the plan sponsors are in the best position to address this situation as they develop the overall process for assigning unique customer identifiers. In response to the comment that requested the Commission specify whether a unique customer identifier is required to be reported at the time an order is originated or received,[369] the Commission notes that Rule 613(c)(7)(i)(A) requires that the NMS plan require that this information be recorded contemporaneously with the reportable event, but permits the reporting of the identifier by 8:00 a.m. Eastern Time on the trading day following the day such information has been recorded.[370] In addition, in response to the commenter that believed that the consolidated audit trail should identify market participants with direct or sponsored access to markets,[371] the Commission notes that under the Rule, to assure the Commission and the SROs of an accurate and complete audit trail for every action that every market participant takes with respect to an order, the sponsored party will be assigned a Customer-ID and the sponsoring broker-dealer will be assigned a CAT-Reporter ID under Rule 613.

The Commission also considered the privacy and security concerns that commenters raised with respect to the use of Customer-IDs.[372] In response to these comments, the Commission is revising proposed Rule 613, as discussed in more detail in Section III.B.2.e. below, to include additional mechanisms to safeguard the privacy and confidentiality of the audit trail data, including the Customer-ID, in large part to address the privacy concerns raised by

369 See SIFMA Letter, p. 11.

370 See Section III.B.1.e., infra.

371 See FINRA Letter, p. 8-9.

372 See ICI Letter, p. 2-4; SIFMA Letter, p. 10-11; Angel Letter, p. 2; Ross Letter, p. 1.

commenters.[373] In response to the commenter that questioned when and at what level customer information would be encrypted,[374] the Commission notes that, while Rule 613 does not explicitly require that this information be encrypted, the Rule contains several safeguards to ensure the privacy and confidentiality of the audit trail data. Specifically, adopted Rule 613(e)(4) requires the NMS plan to include policies and procedures, including standards, to be used by the plan processor to ensure the security and confidentiality of all information reported to the central repository. In addition, one of the considerations the NMS plan must address is how the security and confidentiality of all information, including customer information, reported to the central repository, will be ensured.[375] Based on these provisions, the Commission believes that plan sponsors would need to make sure customer information is protected, and the plan sponsors could require such data to be encrypted.

Additionally, the Commission believes that privacy concerns also could be mitigated if the plan sponsors determine, as permitted by Rule 613, that the unique customer identifiers not travel with the order, and instead be reported to the central repository only upon the receipt or origination of an order. Therefore, if the plan sponsors make this decision, the SROs and their members will not be able to use the unique customer identifier to track the identity of a customer(s) or a customer's order flow.[376] While the unique customer identifier will be linked to information that is sufficient to identify a customer (e.g., the name and address of the customer) and customer account information[377] at the central repository, this information will be accessible

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373 See Section III.B.2.e., infra.

374 See Ross Letter, p. 1.

375 See Rule 613(a)(1)(iv).

376 See also Section III.B.2.e., infra, for a discussion of the provisions in the NMS plan designed to protect the privacy and confidentiality of the consolidated audit trail data.

377 See Rule 613(j)(4).

only by regulators for regulatory purposes.[378] The Commission also notes that the plan sponsors could determine not to require that a customer's social security number or tax identification number be used as a customer's unique identifier to the extent they believe that there are privacy and confidentiality concerns.

(2) Definition of "Customer"

As proposed, Rule 613(j)(1) (renumbered as Rule 613(j)(3)) defined "customer" as "[t]he beneficial owner(s) of the account originating the order; and [t]he person exercising investment discretion for the account originating the order, if different from the beneficial owner(s)." The Commission received two comments regarding the inclusion of beneficial owners in the definition of customer. One commenter questioned the use of a unique customer identifier for both a beneficial owner of an account and the person exercising investment discretion, if different, and noted that if a trade comes into question, the person exercising investment discretion, not the beneficial owner, likely will be the "first person of interest in any type of review or investigation of such trading activity."[379] Another commenter requested further clarity regarding the definition of "customer" for purposes of Rule 613, and suggested that the Commission should define "beneficial owner" to be sure this term is applied correctly.[380] This commenter specifically stated that "[t]he SEC should also provide a definition for the terms 'beneficial owner' and 'customer' to eliminate any doubts as to whom these labels apply. For example, is the 'customer' the entity directing the trade or the beneficial owner of the account?" and added that, "for registered investment advisers, the unique customer identifier should be associated with the investment adviser rather than the underlying beneficial owner. Frequently,

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378 See Rule 613(e)(2). See also Section III.B.2.d., infra.

379 See FINRA Letter, p. 9.

380 See SIFMA Letter, p. 11.

investment advisers aggregate orders for multiple beneficial owners in 'bulk' orders that are routed together and allocated on an average-priced basis to ensure best execution."[381] In response to commenters' concerns about the use of the term "beneficial owner," the Commission is revising Rule 613(j)(1), as proposed (renumbered as Rule 613(j)(3)), to state that "[t]he term 'customer' shall mean: (i) [t]he account holder(s) of the account at a registered broker-dealer originating the order; and (ii) [a]ny person from whom the broker-dealer is authorized to accept trading instructions for such account, if different from the account holder(s)." The Commission believes that the revised Rule will provide it with the customer information required to achieve the objectives of the consolidated audit trail.[382]

In adopting this revised definition, the Commission is clarifying its intent that, with respect to the "account holder" reference under Rule 613(j)(3), the NMS plan submitted to the Commission for its consideration must require broker-dealers to capture information on only the individuals or entities that currently are required to be recorded in the books and records of the broker-dealer pursuant to Rule 17a-3(a)(9) under the Exchange Act.[383] Because this provision does not require broker-dealers to obtain information about their account holders beyond what they are required to obtain today, the Commission believes the modification to the proposed Rule is appropriate because it will reduce the proposed Rule's burden on broker-dealers in recording

381 Id.

382 The Commission also notes that it retains the authority to request additional information from broker-dealers (and other market participants it regulates) where information about a customer of a broker-dealer beyond that required by Rule 613(j)(3) is needed to fulfill its mission.

383 Rule 17a-3(a)(9), among other things, requires a broker-dealer to make and keep a record of the name and address of the "beneficial owner" of each cash or margin account with the broker-dealer. 17 CFR 240.17a-3(a)(9). Rule 613 is not intended to alter in any way the information that a broker-dealer is currently required to obtain under Rule 17a-3(a)(9).

and reporting information about a "customer," as that term will be defined under Rule 613(j)(3). The Commission notes that, under the Rule, as adopted, for joint accounts – where two individuals are required to provide information under Rule 17a-3 of the Exchange Act for one account – information for both persons listed on the joint account would be recorded and reported under Rule 613.[384]

The Commission also believes that it is important to capture the person that has authority to give trading instructions to a broker-dealer for an account, if different from the account holder, because such person likely will be of interest in a review or investigation of activity in such account. Thus, the Commission is modifying the proposed Rule to clarify its intent that under Rule 613 the NMS plan also must capture, in the definition of customer, "[a]ny person from whom the broker-dealer is authorized to accept trading instructions, if different from the account holder(s)."[385] Knowing the identity of the person who is authorized to give the broker-dealer trading instructions for an account, whether the account holder or an adviser or other third party, is a vital component in the investigative process. Further, when investigating violations of the federal securities laws, it is important to promptly identify all potentially relevant parties who may have made trading or investment decisions, which could include both the person authorized to give the broker-dealer trading instructions for such account and the account holder.[386]

Pursuant to the revised definition of "customer" under adopted Rule 613, for example, if an order is entered to buy or sell securities for the account of an investment company or other

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384 The Commission notes that, under Rule 613, both joint account holders would also receive their own unique customer identifier.

385 See Rule 613(j)(3)(ii).

386 For the purpose of Rule 613(j)(3), natural persons who are employed by an entity that is an account holder, and who are authorized to trade for that account, are not considered different from the account holders, and are therefore not covered by Rule 613(j)(3)(i).

pooled investment vehicle (a "fund"), the Rule will capture, in the definition of customer, the fund itself or, if the account at the broker-dealer is held only in the name of the fund's investment adviser from whom the broker-dealer is authorized to accept trading instructions, the Rule will capture the investment adviser.[387] If the account at the broker-dealer is held in the name of the fund itself, the Rule will capture both the name of the fund (pursuant to Rule 613(j)(3)(i)), as well as the name of the fund's investment adviser from whom the broker-dealer is authorized to accept trading instructions (pursuant to Rule 613(j)(3)(ii)). In addition, if an adviser enters an order on behalf of clients that each maintain separate accounts at the broker-dealer originating the order, using those accounts, the Rule would capture both the adviser – as the person providing trading instructions to the broker-dealer (pursuant to Rule 613(j)(3)(ii)) – and the clients, who are the account holders at the broker-dealer (pursuant to Rule 613(j)(3)(i)). If an adviser instead enters an order to buy or sell securities using its own account held at the broker-dealer originating the order, the Rule would capture the adviser (pursuant to Rule 613(j)(3)(i)) but would only capture any client accounts to which the adviser allocates executed trades (pursuant to Rule 613(c)(7)(vi)) if those client accounts were held separately at the same broker-dealer as well.

Furthermore, in cases where multiple individuals in the same trading firm transact through a single account maintained at a broker-dealer in the name of that trading firm, the Rule will require the NMS plan to require recording and reporting of the Customer-ID of the trading firm associated with that account, and not the Customer-IDs of the individual traders who had

387 Pursuant to the definition of "customer" under adopted Rule 613, the Rule would not capture owners of a fund because they are not the account holders at the broker-dealer.

placed the orders.[388] The Commission understands that in some cases broker-dealers may have knowledge of the individual traders transacting within the same firm-wide account, and may even provide reports to the firm holding the account that summarizes trade activity according to individual trader. Because such information is not captured by the Rule, but may be useful in informing regulators about the potential manipulative activities, the SROs may wish to consider how such information might be incorporated into the consolidated audit trail in the future.

The Commission is also modifying a related provision of the Rule, Rule 613(c)(7)(i)(A), to reflect that more than one Customer-ID must be provided upon original receipt or origination of an order if the account holder and the person authorized to give the broker-dealer trading instructions for such account are different or if more than one person is an account holder for the account (such as, for example, joint account holders). Specifically, Rule 613(c)(7)(i)(A) provides that "Customer-ID(s)" (i.e., multiple Customer-IDs) must be provided for each customer, if that is applicable. In addition, the Commission notes that every "customer," as defined by Rule 613(j)(3) will be assigned a Customer-ID; thus, two Customer-IDs maybe associated with one order under the Rule.

iv. Unique Order Identifier

As proposed, the Rule would have required the NMS plan to require each member of an exchange or FINRA to attach, to each order received or originated by the member, a unique order identifier that would be reported to the central repository and that would remain with that

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388 This is because, for the purpose of Rule 613(j)(3), natural persons who are employed by an entity that is an account holder, and who are authorized to trade for that account, are not considered different from the account holders, and are therefore not covered by Rule 613(j)(3)(ii).

If an individual creates and operates two separate entities (as an employee of each such entity) that each maintain a trading account at one or more broker-dealers, the broker-dealers would be required to record and report the Customer-IDs of those entities, and not the customer ID of the individual trader.

order throughout its life, including routing, modification, execution, or cancellation. Specifically, proposed Rule 613(c)(7)(i)(D) (renumbered as Rule 613(c)(7)(i)(B)) would have provided that the national market system plan shall require each national securities exchange, national securities association, and any member of such exchange or association to collect and electronically provide to a central repository details for each order and each reportable event, including, but not limited to, "a unique identifier that will attach to the order at the time the order is received or originated by the member and remain with the order through the process of routing, modification, cancellation, and execution (in whole or in part)." In the Proposing Release, the Commission stated that the use of such an identifier would allow the SROs and the Commission to efficiently link all events in the life of an order and help create a complete audit trail across all markets and broker-dealers that handle the order.[389] Proposed Rules 613(c)(7)(ii)(A), 613(c)(7)(iii)(A), and 613(c)(7)(v)(A) would have required the reporting of a unique order identifier to the central repository for the reportable events of routing and execution. The Commission did not propose to mandate the format of such an identifier or how the identifier would be generated.

The Commission requested comment on whether a unique order identifier that would remain with the order for its life would be necessary or useful for an effective consolidated audit trail. The Commission also specifically requested comment on, among other things, the feasibility and merits of its proposed approach for attaching a unique order identifier to an order, as well as on how multiple "child" orders that may result if the original "parent" order is subsequently broken up, or an aggregation of multiple original orders into a single order, should be addressed.

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389 See Proposing Release, supra note 4, at 32576.

Several commenters expressed opinions on the proposed unique order identifier requirement, with some noting that the Commission's proposal imposed "significant" burdens or challenges on market participants, and others offering alternatives to the Commission's approach to identifying orders.[390] For example, some commenters suggested that the Rule permit the approach used for OATS reporting, in which the broker-dealer initiating or receiving an order would generate its own order identifier, but pass on a separate routing identifier to the entity to which it routes the order, which would generate its own order identifier, but retain and report that routing identifier as well, so that information about the order can be linked together as it is passed from venue to venue.[391] One of these commenters also believed that the OATS approach would avoid certain complexities that could occur with a unique order identifier, such as when the original order is broken up into multiple "child" orders.[392] In a subsequent comment letter, the commenter stated that it could require two new order event types that would allow customer orders handled on a riskless principal or agency basis to be linked to the related representative orders.[393] Another of the commenters suggested that "the adopted CAT filing should require that an order be tracked through its lifecycle and [the Commission should] leave the technical details to [a] requirements analysis."[394]

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390 See Thomson Reuters Letter, p. 3; Liquidnet Letter, p. 6-7; SIFMA Letter, p. 12; FINRA Letter, p. 7; FIF Letter, p. 3; FIF Letter II, p. 2.

391 See Liquidnet Letter, p. 6-7; SIFMA Letter, p. 12; FINRA Letter, p. 7; FIF Letter, p. 3.

392 See FINRA Letter, p. 7-8. FINRA expressed concern that, if two child orders from the same parent order are sent to the same market center, regulators would need to look at time stamps and other attributes, such as share quantity and price, to attempt to create an accurate linkage for each individual child order. FINRA stated that this complexity could be avoided if members used a separate unique routed order identifier for each routed order. Id.

393 See FINRA Proposal Letter, p. 7-8.

394 See FIF Letter II, p. 2.

Another commenter was concerned that, if the originating firm's or customer's name was used as part of the unique order identifier, this could create "potential privacy information risks as every new destination (both internally across information barriers within a firm and externally across broker-dealers) would see where an order originated."[395] Similarly, a third commenter supported the OATS approach of linking a series of separate order identifiers in part because it believed that, if a unique identifier were to pass from firm-to-firm, there was a risk that information about the origin of an order might be inferred.[396] Yet another commenter recommended that the Commission standardize how the order identifier should be structured to ensure consistent reporting between firms, instead of leaving this decision to the plan sponsors.[397]

The Commission has considered the comments received regarding the requirement that the NMS plan mandate a unique order identifier, and is adopting Rule 613 with significant modifications[398] that provide more flexibility for the SROs, as the plan sponsors, to determine whether the NMS plan will require a single unique order identifier or a "series of order identifiers." Specifically, the Rule, as adopted, requires that every order have a "CAT-Order-ID," defined as "a unique order identifier or series of unique order identifiers that allows the central repository to efficiently and accurately link all reportable events for an order, and all

395 See SIFMA Letter, p. 12. See also SIFMA Drop Copy Letter, p. 2 (suggesting a routed order identifier or a child order identifier which would be separate from the unique order identifier of the parent order, and would be reported to the consolidated audit trail separately on a non-real-time basis, as well as linkage information).

396 See FIF Letter, p. 3 (recommending the linking of the order information in a fashion similar to OATS whereby the information would only be available to regulators).

397 See SIFMA Letter, p. 12. In addition, another commenter suggested that order identifiers should be unique by broker and day, similar to the approach used by OATS. See Liquidnet Letter, p. 7.

398 See Rule 613(c)(7)(i)(B); Rule 613(c)(7)(ii)(A); Rule 613(c)(7)(iii)(A); Rule 613(c)(7)(iv)(A); Rule 613(c)(7)(v)(A); Rule 613(c)(7)(vi)(C); and Rule 613(j)(1).

orders that result from the aggregation or disaggregation of the order."[399]

The Commission has modified the Rule from the proposal so that the SROs can draw upon their own expertise, as well as those of other market participants, in developing the most accurate and efficient methodology for tracking an order through its life. Thus, the SROs may submit an NMS plan in which they require a single unique order ID to travel with each originating order; the SROs may submit an NMS plan in which, as suggested by a number of commenters, a series of order IDs, each generated by different market participants, is reported to the central repository in a manner that allows for the accurate linking of reportable events; or the SROs may submit an NMS plan based on any other methodology that meets the requirements of the Rule.

The Commission expects that the details of the methodology proposed by the SROs in the NMS plan will, in part, be based on how the generation and reporting of order identifiers would interact with other technical details involving order tracking in the consolidated audit trail, such as the potential for multiple orders to be aggregated, routed, and disaggregated. However, though the Commission is not prescribing a particular methodology, the Rule does require that SROs take into account a number of considerations, such as accuracy and cost, in designing their methodology.[400]

The Commission notes that, with this modification, a wider array of possible solutions is now available to the SROs as they develop the NMS plan to be submitted to the Commission for its consideration, including those that may better accommodate the infrastructure of existing audit trails and thereby potentially, and possibly significantly, reduce implementation burdens. As indicated above, several commenters suggested that the Rule accommodate the linked order

399 See Rule 613(j)(1).

400 See Section III.C.2.a., infra.

identifier approach, currently used by OATS.[401] However, the Commission also notes that, though the adopted Rule could accommodate such an approach, there historically have been limitations on the accuracy and reliability of linking orders in OATS.[402] It will therefore be very important for the NMS plan to demonstrate how the approach it has selected will ensure that information about all reporting events pertaining to an order will be efficiently and accurately linked together in a manner that allows regulators efficient access to a complete order audit trail.[403] As discussed below, the reliability, accuracy, and confidentiality of the data reported to and maintained by the central repository, as well as the method by which the data in the central repository can be accessed by regulators, are considerations for the Commission in evaluating the NMS plan.[404]

The Commission emphasizes that, under the adopted Rule, regardless of the specific method chosen by the SROs, all orders reported to the central repository must be made available to regulators in a uniform electronic format and in a form in which all events pertaining to the same originating order are linked together in a manner that ensures timely and accurate retrieval of the information for all reportable events for that order.[405] The Commission believes the consolidated audit trail will still achieve significant benefits with this modification.

The Commission recognizes the complexities of order routing in today's markets,

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401 See FIF Letter, p. 3; Liquidnet Letter, p. 7; SIFMA Letter, p. 12; SIFMA Drop Copy Letter, p. 12; FINRA Letter, p. 8.

402 See Section II.A., supra.

403 See Rule 613(j)(1). For example, one of the methods that the SROs could consider using to demonstrate the efficacy of their approach would be to engage appropriate third party experts to confirm that the system's proposed design and functionality would achieve its stated accuracy and reliability benchmarks.

404 See Section III.C.2.a.i., infra; Rule 613(a)(1)(iii) and (iv).

405 See Rule 613(e)(1).

including, as noted by a commenter,[406] the frequent splitting of larger orders into numerous "child" orders or the bundling of smaller orders into one larger order. The Commission believes, however, that since, in today's complex markets, orders are currently and routinely aggregated and disaggregated, practical solutions to record such orders can be developed by the plan sponsors to ensure they are accurately and efficiently tracked through a variety of aggregation and disaggregation events.

With regard to the concern expressed by a commenter that the use of an order identifier(s), as required by Rule 613, could provide the ability to deduce the origin of an order, thereby revealing confidential trading strategies or raising privacy concerns,[407] the Commission notes that this commenter assumed that a unique order identifier "would very likely require members to include the originating firm's or customer's name as part of the identifier."[408] The Commission believes, however, that the SROs will be able to devise a way to assign order identifiers – through random number sequences or otherwise – that would protect the identity of broker-dealers and their customers from disclosure to persons other than authorized regulatory personnel. The Commission also notes that, as discussed in Section III.B.2.e. infra, the adopted Rule requires the NMS plan submitted to the Commission for its consideration to incorporate a variety of policies and procedures to ensure the security and confidentiality of all information reported to the central repository.

Furthermore, because the Rule requires the SROs to discuss the details of each aspect of the NMS plan submitted to the Commission for its consideration, the Commission and the public will be able to consider how well the methodology the SROs developed to link reportable events

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406 See FINRA Letter, p. 4-7.

407 See SIFMA Letter, p. 12. See also FIF Letter, p. 3.

408 See SIFMA Letter, p. 12.

for the same order meets the considerations of accuracy and reliability, as well as those of security and confidentiality. The Commission will then be able to use this information in determining whether to approve the NMS plan submitted.

v. **Time Stamp**

The proposed Rule would have required SROs and their members to report the date and time, to the millisecond, that an order was originated or received, routed out, and received upon being routed, modified, cancelled, and executed.[409] Specifically, proposed Rules 613(c)(7)(i)(H) (renumbered as 613(c)(7)(i)(E)), 613(c)(7)(ii)(C), 613(c)(7)(iii)(C), 613(c)(7)(iv)(B) (renumbered as 613(c)(7)(iv)(C)), and 613(c)(7)(v)(C) provided that the "time of order receipt or origination (in milliseconds)" would be recorded for every order originated or received, routed, modified, cancelled or executed, by a broker-dealer or SRO.

Several commenters expressed opinions on the time stamp requirement. One commenter believed a millisecond standard was not precise enough, explaining that many exchanges currently execute orders in less than a millisecond.[410] This commenter explained that, to detect the manipulative or fraudulent behavior of high frequency traders, it is necessary that time stamps be accurate to a level more detailed than the speed at which trades are executed; otherwise, it would not be possible to determine the time sequence in which trades occurred. The commenter suggested that reports from execution venues (e.g., exchanges, ATSs, dark pools, and large internalizers) should be required to be accurate to 0.01 milliseconds.[411] This

409 See proposed Rules 613(c)(7)(i)(H), 613(c)(7)(ii)(C), 613(c)(7)(iii)(C), 613(c)(7)(iv)(B), 613(c)(7)(v)(C).

410 See Endace Letter, p. 1-2.

411 See Endace Letter, p. 1. The Commission notes that this commenter also suggested that the same time increment be extended to market data feeds to help increase transparency and deter fraudulent activity; however, this comment is outside the scope of this Release.

commenter also suggested that a more liberal time stamp standard of one second might be more appropriate for low-volume broker-dealers.[412] Another commenter, however, expressed concern about the proposed millisecond time stamp requirement, explaining that, "[a]lthough firm systems tend to capture time stamps in milliseconds, reporting in milliseconds would require changes to internal systems given that existing audit trails such as OATS require reporting of time stamps accurate only to the second."[413] Another commenter believed that, because computers have a certain rate of error when keeping time ("time drift"), it is difficult to sequence orders based on millisecond time stamps.[414] As a result, according to this commenter, there is "no real value in requiring data to this level of specificity [based on milliseconds], especially if the goal of time stamping is to sequence the lifecycle of a single order as it moves from origination to execution."[415]

The Commission has considered the comments regarding the precision of the proposed time stamp requirement for the consolidated audit trail and is adopting the millisecond time stamp requirement with modifications from the proposal.[416] As adopted, the Rule provides that the NMS plan submitted shall require the time stamps as set forth in Rule 613(d)(3).[417] Rule 613(d)(3) provides that the NMS plan must require each SRO and its members to "[u]tilize the time stamps required by paragraph (c)(7) of this section, with at minimum the granularity set

412 Id. at 2-3.

413 See SIFMA Letter, p. 14.

414 See FIF Letter, p. 6-7.

415 Id. See Section III.B.1.d.v., infra, for further discussions of "time drift" and the issues raised by this commenter in that regard.

416 See Proposed Rules 613(c)(7)(i)(H), 613(c)(7)(ii)(C), 613(c)(7)(iii)(C), 613(c)(7)(iv)(B), and 613(c)(7)(v)(C).

417 See Rules 613(c)(7)(i)(E), 613(c)(7)(ii)(C), 613(c)(7)(iii)(C), 613(c)(7)(iv)(C), and 613(c)(7)(v)(C).

forth in any national market system plan submitted pursuant to this section, which shall reflect current industry standards and be at least to the millisecond." Rule 613(d)(3) also provides that, "[t]o the extent that the relevant order handling and execution systems of any national securities exchange, national securities association, or member of such exchange or association utilize time stamps in increments finer than the minimum required by the national market system plan, such plan shall require such national securities exchange, national securities association, or member to utilize time stamps in such finer increments when providing data to the central repository, so that all reportable events reported to the central repository by any national securities exchange, national securities association, or member can be accurately sequenced." Rule 613(d)(3) further provides that "[t]he national market system plan shall require the sponsors of the national market system plan to annually evaluate whether industry standards have evolved such that the required time stamp standard should be in finer increments."

The Commission notes that SIPs currently support millisecond time stamps[418] and other entities in the securities industry currently conduct business in millisecond increments or finer.[419] The Commission believes that, given the speed with which the industry currently handles orders and executes trades, it is important that the consolidated audit trail utilize a time stamp that will enable regulators to better determine the order in which reportable events occur. The entry time of orders can be critical to enforcement cases. For example, the timing between order origination and order entry is important in investigating possible market abuse violations, such as

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418 See, e.g., Securities Industry Automated Corporation's ("SIAC") Consolidated Quotation System ("CQS") Output Specifications Revision 40 (January 11, 2010); SIAC's Consolidated Tape Service ("CTS") Output Specifications Revision 55 (January 11, 2010); and Nasdaq's Unlisted Trading Privileges Plan Quotation Data Feed Interface Specifications Version 12.0a (November 9, 2009).

419 See, e.g., http://batstrading.com/resources/features/bats_exchange_Latency.pdf (describing, among other things, the time it takes to accept, process, and acknowledge or fill a member order).

trading ahead of a customer order. In general, determining whether a series of orders rapidly entered by a particular market participant is manipulative or otherwise violates SRO rules or federal securities laws, otherwise being able to reconstruct market activity, or performing other detailed analyses, requires the audit trail to sequence each order accurately. The Commission believes that, for many types of common market activities that operate at the level of milliseconds or less, time stamps in increments greater than a millisecond would not allow this sequencing with any reasonable degree of reliability.

In response to the comment that a millisecond standard is not sufficiently precise, as many exchanges currently execute orders in less than a millisecond,[420] adopted Rule 613(d)(3) provides that the NMS plan must require that, to the extent that the order handling and execution systems of any SRO or broker-dealer utilize time stamps in increments finer than the minimum required by the NMS plan time stamps, such SRO or member must use time stamps in such finer increments when reporting data to the central repository, so that reportable events reported to the central repository by any SRO or member can be accurately sequenced. The Commission believes this approach will improve the accuracy of records with respect to the sequencing of events that occur very rapidly, especially with respect to those market participants that have elected to use time stamps in increments finer than a millisecond.

The Commission recognizes, as a commenter noted,[421] that computers have a certain rate of deviation when keeping time. The requirement that clocks be synchronized within a level of granularity to be specified in the NMS plan[422] is designed to ensure that time drift does not exceed a defined level of deviation. However, the Commission believes that time stamps

420 See Endace Letter, p. 1.

421 See FIF Letter, p. 7.

422 See Section III.B.1.h., infra, for a discussion of clock synchronization.

reported with a millisecond or finer granularity would still provide significant benefits even, contrary to one commenter's assertion,[423] if the time drift between systems is larger than a millisecond. This is because such time stamps would still allow an accurate sequencing of reportable events as may commonly occur within in a single system, tied to a single clock, at levels of a millisecond or finer (e.g., high-frequency trading algorithms). Any drift of such a system's clock relative to the clocks of other systems may of course hinder the time-sequencing of cross-system events, but it would not preclude the ability of regulators from performing a detailed, accurate time-sequenced analysis of all the orders, cancellations, modifications, and executions performed by the specific system of interest.[424] In this regard, the Rule is analogous to the current requirements for OATS reporting: FINRA requires clocks to be synchronized to the second, and requires time stamps to be reported to FINRA in seconds, unless those time stamps are captured by the FINRA member in milliseconds, in which case they must reported to FINRA in milliseconds (notwithstanding the clock sync remaining at a second).[425]

The Commission acknowledges that changes (with their associated costs) might be required to internal broker-dealer systems to comply with a millisecond time stamp requirement. However, given the benefits outlined above, and the apparent widespread use of millisecond time

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423 See FIF Letter, p. 6-7.

424 Similarly, although reporting in increments finer than a millisecond would also enable the accurate time-sequencing of events originating from within a single system or systems operating off the same clock, the Commission recognizes that the effects of time drift across the clocks of different systems could limit the efficacy of time-sequencing sub-millisecond events across those systems.

425 See FINRA's Order Audit Trail System, Frequently Asked Questions, http://www.finra.org/Industry/Compliance/MarketTransparency/OATS/NMS/P122893 (last visited on May 15, 2012).

stamps in the industry today,[426] the Commission believes the cost of requiring the SROs to develop a plan that provides for millisecond time stamps, and to discuss the costs and benefits of the specific solution chosen, is justified.

The Commission also acknowledges that broker-dealers who presently report time stamps to OATS in millisecond increments, but whose systems direct and capture their order activity in finer time increments, could incur costs associated with these time stamps being reported to the central repository with the same granularity at which they are recorded by the broker-dealers.[427] The Commission recognizes that there may be alternatives to reporting events in finer than millisecond increments that enable the central repository to use a different method for accurately time-sequencing sub-millisecond events originating from within a system or systems on a single clock. Therefore, in developing the NMS plan to be submitted to the Commission for its consideration, if the SROs identify one or more such alternatives, the Commission believes that they should address such alternatives in the NMS plan,[428] how such alternatives (i.e., an alternative to reporting in finer than millisecond increments) would ensure that reportable events may be accurately time-sequenced at the sub-millisecond level, and the costs associated with such alternatives both on their own terms and relative to a requirement to report events in the

426 See Endace Letter, p. 1 (stating that "[t]oday Exchanges such as NYSE Euronext and BATS are claiming that they are executing orders in less than a millisecond (see Wall Street Journal on the January 6th 2010) and are displaying details of these trades in increments of milliseconds on their market data feeds. Clearly from an Exchange perspective the publishing of trade data at one millisecond increments is not just possible, its current practice. However, Endace believes that one millisecond increments is not good enough"); SIFMA Letter, p. 14 (acknowledging that, "[a]lthough firm systems tend to capture time stamps in milliseconds, reporting in milliseconds would require changes to internal systems given that existing audit trails such as OATS require reporting of time stamps accurate only to the second").

427 See SIFMA Letter, p. 14.

428 See Rule 613(a)(1)(xii).

same sub-millisecond time stamp as used by a broker-dealer for directing and capturing orders.[429]

The Commission also notes that, because millisecond time stamps may become inadequate to investigate trading as technology evolves and trading speeds increase, the adopted Rule requires that the NMS plan submitted to the Commission for its consideration require the plan sponsors to annually evaluate whether industry standards have evolved such that a finer increment time stamp is appropriate. As this approach is tied to the then-current industry standard used to assess whether to shorten the future time stamp increment, the Commission also believes that this approach helps assure that the time stamps in the consolidated audit trail will be in line with technological developments. Should the industry standard move to a finer time standard, the plan sponsors could modify the minimum standard required by the NMS plan by submitting an amendment to the NMS plan under Rule 608 of Regulation NMS. Such an amendment would need to be considered and would be subject to approval by the Commission, as well as subject to public notice and comment.[430]

vi. Additional Routing Data Elements

Proposed Rules 613(c)(7)(ii) and (iii) would have required that certain additional information be collected and reported specifically to allow regulators to track the life of an order through the routing process. The Commission requested comment as to whether information regarding the routing of orders would be necessary or useful for an effective consolidated audit trail, and asked if any information, in addition to the data elements proposed, should be included in the consolidated audit trail relating to routing.

One commenter noted that the proposed Rule would capture the routing of an order

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429 See Rule 613(a)(1)(vii).

430 See Rule 608(b)(1) under Regulation NMS, 17 CFR 242.608(b)(1).

internally within a broker-dealer, but not the routing of an order internally within an exchange from one execution system to another.[431] This commenter also noted that, as proposed, the Rule would not require an SRO or member to report information indicating that an order was "flashed" or otherwise displayed in a "step-up" mechanism.[432] The commenter believed that this information would be important for the consolidated audit trail to capture.[433]

The Commission believes that it is important to capture the routing of an order internally within a broker-dealer to, for example, evaluate best execution practices.[434] Capturing the time at which a broker-dealer received a customer's order and the time that such order was executed can help determine if the broker-dealer delayed acting on its customer's order. The time at which an order was routed can affect the evaluation of whether the broker-dealer fulfilled its best execution obligations, and, thus, the Commission believes that this internal broker-dealer routing information should be captured by Rule 613. The Commission, however, does not believe that data regarding order processing (i.e., management of an order) within exchange systems is as useful as data regarding internal routing within a broker-dealer[435] because, for example, unlike broker-dealers, exchanges do not have best execution obligations. Further, any issues with an SRO's internal processing would occur at a single venue – the SRO – and, thus, there could be direct follow-up with the SRO. Additionally, the Commission notes that the consolidated audit

431 See GETCO Letter, p. 4.

432 Id.

433 Id.

434 OATS rules currently require the recording and reporting of orders routed internally. See FINRA Rule 7440(c).

435 The Commission acknowledges that certain orders received by an exchange may be routed to another exchange; however, the routing of such an order to the other exchange is largely subject to the rules of the exchange and Rule 613 will capture such routing as a reportable event.

trail will not collect information indicating whether orders were flashed or displayed in a "step-up" mechanism as it concerns an exchange's internal processing and dissemination to its members of an order in the instance when the exchange cannot execute the order because the exchange does not have any available trading interest at the NBBO (depending on the side of the order).[436] Orders that are flashed or displayed through a "step-up" mechanism are not executable because they are displayed only to members of an exchange as an indication of a broker-dealer's interest. The Commission believes it is appropriate not to require the reporting of these flashed or "stepped-up" orders to the central repository because, as noted above, the Commission believes that the tracing of processes within an exchange is not as material to regulators as the routing of orders between markets. Further, as stated, SROs do not have the same legal obligations with regard to handling customer orders as broker-dealers; therefore, the Commission does not believe it is necessary, at this time, to require the consolidated audit trail to track an SRO's internal processing of orders.

The Commission has considered the comments related to the data that is required to be recorded and reported when an order is routed and is adopting Rules 613(c)(7)(ii) and (iii) substantially as proposed.[437] The Commission notes that the Rule requires that the NMS plan require the broker-dealer routing an order and the broker-dealer receiving a routed order – both actions that are defined as "reportable events" under Rule 613 – record and report the CAT-

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436 In general, flash orders are communicated to certain market participants and either executed immediately or withdrawn immediately after communication. The Commission has proposed and sought comment on whether to amend Rule 602 of Regulation NMS under the Exchange Act to eliminate an exception for the use of flash orders by equity and options exchanges. See Securities Exchange Act Release Nos. 60684 (September 18, 2009), 74 FR 48632 (September 23, 2009); 62445 (July 2, 2010), 75 FR 39625 (July 9, 2010).

437 See Section III.B.1.d.vi., supra, for a discussion of the modifications to Rule 613(c)(7)(ii) through (iii).

Reporter-ID of the broker-dealer routing the order and the CAT-Reporter-ID of the broker-dealer receiving the routed order. The Commission believes the requirement to report this information on both the routing and receiving end of a route is not duplicative but, rather, is useful. Specifically, information regarding when a broker-dealer received a routed order could prove useful in an investigation of allegations of best execution violations to see if, for example, there were delays in executing an order that could have been executed earlier. In addition, if a market participant is required to report when it receives an order, regulators could solely rely on information gathered directly from that market participant when examining or investigating the market participant. For example, if a regulator needs to investigate a delay between the time a market participant received an order and the time the market participant acted on the order, under Rule 613, as adopted, the regulator could use information recorded and reported by the market participant itself, rather than rely on information about the receipt and action taken on the order that would be provided by a third party. Information from a third party may be less accurate in general and may not accurately reflect events to the extent there are latencies in order transmission. In addition, the Commission relies on data such as that which would be recorded under Rule 613(c)(7)(ii) and (iii) to improve its understanding of how markets operate and evolve, including with respect to the development of new trading practices, the reconstruction of atypical or novel market events, and the implications of new markets or market rules. For these reasons, the Commission believes that it is important to have both the routing broker-dealer and the receiving broker-dealer report their CAT-Reporter-IDs to the central repository, and that such information could aid regulatory authorities when analyzing the trades of market participants.[438]

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438 The Commission notes that OATS rules also require both the FINRA reporting member routing an order and the FINRA reporting member receiving the order to record and

To reflect terms that have been modified elsewhere in the Rule as adopted, the terms "unique order identifier" and "unique identifier" in Rule 613(c)(7)(ii) and (iii) have been replaced with the terms "CAT-Order-ID" and "CAT-Reporter-ID." In addition, Rule 613(c)(7)(ii) and (iii) now reflect the new time stamp requirement contained in Rule 613(d)(3). Specifically, Rules 613(c)(7)(ii)(C) and 613(c)(7)(iii)(C) provide that the time at which an order is routed or received must be recorded and reported pursuant to Rule 613(d)(3), rather than simply in milliseconds as proposed. The Commission believes these conforming changes are appropriate to reflect the revised terms in the adopted Rule.

vii. Additional Modification, Cancellation, or Execution Data Elements

In addition to the data elements discussed above, proposed Rules 613(c)(7)(iv) and (v) would have required that certain information be collected and provided specifically to allow regulators to track the life of an order through modification, cancellation, or execution. The Commission requested comment as to whether information required under the Rule as proposed would be sufficient to create a complete and accurate consolidated audit trail, and asked if any information, in addition to the data elements proposed, should be included in the consolidated audit trail relating to modifications, cancellations, or executions.

In response, one commenter noted that broker-dealer order management systems may differ in their treatment of order modifications and cancellations, as some, for example, may capture or report only modified data elements, and not necessarily all of the elements of a modified order.[439] The commenter recommended that the consolidated audit trail accommodate such differences, and further suggested requiring only the submission of the order identifier for a

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report certain audit trail data. See FINRA Rule 7440(C). See also Rule 613(c)(7)(ii)(D) and Rule 613(c)(7)(iii)(D) through (E).

439 See SIFMA Drop Copy Letter, p. 4.

cancelled order, not the order's other data elements.[440] Another commenter believed that, "[a]s in the case of the current OATS system, execution data provided to the consolidated audit trail should identify where the trade was publicly reported and have a common identifier that links the audit trail execution reports for the buy and sell orders to the public trade report."[441]

After consideration of the comments regarding the specific audit trail data required for orders that are modified, cancelled, or executed, the Commission is adopting Rules 613(c)(7)(iv) and (v) substantially as proposed, with a modification to require that the NMS plan include a requirement that the CAT-Order-ID for such orders also be recorded and reported to the central repository. This modification is designed to ensure that an order identifier be reported for orders that have been modified or cancelled. The Commission believes that the order identifier is a critical piece of information that will efficiently link an order across markets. Adopted Rules 613(c)(7)(iv) and (v) will also require that the NMS plan submitted to the Commission for its consideration require the recording and reporting of the CAT-Reporter-ID of the broker-dealer or Customer-ID of the person giving the modification or cancellation instruction to reflect the new terminology of the adopted Rule. In addition, Rules 613(c)(7)(iv) and (v) reflect the new time stamp requirement contained in Rule 613(d)(3), as adopted. Specifically, Rules 613(c)(7)(iv)(C) and 613(c)(7)(v)(C) provide that the time at which an order is modified, cancelled, or executed must be recorded and reported pursuant to Rule 613(d)(3), rather than simply in milliseconds as proposed.

The Commission believes it is necessary to require the NMS plan to require the information under Rule 613(c)(7)(iv) and (v) for each order and reportable event because it will assist the Commission and SROs in identifying all changes made to an order (including an

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440 Id.

441 See Liquidnet Letter, p. 7.

execution) and those market participants responsible for the changes (or execution). The Commission believes this information, in combination with the proposed information pertaining to order receipt or origination, will provide regulators with a comprehensive view of all material stages and participants in the life of an order. Among other things, this order information should help regulators investigate suspicious trading activity in a more efficient manner than is currently possible. Regulators will have access to information identifying the customer behind the order and will also see how a customer's order is handled across markets. This data also will improve regulators' understanding of how markets operate and evolve, including with respect to the development of new trading practices, the reconstruction of atypical or novel market events, and the implications of new markets or market rules. In addition, the Commission believes that most of the data proposed to be recorded and reported by the Rule for order modification, cancellation, and execution is data that most broker-dealers already generate in the course of handling an order pursuant to the existing audit trail requirements of several SROs.[442]

The Commission notes that regulatory staff at an SRO or the Commission could use execution information required under Rule 613(c)(7)(v), which will be consolidated with the other audit trail information required under Rule 613 to, for example, detect patterns of reported and unreported transactions effected by a broker-dealer in a particular security by comparing the data reported to the central repository regarding an execution with information reported pursuant to a transaction reporting plan or the OPRA Plan. Depending on the results of that analysis, regulators may undertake further inquiry into the nature of trading by that broker-dealer to determine whether the public received accurate and timely information regarding executions, and whether the broker-dealer complied with the trade reporting obligations contained in SRO rules.

442 See, e.g., FINRA Rule 7440(d); Nasdaq Rule 6950; NYSE Rule 132B.

Patterns of reported and unreported transactions by a particular broker-dealer could also be indicia of market abuse, including the failure to obtain the best execution for customer orders, or possible market manipulation. Thus, the ability to compare the consolidated order execution data, including customer information, with the trades reported to the consolidated tape would be an important component of an effective market surveillance program that is not possible today because regulators currently do not have access to comprehensive cross-market audit trail data, and the process of identifying customers is very labor intensive, time-consuming, and error prone.

In response to the commenter that recommended that the consolidated audit trail accommodate differences in the treatment of modifications by broker-dealer order management systems (i.e., those that report only the modified data elements, not the entire order), and suggested that only an order identifier be reported for a cancellation, not the cancelled order's other data elements,[443] the Commission notes that Rule 613 does not require all of the data elements of a modified order to be reported to the central repository. The Rule only requires the NMS plan to require the reporting of the CAT-Order-ID; the date and time the modification is received or originated; the CAT-Reporter ID of the broker-dealer or the Customer-ID of the person giving the modification instruction; if modified, the price and remaining size of the order; and any other changes to the material terms of the order. The adopted Rule also requires the NMS plan to require the date and time a cancellation is received or originated and the CAT-Reporter-ID of the broker-dealer, or Customer-ID of the person, giving the cancellation instruction to be reported to the central repository. The Commission believes this will ensure that regulators can determine the market participant or person responsible for the cancellation of

443 See SIFMA Drop Copy Letter, p. 4.

an order,[444] and the date and time of the cancellation.

In response to the commenter that suggested that the Rule should require that the execution data be linked with the public trade report using a common identifier,[445] the Commission notes that Rule 613(c)(7)(v)(G) requires the NMS plan submitted to the Commission for its consideration to require that, for an order that has been executed, the SRO or member that executes the order must report to the central repository whether the execution was reported pursuant to an effective transaction reporting plan or OPRA, as applicable. The Commission has considered the commenter's further suggestion that a common identifier link the audit trail execution reports for the buy and sell orders to the public trade report and is not mandating such a requirement under Rule 613; the Commission believes that Rule 613 and its requirements provide a sufficient initial framework for collecting audit trail data that will enhance the ability of regulators to surveil the market for NMS securities.[446] Accordingly, the Commission is adopting Rule 613(c)(7)(v)(G), as proposed, which requires that the plan sponsors include in the NMS plan submitted to the Commission for its consideration a requirement that the broker-dealer report to the central repository whether a trade was reported pursuant to an effective transaction reporting plan or OPRA.

444 See Section III.B.1.iii., supra.

445 See Liquidnet Letter, p. 7.

446 While the Commission is not requiring that execution data be linked with the public trade report using a common identifier, the Commission notes that the Rule does not prohibit the SROs from including a provision in the NMS plan for the establishment of a common identifier to link the audit trail execution reports for buy and sell orders to the public trade report.

e. Rule 613(c)(3): Information to Be Recorded Contemporaneously with the Reportable Event and Reported to the Central Repository by 8:00 a.m. Eastern Time on the Trading Day Following the Day Such Information Has Been Recorded

i. Proposed Rule 613(c)(3)

As proposed, Rule 613(c)(3) would have required the NMS plan to require each SRO and member to collect and provide to the central repository, on a "real time" basis, key data for each order and each reportable event, including the origination or receipt of an order, as well as the routing, cancellation, modification, or execution of the order.[447] Specifically, the proposed Rule would have provided that "[t]he national market system plan submitted pursuant to this section shall require each national securities exchange, national securities association, and member to collect and provide to the central repository the information required by paragraphs (c)(7)(i) through (v) of this section on a real time basis."[448] In the Proposing Release, the Commission noted that "real time" meant "immediately and with no built in delay from when the reportable event occurs."[449]

ii. Comments on Proposed Rule 613(c)(3)

The Commission received a variety of comments about the achievability of the real-time requirement; the accuracy of audit trail data that would be collected and provided in real time; the necessity, merits and usefulness of real-time audit trail data; the costs of real-time reporting; and the proposed Rule's requirement that all audit trail data be collected and reported in real time. These comments are discussed below.

447 See Rule 613(j)(9) for a definition of "reportable event."

448 See proposed Rule 613(c)(3).

449 See Proposing Release, supra note 4, at 32572.

Several commenters believed that reporting data on a real-time basis was achievable.[450] Of these comments, one commenter stated that its current systems could be used to support real-time reporting, and that real-time reporting may be easier to achieve than intraday or end-of-day batch processing.[451] Similarly, another commenter, endorsing the use of FIX Protocol, stated that FIX Protocol is already widely used throughout the financial industry, and that "[a]ll FIX messages are generated in real time for trading."[452]

A significant number of commenters, however, expressed concern about the proposed requirement that the audit trail data be collected and provided to the central repository in real time.[453] Some of these commenters focused on the effect a real-time reporting requirement would have on their systems, and the systems changes that might be needed to achieve real-time reporting. Specifically, commenters argued that a real-time collection and provision requirement would require many industry participants to build entirely new systems or to undertake

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450 See Thomson Reuters Letter, p. 3; Aditat Letter, p. 2; FTEN Letter p. 3; Ameritrade Letter, p. 1 (stating that the scalability of its systems could support real-time reporting); Nasdaq Letter II, p. 3 (stating that a platform supported by FTEN and SMARTS technology would support the real-time provision of data).

451 See Ameritrade Letter, p. 1.

452 See Aditat Letter, p. 1-2. FIX Protocol is a series of messaging specifications for the electronic communication of trade-related messages. It has been developed through the collaboration of banks, broker-dealers, exchanges, industry utilities and associations, institutional investors, and information technology providers from around the world. See What is FIX? available at http://fixprotocol.org/what-is-fix.shtml (last visited on May 7, 2011).

453 See Scottrade Letter, p. 1; ICI Letter, p. 4-6; FINRA/NYSE Euronext Letter, p. 4; GETCO Letter, p. 2; BATS Letter, p. 1-2; SIFMA Letter, p. 3-8; SIFMA February 2012 Letter, p. 1; CBOE Letter, p. 4-5; Direct Edge Letter, p. 3; FINRA Letter, p. 10-13; Wells Fargo Letter, p. 3; Knight Letter, p. 2-3; Leuchtkafer Letter; Broadridge Letter, p. 3; FIF Letter, p. 4; SIFMA Drop Copy Letter, p. 1; Ross Letter, p. 1; FINRA Proposal Letter, p. 3; FIA Letter, p. 1-2.

significant technological upgrades to comply with a real-time reporting requirement.[454] Other commenters stated that real-time reporting would strain their order handling systems and result in latencies and delays in the processing of customer orders.[455] Additionally, one commenter questioned the ability of a real-time consolidated audit trail system to handle periods of immense volume, like the volume on May 6, 2010.[456]

Other commenters who expressed concern about the real-time reporting requirement questioned the accuracy of data that would be reported in real time.[457] One commenter, for example, noted that there would not be an opportunity for data validation if consolidated audit trail data were required to be reported in real time.[458] Another commenter stated that the real-

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454 See Scottrade Letter, p. 1-2; ICI Letter, p. 4-5; SIFMA Letter, p. 4-5; Knight Letter, p. 2. See also BATS Letter, p. 2; Broadridge Letter, p. 3; FIF Letter, p. 4; GETCO Letter, p. 3-4; CBOE Letter, p. 4; FIA Letter, p. 2. In particular, FIA noted its belief that "real-time reporting accounts for a significant portion of the considerable costs associated with the CAT." See FIA Letter, p. 2.

455 See FINRA/NYSE Euronext Letter, p. 5; FINRA Letter, p. 13; SIFMA Letter, p. 5; CBOE Letter, p. 4 (stating that, "given the increased speed of order submission, quote changes, and order cancellation, modifications and executions, a real time submission requirement could strain the systems capacities and computer resources of SROs and many member firms").

456 See FINRA Letter, p. 13. See also Berkeley Letter, p. 2 (noting the "peta-scale" problem of collecting audit trail data generally).

457 See FINRA/NYSE Euronext Letter, p. 5-6; Knight Letter, p. 2-3; CBOE Letter, p. 4; Wells Fargo Letter, p. 3; FINRA Letter, p. 11-12; SIFMA Letter, p. 5; Direct Edge Letter, p. 3; FIA Letter, p. 2.

458 See FINRA/NYSE Euronext Letter, p. 5-6 (noting that "drawing conclusions based solely on real time data increases the potential for inaccuracy because the data has not gone through the full range of validations . . . ."). See also Wells Fargo Letter, p. 3 ("[A]ccurate market information often does not happen in real time."); FINRA Letter, p. 11-12 (stating that current order-handling practices make "accurate real time order reporting problematic, and automated surveillance is only useful if the underlying data is accurate and complete . . . ."); SIFMA Letter, p. 5 ("There also would be data integrity costs in the form of less reliable data, or data that would have to be revised or resubmitted where it otherwise may not have been required if firms had a short window of time to more thoroughly 'scrub' or validate their submissions."); Direct Edge Letter, p. 3 ("Real-

time processing required by real-time reporting would create data integrity issues and, thus, lead to poorer data quality as compared to an approach with a more liberal timeframe, such as next day, or "T+1," reporting.[459] FINRA similarly commented that the data integrity issues that arise when audit trail data is provided on a T+1 basis would be exacerbated by a real-time system.[460] FINRA stated that it performs over 40 billion data validations of order events submitted through OATS every day, and requires its members to repair rejected OATS data.[461]

A number of commenters discussed whether a real-time reporting requirement is necessary. One commenter stressed that the real-time availability of data would facilitate the identification of cross-market events and their origins.[462] This commenter explained that a platform developed using FTEN and SMARTS technology would include real-time risk management and surveillance capabilities.[463] However, most commenters did not believe that real-time data typically would be useful to the Commission and SROs.[464] One commenter

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time data may be less reliable than information collected after the validations that come with settling a transaction.").

459 See Knight Letter, p. 2-3. See also CBOE Letter, p. 4 ("[G]enerally our belief is that next day (T+1) data, which incorporates additional information such as cleared trade data, is a better report resource for generating surveillance and compliance reviews."); FINRA/NYSE Euronext Letter, p. 6 (stating that, "from a market surveillance standpoint, reliable and complete data received on a T+1 basis . . . is generally superior to unvalidated real-time data"); FIA Letter, p. 2 ("We believe the Commission's Proposal overvalues any potential benefits achieved by real-time reporting as compared to reporting on day after trade, or 'T+1,' basis.").

460 See FINRA Letter, p. 11-12.

461 Id. at p. 11.

462 See Nasdaq Letter I, p. 9-10.

463 See Nasdaq Letter II, p. 3.

464 See ICI Letter, p. 5; Leuchtkafer Letter; GETCO Letter, p. 2; FIA Letter, p. 2; Scottrade Letter, p. 2; BATS Letter, p. 2; Angel Letter, p. 3; Broadridge Letter, p. 3; CBOE Letter, p. 4; FINRA/NYSE Euronext Letter, p. 4, 6; FINRA Letter, p. 11; SIFMA Letter, p. 3, 7; SIFMA Drop Copy Letter, p. 1; FINRA Proposal Letter, p. 4, 10-11.

explained that using audit trail data before having an opportunity to validate it "may result in a severely distorted picture of trading and interfere with effective oversight."[465] Another commenter stated that "real-time order information is inherently incomplete and could even be inaccurate and therefore misleading to the users of the data."[466] Some commenters were of the view that the Commission had significantly overvalued the regulatory benefit of real-time data.[467] One of these commenters noted that, "[b]ased on its experience in conducting surveillance, [it] does not believe that it is essential that all of the information proposed to be captured in the CAT be received real time or near-real-time."[468] A commenter suggested that, to the extent any information had to be submitted in real time, it should be limited to data related to certain key events, such as order receipt and origination, order transmittal, execution, modification, and cancellation.[469] Other commenters generally questioned the value of real-time audit trail data, arguing that regulators would still need to rely on traditional investigative techniques, such as taking testimony, to establish securities law violations.[470] Another commenter believed that "[m]any potential uses for the data, including enforcement inquiries probing market behavior, may require either multiple days' worth of data, or data from other markets that is not available on a real-time basis," limiting the ability to use such real-time data provided by the consolidated audit trail.[471]

Some commenters questioned whether the substantial costs that would be associated with

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465 See FINRA Letter, p. 11.

466 See SIFMA February 2012 Letter, p. 1.

467 See FINRA/NYSE Euronext Letter, p. 4; FINRA Letter, p. 11; FIA Letter, p. 2.

468 See FINRA Proposal Letter, p. 4.

469 See SIFMA Drop Copy Letter, p. 1-2. See also FINRA Proposal Letter, p. 10.

470 See GETCO Letter, p. 2; BATS Letter, p. 2.

471 See FIA Letter, p. 2.

providing the data on a real-time basis would outweigh the benefits.[472] One commenter believed that "the SEC has significantly overestimated the incremental utility of real-time data over data received on a T+1 basis" and that "the costs associated with the breadth of real-time reporting proposed by the Commission would be significant and far outweigh the minimal regulatory benefit gained by such a reporting system."[473]

Some commenters who questioned the value of the real-time reporting requirement also suggested that the Commission consider a different timeframe for the reporting of audit trail information. Several commenters, for example, suggested a later timeframe for reporting audit trail data to the central repository. One commenter, an exchange, stated that "[o]ur strong preference would be for submission of information to the central repository through a batch process after the close of the trading day involved."[474] Another commenter suggested a compromise whereby broker-dealers would be subject to next day (or later) reporting requirements, while the SROs could leverage their existing real-time monitoring tools and

472 See Scottrade Letter, p. 1-2; FINRA/NYSE Euronext Letter, p. 4; GETCO Letter, p. 2; BATS Letter, p. 2; SIFMA Letter, p. 3-8; SIFMA February 2012 Letter, p. 1; CBOE Letter, p. 4; FINRA Letter, p. 11-13; Wells Fargo Letter, p. 3; FIA Letter, p. 2.

473 See FINRA/NYSE Euronext Letter, p. 4. Similarly, FINRA believes " the SEC has significantly overvalued the regulatory benefits to be achieved . . . while underestimating some of the problems with relying on real-time data. This is true not only because certain information is difficult, if not impossible, to provide on a real-time basis, but also because real-time data is less reliable." See FINRA Letter, p. 10-11. See also SIFMA February 2012 Letter, p. 1 (stating, "[a]ny potential incremental benefit of receiving this information on a real-time basis is, in our view, substantially outweighed by the additional expense and implementation delays associated with building and maintaining a real-time system"); FIA Letter, p. 2 ("It is not apparent to us from the Proposal that the additional costs associated with a real-time audit trail, compared to a T+1 audit trail, would be offset by any incremental benefits to the Commission.").

474 See CBOE Letter, p. 4.

provide real-time trading information for use in the consolidated audit trail.[475] Several commenters recommended that the Commission permit end-of-day reporting.[476] One commenter noted that end-of-day reporting would alleviate some of the practical challenges firms would face with a requirement to identify beneficial owners on a real-time basis.[477] Another commenter suggested that a reporting deadline of 10-15 minutes would be substantially more workable than a "real-time" reporting requirement.[478] Finally, one commenter suggested that broker-dealers and SROs should retain audit trail information, and submit it only upon regulatory request, so that the central repository would only collect data needed for investigations or

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475 See SIFMA Letter, p. 3; see also SIFMA February 2012 Letter, p. 1 (questioning the regulatory need for real-time data versus data provided on an "end-of-day or 'T+1" basis); FIA Letter, p. 2.

476 See Scottrade Letter, p. 2; ICI Letter, p. 5; BATS Letter, p. 2; Angel Letter, p. 3; Broadridge Letter, p. 3.

477 See ICI Letter, p. 6.

478 See SIFMA Drop Copy Letter, p. 1. The commenter stated that "implementation options and complexity are significantly different if the reporting regime is within 'minutes' rather than 'seconds.' If real-time reporting is required in seconds, then significant re-engineering is required within broker-dealer order management systems and trading systems to support such a requirement (e.g., passing additional information between systems, performance tuning to compensate for additional processing of payload). Instead, if the definition of real-time allows for reporting within minutes (e.g., 10-15 minutes) of the events, it would be substantially less intrusive on order management systems and may allow for greater flexibility in designing reporting systems architecture and more standardized content for events such as order modifications, as described below. Also, as with prior implementations of new trade reporting regimes in the U.S. (e.g., ACT and TRACE), having more liberal reporting timeframes for an appropriate initial period (e.g., 12 months or more) to provide a sufficient period to optimize processes would be very helpful." This commenter also questioned "the need for real-time reporting of the entire set of data elements in the CAT proposal," and believed that "reporting on a T+1 (or in some cases later) basis should satisfy the SEC's stated regulatory objectives more efficiently." Id. See also Nasdaq Letter II, p. 3 (stating its proposed platform could support the provision of data in real time or within 10-15 minutes using drop copies).

surveillance purposes.[479]

One commenter, who did not specifically advocate either real time or reporting on an end-of-day basis, supported a requirement that all trades be reported in a standardized format that will be accessible to the SEC at the end of each trading day.[480]

Some commenters suggested alternative means of collecting audit trail information, assuming such audit trail data would not be on a real-time basis and would not be through the reporting regime set forth by Rule 613. For example, one commenter suggested the Commission consider "a consolidation" of [OATS] and [COATS], audit trails that are produced on a T+1 basis; and a review of the prospect of extracting specific real-time data from surveillance reports currently used by SROs to perform post trade analysis, such as the Large Option Position Report . . . and large trader reports, to obtain real-time risk information that may impact a particular NMS issue or the market in general."[481] This commenter believed that a requirement of real-time reporting should be considered only after other available sources of data have been carefully reviewed, and only to the extent that such a requirement is both necessary and economically feasible.[482] Another commenter, however, urged the Commission not to "lower its expectations for the CAT and accept a more limited audit trail based exclusively on existing systems."[483] One commenter suggested that the Commission consider a "hybrid" approach that would enhance elements of the quotation and transaction information reported in real time, while collecting and

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479 See GETCO Letter, p. 4. The commenter also believed this approach would lower the costs of the consolidated audit trail.

480 See Bean Letter, p. 1.

481 See BOX Letter, p. 2.

482 Id. at p. 3.

483 See Nasdaq Letter II, p. 2.

reporting more specific order information on a T+1 basis or later.[484]

Two commenters commented on the meaning of "real time."[485] One commenter noted that "[our members] request clarification on the definition of real-time data submission as it relates to each data element required by CAT. The granularity/definition of real-time for each element will have a major impact on SROs, their members and CAT system development from both a data quality and database design perspective . . . ."[486] The other commenter noted that the "[t]he term 'real time' is used throughout the document, but never defined. (There are several distinct meanings in the computer industry.)"[487]

The Commission also received comments specifically relating to the cost of reporting the audit trail information in real time under the Rule as proposed. One commenter believed it would cost $1.25 million in initial costs to comply with the Rule as proposed.[488] The commenter divided its $1.25 million estimate into development costs of $750,000 and hardware costs of $500,000 (including hardware, circuits, etc.).[489] In addition, this commenter believed the development timeframe would be 9-12 months "once final architecture is drafted," and would require approximately 6,000 hours of development work.[490] Notably, this commenter said that

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484 See FINRA/NYSE Euronext Letter, p. 6. This commenter stated that "[a]n alternative to the all-encompassing real time order audit trail set forth in the Proposal would be to standardize and consolidate existing real time reporting systems (e.g., enhancing trade reporting and quotation systems with standardized and uniform identification for all broker-dealers) and enhance existing reporting requirements where the need is narrowly focused." See also FINRA Proposal Letter, p. 3-4, 10-11.

485 See FIF Letter, p. 4; Ross Letter, p. 1.

486 See FIF Letter, p. 4.

487 See Ross Letter, p. 1.

488 See Ameritrade Letter, p. 2.

489 Id.

490 Id.

"[t]he assumptions that drove this analysis were that any real time reporting of order events would leverage the capabilities contained within the [OATS] reporting today and that the revised real time system would retire the legacy systems of Bluesheets, OATS, OTS and TRACE."[491] With respect to ongoing costs to provide information, this commenter also stated that it believed the Commission had underestimated the ongoing costs of the proposal.[492] However, another commenter, who opined that the goals of the consolidated audit trail could be achieved for significantly lower costs than the Commission originally estimated, stated that, if the Rule permitted market participants to modify existing systems for collecting and reporting audit trail information, the consolidated audit trail objectives could "be achieved and perhaps even surpassed."[493]

iii. Adopted Rule 613(c)(3)

As described in detail below, the Commission is adopting Rule 613 with two significant modifications to the proposed requirement that the NMS plan submitted to the Commission for its consideration require the collection and provision of key audit trail data to the central repository on a "real time" basis. First, the Rule, as adopted, no longer requires the real-time reporting of consolidated audit trail data but, instead, provides that order event audit trail data must be reported "by 8:00 a.m. Eastern Time on the trading day following the day such information has been recorded by the national securities exchange, national securities association or member."[494] Second, the adopted Rule clarifies that this data is to be recorded

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491 Id.

492 Id.

493 See Thomson Reuters Letter, p. 2.

494 See Rule 613(c)(3). The Rule further provides that the NMS plan "may accommodate voluntary reporting prior to 8:00 a.m. Eastern Time, but shall not impose an earlier reporting deadline on the reporting parties." Id.

"contemporaneously with the reportable event," instead of in "real-time."[495]

(A) Reporting of Audit Trail Data by 8:00 a.m. Eastern Time on the Trading Day Following the Day Such Information Has Been Recorded

The Commission has considered the commenters' concerns regarding a "real-time" reporting requirement for audit trail data, including its achievability and cost effectiveness; the accuracy of audit trail data recorded and reported in real time; and the necessity, merits, and usefulness of real-time audit trail data.[496]

On the one hand, the Commission recognizes that there may be very considerable costs imposed on the industry if audit trail data was required to be reported to the central repository in real time – indeed, the Commission, in the Proposing Release, estimated the costs of creating a real-time consolidated audit trail by assuming that such a requirement would necessitate the wholesale creation of new industry-wide systems. On the other hand, the Commission also received a variety of comments suggesting that real-time reporting could be achieved in a cost-effective manner.[497] And yet other commenters suggested a hybrid approach. For example, SIFMA commented that, although it believed real-time reporting as originally proposed by the Commission would be too costly, intra-day reporting of a subset of audit data delayed 10-15

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495 Id.

496 See Scottrade Letter, p. 1-2; Angel Letter, p. 3; ICI Letter, p. 3-6; FINRA/NYSE Euronext Letter, p. 4, 6; GETCO Letter, p. 2; BATS Letter, p. 1-2; SIFMA Letter, p. 3-8; CBOE Letter, p. 4-5; Direct Edge Letter, p. 3; FINRA Letter, p. 10-13; Wells Fargo Letter, p. 3; Knight Letter, p. 2-3; Leuchtkafer Letter; Broadridge Letter, p. 3; FIF Letter, p. 4; SIFMA Drop Copy Letter, p. 1; Ross Letter, p. 1; FINRA Proposal Letter, p. 3; Nasdaq Letter II, p. 3-4; FIA Letter, p. 1-2.

497 See Thomson Reuters Letter, p. 3; Aditat Letter, p. 2; FTEN Letter p. 3; Ameritrade Letter, p. 1 (stating that the scalability of its systems could support real-time reporting); Nasdaq Letter II, p. 3 (stating that a platform supported by FTEN and SMARTS technology would support the real-time provision of data).

minutes would be possible. SIFMA further described how such reporting might be accomplished through the use of "drop-copy" data.[498]

With respect to concerns about the accuracy of consolidated audit trail data if real-time reporting were required, the Commission recognizes that the real-time reporting of data could result in accuracy issues to the extent SROs and broker-dealers would need to re-enter the required audit trail data into a separately prepared regulatory report containing the required audit trail data for submission to the central repository, as is the case today with OATS reports.[499] The Commission notes, however, that the use of certain existing technologies, such as "drop copies" described by SIFMA, could provide reliable and accurate audit trail data to the central repository because such "drop copies" would reflect the information captured by an SRO or member's order management and execution systems to enter, route, modify, and execute or cancel orders.

The Commission believes that, whether or not real-time reporting of data is required, the creation, implementation, and maintenance of a consolidated audit trail will likely be a complex and significant undertaking for the industry. It therefore recognizes the practical advantages of a more incremental, or more gradual, approach to such an undertaking. After considering the many comments received on the use of real-time data by regulators, the Commission has recognized that, although there might be some additional benefits to receiving data and monitoring the markets intra-day (such as for certain enforcement investigations and the facilitation of real-time cross-market surveillance), the majority of the regulatory benefits gained from the creation of an industry-wide consolidated audit trail, as described in the Proposing Release, do not require real-time reporting. Indeed, the extent of the potential uses of a consolidated audit trail discussed in Section II.A.2., supra, which do not rely on a real-time

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498 See SIFMA Drop Copy Letter.

499 See Section II.A.1.c., supra.

reporting requirement, illustrate the value of a consolidated audit trail even if data is not reported in real-time. Instead, the Rule, as adopted, provides that the NMS plan must require that order event data be reported "by 8:00 a.m. Eastern Time of the trading day following the day such information has been recorded by the national securities exchange, national securities association or member."[500]

The Commission notes that, while the Rule provides that the NMS plan must impose a reporting deadline of 8:00 a.m. Eastern Time of the trading day following the day such information has been recorded by the national securities exchange, national securities association or member, the Rule also provides that the NMS plan may accommodate SROs and members that voluntarily satisfy their reporting obligations earlier.[501]

The Commission acknowledges that, by replacing the requirement that the SROs develop a plan for real-time reporting with a requirement for reporting by 8:00 a.m. the next trading day, the Commission has precluded the possibility that, as some commenters suggested, a mandatory real-time reporting NMS plan might be developed by the SROs for consideration by the Commission and the public.[502] However, given the overall scope and complexity of creating a consolidated audit trail, the Commission has determined that it would be more beneficial to have the SROs and their members focus on those key aspects of a consolidated audit trail that the Commission believes would be the most useful for improving regulatory oversight and monitoring (including, but not limited to, the use of unique customer identifiers, the ability to

500 See Rule 613(c)(3). The Commission notes that Rule 613, as proposed, was inconsistent in its use of the terms "provide" and "report." To eliminate this inconsistency, the Commission is replacing all uses of "provide" with "report," which the Commission believes more accurately describes the requirement the Commission is imposing on national securities exchanges, national securities associations, and members.

501 See note 494, supra.

502 See note 453, supra, and accompanying text.

accurately link an order across its lifecycle, the inclusion of market making quotes, and the addition of options data), rather than focus on how to develop an NMS plan for real-time reporting that may not yield benefits that are equally as useful.[503] The Commission also believes that, as a consequence of this modification, the Rule, as adopted with the 8:00 a.m. reporting deadline, will more readily accommodate a consolidated audit trail that could build upon existing audit trail infrastructures. Meeting the requirement of the Rule may no longer necessitate the creation of completely new infrastructures. In particular, the Commission notes that the OATS technical specifications require OATS data to be reported by 8:00 a.m. the following calendar day.[504] Thus, the Rule, as adopted, would permit the SROs to submit an NMS plan to the Commission for its consideration with reporting timeframes comparable to OATS' requirement, with which all FINRA members are presently capable of complying.[505] As a result, broker-dealers might need to make fewer systems changes to comply with the Rule than they would

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503 The Commission notes that, consistent with adopting an incremental approach to the creation of a consolidated audit trail, even though it is not requiring audit-trail data to be reported in real time, it is adding various additional requirements, discussed in Section III.C.2.a., infra, to the Rule regarding the evolution of the consolidated audit trail, including the possibility for reduced reporting times in the future as technologies evolve.

504 The current OATS technical specifications require OATS reporting by 8:00 a.m. on the calendar day after the reportable event. The Commission notes that the FINRA rules for OATS reporting, however, require that data "shall be transmitted on the day such event occurred" – unless information required by FINRA Rule 7440(b), (c), or (d) (order receipt and origination; order transmittal; order modifications, cancellations, and executions) is unavailable – in such cases, OATS requires reporting on the day the information becomes available. See FINRA Rule 7450(b)(2). Because of the discrepancy between the technical specifications and the applicable FINRA rule, the Commission approved FINRA's proposed rule change to allow OATS reporting as late as 8:00 a.m. the next day. See Securities Exchange Act Release No. 66021 (December 21, 2011), 76 FR 81551 (December 28, 2011).

505 The Commission notes that the Rule, as adopted, provides that an NMS plan must require information to be reported by 8:00 a.m. the following trading day, while OATS requires information to be reported by 8:00 a.m. the following calendar day. Thus, the Rule as adopted provides for a longer reporting period than does OATS with respect to weekends and holidays.

have had to make if real-time reporting were required, though, as discussed in Section II.C.4., supra, OATS in its present form would still need to be modified to meet certain of the other requirements of this Rule.[506] Nevertheless, as suggested by many commenters, fewer systems changes to comply with the Rule should lead to lower costs incurred by broker-dealers.[507]

An additional consequence of the Commission's decision not to require real-time reporting is that, since meeting the requirements of the Rule may no longer necessitate the wholesale creation of new systems, the Commission's proposed cost estimates, which were based on this assumption, may no longer be applicable. As discussed in Section II.C.2., supra, the Commission believes that given the many different ways in which the SROs may develop an NMS plan that meets an 8:00 a.m. reporting requirement, the costs of such reporting will be highly dependent on the details of the specific plan proposed. The Rule, as adopted, therefore directs the SROs to provide these details, along with associated costs, in the NMS plan submitted to the Commission for the Commission and the public to consider. The Commission will be able to consider this information when determining whether to approve the NMS plan submitted.

(B) Recording of Audit Trail Data Contemporaneously with the Reportable Event

As noted above, the Rule as proposed would have required SROs and their members to "collect" audit trail data "on a real time basis." In response to commenters who commented on

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506 As noted in the Proposing Release, supra note 4, at 32592, broker-dealers that rely mostly on their own internal order routing and execution management systems would have needed to make changes to or replace those systems to collect and report the required order and reportable event information to the central repository to comply with the proposed Rule.

507 See e.g., BATS Letter, p. 2; CBOE Letter, p. 2-3; Wells Fargo Letter, p. 2; Knight Letter, p. 3; High Speed, p. 1; FTEN Letter p. 1; Correlix Letter, p. 2; Thomson Reuters Letter, p. 2; FINRA Proposal Letter, p. 16; FINRA/NYSE Euronext Letter, p. 7.

the meaning of "real time," the Commission is adopting this provision with modifications from the proposed Rule. Specifically, Rule 613(c)(3), as adopted, requires that "[t]he national market system plan submitted pursuant to this section shall require each national securities exchange, national securities association, and member to record the information required by paragraphs (c)(7)(i) through (v) of this section contemporaneously with the reportable event."

The Commission believes that the term "contemporaneously" better reflects its intent, as noted in the Proposing Release, that information should be collected immediately and with no built-in delay from when the reportable event occurs. While, in response to commenters, the Commission is no longer requiring the real-time reporting of information, the Commission believes it is important for SROs and broker-dealers to "record" the events contemporaneously. The Commission expects that compliance with this requirement will not be difficult for SROs and broker-dealers with automated systems, which will contain much, if not all, of the data to be reported to the central repository as a result of processing and saving a record of any actions taken by the SRO or broker-dealer. On the other hand, broker-dealers that do not use automated systems will have to ensure that reportable events are manually recorded as they are occurring. In addition, the adopted Rule uses the term "record" in Rule 613(c)(3), instead of the proposed term "collect," because the Commission believes that term more accurately reflects its intent that a contemporaneous record be made when an order event occurs.

f. More Flexible Format for Reporting Consolidated Audit Trail Data to the Central Repository

In the Proposing Release, the Commission expressed its preliminary view that data would need to be collected and provided by SROs and their members to the central repository in a uniform electronic format to assure regulators that they will have ready access to comparable cross-market data.[508] Specifically, Rule 613(c)(2), as proposed, provided that "[t]he national market system plan submitted pursuant to this section shall require each national securities exchange, national securities association, and member to collect and provide to the central repository the information required by paragraph (c)(7) of this section in a uniform electronic format."

However, the Commission received comments suggesting that audit trail data does not necessarily need to be provided by SROs and their members to the central repository in a uniform electronic format, and that such data instead could be converted automatically into a uniform format by the central repository or a third party using existing technology, which could result in lower cost for the securities industry than originally estimated.[509] Specifically, two commenters indicated that technology exists today to convert or "normalize" data that may be produced from disparate systems into a uniform format and that, as a result, implementation of the consolidated audit trail could be simpler and less costly than originally contemplated by the Commission.[510] One of these commenters stated that a number of risk management services and surveillance systems currently receive automatically-generated copies, or "drop copies," of order and execution messages, in real time, from a variety of broker-dealers and exchanges, and convert that information into a common standard format.[511] Two other commenters suggested that firms that currently use FIX should be allowed to continue utilizing FIX,[512] stating that FIX's prevalence in the financial industry would make it cheaper and easier to use FIX as the

508 See Proposing Release, supra note 4, at 32572.

509 See FTEN Letter, p. 3-4, 13-15; Thomson Reuters Letter, p. 2-3.

510 Id.

511 See FTEN Letter, p. 4, 12, 14. See also SIFMA Drop Copy Letter.

512 See FIX Letter, p. 1; Aditat Letter, p. 2.

protocol of the consolidated audit trail.[513] Another commenter stated it could collect information directly from exchanges and other sources of information to minimize reporting obligations, and could leverage its own technology to get information directly from exchanges.[514]

In response to these comments, the Commission has modified this aspect of the proposed Rule. Specifically, adopted Rule 613(c)(2) allows the NMS plan to provide that SROs and their members can report data either "in a uniform electronic format" or "in a manner that would allow the central repository to convert the data to a uniform electronic format, for consolidation and storage."[515] In light of the comments that data from multiple sources could be converted into a uniform format,[516] this modification provides SROs with the flexibility, in devising the NMS plan, to better accommodate a range of proposals, including those based on leveraging technology in a cost-effective manner by permitting data to be converted to a uniform electronic format at the broker-dealer level or at the central repository. The Commission does not believe this change will reduce the accuracy or accessibility of the audit trail data provided to regulators (since the Rule still requires data to ultimately be provided to regulators in a uniform electronic format).

Further, by providing the SROs the ability to use a number of approaches to normalization, broker-dealers and SROs may not need to make substantial changes to their order management and execution systems to comply with Rule 613; instead, the central repository or the broker-dealers could convert such data into a uniform electronic format, and the Rule now provides the plan sponsors with the flexibility to use this approach in the NMS plan submitted to

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513 Id.

514 See Nasdaq Letter II, p. 3.

515 See Rule 613(c)(2).

516 See FTEN Letter, p. 3-4, 13; Thomson Reuters Letter, p. 2-3. See also SIFMA Drop Copy Letter.

the Commission for its consideration. The Commission believes that, to the extent it avoids requiring broker-dealers and SROs to make substantial changes to their order management and execution systems to comply with Rule 613 regarding a uniform electronic format, this type of approach could be a more efficient and cost-effective method for collecting the specified audit trail data required by the Rule.[517] The Commission expects that the NMS plan submitted for its consideration will specify how any normalization approach that might be included in the plan will lead to accurate and reliable data.[518]

g. Timeframe for Reporting Other Data Elements to the Central Repository

i. Proposed Rule 613(c)(4)

While most order and execution information would have been required to be reported to the central repository on a real-time basis under the proposed Rule, the Commission also recognized that not all information required to be reported to the consolidated audit trail would be available to the SROs and their members in real time.[519] In general, the audit trail data required under this timeframe reflected information not typically available until later in the order handling and execution process. This information that would have been provided on an extended timeframe included: (1) the account number for any subaccounts to which the execution is

517 The Commission believes that, if the NMS plan does not require data to be reported to the central repository in a uniform format, broker-dealers and SROs may not have to make substantial changes to their order management and execution systems to comply with Rule 613, and thus may face lower costs than if data were required to be reported in a uniform format because in that instance, broker-dealers may need to make substantial changes to their order management and execution systems to comply with Rule 613. The Commission acknowledges, however, that there would be costs to convert data to a "uniform electronic format for consolidation and storage." On balance, however, the Commission preliminarily believes that broker-dealers might benefit from economies of scale when normalizing data.

518 See Rule 613(a)(1)(iii).

519 See Proposing Release, supra note 4, at 32578.

allocated (in whole or part); (2) the unique identifier of the clearing broker or prime broker (if applicable); (3) the unique order identifier of any contra-side order(s); (4) special settlement terms (if applicable); (5) the short sale borrow information and identifier; (6) the amount of a commission, if any, paid by the customer and the unique identifier of the broker-dealer(s) to whom the commission is paid; and (7) the cancelled trade indicator (if applicable) (collectively, "supplemental audit trail data").[520] Proposed Rule 613(c)(4) would have permitted the supplemental audit trail data to be reported to the central repository promptly after the national securities exchange, national securities association, or member received the information, but in no instance later than midnight of the day that the reportable event occurs or the SRO or member receives such information.

The Commission solicited comments on proposed Rule 613(c)(4) and its requirement that certain audit trail information not available in real time be reported promptly after the national securities exchange, national securities association, or member received the information, but in no instance later than midnight of the day that the reportable event occurs or the SRO or member receives such information. One commenter believed that the timeframe for reporting the specific consolidated audit trail data listed above should be lengthened to T+1 or later.[521] This commenter was concerned that requiring broker-dealers to report certain data elements by midnight could disrupt the trading of certain products.

ii. Adopted Rule 613(c)(4)

After considering the commenter's views on proposed Rule 613(c)(4), the Commission is adopting the Rule with three modifications from the proposed Rule. First, to parallel the 8:00 a.m. deadline by which order event data must be reported to the central repository under adopted

520 See proposed Rule 613(c)(4), 613(c)(7)(vi) through (vii).

521 See SIFMA Letter, p. 8; SIFMA Drop Copy Letter, p. 1.

Rule 613(c)(3), adopted Rule 613(c)(4) requires that the NMS plan provide that supplemental audit trail data be reported by 8:00 a.m. Eastern Time on the trading day following the day the member receives the audit trail data, and provides that the plan may accommodate voluntary reporting prior to 8:00 a.m. Eastern Time, but shall not impose an earlier reporting deadline on the reporting parties.

Second, the adopted Rule no longer requires the reporting of (1) special settlement terms, (2) the amount of commission, if any, paid by the customer, and the unique identifier of the broker-dealer to whom the commission is paid, and (3) the short sale borrow information and identifier. Third, adopted Rule 613(c)(4) requires that the NMS plan provide for the reporting of certain customer identification and customer account information by 8:00 a.m. Eastern Time on the trading day following the day the member receives such data, instead of in "real time," as proposed.[522] These modifications are discussed in more detail below.

(A) Reporting Timeframe

In response to the comments regarding the timing for reporting of consolidated audit trail data elements,[523] the Commission is adopting Rule 613(c)(4) with modifications to the timeframe for reporting supplemental audit trail data. Specifically, the Rule no longer requires that supplemental audit trail data be reported "promptly" after the broker-dealer receives the information but no later than midnight of the day that the reportable event occurred; rather, adopted Rule 613(c)(4) requires the NMS plan to provide that supplemental audit trail data be reported by 8:00 a.m. Eastern Time on the trading day following the day the broker-dealer receives such information. Although the NMS plan may permit broker-dealers to report such information prior to that time, it may not require such earlier reporting. The Commission

522 See Rule 613(c)(7)(viii).

523 See Section III.B.1.g.i., supra.

believes it is appropriate that there be an extended timeframe for reporting this data because this information (e.g., allocation to subaccounts) might not be available until later in the order handling and execution process and, on balance, the Commission does not believe it is necessary that it be reported to the central repository "promptly". Instead, the modification to Rule 613(c)(4), as proposed, now requires that the NMS plan provide that the supplemental audit trail data be reported by 8:00 a.m. Eastern Time following the day the member receives the information, which parallels the adopted Rule 613(c)(3) timeframe for reporting event data. The Commission believes this more flexible standard should reduce implementation burdens and simplify the requirements of adopted Rule 613, without materially reducing the utility of the consolidated audit trail.

The Commission notes that it has made a clarifying change to Rule 613(c)(4), as proposed, to specify that the obligation to report the supplemental audit trail data to the central repository only falls on a broker-dealer, and not on a national securities exchange or national securities association.[524] The Commission believes that this change is appropriate because only broker-dealers receive the types of audit trail data described in Rule 613(c)(vi) through (viii).[525]

(B) Elimination of Certain Data Elements

As previously noted, proposed Rule 613(c)(4) would have required that the following information be reported to the central repository: (1) the account number for any subaccounts to which the execution is allocated (in whole or part); (2) the unique identifier of the clearing

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524 Rule 613(c)(4) now requires that "each member of a national securities exchange or national securities association" provide the information set forth in the Rule; as proposed, Rule 613(c)(4) required "each national securities exchange, national securities association, and member" to provide the information set forth in the Rule.

525 The Commission has also amended Rule 613(c)(4), as proposed, to include the provision of information sufficient to identify the customer and customer account information. See Rule 613(c)(7)(viii); Section III.B.1.g.ii.(C)., supra.

broker or prime broker (if applicable); (3) the unique identifier of any contra-side order(s); (4) special settlement terms (if applicable); (5) the short sale borrow information and identifier; (6) the amount of a commission, if any, paid by the customer and the unique identifier of the broker-dealer(s) to whom the commission is paid; and (7) cancelled trade indicator (if applicable).[526]

After considering general comments suggesting that the Commission reduce the proposed reporting obligations under Rule 613, the Commission is not requiring the following data elements to be reported to the central repository: (1) special settlement terms; (2) the amount of commission, if any, paid by the customer; (3) the unique identifier of the broker-dealer to whom the commission is paid; and (4) the short sale borrow information and identifier.[527] While this data may be useful in the context of certain investigations or market analyses, upon further consideration, the Commission believes that these data elements should not be required by Rule 613 because the Commission does not typically find that these particular audit trail data elements provide enough information relevant to an initial assessment of whether illegal or manipulative activity is occurring in the marketplace to warrant that they be required as a standard part of the audit trail created by Rule 613. If the Commission or the SROs find that such information would be useful to their regulatory responsibilities, they may request the information directly from the broker-dealer with the obligation to record this information, although requests related to short sale borrow information may pose unique challenges. In effect, the Commission believes that the benefit of having these specific audit trail data elements in the consolidated audit trail at this time is unlikely to justify the recording and reporting burden on broker-dealers of providing these elements, particularly in light of the other information required to be reported under Rule

526 See proposed Rule 613(c)(4), 613(c)(7)(vi), 613(c)(7)(vii).

527 See proposed Rules 613(c)(7)(vi)(D), 613(c)(7)(vi)(E), and 613(c)(7)(vi)(F).

613 and the regulators' ability to obtain this information through a follow-up request. The Commission notes that, if the SROs believe that having such data elements as part of the consolidated audit trail could be useful to their regulatory responsibilities, the SROs could determine to require SROs and their members to record and report such data as part of the NMS plan.

With respect to the account number for any subaccounts to which the execution is allocated (in whole or in part) – an audit trail data element that will be required by Rule 613(c)(4), as adopted – the Commission notes that obtaining allocation information is important because part of the goal of Rule 613 is to obtain audit trail information for the life of an order, which would include how an order was ultimately allocated (i.e., to which specific customer and account). The Commission notes, however, that the Rule requires the NMS plan to require a broker-dealer to report only the account number of any subaccounts to which an execution is allocated that is contained in its own books and records for accounts and subaccounts it holds; there is no obligation for the broker-dealer to obtain any additional information about accounts or subaccounts from other broker-dealers or non-broker-dealers who submitted the original order. The Commission further notes that broker-dealers will remain subject to existing regulatory requirements, including recordkeeping and suitability requirements (e.g., "know your customer" rules). Including the account number of any subaccounts to which an execution is allocated in the consolidated audit trail will allow regulators to understand how an allocation of the securities was made among customers of a broker-dealer to, for example, determine if the broker-dealer was favoring a particular customer, to better understand the economic interests of the customer, or as it relates to possible enforcement actions. Similarly, having information regarding the identity of the clearing broker or prime broker for the transaction, the identity of any contra-side order(s), and a cancelled trade indicator by 8:00 a.m. Eastern Time on the trading day following the day that the member receives such information will aid the Commission and the SROs in knowing all of the parties that touched an order (including the clearing broker, prime broker, and contra-side party to the order), and whether the order was cancelled. The Commission believes that all of this information will facilitate regulatory improvements as discussed above in Section II.A.2.

(C) Movement of Certain Data Elements from Event Data to Supplemental Audit Trail Data

As proposed, Rule 613 would have required that, in addition to the Customer-ID, customer account information and other specified information sufficient to identify a customer be reported in real time.[528] The Commission requested comment about the feasibility of this requirement. Several commenters expressed concern over the proposed requirement that customer information be reported in real time upon origination or receipt of an order.[529] One commenter believed that leakage of customer information could "negatively impact investor willingness to trade in the U.S. markets,"[530] and, instead, urged regulators to rely on EBS to provide customer information.[531] Another commenter did not think it was feasible to provide

528 See Proposing Release, supra note 4, at 32573; proposed Rule 613(c)(7)(i)(A), (C).

529 See Liquidnet Letter, p. 3; Direct Edge Letter, p. 4 (emphasizing that it would be more important for exchanges to obtain the identity of the brokers on both sides of an execution for cross-market surveillance purposes); SIFMA Letter, p. 6, 9; Ameritrade Letter, p. 3.

530 See FIF Letter, p. 2-3.

531 This commenter suggested an alternative if the Commission believed customer information was necessary, using both EBS and OATS: EBS could send the central repository customer account information (including account number), and OATS would add a field for the account number to link the OATS reports and customer information together. Id. at p. 2-3.

customer information in real time.[532] Another commenter suggested that the Commission "pare down its list of data points to focus on what would appear on a trade ticket and certain client demographic information."[533] This commenter explained that its suggested approach "makes sense because for most brokers pulling trade ticket information from frontend systems will be straightforward, and client demographics should be easily pulled and populated onto a system for easy retrieval."[534] Another commenter was of the view that only customer information regarding the person exercising investment discretion for the account originating the order, such as an investment adviser, should be required to be reported.[535] This commenter explained that if a trade is not executed an investment advisor would not typically provide information about the owners of the underlying accounts to the broker-dealer and thus this commenter suggested that it would be more practical to disclose underlying account information in relation to executed trades.[536] Another commenter suggested that there be a "requirements analysis" that considers the availability of order and trade data, and noted that allocation data is not available at the time of order entry.[537]

In recognition of commenters' concerns that this information may not be available in real time[538] and to reduce the reporting burdens on broker-dealers, the Commission is moving data elements, including the customer's name, address, and account information, and large trader identifier (if applicable) (collectively defined as "customer attributes") from the order event data

532 See SIFMA Letter, p. 6, 9.

533 See Ameritrade Letter, p. 2-3.

534 Id.

535 See Liquidnet Letter, p. 3.

536 See Liquidnet Letter, p. 3, 5-6.

537 See FIF Letter II, p. 2.

538 See SIFMA Letter, p. 6; Liquidnet Letter, p. 3.

category to the supplemental audit trail data category.[539] As a result, the Commission is adopting the Rule to provide that the NMS plan require that customer attributes[540] including the customer's name, address,[541] and customer account information be reported under Rule 613[542] no later than 8:00 a.m. Eastern Time on the trading day following the day that the member receives the information.[543] The Commission expects that the Customer-ID will be able to be linked to the customer attributes in the consolidated audit trail.

The Commission believes that, to realize many of the objectives of a consolidated audit trail, the specific attributes of a customer must be recorded and, when needed, made available to regulators. Without these customer attributes, the data recorded is effectively anonymized, which would prevent regulators from using the enhanced consolidated audit trail data to take any enforcement action against specific individuals. The Commission believes customer attributes[544] are necessary because regulatory authorities need to accurately and efficiently identify the customer to effectively surveil and analyze the markets, and enforce the securities laws. For

539 See also Rule 613(j)(4) which defines "customer account information" to include, but not be limited to, account number, account type, customer type, date account opened, and large trader identifier (if applicable).

540 Rule 613(j)(3), as adopted, defines the term "customer" to mean the account holder(s) of the account at a registered broker-dealer originating the order; and any person from whom the broker-dealer is authorized to accept trading instructions for such account, if different from the account holder(s).

541 See Proposing Release, supra note 4, at 32573.

542 The Commission notes that, under the Rule, a broker-dealer must only report the account number for the account the customer used to submit an order, not the account numbers for all accounts of a customer.

543 See Rule 613(c)(4).

544 As adopted, Rule 613(c)(7)(viii) provides that, "[f]or original receipt or origination of an order, the following information: (A) Information of sufficient detail to identify the customer; and (B) Customer account information" be recorded and reported to the central repository.

example, as noted in the Proposing Release,[545] a trader may trade through multiple accounts at multiple broker-dealers. Being able to identify the account holder aids in the identification and investigation of suspicious trading activity. Accordingly, the unique customer identifier that is required to be reported to the central repository for original receipt, origination, modification, or cancellation of an order,[546] and that links together all reportable events by the same customer, must ultimately link back to information regulators could use to identify the party. With this information, regulators could more quickly initiate investigations, and more promptly take appropriate enforcement action. While this information could be requested from broker-dealers by the Commission and the SROs on a case-by-case basis, the Commission believes that achieving these benefits requires having such information maintained in a uniform format that is readily accessible to the Commission and the SROs.

Furthermore, in response to the commenters concerns with respect to the confidentiality of this sensitive information,[547] and as discussed in more detail below, the adopted Rule includes requirements for enhanced safeguards with respect to the privacy and confidentiality of consolidated audit trail data, including customer information.[548]

In response to the commenter who suggested only information appearing on the trade ticket and certain client demographic information[549] be collected, the Commission notes that it may be feasible for the NMS plan to allow customer identifying and account information to be reported by a broker-dealer to the central repository only when the customer opens or closes an

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545 See Proposing Release, supra note 4, at 32578.

546 See Section III.B.1.d.iii., supra.

547 See FIF Letter, p. 3.

548 See Section III.B.3.b., infra.

549 See Ameritrade Letter, p. 2-3.

account (or at the time the consolidated audit trail is first implemented for pre-existing accounts) -- this information may not need to be re-reported with every order.[550] Under this approach, the specified customer attributes may be stored in the central repository and automatically linked to an order whenever an order with the applicable Customer-ID is reported. As the Commission noted in the Proposing Release,[551] broker-dealers today, as part of their books and records requirements, must take reasonable and appropriate steps to ensure the accuracy of the customer information with respect to orders received.[552] Following adoption of the Rule, and the creation and implementation of the consolidated audit trail, broker-dealers will continue to be subject to this requirement as they report customer information to the central repository. The Commission believes that allowing the specified customer attributes to be reported to the central repository by 8:00 a.m. Eastern Time on the trading day following the day that a broker-dealer first receives this information appropriately balances the regulatory need with the practical burdens of supplying it in real time as originally proposed.

In response to the commenter who stated that an investment adviser would not typically provide information about the owners of the underlying accounts to the broker-dealer if the trade is not executed,[553] the Commission notes that, in the case of an adviser that enters an order to buy or sell securities using its own account held at the broker-dealer originating the order, the Rule, as adopted, would only require the NMS plan to require the capture of information about the

550 However, if any information previously reported by a broker-dealer to the central repository changes, the broker-dealer would need to report the updated information to the central repository by 8:00 a.m. Eastern Time on the trading day following the day that the broker-dealer receives the updated information

551 See Proposing Release, supra note 4, at 32566.

552 See, e.g., Rules 17a-3, 17a-4, 17a-25 under the Exchange Act, 17 CFR 240.17a-3, 17a-4, 17a-25.

553 See Liquidnet Letter, p. 3, 5-6.

owners of the underlying client accounts for which the order was placed if there is an executed trade, and if the executed trade is allocated (pursuant to Rule 613(c)(7)(vi)) to the accounts of the adviser's clients at the same broker-dealer.[554] However, the Commission notes that, in the case of an adviser that enters an order on behalf of clients that each maintain separate accounts at the broker-dealer originating the order, using those accounts, the Rule would require the NMS plan to require the capture of both the adviser – as the person providing trading instructions to the broker-dealer (pursuant to Rule 613(j)(3)(ii)) – and the clients, who are the account holders at the broker-dealer (pursuant to Rule 613(j)(3)(i)), even if the order did not result in execution.

Finally, in the Proposing Release,[555] the Commission specifically requested comment on whether there are laws or other regulations in other jurisdictions that would limit or prohibit members from obtaining the proposed customer information for non-U.S. customers. The Commission also requested comment on how members currently obtain such information. If broker-dealers did encounter special difficulties in obtaining customer information from other jurisdictions, the Commission requested comment on how the proposed consolidated audit trail requirements should be modified to address such difficulties.

The Commission received one comment on this issue.[556] The commenter expressed concern that, if broker-dealers were forced to refuse orders from non-U.S. customers because the laws of another jurisdiction prohibited disclosure of certain customer information, U.S. broker-dealers would be penalized and trading activity may shift offshore.[557] The commenter recommended that the Commission adopt a limited exemption that would allow broker-dealers to

554 See Rule 613(j)(3); see also Section III.B.1.d.iii.(C)(2)., supra (discussing the definition of "customer" as applied to investment advisers).

555 See Proposing Release, supra note 4, at 32573.

556 See SIFMA Letter, p. 21.

557 Id.

accept orders from non-U.S. broker-dealers without providing customer information, in recognition of the fact that these broker-dealers are subject to regulation in their home countries.[558]

In the Rule, as adopted, "customer" is defined as "(i) [t]he account holder(s) of the account at a registered broker-dealer originating the order; and (ii) [a]ny person from whom the broker-dealer is authorized to accept trading instructions for such account, if different from the account holder(s)." Under this definition, the non-U.S. broker-dealer referred to above is the "customer" of the U.S. broker-dealer for purposes of the rule. The U.S. broker-dealer would be required to record customer information for transactions in NMS securities only with respect to its foreign broker-dealer customer. There is no requirement to record information about the customers of such foreign broker-dealer. Because the Rule as adopted does not require a non-U.S. broker-dealer placing orders in NMS securities through a U.S. broker-dealer to provide information about its customers to the consolidated audit trail, the Commission believes that the requested limited exemption is unnecessary.

Although the Commission is aware that the privacy laws of some, but not all, foreign jurisdictions may hinder a foreign broker-dealer's ability to disclose personal identifying and account information of their customers absent customer authorization, the Rule as adopted does not require the foreign broker-dealer to disclose this information about its customers.[559] Accordingly, a non-U.S. customer desiring to trade in the U.S. markets would be permitted to do so through a foreign broker-dealer without having to disclose its personal data to the

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558 Id.

559 The Rule does, of course, require the NMS plan submitted to the Commission for its consideration to require the foreign broker-dealer to disclose information about itself to the U.S. broker-dealer, as such information would be expected to be part of the records of the U.S. broker-dealer holding a foreign broker-dealer account.

consolidated audit trail. Because the Rule as adopted does not require a foreign broker-dealer to disclose personal identifying and account information of its customers to the consolidated audit trail, the Commission does not believe that trading in NMS securities will shift offshore as a result of the customer identification requirements.

h. Clock Synchronization

As proposed, Rules 613(d)(1) and (2) required that the NMS plan filed with the Commission include a requirement that each SRO and its members synchronize their business clocks that they use for the purposes of recording the date and time of any event that must be reported to the time maintained by the National Institute of Standards and Technology ("NIST"), consistent with industry standards.[560] The SROs and their members also would have been required to annually evaluate the clock synchronization standard to determine whether it should be changed to require finer increments, consistent with any changes to industry standards.[561] This clock synchronization would have been required to occur within four months after effectiveness of the NMS plan.[562]

A few commenters expressed concerns with the Commission's proposed approach to clock synchronization, and a few commenters provided comments specifically relating to the Commission's estimated costs relating to clock synchronization.[563] One commenter preferred a synchronization standard measured in seconds and believed that synchronizing at the millisecond level would require specialized software configurations and expensive hardware.[564] This

560 See proposed Rule 613(d)(1).

561 See proposed Rule 613(d)(2).

562 See proposed Rule 613(a)(3)(ii).

563 See SIFMA Letter, p. 14; FIF Letter, p. 6-7; Broadridge Letter, p. 3; Endace Letter, p. 2.

564 See FIF Letter, p. 6.

commenter also was of the view that there could be material problems with systems latency if processors were required to re-synchronize clocks every few seconds to address "time drift" issues – further deviations from the time maintained by the NIST that may occur after a clock is synchronized.[565] Another commenter suggested that a clock synchronization standard shorter than the three second standard currently required by FINRA for OATS compliance might be impossible to achieve across market participants.[566] A third commenter was concerned that implementing clock synchronization could require firms to make modifications to a variety of related applications.[567] One commenter noted that synchronizing clocks to milliseconds would require costly specialized software and hardware.[568]

On the other hand, one commenter – a provider of data capture and time stamping technology – noted that "[t]he advent of relatively low cost GPS receivers that derive absolute timing information accurate to better than 0.1 micro-seconds has significantly eased the problem of clock synchronization across multiple global locations," that "[s]uch technology costs a few thousands of dollars per installation," and that "[i]t is already in use by exchanges and high frequency traders."[569] Another commenter expressed support generally for the Commission's proposed approach to clock synchronization.[570]

After considering the comments received on this issue, the Commission is adopting Rule 613(d)(1) as proposed. As this provision requires that the NMS plan require clock

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565 See FIF Letter, p. 6-7 (stating that currently "time drift" is an issue, despite advancements in synchronization technology, with at least one exchange experiencing time drifts between one and three seconds, and the SIP having its own time drift).

566 See SIFMA Letter, p. 14.

567 See Broadridge Letter, p. 3.

568 See FIF Letter, p. 7.

569 See Endace Letter, p. 2.

570 See Liquidnet Letter, p. 8.

synchronization consistent with industry standards, the Commission expects the NMS plan that is submitted to specify the time increment within which clock synchronization must be maintained, and the reasons the plan sponsors believe this represents the industry standard. The Commission notes that FINRA currently requires its members to synchronize their business clocks used for OATS reporting to within one second of the time maintained by NIST.[571] The Commission believes that the current industry standard for conducting securities business is more rigorous than one second. For example, as one commenter noted, technology used today by exchanges and high frequency trading firms synchronizes clocks to increments well within the millisecond level.[572] The Commission recognizes, as another commenter noted, that some firms may need to upgrade their technology to meet the industry standard,[573] and that there will be attendant costs for such upgrading.[574]

The Commission continues to believe that it is appropriate to require members of the securities industry to synchronize their clocks to the time maintained by NIST. Effective clock synchronization is essential to maintaining an accurately time-sequenced consolidated audit trail, particularly one where time stamps will be in millisecond increments or less. Because the consolidated audit trail will capture trading activity occurring across markets, if the business clocks used by SROs and their members for the purposes of recording the date and time for reportable events are not properly and consistently synchronized, the consolidated audit trail data

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571 See OATS Reporting Technical Specifications (May 3, 2011), available at http://www.finra.org/web/groups/industry/@ip/@comp/@regis/documents/appsupportdocs/p123579.pdf (last accessed December 8, 2011). In addition, FINRA allows clock drift of an additional two seconds before re-synchronization is required.

572 See Endace Letter, p. 2.

573 See FIF Letter, p. 6-7.

574 The Commission notes that one commenter suggested that the cost might be limited because GPS receivers could be used and installed for a few thousand dollars per installation. See Endace Letter, p. 2.

will not be accurately time-sequenced. It is critical for the consolidated audit trail to allow regulators the capability to accurately determine the order in which all reportable events occur.[575]

The Rule as proposed required that both the SROs and their members annually evaluate the clock synchronization standard to determine whether it should be changed to require finer increments, consistent with any changes in the industry standard.[576] The Commission believes that the obligation to evaluate the clock synchronization standard annually should be borne by the SROs as the plan sponsors, not SRO members. The Commission believes that it is appropriate for the SROs, as regulators of the securities markets and users of the consolidated audit trail data, to have the obligation to evaluate whether a change in the clock synchronization standard is warranted.[577] Therefore, the adopted Rule provides that the NMS plan shall require SROs to evaluate annually the clock synchronization standard set forth in the NMS plan.[578]

The Commission recognizes, as a commenter noted,[579] that time drift is an issue that must be addressed by the plan sponsors, to prevent a deterioration of the accuracy of the data in the consolidated audit trail. Therefore, the Commission expects the NMS plan to address the maximum amount of time drift that would be allowed before clocks must be re-synchronized, and why this is consistent with the industry standard.

As with many other aspects of the Rule, the costs of this requirement are highly dependent on the details of the solution proposed by the SROs because the Commission is

575 See Section III.B.1.d.v., supra (explaining the importance to enforcement cases of an accurately timed record of order events).

576 See proposed Rule 613(d)(2).

577 See Rule 613(d)(2).

578 Rule 613(d)(2) provides that "[e]ach national securities exchange and national securities association [shall] evaluate annually the clock synchronization standard to determine whether it should be shortened, consistent with changes in industry standards . . . ."

579 See FIF Letter, p. 7.

leaving it up the SROs to determine the maximum allowable time drift. As such, the SROs must discuss in their submitted plan the clock-synchronization standard they proposed, what alternatives were considered, and the rationale behind their choice. Once the NMS plan is received, the Commission, as well as the public, will be able to consider the extent to which the proposed synchronization standard supports the ability of regulators to fully achieve the benefits afforded by the creation of a cross-market consolidated audit trail.

2. Central Repository

a. Central Repository as a Facility of the SROs

As proposed, Rule 613(e) required that the NMS plan provide for the creation and maintenance of a central repository,[580] which would have been a "facility" of each exchange and FINRA.[581] The central repository would have been jointly owned and operated by the exchanges and FINRA, and the NMS plan would have been required to provide, without limitation, the Commission and SROs with access to, and use of, the data reported to and consolidated by the central repository for the purpose of performing their respective regulatory and oversight responsibilities pursuant to the federal securities laws, rules, and regulations.[582] Each of the exchanges and FINRA would have been a sponsor of the plan[583] and, as such, would have been

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580 See proposed Rule 613(e)(1).

581 The term "facility" is defined in Section 3(a)(2) of the Exchange Act, with respect to an exchange, to include "its premises, tangible or intangible property whether on the premises or not, any right to use such premises or property or any service thereof for the purpose of effecting or reporting a transaction on an exchange (including, among other things, any system of communication to or from the exchange, by ticker or otherwise, maintained by or with the consent of the exchange), and any right of the exchange to the use of any property or service." 15 U.S.C. 78c(a)(2).

582 See proposed Rule 613(e)(2).

583 See proposed Rule 613(a)(4).

jointly responsible for selecting a plan processor to operate the central repository.[584]

The Commission requested comment on the need for a central repository to receive and retain the consolidated audit trail information, whether there would be alternatives to creating a central repository for the receipt of order audit trail information, and whether it would be practical or appropriate to require the SROs to jointly own and operate the central repository.

A few commenters discussed the proposed ownership structure of the central repository.[585] One commenter argued that the central repository should be owned and operated by the Commission, or a non-SRO formed specifically to operate the central repository, and expressed concern that the central repository could be used by SROs as a source of revenue through the imposition of penalties.[586] Another commenter recommended that the Commission own the repository and not outsource it to a third party, explaining that, in systemically important events, it may be necessary to have immediate and direct access to the data, without an intermediary.[587] Yet another commenter noted that the decision to use OATS or another system as the basis for the consolidated audit trail system should be separate from the choice of the party that will be responsible for building and operating the central repository.[588]

The Commission received a couple of comments specifically regarding the costs of the creation and maintenance of the central repository. FINRA, in one of its comment letters, submitted a "blueprint" for a version of a consolidated audit trail based on enhancements to OATS – though without certain key elements proposed to be required by the adopted Rule – and

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584 See proposed Rule 613(a)(3)(i).

585 See Ameritrade Letter, p. 4; High Speed Letter, p. 1; BATS Letter, p. 2.

586 See Ameritrade Letter, p. 4.

587 See High Speed Letter, p. 1.

588 See BATS Letter, p. 2.

estimated initial costs for developing the repository to be between $100 million and $125 million, with ongoing annual costs to be between $30 million and $40 million.[589] Another commenter suggested the use of cloud computing for the central repository which it believed would cost less than $10 million per year.[590]

The Commission has considered the comments and is adopting as proposed the requirement in Rule 613(e)(1) that the NMS plan provide for the creation of a central repository. The Commission believes that having a central repository is important to ensuring access to consolidated data for the Commission and SROs, and for ensuring consistency, quality, and security in the audit trail data.

As adopted, Rule 613(e)(1) does not dictate a particular audit trail collection system to be used as the central repository for the consolidated audit trail, but, instead, delineates the required core features of such a system.

The Commission considered the commenter's recommendation that it should own the central repository[591] but determined that such ownership is not necessary as long as the central repository has the core features articulated in the Rule, the Commission and SROs have full access to the audit trail data for regulatory purposes, and the central repository is a facility of each SRO subject to Commission oversight.[592] The Commission notes that, because the central repository will be jointly owned by, and a facility of, each SRO, it will be subject to Commission oversight. The Commission will have unfettered access to the data in the central repository without being its owner.

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589 See FINRA Proposal Letter, p. 14-16.

590 See High Speed Letter, p. 1.

591 See Ameritrade Letter, p. 4.

592 See note 581, supra (describing the nature of a "facility").

The Commission also considered the comment that the central repository should be owned by a non-SRO specifically formed to operate the central repository.[593] The Commission, however, believes that it will have more regulatory authority over the central repository as a facility of each SRO than it would have if the central repository were owned or operated by a non-SRO. First, the Commission has the statutory obligation to oversee the SROs, including facilities thereof, and to ensure that SROs enforce compliance by their members with the respective SRO's rules, and the federal securities laws, rules, and regulations.[594] Second, a facility of an SRO is subject to the rule filing requirements of Section 19(b) of the Exchange Act.[595]

In response to the commenter who expressed concern that the plan sponsors would use the central repository to generate revenue through penalties,[596] the Commission notes that any penalty provisions must be provided in the NMS plan submitted to the Commission for its consideration, or in a future amendment to the NMS plan, if the NMS plan is approved. The Commission will review the NMS plan submitted for its consideration, which also will be subject to public notice and comment, to assure itself that the NMS plan is designed to be applied fairly and otherwise in a manner consistent with the Exchange Act. The Commission expects

593 See Ameritrade Letter, p. 4.

594 See, e.g., 15 U.S.C. 78b; 15 U.S.C. 78f(b); 15 U.S.C. 78o-3(b); 15 U.S.C. 78s(h)(1).

595 Section 19(b)(1) of the Exchange Act defines the term "proposed rule change" to mean "any proposed rule or rule change in, addition to, or deletion from the rules of [a] self-regulatory organization." Pursuant to Section 3(a)(27) and 3(a)(28) of the Exchange Act, the term "rules of a self-regulatory organization" means (1) the constitution, articles of incorporation, bylaws and rules, or instruments corresponding to the foregoing, of an SRO, and (2) such stated policies, practices and interpretations of an SRO (other than the Municipal Securities Rulemaking Board) as the Commission, by rule, may determine to be necessary or appropriate in the public interest or for the protection of investors to be deemed to be rules.

596 See Ameritrade Letter, p. 4.

that the NMS plan's penalty provisions would provide sufficient detail regarding the circumstances in which any penalties would apply, and any restrictions on how payments of such penalties may be used, to permit the Commission to determine that such penalty provisions are fair and consistent with the Exchange Act. As the central repository will be a facility of the plan sponsors, the rules governing it must be consistent with the Exchange Act.[597] In addition, future amendments to the penalty provisions would either be reviewed as an amendment to the NMS plan, under Rule 608 of Regulation NMS, or, because the central repository is a facility of the SROs, as a proposed rule change of the central repository under Section 19 of the Exchange Act.[598] Additionally, the Commission has the authority to review any action taken or failure to act by any person under an effective NMS plan, pursuant to Rule 608(d)(1) of Regulation NMS.[599] Lastly, any penalty provisions included in the NMS plan approved by the Commission will be subject to the Commission's inspection and examination program of SROs to ensure they are implemented fairly in a manner consistent with the Exchange Act.[600]

In response to the comments regarding the costs of the creation and maintenance of a

597 See note 581, supra (describing the nature of a "facility").

598 15 U.S.C. 78s.

599 17 CFR 242.608(d)(1). If the Commission does not make a finding that the action or failure to act is consistent with the provisions of the NMS plan and was applied in a manner consistent with the Act, or if it finds that such action or failure to act imposes any burden on competition not necessary or appropriate in furtherance of the purposes of the Act, the Commission, by order, can set aside such action and/or require such action with respect to the matter reviewed as the Commission deems necessary or appropriate in the public interest, for the protection of investors, and the maintenance of fair and orderly markets, or to remove impediments to, and perfect the mechanisms of, the NMS plan. 17 CFR 242.608(d)(3).

600 The Commission notes that, as part of its inspection and examination program, its staff has the authority to examine the application of any penalty provisions in the NMS plan to determine whether they have been applied fairly. In this manner, the Commission will be able to monitor how the plan sponsors have applied any penalty provisions set out in the NMS plan approved by the Commission.

central repository, the Commission notes that the costs would be highly dependent on the decisions the SROs make with respect to each of the areas in which the Commission has provided flexibility to the SROs in crafting the NMS plan to be submitted to the Commission for its consideration. For example, cost estimates could vary depending on whether the NMS plan requires unique order identifiers or permits "a series of order identifiers." Such cost estimates also could vary because the Rule does not specify details regarding, among other things, the security and confidentiality procedures of the central repository, the system for assigning customer identifiers, the format(s) of data reported to the central repository, the methods by which regulators will access data in the central repository, whether an annual independent evaluation will be required, how reportable events related to the same order will be linked, or how errors will be processed. Such information will be known only after the filing of the NMS plan and, thus, the Commission believes it is appropriate to defer consideration of such costs until the NMS plan is submitted for its consideration. Once it is submitted, the Commission will be able to use this information in determining whether to approve the NMS plan.

The Commission notes that other provisions of the Rule that are applicable to the central repository, discussed below, have been modified from the proposal, including provisions relating to the format in which the data may be reported,[601] and to the security and confidentiality of the consolidated audit trail data.[602]

b. Receipt, Consolidation, and Retention of Data

1. Audit Trail Data

In addition to providing for the creation and maintenance of the central repository, Rule 613(e), as proposed, also would have required the central repository to receive, consolidate, and

601 See Section III.B.2.b., infra; Rule 613(e)(1).

602 See Section III.B.2.e., infra; Rule 613(e)(4)(i).

retain all data reported by the SROs and their members pursuant to the Rule and the NMS plan.[603]

The Commission is adopting, substantially as proposed, the provisions in Rule 613(e) regarding the responsibility of the central repository to receive, consolidate, and retain the audit trail data, but with a few modifications to reflect changes the Commission made to other sections of Rule 613.[604]

The first change to Rule 613(e)(1) is a conforming change to the modification in adopted Rule 613(c)(2) that permits the NMS plan to provide that audit trail data be reported to the central repository either in a uniform electronic format, or in a manner that would allow the central repository or a third party to convert the data to a uniform electronic format for consolidation and storage.[605] Given the need for cross-market comparability and ready access,[606] the adopted Rule requires that, to the extent the NMS plan does not require that data be reported to the central repository in a uniform electronic format, the central repository must convert the data to a uniform electronic format for consolidation and storage.[607] The Commission notes that, regardless of whether the NMS plan submitted to the Commission for its consideration elects to have the central repository normalize audit trail data reported, the Rule requires the central repository to consolidate and store the data in a uniform electronic format.

The second change to Rule 613(e)(1) reflects the Commission's view that, while it is appropriate to provide the plan sponsors with the flexibility to determine how an order will be

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603 See proposed Rule 613(e)(1).

604 See Sections III.B.1.d. and III.B.1.f., supra.

605 See Rule 613(c)(2); see Section III.B.1.f., supra.

606 See Proposing Release, supra note 4, at 32564. See also Section III.B.2.d., infra.

607 See note 516, supra.

identified, audit trail data must be stored in the central repository in a manner that will allow order information to be retrieved in a timely and accurate fashion. Accordingly, adopted Rule 613(e)(1) requires that the audit trail data consolidated in the central repository be stored "in a form in which all events pertaining to the same originating order are linked together in a manner that ensures timely and accurate retrieval . . . for all reportable order events for that order." The Commission notes that, regardless of whether the NMS plan submitted to the Commission for its consideration elects to use a series of order identifiers or a unique order identifier, the Rule requires the central repository to be able to link together all reporting events pertaining to an order.

In looking ahead to considering the overall cost of creating, implementing, and maintaining a consolidated audit trail in connection with the NMS plan, the Commission recognizes that, in addition to the costs to SRO members who would be required to record and report data to the central repository, there also will be costs associated with creating and maintaining a central repository. These costs may include: (1) the purchase and maintenance of servers and systems to receive, consolidate, and retain audit trail data, and to allow access to and searches on the data; (2) the development of policies and procedures relating to the timeliness, accuracy, completeness, security, and confidentiality of the data collected; (3) the development and maintenance of a comprehensive information security program for the central repository; and (4) dedicated staff, including a CCO.

2. NBBO Information, Transaction Reports, and Last Sale Reports

In addition to receiving, consolidating, and retaining audit trail data reported pursuant to Rule 613(c), Rule 613(e)(5), as proposed, would have required the central repository to collect and retain, on a current and continuing basis and in a format compatible with the information collected pursuant to Rule 613(c)(7),[608] the NBBO information for each NMS security,[609] as well as transaction reports reported pursuant to an effective transaction reporting plan filed with the Commission pursuant to, and meeting the requirements of, Rule 601 of Regulation NMS under the Exchange Act.[610] In addition, last sale reports reported pursuant to the OPRA Plan filed with the Commission pursuant to, and meeting the requirements of, Rule 608 of Regulation NMS under the Exchange Act would have been required to be collected and retained.[611]

One commenter expressed its belief that, "[a]s in the case of the current OATS system, execution data provided to the consolidated audit trail should identify where the trade was publicly reported and have a common identifier that links the audit trail execution reports for the buy and sell orders to the public trade report."[612] The Commission believes that the proposed requirement for the central repository to collect and retain NBBO information, as well as transaction reports and last sale reports,[613] would facilitate the ability of SRO and Commission staff to search across order, NBBO, and transaction databases. Moreover, inclusion of NBBO information would permit regulators to compare order execution information to the NBBO information readily as all of the information will be available in a compatible format in the same database. This information also would be available to the Commission to assist in its oversight efforts.

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608 See Section III.B.1.d., supra.

609 See proposed Rule 613(e)(5)(i).

610 The effective transaction reporting plans include the CTA Plan and the UTP Plan. See note 101, supra; proposed Rule 613(e)(5)(ii).

611 See proposed Rule 613(e)(5)(iii).

612 See Liquidnet Letter, p. 7. See also Section III.B.d.vii., supra.

613 See proposed Rule 613(e)(5)(i) through (iii).

Additionally, requiring the central repository to collect and retain the NBBO and transaction information in a format compatible with the order execution information would aid in monitoring for regulatory compliance (e.g., Rule 201 of Regulation SHO). Also, this information would be useful in conducting market analyses (e.g., how order entry affects NBBO prices and depth). The Commission believes that the requirement that the central repository collect transaction reports reported pursuant to the CTA, UTP, and OPRA plans[614] would allow regulators to more efficiently evaluate certain trading activity. For example, a pattern of unreported trades may cause the staff of an SRO to make further inquiry into the nature of the trading to determine whether the public is receiving accurate and timely information regarding executions and that market participants are continuing to comply with the trade reporting obligations under SRO rules. Similarly, a pattern of unreported transactions could be indicia of market abuse, including failure to obtain best execution for customer orders or possible market manipulation. The Commission believes that having the quotation and transaction information currently collected with respect to NMS securities in the same data repository – and in a compatible format – as part of the consolidated audit trail would enhance regulatory efficiency when analyzing the data.

After considering the comment on this provision,[615] the Commission is adopting proposed Rule 613(e)(5)(ii) and (e)(5)(iii) (renumbered as Rule 613(e)(7)(ii) and (e)(7)(iii)), as proposed, and the requirement of proposed Rule 613(e)(5)(i) (renumbered as Rule 613(e)(7)(i)) for the NMS plan to require the central repository to collect and retain NBBO information for each NMS security substantially as proposed, but is clarifying that the NBBO information must

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614 See proposed Rule 613(e)(7)(i) through (iii).

615 See Liquidnet Letter, p. 7.

include size and quote condition.[616] NBBO size information is integral to determining whether best execution and order handling requirements were satisfied for a particular order because these requirements depend on the relationship between the size of the order and the displayed size at the NBBO. NBBO quote condition information is integral to determining whether or not quotes are immediately accessible. For example, quote condition information that identifies whether the quote reflecting the NBBO was automated, and therefore subject to trade-through protection, or manual[617] may be an important consideration in determining whether the duty of best execution was satisfied. The NBBO price, size, and quote condition is used by regulators to evaluate members for compliance with regulatory requirements, such as the duty of best execution or Rule 611 of Regulation NMS.[618] The Commission acknowledges that there will be costs to the central repository to purchase and to retain NBBO information, transaction reports, and last sale reports. However, the Commission believes that the benefits associated with having such information included in the central repository justify the costs to the SROs of requiring that they include this in the NMS plan submitted to the Commission for its review.

3. Retention of Information

As proposed, Rule 613(e)(6) would have provided that the NMS plan require the central repository to retain the information collected pursuant to Rule 613(c)(7) and (e)(5) in a convenient and usable standard electronic data format that is directly available and searchable

616 Quote condition is a field in the CQS feed that provides information on a quote, including whether such quote is an opening quote, closing quote, news pending, slow on ask side, slow on bid side, order imbalance or non-firm quote. See CQS Output Multicast Line Interface Specification, Version 48 (October 11, 2011), Appendix G.

617 Manual quotes are not eligible for automatic execution and do not have trade through protection under Rule 611 of Regulation NMS. See 17 CFR 242.600(57) for a definition of a protected bid or protected offer.

618 17 CFR 242.611.

electronically without any manual intervention for a period of not less than five years. The information would have been required to be available immediately, or, if immediate availability could not reasonably and practically be achieved, a search query would have been required to begin operating on the data not later than one hour after the search query is made.[619]

One commenter suggested that the Commission modify the time standard for the availability of older data to a next day (or later) standard, as the need for regulators to have immediate access to the data diminishes over time. The commenter stated that a requirement that the data be made available the next day, or after another longer period of time, would be less burdensome on the consolidated audit trail system and less costly, while still meeting the needs of regulators.[620] Another commenter believed that there could be difficulties in querying and analysis because the proposal did not specify how the data would be stored in the central repository.[621]

In response to the commenters' concerns, the Commission is modifying the proposed Rule. Specifically, Rule 613(e)(8) (renumbered from proposed Rule 613(e)(6)) provides that "[t]he national market system plan submitted pursuant to this section shall require the central repository to retain the information collected pursuant to [Rules 613(c)(7) and (e)(7)] in a convenient and usable standard electronic data format that is directly available and searchable electronically without any manual intervention for a period of not less than five years." The adopted Rule does not require, as was proposed, that the consolidated audit trail data be available immediately, or if immediate availability cannot reasonably and practically be achieved, any

619 See proposed Rule 613(e)(6).

620 See Nasdaq Letter I, p. 10-11.

621 See Ross Letter, p. 1.

search query must begin operating on the data not later than one hour after the search query is made.[622]

The Commission believes that it is unnecessary for the Rule to require a timeframe within which consolidated audit trail data must be available or a timeframe for when a search must begin after the query is made because, as discussed below,[623] the Rule, as adopted, includes a provision that requires the NMS plan to specifically address the "time and method by which the data in the central repository will be made available to regulators, in accordance with paragraph (e)(1) of this section, to perform surveillance or analyses, or for other purposes as part of their regulatory and oversight responsibilities."[624] The Commission will consider the response to this provision contained in the NMS plan submitted by the plan sponsors to the Commission, regarding the time and method by which the data in the central repository can be accessed and used by regulators as part of their regulatory and oversight responsibilities – which would encompass queries – as it evaluates the NMS plan. The Commission believes this provision provides flexibility to the SROs to devise an access requirement that meets the needs of regulators in a cost-effective and timely manner,[625] rather than establishing a strict deadline for all data to be accessible from the central repository.

c. Timeliness, Accuracy, Integrity, and Completeness of the Consolidated Data

As proposed, Rule 613(e)(4)(ii) would have required the NMS plan to include policies

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622 See proposed Rule 613(e)(6).

623 See Section III.C.2.a.i., infra.

624 See Rule 613(a)(1)(ii).

625 The Commission acknowledges there would be costs to the central repository for retaining data received or collected by the central repository pursuant to Rule 613. As discussed in Section I., supra, the NMS plan submitted to the Commission for its consideration will include a detailed analysis of the costs of the Rule for the Commission and the public to consider after the NMS plan has been submitted.

and procedures, including standards, for the plan processor to ensure the timeliness, accuracy, and completeness of the data provided to the central repository. In addition, proposed Rule 613(e)(4)(iii) would have required that the NMS plan include policies and procedures, including standards for the plan processor to reject data provided to the central repository that does not meet these validation parameters, and for SROs and members to re-transmit corrected data. Finally, proposed Rule 613(e)(4)(iv) would have required that the NMS plan include policies and procedures, including standards, to ensure the accuracy of the consolidation by the plan processor of the data provided to the central repository.

The Commission requested comment on these proposed requirements.[626] The Commission asked if this approach was practical to ensure the integrity of the data, and whether there were alternative methods that would achieve the same purpose that would be preferable. The Commission also requested comment on how much latency would result from a validation procedure.

The Commission received comments focusing concern on the potential for errors in the consolidated audit trail and the negative effects of errors in the consolidated audit trail.[627] One commenter stated that the "key principles [that] best ensure that the regulatory goals of the consolidated audit trail are met in a cost efficient manner" include a system that "avoids data quality issues through data validation safeguards and a structure that reads data as close to the point of origin as possible to avoid data translation errors when data is processed through intermediary applications."[628] Another commenter stated that "the CAT facility would also need

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626 See Proposing Release, supra note 4, at 32582.

627 See Aditat Letter, p. 2; FIF Letter, p. 4; FINRA Letter, p. 11; Nasdaq Letter I, p. 8.

628 See Nasdaq Letter I, p. 8.

a mechanism to identify and correct data that was inaccurate."[629] Another commenter noted that, "if any other protocol [other than FIX] is used a translation is required to transform data into a different protocol. This introduces error and offers the potential for manipulation of the data. Using FIX means the SEC is looking at the original format of the data."[630]

As a point of reference, summary data about OATS provided by FINRA to Commission staff indicates that approximately 0.25% of the intra-firm data reported daily by members contains errors.[631] Additionally, according to FINRA, when errors relating to the linkage of order reports are detected, members have no obligation to correct the errors.[632] As a result, approximately 1-2% of each day's recorded events remain unmatched (i.e., multi-firm events, such as order routing, that cannot be reconciled).[633] This deficiency in the OATS process diminishes the completeness and overall usefulness of the audit trail OATS creates.

In a comment letter, FINRA discussed the challenge of obtaining accurate audit trail information if the data was required in real time, and it noted the actions it undertakes to ensure the accuracy and completeness of its audit trail data and minimize errors.[634] FINRA stated that, "to ensure the integrity of OATS data submitted, FINRA performs over 152 separate OATS data validations on each order event, each of which can result in OATS data submissions being rejected and generating an error message.[635] As a result, FINRA performs over 40 billion

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629 See FIF letter, p. 4.

630 See Aditat Letter, p. 2.

631 See Commission Staff Memorandum, supra, note 64.

632 Id.

633 Id.

634 See FINRA Letter, p. 11.

635 Id.

separate checks each day to ensure OATS data conforms to all applicable specifications.[636] Members are then required by rule to repair and resubmit such data that did not meet OATS specifications.[637] Although members' OATS compliance rates are very high on average, almost 425,000 reports per day, on average, are rejected and must be corrected.[638] Accordingly, to use audit trail data before such validations have been performed may result in a severely distorted picture of trading and interfere with effective oversight."[639]

With respect to mechanisms to ensure compliance by SROs with the requirements of the plan, one commenter stated that "Commission rules should focus on the reasonable design of systems, processes and procedures to fulfill their objectives and patterns and practice of non-compliance rather than looking to any failure as a rule violation. This is particularly important in the context of data errors or similar matters."[640]

Finally, another commenter believed that "major market participants" should retain "detailed information of all network packets and trade data at both the ingress and egress of their

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636 Id.

637 Id.

638 Id.

639 Id. FINRA also noted, however, that "compliance rates for OATS steadily improved over time as members gained experience with the system. For example, when the OATS rules were first implemented, the match rate between executed orders and the related trade report submitted to an NASD transaction reporting system was only 76%. Currently, this match rate is consistently over 99%, which reflects the significant time and effort that has been expended by the industry to make their systems OATS compliant. FINRA believes that creation of a new system, rather than building off of an existing reporting infrastructure, will necessarily create a learning curve and lead to reduced compliance rates over the short-term." Id. The Commission acknowledges that there could be a learning curve for compliance with the NMS plan requirements for the reporting of data. The Commission, however, expects the NMS plan to minimize such reduced compliance rates to the extent reasonably practicable.

640 See Nasdaq Letter I, p. 13.

infrastructure."[641] This commenter believed that this information would not need to be forwarded to "any audit authority" but explained that such information could be used by regulators in the event a "denial of service" attack were to occur at a network level to slow market activities or hinder the flow of market information. This commenter further explained that having this information would "greatly improve confidence in the integrity of data and act as a further deterrence for fraudulent activity."[642]

After consideration of the comments received, the Commission is adopting Rule 613(e)(4)(ii) substantially as proposed. Thus, the NMS plan must have policies and procedures, including standards, to ensure the timeliness, accuracy, and completeness of the data received. The Commission believes that audit trail data that is timely, accurate, and complete is critical to the usefulness and effectiveness of Rule 613. However, the Commission is adding the term "integrity" to the list of items that the policies and procedures adopted by the plan sponsors, as set forth in Rule 613(e)(4)(ii), must address.[643] The addition of "integrity" is designed to help emphasize that data should not be subject to benign or malicious alteration, so that such data would be consistent and reliable at each point of transmission throughout its lifecycle (i.e., transmission from the SRO or member to the central repository, data extraction, transformation and loading at the central repository, data maintenance and management at the central repository, and data access by regulators). The Commission believes that the integrity of the audit trail data is critical to the usefulness and effectiveness of the consolidated audit trail.

The Commission also is adopting Rule 613(e)(4)(iv), renumbered as Rule 613(e)(4)(iii),

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641 See Endace Letter, p. 2-3.

642 Id. at p. 3.

643 Rule 613(e)(4)(ii) provides that the NMS plan shall include policies and procedures, including standards, to ensure the timeliness, accuracy, integrity, and completeness of the data provided to the central repository.

as proposed, which provides that the NMS plan submitted shall include policies and procedures, including standards, to be used by the plan processor to ensure the accuracy of the consolidation by the plan processor of the data reported to the central repository. The Commission believes that policies and procedures, including standards, to be used to ensure accuracy of the consolidated data are important and necessary because the benefits of ensuring that data is accurately reported to the central repository would be lost if the consolidation process is not as equally robust. The regulatory benefits of a consolidated audit trail are therefore based, in part, on the timeliness, accuracy, completeness, and integrity of the data ultimately available to regulators from the central repository.

As described above in Sections III.B.1.f. and III.B.1.d.iv., the adopted Rule provides the SROs with more flexibility than the proposed Rule in developing (a) the format(s) of data to be reported to the central repository, and (b) the methods by which order identifiers will be used to link reportable events. Accordingly, the Commission expects the policies and procedures included in the NMS plan submitted to the Commission for its consideration to apply to both the transmission of audit trail data from SROs and their members to the central repository, and the consolidation and retention of that data, and other information collected pursuant to the Rule, by the central repository, including, but not limited to, any normalization or conversion of the data to a uniform electronic format, and procedures for how reportable events are accurately linked. The Commission believes that it is critical to the usefulness of the consolidated audit trail that the SROs and their members report data in a manner that is accurate and complete, and that the central repository takes any and all appropriate measures to consolidate and retain that data in the same manner. To the extent the data is not accurate or complete, the ability of SRO and Commission staff to utilize the data to accomplish the goal of the consolidated audit trail will be compromised.[644]

In light of the comments the Commission received that noted the concern about the potential for errors in the consolidated audit trail, as well as the impact such errors may have on the consolidated audit trail,[645] the Commission is revising Rule 613(e)(4)(iii) as proposed (renumbered as Rule 613(e)(6)(i)). Specifically, Rule 613(e)(6)(i) requires the NMS plan submitted to the Commission for its consideration to "[s]pecify a maximum error rate to be tolerated by the central repository for any data reported pursuant to Rule 613(c)(3) and (c)(4); describe the basis for selecting such maximum error rate; explain how the plan sponsors will seek to reduce the maximum error rate over time; describe how the plan will seek to ensure compliance with such maximum error rate and, in the event of noncompliance, will promptly remedy the causes thereof."[646] Rule 613(e)(6)(ii) states that the NMS plan shall "[r]equire the central repository to measure the error rate each business day and promptly take appropriate remedial action, at a minimum, if the error rate exceeds the maximum error rate specified in the plan." Rule 613(e)(6)(iii) and (iv) provide that the NMS plan shall "[s]pecify a process for identifying and correcting errors in the data reported to the central repository pursuant to [Rule 613(c)(3) and (c)(4)], including the process for notifying the national securities exchanges, national securities associations, and members who reported erroneous data to the central repository about such errors, to help ensure that such errors are promptly corrected by the reporting entity, and for disciplining those who repeatedly report erroneous data; and . . .

644 See Section II.A., supra.

645 See Aditat Letter, p. 2; FIF Letter, p. 4; FINRA Letter, p. 11; Nasdaq Letter I, p. 8.

646 See Rule 613(e)(6)(i). The term "error rate" is defined in Rule 613(j)(6) to mean "[t]he percentage of reportable events collected by the central repository in which the data reported does not fully and accurately reflect the order event that occurred in the market." The SROs should consider calculating an aggregate error rate as well as error rates for subcategories such as trade reporting and quote reporting.

[s]pecify the time by which data that has been corrected will be made available to regulators."[647]

As noted above, the Commission believes the availability of accurate consolidated data is a critical component of a useful and effective audit trail. Ideally, there would be no errors in the recording or reporting of any audit trail data element, and every data element of every reportable event would be accurately recorded by the SROs and their members, and then accurately reported to the central repository under Rule 613, resulting in a consolidated audit trail that reflects all actions relating to every order in the market for securities. However, because the Commission understands that, to some extent, errors in reporting audit trail data to the central repository will occur, the Commission believes it is appropriate to adopt a provision in Rule 613 that requires the NMS plan to set forth the maximum error rate to be tolerated by the central repository in the reporting of audit trail data, as well as to specify a process for identifying and correcting such errors.[648]

The Commission notes that the Rule leaves to the plan sponsors the ability to determine the acceptable maximum error rate, although the Rule does require that the NMS plan must explain the basis for selecting such rate. The Rule also requires the NMS plan submitted to the Commission for its consideration to set forth how the plan sponsors will seek to reduce such maximum error rate over time, thereby increasing the accuracy of audit trail data. Further, the Rule requires the NMS plan to have in place a means to ensure compliance with the maximum error rate so that SROs and their members are incentivized to comply with the maximum error rate, and to set forth a plan for promptly remedying the causes for any noncompliance.

Since the Rule leaves many of the specific details regarding error rates and error-correction processes for the plan sponsors to determine, and because the accuracy and

647 See Rule 613(e)(6)(iii) through (iv).

648 See Rule 613(e)(6).

completeness of data ultimately received by regulators is of such significance to the effective use of a consolidated audit trail, the Commission, as well as the public, would likely consider such details very important in their overall evaluation of the submitted plan. Furthermore, given that the approval of any plan by the Commission would, in part, be based on expectations of maximum error rates, the Commission believes it is equally important for objective measures to be reported that track how well the plan is meeting such expectations. Thus, to ensure the accuracy of the audit trail data generally meets these expectations, Rule 613(e)(6)(ii) also requires that the error rate identified in the NMS plan be measured each business day and that remedial action be taken if, on any given day, the error rate exceeds the maximum error rate set forth in the NMS plan.[649]

The Commission also believes it is appropriate to require the SROs to formulate a process for identifying and dealing with errors, and to require that the SROs or the members reporting erroneous data be notified that an error in reporting has occurred.[650] In addition, the Commission believes it is appropriate to require the SROs to develop a process to help ensure that errors are promptly corrected by the reporting SRO or member. The Commission understands that requirements similar to these are currently implemented by FINRA as part of their OATS process, though cross-firm errors, such as those leading to irreconcilable or unmatched routes, are not generally corrected under the OATS process.[651] The Commission

649 The Commission recognizes that in any complex system there is always a risk of occasional unexpected errors, or errors caused by rare and unexpected events. However, the Commission believes that, by tracking error rates on a daily basis, the SROs, and the Commission would be able to observe any repeated patterns or longer-term trends that suggest more systematic problems or concerns with data collection, reporting, or consolidation processes.

650 See Rule 613(e)(6)(iii) through (iv).

651 See Commission Staff Memorandum, supra note 64.

further believes that disciplining SROs and members that repeatedly report erroneous audit trail data, as required by Rule 613(e)(6)(iii), is appropriate given the need to maintain an accurate consolidated audit trail for regulatory purposes. Finally, given that the NMS plan submitted to the Commission for its consideration is required to specify a process for correcting errors, the Commission also believes it is appropriate to require, pursuant to Rule 613(e)(6)(iv), that the NMS plan submitted to the Commission for its consideration specify the time by which data that has been corrected will be made available to regulators. In reviewing the NMS plan submitted for its consideration, the Commission will therefore be able to consider the time that uncorrected but consolidated data (which was reported to the central repository by 8:00 a.m. Eastern Time on the trading day following the day such information was recorded) would be available for use by regulators, the expected error rate of this data, and the time at which a corrected version of this data would be made available to regulators. These three parameters will help inform regulators as to the potential effectiveness of starting different types of surveillance and monitoring activities at different times.[652]

The Commission acknowledges there would be costs to the central repository associated with developing policies and procedures related to the timeliness, accuracy, integrity, and completeness of data, including, but not limited to, processes for identifying and correcting errors in the audit trail data received, and measuring the error rate on a daily basis. However, the size of these costs depends significantly on the specific details of the NMS plan submitted to the Commission for its consideration. Once the SROs submit the NMS plan to the Commission for its consideration specifying the details, parameters, and estimated costs of such processes, as well as the maximum error rate expected under such processes, the Commission and the public

652 See Rule 613(a)(1)(ii).

will be able to consider this information when determining whether to approve the NMS plan.

d. Access to the Central Repository and Consolidated Audit Trail Data for Regulatory and Oversight Purposes

As proposed, each national securities exchange and national securities association, as well as the Commission, would have had access to the central repository for the purposes of performing its respective regulatory and oversight responsibilities pursuant to the federal securities laws, rules, and regulations.[653] This access would have included all systems of the central repository, and the data reported to and consolidated by the central repository.[654] In addition, the Commission proposed to require that the NMS plan include a provision requiring the creation and maintenance by the central repository of a method of access to the consolidated data.[655] This method of access would have been required to be designed to include search and reporting functions to optimize the use of the consolidated data. The Commission requested comment on whether it should allow the consolidated audit trail data to be made available to third parties, such as for academic research.

One commenter supported limiting access to the consolidated audit trail data to the Commission and SROs for regulatory purposes, but suggested it would also be appropriate to share the data with the CFTC.[656] Other commenters supported the idea of providing "anonymized" data for academic use, as long as appropriate controls were established to assure regulators and market participants that confidential trading information could not be revealed.[657] Specifically, one commenter endorsed the use of the data "with appropriate safeguards" by

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653 See proposed Rule 613(e)(2).

654 Id.

655 See proposed Rule 613(e)(3).

656 See Liquidnet Letter, p. 8-9. See also SIFMA Letter, p. 19.

657 See Angel Letter, p. 3; Albany Letter, p.1-4; and TIAA-CREF Letter, p.4.

academic researchers, explaining that it will "promote understanding of the markets," and "lead to better policy decisions and thus more fair and orderly markets."[658] Similarly, another commenter also supported the use of the data by certain third parties and stated that "[a]ccess to real-world data can help research immensely."[659]

The Commission also received a comment that argued for extending access to the consolidated audit trail data to certain individuals who have a fiduciary responsibility to shareholders of a company. This commenter explained that such access would allow them to audit all trading activity in the equity or other derivative securities of that company.[660]

The Commission recognizes there may be certain benefits to the types of expanded access to data in the central repository that has been suggested by various commenters, but, for the reasons discussed below, it is adopting the provisions in Rule 613 regarding access by regulatory authorities at the SROs and the Commission to the systems operated by the central repository, and to the data received, consolidated, and retained by the central repository, substantively as proposed in Rule 613(e)(3), but with one clarification regarding the requirement for access by regulators.[661] Specifically, Rule 613(e)(3), as adopted, provides that "[t]he national market system plan submitted pursuant to this section shall include a provision requiring the creation and maintenance by the plan processor of a method of access to the consolidated data

658 See Angel Letter, p. 3.

659 See Albany Letter, p. 1-3. This commenter acknowledged the privacy concerns involved in making the data available for academic research, but stated that researchers have faced similar challenges before and researchers are capable of developing a way to access and share information without the risk of divulging trading strategies or identities. The commenter also stated that data released after a delay would limit the data's usefulness.

660 See Van Bokkelen Letter, p. 1.

661 See Rule 613(e)(3). See also Rule 613(a)(1)(ii) (requiring the NMS plan to detail how readily the NMS plan will allow data in the central repository to be accessed by regulators, as well as the regulators' manner of access); see also Section III.C.2.a.i., infra.

stored in the central repository that includes the ability to run searches and generate reports." As proposed, Rule 613(e)(3) would have provided that the central repository must have a "reporting function." The Commission believes that this language is ambiguous and may have implied that the central repository was required to do more than respond to search queries. Accordingly, the Commission is replacing the requirement in proposed Rule 613(e)(3) that the central repository provide "search and reporting functions" with the requirement that there be "the ability to run searches and generate reports." The change in language from that contained in the Rule, as proposed, is not intended to change the substance of the requirement.

In response to the commenter who suggested sharing data with the CFTC, the Commission notes that it has shared information with the CFTC in the past and that it intends to continue sharing information when the situation so warrants. The Commission notes that, among other arrangements, it currently has information-sharing agreements with other regulators. The Commission also agrees with commenters that there may be benefits to allowing academics or other third parties to have access to data collected by the central repository. Academic and other third-party analyses are helpful to the Commission in performing its own evaluation of the economic costs and benefits of regulatory policy. The Commission also notes that one commenter believes that the ability of companies to detect manipulative trading activity in their securities could be enhanced if certain individuals, who have a fiduciary responsibility to shareholders, were given access to limited consolidated audit trail data. However, because the creation and implementation of the consolidated audit trail is in the formative stage, and in light of commenters' concerns about the privacy and security of the information, the Commission believes it is premature to require that the NMS plan require the provision of data to third parties.

Though the Commission is not specifying a particular process, or any details, regarding the mechanism(s) by which regulators will access data in the central repository, the Rule requires the SROs to provide such details and cost estimates in its NMS plan submitted to the Commission for its consideration.[662] Further, as discussed below in Section III.C.2.c., the Commission is providing the SROs with detailed regulator use cases for how regulators would likely make use of the data in the central repository. These regulator use cases are designed to help the SROs respond with sufficient details in the NMS plan submitted to the Commission for its consideration so that, along with associated cost estimates also required to be provided by the SROs, the Commission and the public will be able to fully consider the NMS plan submitted.

e. Confidentiality of Consolidated Data

Rule 613(e)(4)(i), as proposed, would have required that the NMS plan include policies and procedures, including standards, to be used by the plan processor to ensure the security and confidentiality of all information reported to, and maintained by, the central repository. The plan sponsors and employees of the plan sponsors and central repository would have been required to agree to use appropriate safeguards to ensure the confidentiality of such data, and not to use such data other than for surveillance and regulatory purposes.[663] As proposed, Rule 613 also would have required the NMS plan to include mechanisms to ensure compliance by the plan sponsors and their members with the requirements of the plan.[664]

In the Proposing Release, the Commission solicited comments regarding what steps should be taken to ensure appropriate safeguards with respect to the submission of customer information, as well as the receipt, consolidation, and maintenance of such information in the

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662 See Sections III.C.2.a.i through ii., infra; Rule 613(a)(1)(ii) through (vii).

663 See proposed Rule 613(e)(4)(i). However, a plan sponsor also would be permitted to use the data it submits to the central repository for commercial or other purposes as otherwise permitted by applicable law, rule or regulation. Id.

664 See proposed Rule 613(h)(3), Rule 613(g)(4).

central repository. The Commission requested comment on the issue of appropriate safeguards to be put in place by the SROs and the central repository to help ensure confidentiality. The Commission also asked whether the proposed Rule should: (1) require that SROs put in place specific information barriers or other protections to help ensure that data is used only for regulatory purposes; (2) provide for an audit trail of the SROs' personnel access to, and use of, information in the central repository to help monitor for compliance with appropriate usage of the data; and (3) include a requirement that the NMS plan include policies and procedures to be used by the plan processor to ensure the security and confidentiality of information reported to, and maintained by, the central repository be expanded to include the content of any searches or queries performed by the SROs or the Commission on the data.[665]

Several commenters expressed concern about how to best ensure the confidentiality of the data collected.[666] One commenter generally argued that safeguards for the audit trail data had not been sufficiently addressed in the Proposing Release.[667] Another commenter recommended that the operator of the central repository and the SROs be required to implement security policies, processes, and practices consistent with industry best practices for the protection of sensitive information and that such policies, processes, and practices be audited on an annual basis by a third-party expert.[668] Similarly, one commenter suggested that vendors also should

665 See Proposing Release, supra note 4, at 32582.

666 See Scottrade Letter, p. 2 (expressing concern that trading strategies and confidential customer information could be at risk from cyber-attacks or accidental data breaches); ICI Letter, p. 2-4; Ross Letter, p.; 1 Liquidnet Letter, p. 4. See also Ameritrade Letter, p. 3; Thomson Reuters Letter, p. 4; BATS Letter, p. 3; Managed Funds Association Letter, p. 2-3.

667 See Ameritrade Letter, p. 3-4.

668 See Liquidnet Letter p. 4.

implement best practices with regard to security, reliability, and integrity of data.[669] Another commenter stated that SROs should be subject to the same privacy and data protection standards as those to which broker-dealers are subject, and that SRO members should not be held responsible, and be indemnified by the SROs, for any breaches of customer or firm information.[670]

One commenter offered several specific recommendations for enhancing the security of audit trail information.[671] This commenter suggested that the Commission should expressly state who would have access to the data, when they could access it, and how they could use it, and further recommended that all data sent to the central repository be encrypted, and that certain fields be "masked" or be subject to delayed end-of-day reporting.[672] In addition, this commenter suggested that the Commission and each SRO should adopt a robust information security program, and that the Commission should explain how it intends to treat requests for audit trail data.[673]

Another commenter suggested that the Rule more explicitly enunciate permissible and impermissible uses of the consolidated audit trail and suggested including a requirement regarding the SROs' personnel access to and use of audit trail data, as well as a commitment by the Commission to review each SRO with respect to the adequacy of information barriers.[674] Similarly, a commenter suggested that access to audit trail data be limited to employees of

669 See Thomson Reuters Letter, p. 4.

670 See TIAA-CREF Letter, p. 4.

671 See ICI Letter, p. 2-4.

672 Id. at 3.

673 Id.

674 See BATS Letter, p. 3.

regulators whose function is to monitor and surveil that market.[675] This commenter supported the restriction that consolidated audit trail data only be used for regulatory purposes.[676]

One commenter asked how and at what level customer data would be encrypted.[677] This commenter listed specific aspects of data encryption that would need to be addressed, and noted that potential burdens could be associated with encryption.[678] Finally, one commenter recommended that the Commission express its intention to withhold audit trail data from the public pursuant to Freedom of Information Act ("FOIA")[679] exemptions.[680]

The Commission considered the concerns expressed by commenters about the sensitivity of much of the information that will be consolidated by the central repository, and believes that maintaining the confidentiality of customer and other information reported to the central repository is essential. Without adequate protections, market participants would risk the exposure of highly-confidential information about their trading strategies and positions.

The Commission notes that that it currently has controls and systems for its own use and handing of audit trail information. Nevertheless, given the sensitivity of certain information that will be produced by the consolidated audit trail – as well as the fact that such information should be more readily available and provided in a more usable format than existing audit trail information – the Commission intends to review the controls and systems that it currently has in place for the use and handling of audit trail information. The Commission further intends to evaluate whether any additional controls and systems may be required to adequately protect the

675 See Managed Funds Association Letter, p. 2-3.

676 Id.

677 See Ross Letter, p. 1.

678 Id.

679 5 U.S.C. 552.

680 See ICI Letter, p. 4.

sensitive information provided to it under the consolidated audit trail.[681]

In addition, adopted Rule 613(e)(4)(i) requires that the NMS plan include policies and procedures that are designed to ensure implementation of the privacy protections that are necessary to assure regulators and market participants that the NMS plan provides for rigorous protection of confidential information reported to the central repository. Specifically, adopted Rule 613(e)(4)(i)(A) requires that "[a]ll plan sponsors and their employees, as well as all employees of the central repository, agree to use appropriate safeguards to ensure the confidentiality of such data and agree not to use such data for any purpose other than surveillance and regulatory purposes, provided that nothing in [Rule 613(e)(4)(i)(A)] shall be construed to prevent a plan sponsor from using the data that it submits to the central repository for regulatory, surveillance, commercial, or other purposes as otherwise permitted by applicable law, rule, or regulation." Further, in response to a comment,[682] adopted Rule 613(e)(4)(i)(B) adds the requirement to the Rule, as proposed, that the plan sponsors adopt and enforce rules that: (1) require information barriers between regulatory staff and non-regulatory staff with regard to access and use of data in the central repository, and (2) permit only persons designated by plan sponsors to have access to the data in the central repository.[683] In addition, the Commission is modifying the Rule, as proposed, to require that the plan processor must: (1) develop and maintain a comprehensive information security program, with dedicated staff, that is

681 For example, appropriate confidentiality protections will need to be programmed in any Commission systems that collect, store, or access data collected from the central repository. In addition, it may be appropriate to establish multiple access levels for Commission staff so that staff members are allowed only as much access as is reasonably necessary in connection with their duties.

682 See ICI Letter, p. 3

683 Rule 613(e)(4)(i)(B); see ICI Letter, p. 3 (recommending that "the confidential nature of the information supports limiting access to the CAT data to regulators and repository staff").

subject to regular reviews by the central repository's CCO, (2) require the central repository to have a mechanism to confirm the identity of all persons permitted to access the data, and (3) maintain a record of all instances where such persons access the data.[684]

The Commission believes these provisions should create a framework for the SROs to establish a thorough and exacting process for helping ensure the continued effectiveness of the confidentiality safeguards. Further, the Commission believes these additional provisions are appropriate because they clarify the types of confidentiality safeguards that the NMS plan submitted to the Commission for its consideration must have to preserve the confidentiality of the information that is received, consolidated, and retained by the central repository. The provision requiring information barriers is designed to, for example, protect and prevent audit trail data, which are to be used only for regulatory purposes, from being communicated to any personnel at an SRO that are engaged in non-regulatory or business activities. Additionally, the Rule's requirement that policies and procedures submitted as part of the NMS plan provide that: (i) only persons designated by the plan sponsors have access to the central repository data, (ii) the plan processor have a mechanism to confirm the identity of all persons permitted access to the data, and (iii) the plan processor maintain a record of all instances where such persons access the data. These provisions are designed to assure regulators and market participants that only designated persons are allowed access to the consolidated audit trail data, and that the central repository will have a method to track such access. With respect to the commenter that suggested the Commission more explicitly enunciate permissible and impermissible uses of the

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684 See Rule 613(e)(4)(i)(C). The Commission expects that the central repository's CCO would be responsible for determining the frequency of these regular reviews in the first instance, in accordance with industry standards for the review of information security, taking into account the sensitivity of the data stored in the central repository. See Rule 613(b)(5) for a description of the CCO.

consolidated audit trail,[685] the Commission notes that any security and confidentiality provisions included in the NMS plan approved by the Commission will be subject to the Commission's inspection and examination program of SROs to ensure that they are implemented fairly in a manner consistent with the Exchange Act.[686]

The Commission believes that an outline or overview description of the policies and procedures that would be implemented under the NMS plan submitted to the Commission for its consideration would be sufficient to satisfy the requirement of the Rule. The Commission believes it is important for the NMS plan submitted to the Commission to establish the fundamental framework of these policies and procedures, but recognizes the utility of allowing the plan sponsors flexibility to subsequently delineate them in greater detail with the ability to make modifications as needed.

The Commission considered the comment that asked when and at what level customer information would be encrypted.[687] The Commission notes that, while Rule 613 does not require that this information be encrypted, the Rule contains several safeguards, discussed in this section, to ensure the privacy and confidentiality of the audit trail data. Based on these provisions,[688] the

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685 See BATS Letter, p. 3. See also Managed Funds Association Letter, p. 2-3.

686 The Commission notes that, as part of its inspection and examination program, its staff has the authority to examine the application of any security and confidentiality provisions in the NMS plan to determine whether they have been applied fairly. In this manner, the Commission will be able to monitor how the plan sponsors have applied any such provisions set out in the NMS plan approved by the Commission, and whether their uses of the consolidated audit trail were consistent with the plan and the Exchange Act.

687 See Ross Letter, p. 1.

688 Specifically, adopted Rule 613(e)(4) requires the NMS plan to include policies and procedures, including standards, to be used by the plan processor to ensure the security and confidentiality of all information submitted to the central repository. In addition, one of the considerations the NMS plan must address is how the security and confidentiality of all information, including customer information, submitted to the central repository, will be ensured. See Rule 613(a)(1)(iv).

Commission believes that plan sponsors would need to make sure customer information is protected, which could be accomplished by data encryption, if they so choose. Additionally, the Commission notes that the unique customer identifier is only reported once to the central repository – by the broker-dealer that is either originating the order or is the original recipient of the order. Because the unique customer identifier does not travel with the order as it is routed to other market participants, only the originating broker-dealer should be able to determine the identity of the customer of the order. The Commission considered the comment that recommended that the Commission express its intention to withhold audit trail data from the public pursuant to FOIA.[689] The adopted Rule places no affirmative obligations on the Commission to provide information to any third parties. Further, the Commission believes there are bases under FOIA to withhold customer information, including 5 U.S.C. 552(b)(4) (trade secrets, commercial or financial information), 5 U.S.C. 552(b)(6) (personal information affecting an individual's privacy), and 5 U.S.C. 552(b)(8) (records related to examinations of financial institutions). The Commission intends to assert all appropriate exemptions in response to a FOIA request for information related to the consolidated audit trail's customer information.

The Rule, as adopted, also states that the NMS plan must require the SROs to adopt penalties for non-compliance with any policies and procedures of the plan sponsors or central repository, described above, with respect to information security.[690] The Commission believes this provision is appropriate because it provides an incentive to SROs to comply with the central repository's information security program. The Commission encourages SROs to include in their comprehensive information security program developed and maintained by the plan processor provisions for notifying any customer or other market participant whose information

689 See ICI Letter, p. 4.

690 See Rule 613(e)(4)(i)(D).

may have been compromised by a security breach, so that appropriate remedial steps may be taken.

Additionally, given the importance of the security of data consolidated in the central repository, and in response to the commenter who recommended an annual third-party audit of the security of the central repository,[691] the Commission has added Rule 613(e)(5) to require the NMS plan submitted to the Commission for its consideration to address whether there will be an annual, independent evaluation of the security of the central repository and (1) if so, provide a description of the scope of such planned evaluation, and (2) if not, provide a detailed explanation of the alternative measures for evaluating the security of the central repository that are planned instead. As with most information technology systems, the central repository's system will include measures to assure regulators and market participants of the security of the system. An independent evaluation of the security of the central repository could aid the central repository in identifying and correcting potential areas of weakness or risk. While the Commission is leaving it to the plan sponsors to determine whether the NMS plan will require an annual audit, given the confidential nature of information that will be stored at the central repository, the Commission believes that the NMS plan submitted to the Commission for its consideration must, at a minimum, address whether such an audit is appropriate.

The Commission also notes that, as discussed below,[692] it is adding a specific provision that requires the NMS plan submitted to the Commission for its consideration to discuss the security and confidentiality of the information reported to the central repository.[693] With this information, the Commission, as well as the public, will be able review in detail how the NMS

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691 See Liquidnet Letter, p. 4.

692 See Section III.C.2.a.i., infra.

693 See Rule 613(a)(1)(iv).

plan proposes to ensure the security and confidentiality of such information in deciding whether to approve the NMS plan.

The Commission believes that, collectively, these provisions are appropriate because of the confidential and commercially valuable information that the central repository will contain. The Commission believes that the purpose and efficacy of the consolidated audit trail would be compromised if the Commission, the SROs and their members could not rely on the confidentiality and security of the information stored in the central repository. The Commission acknowledges there would be costs associated with a comprehensive information security program, including, but not limited to, compensating a CCO and a dedicated staff, and establishing policies and procedures, as well as for an annual, independent evaluation of the central repository's security (if such an evaluation is required by the NMS plan submitted to the Commission for its consideration) or alternative measures (if such an evaluation is not). Once the SROs have submitted the NMS plan to the Commission that, as required, contains details about the security and confidentiality of the audit trail data, the Commission and the public will be able to consider this information when evaluating the NMS plan.

3. Other Required Provisions of the NMS Plan

a. Compliance with the NMS plan

1. Exchanges and Associations

As proposed, Rule 613(h) would have provided that each plan sponsor shall comply with the provisions of an NMS plan submitted pursuant to the proposed Rule and approved by the Commission.[694] In addition, the proposed Rule would have provided that any failure by a plan sponsor to comply with the provisions of the NMS plan could be considered a violation of the

694 See proposed Rule 613(h)(1).

proposed Rule.[695] The proposed Rule also would have required that the NMS plan include a mechanism to ensure compliance by the sponsors with the requirements of the plan.[696]

One commenter expressed concern that there would be competitive implications if the NMS plan were to include provisions that would permit SROs to assess penalties against one another for non-compliance.[697] This commenter recommended, instead, that the NMS plan include a "fee recoupment" provision so the plan administrator could recoup costs incurred as a result of an error by a particular SRO.[698] The commenter maintained that a "fee recoupment" provision, coupled with the risk of Commission disciplinary action for a "pattern or practice" of non-compliance, would be a sufficient penalty.[699]

After considering the comment received on the issue of compliance with the NMS plan by exchanges and associations,[700] the Commission is adopting Rule 613(h) substantially as proposed, with a modification to Rule 613(h)(3) to specify that a mechanism to ensure compliance by the sponsors of the NMS plan with the requirements of the plan "may include penalties where appropriate" and a technical modification to proposed Rule 613(h)(1) and (2).[701] The Commission believes that specifying that the mechanism to ensure compliance by the

695 See proposed Rule 613(h)(2).

696 See proposed Rule 613(h)(3).

697 See Nasdaq Letter I, p. 13.

698 Id.

699 Id.

700 Id.

701 This technical modification simplifies the language of Rule 613(h)(1) and (2) from the proposal. Adopted Rule 613(h)(1) and (2) deletes the language "submitted pursuant to this section" and "of which it is a sponsor." Adopted Rule 613(h)(1) and (2), like the proposed Rule, requires each SRO to comply with the provisions of the NMS plan "approved by the Commission." Because each SRO will be a member of the NMS plan approved by the Commission, it is not necessary to include the phrases not adopted.

sponsors of the NMS plan may include a penalty provision where appropriate provides the plan sponsors with an appropriate tool – including potential disciplinary action – to help ensure compliance by SROs with the terms and provisions of the NMS plan.[702] The Commission notes that a penalty provision could provide an incentive for each SRO to comply with all the provisions of the NMS plan because each SRO will seek to avoid incurring any penalty under the Rule. The incentive to avoid a penalty could also reduce the risk of non-compliance with the Rule. The Commission notes, however, that the adopted Rule does not mandate that the NMS plan's enforcement mechanism include penalties, as there might be other mechanisms to enforce or encourage compliance with the Rule, and the Commission believes that the SROs, in the first instance, should design such mechanisms in their role as plan sponsors. However, the Commission expects that if the SROs design compliance mechanisms that do not incorporate penalties, they would explain in the NMS plan how such mechanisms are expected to help ensure compliance by SROs with the terms and provisions of the NMS plan.[703]

With respect to the comment concerning the potential competitive implications of allowing the plan sponsors to impose penalties against each other for non-compliance, the Commission notes that it will carefully review the NMS plan submitted for its consideration, including any proposed mechanisms to help ensure compliance with the NMS plan and the adopted Rule, to help ensure that penalty provisions, if any, are designed to be applied fairly and

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702 Any such provision would be subject to notice and comment pursuant to Rule 608 of Regulation NMS.

703 The Commission notes that any failure by a national securities exchange or national securities association to comply with the provisions of the NMS plan approved by the Commission will be considered a violation of Rule 613, and that the Commission could take appropriate steps to address such a violation, including imposing penalties as appropriate. See Rule 613(h)(2).

in a manner consistent with the Exchange Act.[704] As the central repository will be a facility[705] of the SROs, the rules governing it must be consistent with the Exchange Act. In addition, any future amendment to the penalty provisions applicable to the SROs would either be reviewed as an amendment to the NMS plan (effected through public notice and comment and taking into account the relevant considerations contemplated by Rule 613(a)(1)) or, because the central repository is a facility of the SROs, as a proposed rule change of the central repository under Section 19 of the Exchange Act.

The Commission notes that the Commission's examination authority under Section 17 of the Exchange Act[706] extends to the central repository because it is a facility of the SROs and, thus, the Commission will have the opportunity to inspect the central repository and its books and records for compliance with any penalty provisions set out in the NMS plan. Additionally, the Commission has the authority to review any actions taken under the NMS plan, pursuant to Rule 608(d)(1) of Regulation NMS,[707] for burdens on competition, among other matters.[708]

In response to the comment suggesting a "fee recoupment" provision in the NMS plan, the Commission notes that Rule 613(b)(4), as adopted, provides that "[t]he national market system plan submitted pursuant to this section shall include a provision addressing the manner in which the costs of operating the central repository will be allocated among the national securities exchanges and national securities associations that are sponsors of the plan, including a provision addressing the manner in which costs will be allocated to new sponsors to the plan." In this regard,

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704 See Section III.B.2.a., supra.

705 See supra note 581 (describing the nature of a "facility").

706 15 U.S.C. 78q.

707 17 CFR 242.608(d)(1).

708 Id.

to the extent a "fee recoupment" is a method for recouping costs incurred by the central repository as a result of an error in reporting to the consolidated audit trail, as stated by a commenter,[709] the Commission notes that, pursuant to Rule 613(b)(4), the plan sponsors may, if they deem it appropriate, include a fee recoupment provision in the NMS plan submitted to the Commission for its consideration.[710]

2. Members

Proposed Rule 613(g) would have included provisions to subject members of each SRO to the requirements of Rule 613. Specifically, as proposed, the Rule would have required each SRO to file with the Commission, pursuant to Section 19(b)(2) of the Exchange Act[711] and Rule 19b-4 thereunder,[712] a proposed rule change to require its members to comply with the requirements of the proposed Rule and the NMS plan.[713] Further, the proposed Rule directly would have required each member to (1) collect and submit to the central repository the information required by the Rule, and (2) comply with the clock synchronization requirements of the proposed Rule.[714] The proposed Rule also would have required that the NMS plan include a provision that each SRO, by subscribing to and submitting the plan to the Commission, agrees to enforce compliance by its members with the provisions of the plan.[715] Finally, the proposed

709 See Nasdaq Letter I, p. 13.

710 Any such provision would be subject to notice and comment pursuant to Rule 608 of Regulation NMS.

711 15 U.S.C. 78s(b)(2).

712 17 CFR 240.19b-4.

713 See proposed Rule 613(g)(1). This provision in the proposed Rule echoes the requirement contained in Rule 608 that "each self-regulatory organization also shall, absent reasonable justification or excuse, enforce compliance with any such plan by its members and persons associated with its members." 17 CFR 242.608(c).

714 See proposed Rule 613(g)(2).

715 See proposed Rule 613(g)(3).

Rule would have required the NMS plan to include a mechanism to ensure compliance with the requirements of the plan by the members of each SRO that is a sponsor of the NMS plan submitted pursuant to this Rule and approved by the Commission.[716]

One commenter expressed the view that "enforcement of [the consolidated audit trail] . . . should be accomplished through a policies and procedures rule framework – similar to that of Regulation NMS. To enforce the rule from a strict liability perspective would simply be the wrong approach and would result in thousands of technical (non-material) violations, which is clearly not the intent of the rule."[717]

After considering the comment regarding Rule 613's provisions on compliance with the Rule by members of the SROs, the Commission is adopting Rule 613(g) substantially as proposed, with technical modifications to proposed Rule 613(g). These technical modifications simplify the language of Rule 613(g). Adopted Rule 613(g) does not include the phrase that applied the requirements therein to each member of an SRO "that is a sponsor of the national market system plan submitted pursuant to this section and approved by the Commission." Because each SRO will be a member of the NMS plan approved by the Commission, it is not necessary to include the deleted language.

In addition, the Commission modified Rule 613(g)(2) as proposed to provide that, "[e]ach member of a national securities exchange or national securities association shall comply with all the provisions of any approved national market system plan applicable to members." This change requires members to comply with all applicable provisions of the NMS plan as approved by the Commission instead of with the specific provisions contained in the Rule relating to recording and reporting data and clock synchronization since the requirements contained in the NMS plan may

716 See proposed Rule 613(g)(4).

717 See Knight Letter, p. 3.

differ or be more specific than the requirements stated in the Rule.

To be in compliance with the NMS plan, members must record and report all data elements required by the NMS plan within the time specified in the plan. To this end, the plan sponsors must develop a way to ensure that each member that takes action with respect to an order (e.g., originates, receives, routes, modifies, cancels or executes an order) records and reports all required elements associated with a reportable event, as the plan sponsors must also develop a mechanism to address any lapses in compliance with the NMS plan with a goal of ensuring the central repository is receiving a complete record of the life of an order.

The Commission does not agree with the commenter that believed that enforcement of the consolidated audit trail will necessarily "result in thousands of technical (non-material) violations, which is clearly not the intent of the rule."[718] The Commission notes that the adopted Rule does not address the means of achieving compliance with the requirements of the consolidated audit trail. Rather, adopted Rule 613(g) simply provides that the SROs must submit proposed rule changes to require their members to comply with the requirements of an NMS plan approved by the Commission.

The Commission acknowledges there would be costs to the SROs for filing with the Commission proposed rule changes to require their members to comply with Rule 613 and the NMS plan approved pursuant thereto. The Commission, however, believes that the Rule should include these rule filing requirements for the reasons discussed above.

b. Operation and Administration of the NMS Plan

Proposed Rule 613(b) sets forth requirements concerning the operation and administration of the NMS plan. As proposed, Rule 613(b)(1) would have required that the

718 See Knight Letter, p. 3.

NMS plan include a governance structure to ensure fair representation of the plan sponsors and provisions governing the administration of the central repository, including the selection of a plan processor. Rule 613(b)(2), as proposed, also would have required the plan sponsors to include in the NMS plan a provision addressing the requirements for the admission of new sponsors to the plan and the withdrawal of sponsors from the plan. In addition, proposed Rule 613(b)(3) would have required the NMS plan to include a provision addressing the percentage of votes required by the plan sponsors to effectuate amendments to the plan, and proposed Rule 613(b)(4) would have required that the plan sponsors develop a process for allocating among themselves the costs associated with creating and maintaining the central repository, including a provision addressing the manner in which such costs would be allocated to sponsors who join the plan after it has been approved.

Finally, proposed Rule 613(b)(5) would have required the NMS plan to require the appointment of a CCO to regularly review the operation of the central repository to assure its continued effectiveness in light of market and technological developments, and make any appropriate recommendations to the plan sponsors for enhancement to the nature of the information collected and the manner in which it is processed. In the Proposing Release, the Commission stated that it expected the CCO would establish the procedures necessary to ensure that the operations of the central repository keep pace with technical developments and to make any necessary upgrades or changes to the central repository to maintain its efficacy.[719]

The Commission received comments addressing the proposed requirements for operation and administration of the NMS plan.[720] One commenter suggested that the NMS plan should

719 See Proposing Release, supra note 4, at 32585.

720 See Nasdaq Letter I, p. 3, 13; Direct Edge Letter, p. 5; FIF Letter, p. 1, 8; FINRA Letter, p. 15; SIFMA February 2012 Letter, p. 1.

contain a voting mechanism that requires less than unanimity, and with an effective tie breaking mechanism.[721] This commenter also recommended that the governance structure "limit the ability of individual SROs to make modifications on a unilateral basis that could escalate costs by forcing the operator and firms to absorb costs that do not advance the interests of investors."[722]

Two commenters expressed views on the selection and role of the plan processor.[723] One suggested that the SROs should select the processor through a "request for proposal."[724] Another commenter generally believed that the allocation of plan processor costs warranted more consideration.[725] This commenter expressed concern with regard to the SROs owning the plan processor, noting in particular that unanimous consent would be required for all board actions.[726] This commenter stated that the plan processor alone should handle rulemaking and compliance, subject to oversight by an "industry group."[727] Another commenter stated that, "[r]egarding the governance of the national market system plan [contemplated] by the proposal, we wish to reiterate that the SEC should provide the broker-dealer industry with an official 'seat at the table' alongside the SROs, so that [the broker-dealers] can review and comment on system requirements as they are being developed and vote on plan amendments going forward."[728]

After considering these comments, for the reasons discussed below, the Commission is

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721 See Nasdaq Letter I, p. 3, 13.

722 Id. at p. 3.

723 See FIF Letter, p. 1; Direct Edge Letter, p. 5.

724 See FIF Letter, p. 8.

725 See Direct Edge Letter, p. 4-5.

726 Id. at p. 5.

727 Id.

728 See SIFMA February 2012 Letter, p. 1.

adopting Rule 613(b) as proposed, but with the addition of two new requirements. Specifically, in addition to the provisions included in the proposed rule,[729] Rule 613(b), as adopted, provides that the national market system plan submitted shall include: "a provision requiring the plan sponsors to provide to the Commission, at least every two years after effectiveness of the national market system plan, a written assessment of the operation of the consolidated audit trail . . . , [and] an Advisory Committee . . . includ[ing] representatives of the member firms of the plan sponsors."[730]

The requirement that the NMS plan require the appointment of a CCO to regularly review the operation of the central repository and make any appropriate recommendations for enhancements[731] is one method to facilitate the consolidated audit trail's ability to evolve over time in terms of technology, functionality, and accuracy. Adopted Rule 613(b)(6) supplements this requirement by now requiring that the NMS plan "include a provision requiring the plan sponsors to provide to the Commission, at least every two years after effectiveness of the national market system plan, a written assessment of the operation of the consolidated audit trail. Such

729 Proposed Rule 613(b) required that the NMS plan include "a governance structure to ensure fair representation of the plan sponsors, and administration of the central repository, including the selection of the plan processor, . . . [a] provision addressing the requirements for the admission of new sponsors of the plan and the withdrawal of existing sponsors from the plan, . . . [a] provision addressing the percentage of votes required by the plan sponsors to effectuate amendments to the plan, . . . [a] provision addressing the manner in which the costs of operating the central repository will be allocated among the national securities exchanges and national securities associations that are sponsors of the plan, including a provision addressing the manner in which costs will be allocated to new sponsors to the plan. . . [and the] appointment of a Chief Compliance Officer to regularly review the operation of the central repository to assure its continued effectiveness in light of market and technological developments, and make any appropriate recommendations for enhancements to the nature of the information collected and the manner in which it is processed."

730 See Rule 613(b)(6); Rule 613(b)(7).

731 See Rule 613(b)(5).

document shall include, at a minimum: (i) [a]n evaluation of the performance of the consolidated audit trail including, at a minimum, with respect to data accuracy (consistent with [Rule 613(e)(6)]), timeliness of reporting, comprehensiveness of data elements, efficiency of regulatory access, system speed, system downtime, system security (consistent with [Rule 613 (e)(4)]), and other performance metrics to be determined by the Chief Compliance Officer, along with a description of such metrics; (ii) [a] detailed plan, based on such evaluation, for any potential improvements to the performance of the consolidated audit trail with respect to any of the following: improving data accuracy; shortening reporting timeframes; expanding data elements; adding granularity and details regarding the scope and nature of Customer-IDs; expanding the scope of the NMS plan to include new instruments, and new types of trading and order activities; improving the efficiency of regulatory access; increasing system speed; reducing system downtime; and improving performance under other metrics to be determined by the Chief Compliance Officer; (iii) [a]n estimate of the costs associated with any such potential improvements to the performance of the consolidated audit trail, including an assessment of the potential impact on competition, efficiency, and capital formation; and (iv) [a]n estimated implementation timeline for any such potential improvements, if applicable."[732] The Commission believes these provisions will help plan sponsors understand and evaluate any deficiencies in the operation of the consolidated audit trail and to propose potential enhancements to the NMS plan, as appropriate, taking cost effectiveness into consideration. These provisions also will allow the Commission to assess any such potential improvements, accounting for the considerations contemplated by Rule 613(a)(1), the specific requirements of

732 See Rule 613(b)(6). The written assessment could also further inform the extent to which it could be appropriate to share certain information collected by the consolidated audit trail with third parties. See Section III.B.2.d.

the approved NMS plan, and any changes or additions to these requirements that the Advisory Committee, the SROs, or the Commission may wish to consider in the future. The Commission believes that such enhancements, if any, to the consolidated audit trail could improve the ability of the SROs and the Commission to conduct effective market oversight by keeping up with continually-changing technologies and markets, by, for example, allowing the SROs and the Commission to conduct their market oversight more quickly, accurately, and/or comprehensively, as well as possibly at lower costs. Similarly, the Commission believes that adding granularity and details regarding the scope and nature of Customer-IDs, adding new instruments, or including new trading or order activities could allow regulators to have a more complete picture of the markets and market participants, which could also lead to more effective market oversight. The Commission believes that performing this assessment no later than every two years is reasonable given the rapid speed at which the markets and related technologies are evolving. The Commission also believes that the written assessment, required by Rule 613(b)(6), will help inform the Commission about the likely feasibility, costs, and impact of, and the plan sponsors' approach to, the consolidated audit trail evolving over time. The Commission would expect to make the document publicly available on its website.

In response to the comment requesting that the broker-dealer industry receive a "seat at the table" regarding governance of the NMS plan,[733] the adopted Rule requires that the NMS plan submitted to the Commission for its consideration include a provision requiring the creation of an Advisory Committee, composed at least in part by representatives of the members of the plan sponsors, "to advise the plan sponsors on the implementation, operation and administration

[733] See SIFMA February 2012 Letter, p. 1.

of the central repository."[734] Further, the adopted Rule requires that the NMS plan submitted to the Commission for its consideration require that "[m]embers of the Advisory Committee shall have the right to attend any meetings of the plan sponsors, to receive information concerning the operation of the central repository, and to provide their views to the plan sponsors."[735] Pursuant to the Rule, the NMS plan also shall set forth the term and composition of the Advisory Committee, which composition shall include representatives of the member firms of the plan sponsor.[736] The Rule further provides that the plan sponsors may meet without the Advisory Committee members in executive session if, by affirmative vote of a majority of the plan sponsors, the plan sponsors determine that such an executive session is required.[737] The Commission believes that, given the scope of the Rule, both in terms of the market participants that may be affected by the Rule and the breadth of the audit trail information that will be collected, it is important that the plan sponsors solicit input from their members because this could help inform the plan sponsors of any expected or unexpected operational or technical issues that may arise in the implementation of the Rule and/or the operation of the central repository, and help assure the Commission and market participants that any requirements imposed on SRO members will be accomplished in a manner that takes into account the burdens on SRO members. The Commission believes that the Advisory Committee could provide members of the SROs with a forum for informing the plan sponsors of any potential implementation or operational issues faced by them in connection with the consolidated audit trail. Plan sponsors also will be able to draw on the knowledge and experience of these members

734 See Rule 613(b)(7)(i).

735 See Rule 613(b)(7)(ii).

736 See Rule 613(b)(7)(i).

737 See Rule 613(b)(7)(ii).

to help assure the Commission and market participants that any requirements imposed on SRO members will be accomplished in a manner that takes into account the costs to SRO members. The Commission also believes that an Advisory Committee could help foster industry consensus on how to approach and resolve possible issues that may be disputed, and approaches that may conflict, regarding operation of the consolidated audit trail. In this regard, the Commission encourages the plan sponsors to, in the NMS plan, provide for an Advisory Committee whose composition includes SRO members from a cross-section of the industry, including representatives of small-, medium- and large-sized broker-dealers.

The Commission believes the requirement for the NMS plan to create the Advisory Committee, as well as the requirement in Rule 613(a)(1)(xi), discussed below, that requires the NMS plan to require a discussion of the process by which the plan sponsors solicited the views of their members on the creation, implementation, and maintenance of the consolidated audit trail, a summary of those views, and how the plan sponsors took those views into account when preparing the NMS plan, are responsive to commenters' views that more input by industry representatives, such as members of the SROs who are subject to the requirements of Rule 613, would be advantageous to the creation, implementation, and maintenance of the consolidated audit trail.[738]

In addition, because the members of the Advisory Committee will have the right to attend all meetings of the plan sponsors (with the exception of executive sessions), to receive information concerning the operation of the central repository, and to provide their views to the plan sponsors, the governance process of the central repository will be more transparent to all market participants that will be affected by Rule 613. Further, the Commission believes the

738 See Rule 613(a)(1)(xi); Section III.C.2.a.iii.c., infra, for a discussion of the tenth consideration.

inclusion of SRO members on the Advisory Committee will increase the efficacy of the central repository. These market participants will have first-hand experience with the operation of the central repository, as they are required to report data to the facility, allowing them to provide informed input on any problems currently facing the central repository of which they are aware, and on any future actions that the central repository might or should take to address such problems. Finally, the Commission believes that an Advisory Committee structure that also permits the plan sponsors to meet in executive session without members of the Advisory Committee appropriately balances the need to provide a mechanism for industry input into the operation of the central repository, against the regulatory imperative that the operations and decisions regarding the consolidated audit trail be made by SROs who have a statutory obligation to regulate the securities markets, rather than by members of the SROs, who have no corresponding statutory obligation to oversee the securities markets.

The Commission also considered the comment that provided other suggestions on the governance of the NMS plan and believes that the commenter's concerns regarding a unanimity requirement in the NMS plan have merit.[739] Accordingly, the Commission urges the SROs to take into account the need for efficient and fair operation of the NMS plan governing the consolidated audit trail, and consider the appropriateness of a unanimity requirement and the possibility of a governance requirement other than unanimity, or even super-majority approval, for all but the most important decisions. The Commission believes that an alternate approach may be appropriate to avoid a situation where a significant majority of plan sponsors – or even all but one plan sponsor – supports an initiative but, due to a unanimous voting requirement,

[739] See Nasdaq Letter I, p. 3, 13.

action cannot be undertaken.[740] Therefore, the Commission believes the SROs should consider alternative governance structures that would ensure that decisions made by the SROs are both achieved and implemented efficiently, in the interest of advancing the Commission's mission. The Commission notes that the NMS plan submitted to the Commission for its consideration will be published for public comment, and industry participants will have an opportunity at that time to submit comments on the governance structures proposed by the plan sponsors. Further, the Commission believes, as discussed above, that unanimity need not be the standard for decision-making with regard to matters relating to the operation of the consolidated audit trail. Thus, the plan sponsors have flexibility under the Rule to determine the governance structures that will facilitate the effective and efficient oversight of the plan processor.

In response to the comments regarding the selection and role of the plan processor,[741] the Commission believes that the SROs, as the plan sponsors of the NMS plan governing the operation of the consolidated audit trail, should retain the authority to select and oversee the plan processor. The Commission believes that the SROs are in the best position to understand how the plan processor should operate and to address the need for changes when necessary. The SROs also have the flexibility under the Rule to consult the Advisory Committee, for example, to assist the SROs in their selection process and in their determination of whether modifications are necessary to address innovations in the industry if they believe that such participation is needed.

The Commission acknowledges that, in addition to the many costs and burdens associated with the creation, implementation, and maintenance of a consolidated audit trail, with

740 See, e.g., Options Order Protection and Locked/Crossed Market (Securities Exchange Act Release No. 60405 (July 30, 2009), 74 FR 39362 (August 6, 2009)) (including a unanimous voting requirement).

741 See FIF Letter, p. 1; Direct Edge Letter, p. 5.

regards to the specific requirements discussed in this section, there would be costs to the SROs for appointing a CCO to the central repository, providing the Commission with the written assessment of the operation of the consolidated audit trail, and creating an Advisory Committee.[742] For the reasons discussed above, the Commission believes these requirements are important to the efficient operation and practical evolution of the consolidated audit trail, and are responsive to many commenters' concerns about governance structure, cost allocations, and the inclusion of SRO members as part of the planning process. The Commission is therefore requiring the SROs to include these requirements in the NMS plan submitted to the Commission for its consideration. After the SROs submit the NMS plan, the Commission and the public will have more detailed information in evaluating the NMS plan.

c. Surveillance

As proposed, Rule 613(f) would have required each SRO subject to the Rule to develop and implement a surveillance system, or enhance existing surveillance systems, reasonably designed to make use of the consolidated audit trail data. The Rule, as proposed, also would have required each SRO to implement its new or enhanced surveillance system within fourteen months after the effectiveness of the NMS plan.[743]

Commenters generally expressed support for the proposal's requirement that SROs implement surveillance systems that make use of the consolidated information.[744] One commenter stated that the enhanced surveillance that could be achieved with the audit trail would

742 As discussed and for the reasons set forth in Section I., supra, in light of the multi-step process for developing and approving an NMS plan that will govern the creation, implementation, and maintenance of a consolidated audit trail, the Commission is deferring a detailed analysis of costs and benefits of this requirement of the Rule until after the NMS plan has been submitted.

743 See proposed Rule 613(a)(3)(iv).

744 See Nasdaq Letter I, p. 10; Thomson Reuters Letter, p. 4.

likely attract additional trading volume to the U.S. markets and that the consolidated audit trail would benefit the SROs by permitting them to conduct surveillance themselves, thus "reducing their risks and their costs."[745] Another commenter noted that the proposed consolidated audit trail would be a "critical first step toward consolidated market surveillance," and would lower costs for markets and their participants through economies of scale.[746] A third commenter opined that a centralized database such as the consolidated audit trail is necessary to bring together data from exchanges, ECNs, and dark pools to properly regulate trading.[747] However, one commenter maintained that a "Commission-mandated market regulator" would be costly for the securities industry and create the potential for a lack of surveillance innovation.[748] A commenter recommended that the Commission monitor the surveillance systems and provide guidance to the SROs in establishing their surveillances.[749] Finally, one commenter suggested that outsourcing surveillance to regulators could result in lower costs for markets, and recommended several specific security and analytical features for such a surveillance system.[750]

After considering the comments, for the reasons discussed below, the Commission is adopting Rule 613(f) as proposed. Specifically, the Rule requires that each SRO develop and implement a surveillance system, or enhance existing surveillance systems, reasonably designed to make use of the consolidated information contained in the consolidated audit trail.[751] The Commission believes that it is appropriate to require SROs to enhance their surveillance

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745 See Thomson Reuters Letter, p. 4.

746 See FINRA/NYSE Euronext Letter, p. 3-4. See also Nasdaq Letter I, p. 8.

747 See IAG Letter, p. 2.

748 See BATS Letter, p. 2-3.

749 See Nasdaq Letter I, p. 10.

750 See iSys Letter, p. 2-3.

751 See Rule 613(f).

programs to make full use of the increased functionalities and the timeliness of the consolidated audit trail. Additionally, because trading and potentially manipulative activities could take place across multiple markets, the Commission supports efforts to coordinate surveillance among the SROs, such as through a plan approved pursuant to Rule 17d-2 under the Exchange Act,[752] or through regulatory services agreements between SROs. In this regard, as commenters have noted, SROs could "outsource" surveillance efforts to another SRO, if there are efficiencies to be gained. With respect to the comment regarding the benefits to be gained by creating a "single market regulator," the Commission believes that mandating such an entity or structure goes beyond the scope of the Rule.[753]

The Commission notes that it intends to review its own surveillance activities in light of the consolidated audit trail and intends to take steps to enhance its surveillance capabilities to take advantage of consolidated audit trail data. The Commission anticipates that such steps will be informed by – and may in turn help inform – the surveillance enhancement measures required to be taken by the SROs under adopted Rule 613(f).

The Commission also is adopting Rule 613(a)(3)(iv) as proposed, which requires the NMS plan to require each SRO to implement its new or enhanced surveillance system within fourteen months after the effectiveness of the NMS plan. Since Rule 613(a)(3)(iii) will require the NMS plan to require SROs to begin reporting to the central repository within one year after effectiveness of the NMS plan, the Commission believes the two additional months provided by

752 17 CFR 240.17d-2.

753 The Commission has examined the issue of a single market regulator in the past, specifically in the Intermarket Trading Concept Release (see Securities Exchange Act Release No. 47849 (May 14, 2003), 68 FR 27722 (May 20, 2003)); however, a single regulator structure is not suggested by the adopted Rule.

this timeframe is reasonable and sufficient to allow SROs to update their surveillance systems and allow for testing of new surveillances.

The Commission acknowledges there would be costs to the SROs for developing and implementing surveillance systems, or enhancing existing surveillance systems, reasonably designed to make use of the consolidated audit trail. However, the Commission believes it may be possible for SROs to retire some of their existing, and perhaps less-efficient, audit trail and surveillance systems once the consolidated audit trail is operational. As discussed in Section III.C.a.iv. below, the adopted Rule requires the SROs to consider and discuss the potential for costs savings if other SRO systems, and their associated surveillances, were migrated to the consolidated audit trail.[754] Once such information is submitted in the NMS plan submitted to the Commission for its consideration, the Commission and the public will be able to consider the information in evaluating the NMS plan.

C. NMS Plan Process

As proposed, Rule 613(a)(1) would have required each SRO to jointly file on or before 90 days from approval of the Rule an NMS plan to govern the creation, implementation, and maintenance of a consolidated audit trail and a central repository. Section III.A. above discusses the use of an NMS plan to create, implement, and maintain a consolidated audit trail. This Section focuses on the process the SROs must follow when submitting to the Commission the NMS plan that satisfies the requirements discussed in Section III.B. above and the process the Commission will undergo when evaluating whether to approve the NMS plan.

1. Comments on the NMS Plan Process

754 These cost savings may accrue to any SRO that would no longer need to operate a retired system, as well as to any SRO members that would no longer be required to report to such systems.

The Commission received several comments regarding how best to develop an NMS plan that will govern the creation and implementation of a consolidated audit trail, as well as the time needed to do so. Several commenters suggested that the Commission undergo a RFP or RFI process to create a consolidated audit trail.[755] Specifically, one commenter suggested that the Commission outline a set of goals it intends to achieve through creation of a consolidated audit trail and allow an industry working group to determine the data elements that must be reported and other technical requirements.[756] Another commenter opined that an RFP process would facilitate the identification of the costs and benefits of the audit trail, as well as the consideration of a wider range of technological solutions.[757] Further, some commenters requested more specific information about the audit trail system to determine the best approach for implementing the consolidated audit trail.[758]

Some of these commenters stressed that more time should be allotted for the planning and design of the NMS plan due to the comprehensive business analysis that would be needed in the initial stages of the consolidated audit trail.[759] Commenters recommended extensive, "up-front business analysis,"[760] explaining that if conducted "during the CAT plan development process, [they] are confident that issues would emerge earlier in the process, leading to more efficient and

755 See FIF Letter, p. 1, 9; FIF Letter II, p. 1-2; STA Letter, p. 2; Direct Edge Letter, p. 2-3, 5. See also Section II.C.3.

756 See FIF Letter II, p. 2.

757 Id. at p. 3.

758 See Broadridge Letter, p. 2; FIF Letter, p. 8. See also Ross Letter, p. 1 (discussing examples of information security details to consider); Nasdaq Letter I, p. 6 (stating that the proposed Rule provided "incomplete technical information on which design and features make the most sense").

759 See FIF Letter II, p. 2-3; STA Letter, p. 2. See also Nasdaq Letter I, p. 6.

760 See FIF Letter II, p. 1, 3; STA Letter, p. 1, 3. See also Nasdaq Letter I, p. 6.

cost-effective solutions."[761] The commenters believed that the business analysis would require many discussions involving the Commission, the SROs and teams comprising members of the securities industry.[762] The commenters also suggested that the business analysis could include an RFI "to engage potential solution providers early in the process,"[763] and stated that the time needed to perform the analysis to produce a "detailed blueprint for CAT"[764] would be closer to six months,[765] rather than the proposed 90 days.[766] As a basis for their suggestions, one of the commenters provided a breakdown of the time and the types of work needed for FINRA's expansion of OATS to all NMS securities.[767] This commenter noted that over one-third of the time required for the project was spent on conducting business analysis, and that one-third of the time was spent on project development.[768]

In addition, some commenters noted that a consolidated audit trail could be implemented in a number of ways, and thus recommended that the Commission replace the specific system requirements of the proposed Rule with more general "end-user" requirements, perform an

761 See FIF Letter II, p. 2; STA Letter, p. 1.

762 See FIF Letter II, p. 1; STA Letter, p. 1-2.

763 See FIF Letter II, p. 2; STA Letter, p. 2.

764 See FIF Letter II, p. 1-2; STA Letter, p. 2.

765 See FIF Letter II, p. 2; STA Letter, p. 2-3.

766 See proposed Rule 613(a)(1).

767 See FIF Letter II, p. 3. The commenter also provided the cost to the industry for the expansion of OATS to all NMS stocks - $48 million. The Commission notes that this is the cost for the project as a whole, not solely for the planning phase, and therefore is not entirely attributable to the cost of the creation and filing of the NMS plan required by Rule 613.

768 The time remaining was spent on "testing and other activities." See FIF Letter II, p. 3.

analysis of how existing audit trail systems do and do not meet the needs of regulators, and perhaps even engage in a formal RFP process.[769]

2. Adopted Rule

After considering the comments regarding the NMS plan process, the Commission is adopting proposed Rule 613(a)(1) with modifications. First, the Rule now requires the SROs to provide much more information and analysis to the Commission as part of their NMS plan submission. These requirements have been incorporated into the adopted Rule as "considerations" that the SROs must address, and generally mandate that the NMS plan discuss: (1) the specific features and details of the NMS plan (e.g., how data will be transmitted to the central repository, and when linked data will be available to regulators); (2) the SROs' analysis of NMS plan costs and impact on efficiency, competition, and capital formation; (3) the process followed by the SROs in developing the NMS plan (e.g., solicitation of input from members of the SROs); and (4) the information about the implementation and milestones of the consolidated audit trail. Second, the Commission is furnishing further details about how it envisions regulators would use, access, and analyze consolidated audit trail data through a number of "use cases." Third, the Commission is extending the amount of time allowed for the SROs to submit the NMS plan from 90 days from the date of approval of Rule 613 to 270 days from the date of publication of the Adopting Release in the Federal Register. A discussion of these modifications and the "use cases" follows.

[769] See Nasdaq Letter I, p. 12; FIF Letter II, p. 2-3; STA Letter, p. 1-3; Direct Edge Letter, p. 2-3, 5.

a. NMS Plan Considerations

As noted above,[770] the Commission believes that the collective effect of the modifications and additions described above will be to significantly expand the solution set that could be considered by the SROs for creating, implementing, and maintaining the consolidated audit trail and provide the SROs with increased flexibility in how they choose to meet the requirements of the adopted Rule. Further, given these changes to the Rule discussed above and the wide array of commenter's views on how to best implement a consolidated audit trail,[771] the Commission expects that the SROs will seriously consider various options as they develop the NMS plan to be submitted to the Commission for its consideration. The costs and benefits of the consolidated audit trail are highly dependent on the specific solutions proposed by SROs.

Accordingly, as part of the multi-step process for developing and approving an NMS plan that will govern the creation, implementation, and maintenance of a consolidated audit trail, the Commission is deferring its economic analysis of the actual creation, implementation, and maintenance of a consolidated audit trail itself (in contrast to the costs of the actions the SROs are required to take upon approval of the adopted Rule[772]) until such time as it may approve the NMS plan submitted to the Commission for its consideration. In light of the expanded set of solutions that should be available as a result of the changes described above and to facilitate a more robust economic analysis, the adopted Rule now requires the SROs to provide much more

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770 See Section I., supra.

771 See, e.g., FINRA Letter, p. 14 (advocating that SROs build off existing audit trails to develop a consolidated audit trail) and Nasdaq Letter I, p. 11-12 (arguing against building off existing audit trail systems and supporting the development of new system to establish a consolidated audit trail). See also Section II.C.4., supra.

772 These actions include the requirement that the SROs develop an NMS plan, utilizing their own resources and undertaking their own research that addresses the specific details, cost estimates, considerations, and other requirements of the Rule.

information and analysis to the Commission as part of their NMS plan submission. The Commission is therefore requiring the SROs to discuss, as part of their NMS plan "considerations" that detail how the SROs propose to implement the requirements of the plan, cost estimates for the proposed solution, and a discussion of the costs and benefits of alternate solutions considered but not proposed.

This additional information and analysis are intended to ensure that the Commission and the SROs have sufficiently detailed information to carefully consider all aspects of the NMS plan ultimately submitted by the SROs, facilitating an analysis of the extent to which the NMS plan would allow regulators to effectively and efficiently carry out their responsibilities. The NMS plan submitted by the SROs will be published for public comment and reviewed by the Commission for consistency with the Exchange Act and the rules thereunder. As a result, all interested persons, including market participants, regulatory authorities, and the general public, will have an opportunity to provide meaningful comments on the details and costs of the NMS plan submitted, which the Commission will review and consider.

i. Features and Details of the NMS Plan

The first six considerations the Rule requires the SROs to address in the NMS plan relate to the features and details of the NMS plan. These six considerations require the NMS plan to specify and explain the choices made by the SROs to meet the requirements specified in the Rule for the consolidated audit trail. The Commission intends to use the discussion of these considerations to evaluate the NMS plan submitted for its consideration and how well it meets the objectives described in Section II.B.2.

- <u>Rule 613(a)(1)(i)</u>

Rule 613(a)(1)(i) requires the NMS plan submitted to discuss "[t]he method(s) by which data is reported to the central repository, including, but not limited to, the sources of such data and the manner in which the central repository will receive, extract, transform, load and retain such data. . . ." The Rule also requires the NMS plan to discuss the basis for selecting such method(s).

The Commission believes that requiring that the NMS plan discuss the method(s) by which data is reported to the central repository is important because the method for reporting data and the source of the data are significant to the effectiveness of the consolidated audit trail and could affect, and potentially enhance, the reliability and the accuracy of the data that is reported to the central repository.[773] Discussing such method(s), as well as the basis for selecting such method(s), should help assure the Commission that the plan sponsors have considered the various alternatives and selected the method(s) that best achieves the objectives of the consolidated audit trail in a cost-effective manner.[774] In addition, Rule 613(a)(1)(i) requires that the NMS plan describe how the central repository will receive, extract, transform, load and retain data because the Commission believes that this information is integral to a comprehensive understanding of the operation of the central repository proposed in the NMS plan.

- Rule 613(a)(1)(ii)

Rule 613(a)(1)(ii) requires the NMS plan to address "[t]he time and method by which the data in the central repository will be made available to regulators, in accordance with [Rule 613(e)(1)] to perform surveillance or analyses, or for other purposes as part of their regulatory and oversight responsibilities."

The time and method by which data will be made available to regulators are fundamental

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773 See Section III.B.2.c., supra.

774 The Commission notes that another related consideration that must be discussed by the NMS plan includes the alternative approaches to creating the consolidated audit trail that the plan sponsors considered. See Rule 613(a)(1)(xii).

to the utility of the consolidated audit trail because the purpose of the consolidated audit trail is to assist regulators in fulfilling their responsibilities to oversee the securities markets and market participants.[775] The NMS plan submitted should discuss these issues in detail, guided, in particular, by the issues and questions raised in the "Regulator Use Cases" described in Section III.C.2.b., below.

The importance of this consideration was discussed in the Proposing Release.[776] The Commission emphasized the necessity of the data being in a uniform electronic format so that regulators would be able, among other things, to effectively and efficiently detect and investigate illegal trading across markets, without having to spend valuable time and resources reconciling audit trail formatting differences in the data.[777] In addition, the Proposing Release noted that requiring the order and trade data to be collected in one location in a single format would allow regulators ready access to the data for use in market reconstructions, market analyses, surveillance and investigations,[778] as regulators could then retrieve the information that they need much faster than the current process of requesting data from multiple parties without having to reconcile disparate audit trail information. Also, in the Proposing Release, the Commission noted the importance of SRO regulatory staff having direct access to consolidated audit trail data.[779] The Commission continues to believe that it is vital that regulators have ready access to the consolidated audit trail data in the central repository so that this information can be

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775 See Section II.A., supra, for additional discussion of the timeliness of access to current audit trail data.

776 See Proposing Release, supra note 4, at 32564.

777 Id. at 32564-32565 and 32594. Differences in audit trail data requirements between markets can hinder the ability of regulators to piece together related illegal trading activity occurring across several markets.

778 Id. at 32594.

779 Id. at 32567.

effectively and efficiently used in fulfilling their regulatory responsibilities.

- Rule 613(a)(1)(iii)

Rule 613(a)(1)(iii) requires the NMS plan to address "[t]he reliability and accuracy of the data reported to and maintained by the central repository throughout its lifecycle, including transmission and receipt from market participants; data extraction, transformation and loading at the central repository; data maintenance and management at the central repository; and data access by regulators."

The Commission believes the reliability and accuracy of the data is a critical aspect of the consolidated audit trail, because the usefulness of the data to regulators would be significantly impaired if it is unreliable or inaccurate. If the reliability and accuracy of reported data is not maintained by the central repository during the period it is required to be retained and throughout the various uses to which it may be put by regulators, then its value to regulators will be substantially diminished.

Accordingly, the NMS plan submitted should discuss in detail, among other things, how the consolidated audit trail envisioned by the sponsors would be designed, tested and monitored to ensure the reliability and accuracy of the data collected and maintained by the central repository (e.g., during transmission from the SRO or member to receipt by the central repository,[780] data extraction, transformation and loading at the central repository,[781] data

780 "Transmission from the SRO or member to receipt by the central repository" refers to the process through which SROs and their members report data to the central repository.

781 "Data extraction, transformation and loading at the central repository" is the process during which the central repository accepts data reported by the SROs and their members, converts it into a uniform electronic format, if necessary, and receives it into the central repository's internal systems.

maintenance and management at the central repository,[782] and data access by regulators[783]).

The Commission notes that, when proposing Rule 613, it highlighted the importance of this consideration by emphasizing that the reliability and accuracy of the data are critical to the integrity and effectiveness of the consolidated audit trail.[784] Indeed, Rule 613(e)(4)(ii), like the proposed Rule, specifically requires the plan sponsors to establish policies and procedures for the plan processor to ensure the timeliness, accuracy and completeness of the audit trail data reported to the central repository.

- Rule 613(a)(1)(iv)

Rule 613(a)(1)(iv) requires the NMS plan to discuss "[t]he security and confidentiality of the information reported to the central repository."

The Commission is including this consideration because it believes that keeping the data secure and confidential is crucial to the efficacy of the consolidated audit trail and the confidence of market participants. Exposure of highly-confidential information about the trading strategies and positions of market participants through a security breach, for example, could impact the confidence of the public in the central repository and in trading on the U.S. markets. The Commission understood the importance of security and confidentiality provisions when it proposed Rule 613(e)(4) to require the NMS plan to include policies and procedures, including

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782 "Data maintenance and management at the central repository" refers to the process for storing data at the central repository, indexing the data for linkages, searches, and retrieval, dividing the data into logical partitions when necessary to optimize access and retrieval, and the creation and storage of data backups.

783 As noted in Section III.B.1.d.iv., supra, for example, regardless of whether the NMS plan elects to use a series of order identifiers or a unique order identifier, it will be very important to demonstrate how the approach selected in the NMS plan will ensure that information about all events pertaining to an order will be reliably and accurately linked together in a manner that allows regulators efficient access to complete order information.

784 See Proposing Release, supra note 4, at 32582, 32596.

standards, to be used by the plan processor to ensure the security and confidentiality of all information reported to, and maintained by, the central repository.[785] Numerous commenters also noted the importance of maintaining the security and the confidentiality of the data collected pursuant to the proposed Rule.[786]

- <u>Rule 613(a)(1)(v)</u>

Rule 613(a)(1)(v) requires the NMS plan to address "[t]he flexibility and scalability of the systems used by the central repository to collect, consolidate and store consolidated audit trail data, including the capacity of the consolidated audit trail to efficiently incorporate, in a cost-effective manner, improvements in technology, additional capacity, additional order data, information about additional securities or transactions, changes in regulatory requirements, and other developments."

The Commission believes that the flexibility and scalability of the systems used by the central repository are important to the effectiveness of the consolidated audit trail, and, accordingly, the Commission believes the NMS plan under Rule 613 should address potential "built-in" obsolescence that may arise as a result of the SROs' choice of systems or technology. For this reason, the NMS plan should address how, taking into consideration the costs and benefits, including the potential impact on competition, efficiency, and capital formation, the consolidated audit trail systems might be designed to accommodate: (1) potential growth in the

785 In addition, proposed Rule 613(e)(4)(i) required plan sponsors, and employees of the plan sponsors and central repository to agree to use appropriate safeguards to ensure the confidentiality of such data, and not to use such data other than for surveillance and regulatory purposes.

786 <u>See</u> Scottrade Letter, p. 2; ICI Letter, p. 2-4; Liquidnet Letter, p. 4; Ameritrade Letter, p. 3; Thomson Reuters Letter, p. 4; BATS Letter, p. 3; Managed Funds Association Letter, p. 2-3; Ross Letter, p. 1. The Commission notes that it is adopting Rule 613(e)(4) with modifications – the Commission has added provisions to the Rule to help ensure the confidentiality of the data submitted to and retained by the central repository. <u>See</u> Section III.B.2.e., <u>supra</u>.

trading volume or message traffic relating to NMS securities; (2) possible expansion to include other non-NMS securities;[787] (3) additional data fields that the SROs or the Commission might determine to require in the future (such as new order characteristics); and (4) potential technological developments that might allow the consolidated audit trail to be operated in a more timely, reliable, and cost-effective manner.

As noted in the Commission's Concept Release on equity market structure,[788] the market for trading securities has changed dramatically in recent years and, as technology advances, trading systems and trading strategies also change. The Commission believes that it is important for the consolidated audit trail to keep pace with market developments. It must be designed in a way that allows it to do so efficiently and in a cost-effective manner to assure regulators of its continued usefulness. Thus, the Commission has identified the flexibility and scalability of the systems used by the central repository to collect, consolidate and store audit trail data as a consideration that must be discussed in the NMS plan submitted to the Commission for its consideration. To sufficiently address this consideration, the Commission expects the NMS plan to describe in detail how the consolidated audit trail envisioned by the sponsors would be designed to accommodate additional message traffic for orders in NMS securities, how readily

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787 Rule 613(i) requires the NMS plan to include a provision requiring each SRO to jointly provide to the Commission a document outlining how the consolidated audit trail could be expanded to products other than NMS securities. See also Section III.B.1.a., supra. The consideration of flexibility and scalability of the systems requires the SROs to address whether the system proposed in the SRO's NMS plan submission can accommodate the expansion, while the document required by Rule 613(i) will discuss more broadly how the SROs could incorporate into the consolidated audit trail information with respect to equity securities that are not NMS securities, debt securities, primary market transactions in equity securities that are not NMS securities, and primary market transactions in debt securities, including details for each order and reportable event that may be required to be provided, which market participants may be required to provide the data, an implementation timeline, and a cost estimate.

788 See Concept Release on Equity Market Structure, supra note 87.

capacity could be expanded, and the existence of any capacity limits. The Commission also would expect the NMS plan to discuss in detail the extent to which the proposed consolidated audit trail could accommodate potential additional data elements, order characteristics, and other types of securities such as non-NMS securities, debt securities, primary market transactions in equity securities that are non-NMS securities, and primary market transactions in debt securities, how quickly this could be done, and whether any limits exist on the ability of the proposed system to accommodate these types of changes. Additionally, the Commission would expect the NMS plan to further discuss whether and how the consolidated audit trail could be upgraded to keep pace with improvements in technology, such as improvements to the speed of systems processing.

The Commission believes these descriptions are important because, otherwise, what initially appears to be an effective and cost-effective NMS plan could become significantly less so over time as markets evolve and if, for example, order volumes increase, new order types are developed, and additional data elements or other types of securities, such as non-NMS securities, debt securities, primary market transactions in equity securities that are non-NMS securities, and primary market transactions in debt securities, are potentially incorporated into the consolidated audit trail.

The Commission notes that issues relating to the potential flexibility and scalability of the consolidated audit trail were raised in the Proposing Release. For example, the Commission stated that, while the proposal was limited to NMS securities, the Commission ultimately intended the consolidated audit trail to cover secondary market transactions in other securities and information on primary market transactions.[789] In fact, as discussed above, the Commission

[789] See Proposing Release, supra note 4, at 32568-32569.

specifically proposed that the NMS plan contain provisions relating to the possible expansion of the consolidated audit trail to products other than NMS securities.[790] In addition, in the Proposing Release, the Commission specifically noted its concerns with the lack of scalability of the existing EBS system and the fact that the volume of transaction data subject to reporting under the EBS system can be significantly greater than the system was intended to accommodate in a typical request for data.[791]

- Rule 613(a)(1)(vi)

Rule 613(a)(1)(vi) requires the NMS plan to address "[t]he feasibility, benefits, and costs of broker-dealers reporting to the consolidated audit trail in a timely manner: (A) [t]he identity of all market participants (including broker-dealers and customers) that are allocated NMS securities, directly or indirectly, in a primary market transaction; (B) [t]he number of such securities each such market participant is allocated; and (C) [t]he identity of the broker-dealer making each such allocation."

In the Proposing Release, the Commission stated that "it would be beneficial to provide for the possible expansion of the consolidated audit trail to include information on primary market transactions in NMS stocks" and required in proposed Rule 613 that the plan sponsors address such expansion in a document provided to the Commission within two months after effectiveness of the NMS plan.[792] The Commission continues to believe, for the reasons set forth below, that a potential expansion of the consolidated audit trail to cover primary market

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790 Id. at 32569-70.

791 Id. at 32567.

792 See Proposing Release, supra note 4, at 32569 and 32610. The Commission noted in the Proposing Release that a "primary market transaction is any transaction other than a secondary market transaction and refers to any transaction where a person purchases securities in an offering." Proposing Release at n. 167.

transactions would be beneficial. Specifically, the Commission believes that the SROs should address – at the time of the submission of the NMS plan to the Commission, rather than as part of a later expansion plan – the feasibility, benefits, and costs of recording and reporting information about allocations of NMS securities in primary market transactions as part of the consolidated audit trail.

As with the data sources discussed in Section II.A, the sources of information currently available to the Commission regarding allocations of NMS securities in primary market transactions are each limited in their ability to provide accurate, complete, accessible, and timely information.[793] For example, while the Commission and FINRA can request information about allocations from the books and records of broker-dealers, such requests are unduly cumbersome for both regulators and market participants, potentially involving multiple time-consuming individual requests.[794] Other sources of information about allocations of NMS securities in primary market transactions – including public sources[795] – are also limited in certain respects.[796]

793 See Section II.A. for a discussion of these four qualities.

794 See, e.g., Exchange Act Rules 17a-3 and 17a-4 (requiring broker-dealers to make and keep "records of purchases and sales of securities").

795 Regulation S-K requires registrants to provide information related to the number of offered securities that are underwritten by each syndicate member in an effort to describe the nature of the obligation of the syndicate members with respect to the offered securities. See 17 CFR 229.508(a). This information comprises investor-focused disclosures, rather than information that may be needed by regulators for investigative and other purposes, such as the information contemplated by Rule 613(a)(1)(vi).

796 For example, FINRA rules require the lead underwriters of an IPO to collect and provide issuers – but not the public, FINRA, or the Commission – with names of institutional investors who received allocations and aggregated information regarding the allocation to retail investors. See FINRA Rule 5131(d).

The Depository Trust Company ("DTC") also collects information on some IPO allocations in its IPO Tracking System at the discretion of the lead underwriter. See 61 FR 25253 (May 20, 1996). However, as well as being discretionary and therefore only addressing a subset of primary market transactions, the IPO Tracking System only

In light of these limitations, data about the allocations of NMS securities in primary market transactions could also improve market analysis by the Commission and the SROs, which could in turn help better inform rulemaking and other policy decisions. Specifically, such data might aid the Commission and the SROs in better understanding the role of such allocations in the capital formation process. Combining this data with the secondary market data to be collected by the consolidated audit trail could allow regulators to calculate investor positions and when and how the investors receiving allocations sell their securities. Such data could also facilitate a better understanding of how securities are allocated in a primary market transaction, how allocations differ across broker-dealers and investors, and what types of investors are allocated securities. This analysis is virtually infeasible on a market-wide basis today because the data collection process using current sources of information is so cumbersome.

In addition, if the consolidated audit trail included data regarding the allocations of NMS securities in primary market transactions, SROs could be better able to monitor for compliance with their rules related to such transactions.[797] The data also could more broadly assist SROs in their examinations and investigations related to allocations in initial public offerings ("IPOs") and other primary market transactions by providing a richer data set for evaluating possible compliance issues. For example, the SROs could use IPO allocation information, combined with the secondary market transaction information in a consolidated audit trail, to run surveillance on

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includes allocations to persons with DTC accounts, which generally excludes retail investors.

797 See, e.g., FINRA Rules 5130 and 5131. FINRA Rule 5130 imposes certain restrictions on primary market transactions. FINRA Rule 5131 prohibits certain allocation practices such as "spinning," which refers to an underwriter's allocation of IPO shares to directors or executives of investment banking clients in exchange for receipt of investment banking business. See Securities Exchange Act Release No. 64521 (May 18, 2011), 76 FR 29808 (May 23, 2011) (Order Approving SR-FINRA-2011-017). Certain "quid pro quo" practices are also addressed by FINRA Rule 5131.

whether sales in the IPO auction were marked accurately (i.e., "long" or "short") and in compliance with applicable requirements.[798] Allocation data could also allow SROs to conduct surveillance for "red flags" they might develop regarding potential suitability issues related to customer allocations, as well as potentially improper allocations to customers (such as kickbacks).

The Commission could also enhance its own examination and investigation processes if data regarding the allocations of NMS securities in primary market transactions were included in the consolidated audit trail. Without access to a single centralized database of allocations, Commission staff must rely on more limited data sources that generally enable only either broad-based sweeps or one-off investigations based on particularized suspicion of wrongdoing. Because the relevant data would be readily available for analysis, including information about allocations as part of the consolidated audit trail could facilitate the Commission's identification of particular risks and exam candidates. Other examinations undertaken by the Commission staff address whether employees of a regulated entity are in compliance with the rules applicable to their transactions related to primary market transactions. Having allocation information available before such an examination commences could allow staff to enhance their pre-examination research, better focus on the sources of potential violations, and ultimately foster more effective and efficient examinations.

In investigations related to primary market transactions, the Commission staff generally must obtain data from underwriters post-transaction, which can take considerable time owing to

[798] Currently, SROs must request customer account information during examinations of broker-dealers to check for compliance with order marking rules.

the limitations on current sources of data noted above.[799] Including data about the allocations of NMS securities in primary market transactions in the consolidated audit trail could enable investigations to proceed more efficiently and to more quickly assess whether alleged violations of various rules under the Exchange Act, such as Regulation M and Rule 10b-5, warrant investigation.[800] In addition, the Commission believes that information about allocations could help the SROs and Commission investigate allegations of improper allocations, such as allocations subject to "spinning"[801] or "laddering."[802] Currently, these types of investigations would require requesting data from underwriters, and in some cases, other parties (such as investment advisors) involved in the primary market transaction.

Given these potential benefits, the Commission believes that it is important – consistent with its view in the Proposing Release – for the SROs to address the feasibility, benefits, and costs of recording and reporting information about allocations of NMS securities in primary market transactions as part of the consolidated audit trail. However, unlike other potential additions to the consolidated audit trail – e.g., the inclusion of debt securities – that will be contemplated later in expansion plans, allocations of NMS securities in primary market transactions are uniquely tied to the central element of the NMS plan – the reporting of data

799 This approach also may unduly burden the lead underwriter as the "gatekeeper" of such information and prevents the Commission and SROs from pursuing investigative techniques that may rely on reaching out to individual market participants for preliminary information without using the underwriter.

800 See note 242, supra.

801 See note 795, supra.

802 "Laddering" is a practice that generally refers to inducing investors to give orders to purchase shares in the aftermarket at particular prices in exchange for receiving IPO allocations. See NYSE/NASD IPO Advisory Committee report and Recommendations (May 2003), at 6, available at http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p010373.pdf.

regarding trading in NMS securities. For example, allocations in primary market transactions may have a significant impact on trading and other activity in the secondary market, and behavior in the primary market may influence behavior in the secondary market through initial pricing and other mechanisms. More broadly, IPOs and other primary market transactions continue to be a source of particular interest for market participants and observers because of, among other things, their role in the capital formation process. In light of these considerations, the Commission believes it is appropriate to require the SROs to address allocations of NMS securities in primary market transactions at the time that the NMS plan is submitted under adopted Rule 613(a)(1), rather than as part of an expansion plan under adopted Rule 613(i).

At the same time, the Commission recognizes that firms may use systems and methods to handle information regarding allocations of NMS securities in primary market transactions that differ from those used to handle information regarding secondary market transactions in such securities. Such differences may affect the extent to which information regarding allocations may be readily incorporated into the consolidated audit trail described by the NMS plan mandated by Rule 613. For example, the unique features of allocations of NMS securities in primary market transactions may require different reporting timeframes, different information security controls, or additional data elements that would not be required for other information being reported to the central repository and that are not contemplated by Rule 613. Because of these potential differences, the Commission believes it is appropriate to require the SROs to address the feasibility, costs, and benefits of their members reporting information regarding allocations of NMS securities in primary market transactions, rather than require the NMS plan to require such reporting at the outset.

The Commission acknowledges that plan sponsors nevertheless will incur costs to address the feasibility, benefits, and costs of incorporating information about allocations of NMS securities in primary market transactions into the consolidated audit trail. Among other things, the plan sponsors will need to undertake an analysis of technological and computer system acquisitions and upgrades that would be required to include information about such allocations. However, given the potential benefits described above of including such information in the consolidated audit trail, the Commission believes these costs are justified.

ii. Analysis of the NMS Plan

As noted above, in consideration of the views expressed, suggestions for alternatives, and other information provided by those commenting on the proposed Rule, the Commission is adopting Rule 613 with significant modifications to a number of the proposed requirements. In certain instances these modifications alter the data and collection requirements of the proposed Rule. In other instances, the adopted Rule has been altered to be less prescriptive, and hence less limiting, in the means the SROs may use to meet certain requirements. These modifications significantly expand the solution set that could be considered by the SROs for creating, implementing, and maintaining a consolidated audit trail and thus provide the SROs with increased flexibility in how they choose to meet the requirements of the adopted Rule, relative to the solution set that would have been available under the requirements of the proposed Rule.

Because these modifications permit a wider array of solutions to be considered by the SROs, including solutions that could capitalize on existing systems and standards,[803] the assumptions underlying the Commission's cost estimate in the Proposing Release that new,

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[803] See, e.g, FINRA Letter, p. 14; SIFMA Letter, p. 16-18.

large-scale market systems would need to be developed from scratch may no longer be valid.[804] Thus, as part of the multi-step process for developing and approving an NMS plan that will govern the creation, implementation, and maintenance of a consolidated audit trail, the Commission is deferring its economic analysis of the actual creation, implementation, and maintenance of a consolidated audit trail itself (in contrast to the costs of the actions the SROs are required to take upon approval of the adopted Rule)[805] until such time as it may approve any NMS plan submitted to the Commission for its consideration – that is, after the NMS plan, together with its detailed information, including cost estimates for the creation, implementation, and maintenance of the consolidated audit trail, and analysis, has been submitted by the SROs to the Commission and there has been an opportunity for public comment. The Commission believes that the information and analyses will help inform public comment regarding the NMS plan and will help inform the Commission as it evaluates whether to approve the NMS plan. In this way, the Commission can be better informed about the costs for the development, implementation, and maintenance of the consolidated audit trail that benefit from cost data and information provided by the SROs in conjunction with – and guided by – their development of an NMS plan that complies with the requirements of the adopted Rule. In addition, as noted above,[806] the Rule includes a mandate that in determining whether to approve the plan and whether the plan is in the public interest, the Commission must consider the impact of the NMS plan on efficiency, competition, and capital formation.

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804 The methodology in the Proposing Release assumed that the scope of the required systems changes would be comparable to those made in connection with Regulation NMS. See Proposing Release, supra note 4, at 32597 n. 352. See also Section I., supra.

805 These actions include the requirement that the SROs develop an NMS plan, utilizing their own resources and undertaking their own research that addresses the specific details, cost estimates, considerations, and other requirements of the Rule.

806 See Section I., supra.

- Rule 613(a)(1)(vii)

Rule 613(a)(1)(vii) requires the NMS plan to include "[t]he detailed estimated costs for creating, implementing, and maintaining the consolidated audit trail as contemplated by the national market system plan, which estimated costs should specify: (A) [a]n estimate of the costs to the plan sponsors for creating and maintaining the central repository; (B) [a]n estimate of the costs to members of the plan sponsors, initially and on an ongoing basis, for reporting the data required by the national market system plan; (C) [a]n estimate of the costs to the plan sponsors, initially and on an ongoing basis, for reporting the data required by the national market system plan; and (D) [h]ow the plan sponsors propose to fund the creation, implementation, and maintenance of the consolidated audit trail, including the proposed allocation of such estimated costs among the plan sponsors, and between the plan sponsors and members of the plan sponsors."[807]

Commenters opined on the costs of funding the consolidated audit trail in general.[808] One commenter stated that the Commission should give "important consideration to alternative means to help fund the creation of what is essentially a public utility in [the consolidated audit trail]," suggesting the Commission "should itself pay user fees to help build and run the [consolidated audit trail]," or that the government should underwrite low-cost loans for market participants aimed to pay the costs of the consolidated audit trail.[809] Another commenter suggested that the cost of creating and maintaining the central repository should be shared among all market participants, including broker-dealers, ATSs, and exchanges.[810] Another commenter

807 See Rule 613(a)(1)(vii).

808 See Wells Fargo Letter, p. 4; SIFMA Letter, p. 22.

809 See Wells Fargo Letter, p. 4.

810 See Liquidnet Letter, p. 9.

stated that, if the Commission requires the SROs to fund the creation of the consolidated audit trail (i.e., the central repository), SROs may be forced to raise transaction fees, which would "resurrect the distortions caused by high transaction fees, potentially increase the use of flash orders, if allowed, and discourage trading activity."[811]

The Commission also received comments regarding the allocation of the costs of the consolidated audit trail.[812] One commenter emphasized that the NMS plan must provide for an equitable allocation of costs, including the sharing of expansion costs by the parties that benefit from any new products added to the consolidated audit trail.[813] One commenter suggested that the Commission should require trading venues to allocate system costs for the consolidated audit trail "at least partially based on message traffic . . . ."[814] Similarly, another commenter, opining that exchanges currently bear a disproportionate amount of the costs for market surveillance and noting that exchanges would also be forced to shoulder the costs of the consolidated audit trail, suggested that other venues, such as ATSs and internal broker-dealer platforms, should bear a proportionate share of the costs of creating, implementing, and maintaining the consolidated audit trail.[815] This commenter also suggested that the Commission fund the audit trail using fees assessed on high frequency traders who cancel a "disproportionately high" percentage of their orders,[816] arguing that this "would have the added benefit of deterring a practice that, at best, adds little value in the price discovery process and, at worst, is potentially manipulative or even

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811 See SIFMA Letter, p. 22.

812 See Nasdaq Letter I, p. 13-14; BOX Letter, p. 3; Liquidnet Letter, p. 9; Kaufman Letter, attachment p. 3.

813 See Nasdaq Letter I, p. 13-14.

814 See Kaufman Letter, attachment p. 3.

815 See Schumer Letter, p. 1.

816 Id. at p. 1-2.

fraudulent."[817]

The Commission believes that the issues surrounding how the consolidated audit trail should be funded, and how costs in creating, implementing, and maintaining the consolidated audit trail should be allocated, are important, and the Rule requires information about those issues to be provided by the SROs in the NMS plan submitted to the Commission for its consideration. In response to comments and in recognition that an initiative of the size and scope of the consolidated audit trail necessarily will require substantial expenditures by the SROs and their members, the Commission is requiring, pursuant to Rule 613(a)(1)(vii), the SROs to include in the NMS plan, a discussion of costs and how such costs will be allocated. As discussed above, the Commission believes that the SROs will incur costs to create and maintain the central repository.[818] Also, as discussed above, SROs and their members may need to make systems changes or to purchase new systems to record and report the data required by the NMS plan to the central repository.[819] SROs and their members will incur upfront costs, as well as ongoing costs to record and report such information. Because, as noted above, these costs can only be analyzed once the SROs narrow the array of choices they have and develop a detailed NMS plan,[820] the Commission believes that the most robust approach for estimating these costs is for the SROs to provide such cost estimates in conjunction with, and guided by, their development of the NMS plan. The Commission believes that a fulsome discussion in the NMS plan of the estimated costs to SROs and their members will aid commenters in providing useful comments that will further the Commission's understanding of the cost implications of the consolidated

817 Id. at p. 2.

818 See Section III.B.2., supra.

819 See Section III.B.1., supra.

820 See Section I., supra.

audit trail. In addition, a fulsome discussion will aid the Commission in its evaluation of whether to approve the NMS plan and in conducting its own analysis of the costs and benefits of the NMS plan.

There also would be costs associated with establishing and operating the central repository that will be jointly owned by the plan sponsors. The Commission believes it is important to understand how the plan sponsors plan to allocate such costs among themselves to help inform the Commission's decision regarding the possible economic or competitive impact of the NMS plan amongst the SROs. In addition, although the plan sponsors likely would initially incur the costs to establish and fund the central repository directly, they may seek to recover some or all of these costs from their members. If the plan sponsors seek to recover costs from their members, the Commission believes that it is important to understand the plan sponsors' plans to allocate costs between themselves and their members, to help inform the Commission's decision regarding the possible economic or competitive impact of the NMS plan.

- Rule 613(a)(1)(viii)

Rule 613(a)(1)(viii) requires the NMS plan to include "[a]n analysis of the impact on competition, efficiency, and capital formation of creating, implementing, and maintaining the national market system plan."

Rule 608(a)(4)(ii)(C) under Regulation NMS already requires every NMS plan submitted to the Commission to be accompanied by an analysis of the impact on competition of implementation of the plan.[821] This requirement is designed to help inform the Commission's evaluation of whether the NMS plan will impose a burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act. The Rule re-states the

[821] See 17 CFR 242.608(a)(4)(ii)(C).

application of the Rule 608(a)(4)(ii)(C) requirement to provide an analysis of the NMS plan's impact on competition and imposes a requirement that the NMS plan also include an analysis of the impact on efficiency and capital formation.[822]

These requirements are designed to help inform the Commission's understanding of whether the NMS plan may promote efficiency and capital formation. As an initial matter, the SROs will be providing an analysis of the economic consequences of the NMS plan they develop and propose. As noted above, because the specific requirements of the NMS plan will not be known until the NMS plan is submitted, and the SROs will be providing that analysis, the Commission will consider the impact of the proposed consolidated audit trail on efficiency, competition, and capital formation in deciding whether to approve the NMS plan. The Commission, however, will consider such analysis in determining whether to approve the NMS plan and whether the plan is in the public interest under Rule 608(b)(2).[823]

iii. Process Followed to Develop the NMS Plan

The following two considerations require the NMS plan to address how the SROs solicited the input of their members and other appropriate parties in their design of the NMS plan, and to detail the alternative consolidated audit trail designs considered and rejected by the SROs. These considerations will inform the Commission's evaluation of the NMS plan submitted for its consideration.

- Rule 613(a)(1)(xi)

Rule 613(a)(1)(xi) requires the NMS plan to discuss "[t]he process by which the plan sponsors solicited views of their members and other appropriate parties regarding the creation, implementation, and maintenance of the consolidated audit trail, a summary of the views of such

822 See Rule 613(a)(1)(viii).

823 See Rule 613(a)(5).

members and other parties, and how the plan sponsors took such views into account in preparing the national market system plan."

The Commission believes that the SROs' consideration of the views of their members is important because, given the scope of the Rule, it will affect many market participants and will require them to report a broad range of audit trail information. Ensuring that market participants with varied perspectives have a role in developing the NMS plan submitted to the Commission for its consideration could help inform the plan sponsors of operational or technical issues that may arise in the implementation of the NMS plan, and help assure the Commission and market participants that the requirements imposed on members are done so in an efficient and cost-effective manner.[824] Similarly, the Commission believes it is important that the SROs consider the views of other parties – such as back office service providers, market operations specialists, and technology and data firms – as may be appropriate in light of the Rule's goal of creating, implementing, and maintaining a complex system that may entail changes to multiple other systems and functionalities involved across the lifecycle of an order. Such parties could offer operational and technical expertise to the SROs, including, among other things, by identifying issues that may arise in the interface between legacy and new systems. In addition, the inclusion of such parties in the deliberative process could also result in the introduction of additional alternative approaches.

The Commission also believes that it is appropriate to require the SROs to set out in the NMS plan a summary of the views expressed by such members and other parties and how the SROs took those views into account in developing the NMS plan. This requirement is designed to inform the Commission about the extent to which the SROs considered the views of their

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824 <u>See</u> Section II.C.3., <u>supra</u>, for a summary of comments suggesting wider involvement in the development of the consolidated audit trail.

members and other appropriate parties as they undertook the complex task of developing the NMS plan for a consolidated audit trail, to facilitate a cost estimate by the SROs that takes into account the costs members will incur in creating, implementing, and maintaining the consolidated audit trail, as well as to encourage the consideration of reasonable alternative approaches contemplated by Rule 613(a)(1)(xii) in the plan formulation process.

The Commission received several comments advocating inclusion of the broker-dealer community and other appropriate parties in the planning of the consolidated audit trail.[825] One commenter, with respect to NMS plan governance, urged the inclusion of "an official 'seat at the table' alongside the SROs" for members of the broker-dealer industry.[826] Another commenter recommended that the Commission seek greater SRO and broker-dealer involvement in the front-end planning before adopting a final rule to make all parties aware of potential design tradeoffs, and establish appropriate timelines for implementation and compliance.[827] A further commenter advocated allowing working groups to engage in dialogue with the Commission, broker-dealers and the SROs to effectively conduct the business analysis needed to build the consolidated audit trail.[828] Additionally, one commenter suggested that the Commission staff should form and engage working groups comprised of representatives from the "affected constituents," specifically brokers and "key technology vendors,"[829] and that such working groups could work with the Commission to develop a request for proposal."[830] Similarly, another commenter urged the Commission to require an industry working group of SROs and a

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825 See FIF Letter II, p. 2; SIFMA February 2012 Letter, p. 1; STA Letter, p. 1-2.

826 See SIFMA February 2012 Letter, p. 1.

827 See Broadridge Letter, p. 2.

828 See FIF Letter II, p. 2, STA Letter, p. 1-2.

829 See Direct Edge Letter, p. 2.

830 See Direct Edge Letter, p. 2.

representative group of broker-dealers to address the "complexities involved in developing such a system."[831] One commenter suggested encouraging the participation of issuers and other market participants in the creation of the consolidated audit trail,[832] and another commenter advocated the inclusion of "broad industry participation from the SEC, FINRA, exchange, broker dealer and vendor communities."[833]

The Commission considered the comments recommending wider industry involvement in the creation of the consolidated audit trail and believes that, since the consolidated audit trail will be a regulatory tool used by the SROs and the Commission, it is appropriate for the SROs, when developing the NMS plan, to request input from the securities industry as well as technological advice. The Commission believes that this input should be sought during the preparation of the NMS plan submitted to the Commission for its consideration,[834] during the comment process,[835] and subsequent to the approval of an NMS plan.[836]

831 See Ameritrade Letter, p. 2.

832 See IAG Letter, p. 3 (also recommending that the consolidated audit trail, in general, should involve a reduction in its size and scope, as well as a review of the capabilities of existing systems).

833 See FIF Letter II, p. 1-3. See also STA Letter, p. 1-3 (recommending the same, but with the inclusion of the investor community and institutional asset managers).

834 See also Rules 613(a)(1)(vii)(A) and (D), respectively requiring "[a]n estimate of the costs to the plan sponsors for establishing and maintaining the central repository" and an explanation of "[h]ow the plan sponsors propose to fund the creation, implementation, and maintenance of the consolidated audit trail, including the proposed allocation of such estimated costs among the plan sponsors, and between the plan sponsors and members of the plan sponsors."

835 The Commission notes that any NMS plan submitted and any amendment to the plan would be subject to notice and public comment, during which members of the industry and other interested persons may provide comments on the NMS plan. 17 CFR 242.608(b)(1).

836 See Rule 613(b)(7). See also Section III.B.3.b., supra.

- Rule 613(a)(1)(xii)

Rule 613(a)(1)(xii) requires the NMS plan to discuss "[a]ny reasonable alternative approaches to creating a consolidated audit trail that the plan sponsors considered in developing the national market system plan, including, but not limited to, a description of any such alternative approach; the relative advantages and disadvantages of each such alternative, including an assessment of the alternative's costs and benefits; and the basis upon which the plan sponsors selected the approach reflected in the national market system plan."[837] The Commission believes this consideration is appropriate because it reflects the view, supported by commenters, that there are alternative approaches to creating, implementing, and maintaining the consolidated audit trail. The Commission believes that requiring the SROs to discuss alternatives considered helps ensure that the plan sponsors have appropriately weighed the merits of the various approaches that might be considered to create, implement, and maintain the consolidated audit trail, by requiring the NMS plan to describe the alternatives that the plan sponsors considered before making any significant decision with respect to the consolidated audit trail, and the relative advantages and disadvantages, including costs and benefits, of such alternatives. The Commission also believes that requiring transparency with respect to alternative approaches and the decision-making process of the SROs will facilitate public comment on the NMS plan and the wisdom of the approach selected by the plan sponsors. Similarly, such transparency should provide the Commission with useful insights into the rationale for the approach chosen by the plan sponsors as it considers whether to approve the NMS plan submitted to the Commission. The Commission also notes that this consideration complements Rule 613(a)(1)(vii), discussed above, which requires that the NMS plan discuss the

[837] See Rule 613(a)(1)(xii).

detailed estimated costs to the plan sponsors for creating, implementing, and maintaining the consolidated audit trail, because this consideration requires the NMS plan to provide the costs of the alternatives that were not adopted by the plan sponsors in the NMS plan submitted to the Commission.

iv. Implementation and Milestones of the Consolidated Audit Trail

The following two considerations are designed to elicit additional information from the plan sponsors about the implementation and milestones of the consolidated audit trail. These will inform the Commission's evaluation of the NMS plan submitted to the Commission for its consideration, particularly in the degree to which the consolidated audit trail can replace existing data sources and in how effectively the proposed plan will meet the objectives discussed in Section II.B.2.

- Rule 613(a)(1)(ix)

Rule 613(a)(1)(ix) requires the NMS plan to discuss "[a] plan to eliminate existing rules and systems (or components thereof) that will be rendered duplicative by the consolidated audit trail, including identification of such rules and systems (or components thereof); to the extent that any existing rules or systems related to monitoring quotes, orders, and executions provide information that is not rendered duplicative by the consolidated audit trail, an analysis of: (A) [w]hether collection of such information remains appropriate; (B) [i]f still appropriate, whether such information should continue to be separately collected or should instead be incorporated into the consolidated audit trail; and (C) [i]f no longer appropriate, how the collection of such information could be efficiently terminated; the steps the plan sponsors propose to take to seek Commission approval for the elimination of such rules and systems (or components thereof); and a timetable for such elimination, including a description of the phasing-in of the consolidated audit trail and phasing-out of such existing rules and systems (or components thereof)."[838]

As noted in the Proposing Release and above, many exchanges and FINRA each have their own disparate audit trail rules.[839] Thus, a member of the various exchanges and FINRA could be subject to the audit trail rules of, and be required to submit different information to, more than one exchange and FINRA. In addition, several commenters discussed the potential reduction in costs for the creation, implementation, and maintenance of a consolidated audit trail if existing SRO audit trail requirements were eliminated. In particular, one commenter stated that, "over the long-term, the costs of developing a carefully designed and appropriately scaled consolidated audit trail could be offset in part by eliminating the individual SRO reporting requirements imposed under existing audit trail systems."[840] This commenter also urged the SROs and the Commission "to rely to the fullest extent possible on the consolidated audit trail data for market reconstructions, investigations, and analysis, rather than requesting data from broker-dealers. This would be more efficient for both firms and regulators and would help maximize the utility of the consolidated audit trail."[841]

Another commenter similarly stated that "a consolidated trail and consolidated market surveillance should achieve economies of scale that ultimately lower costs for both the markets themselves and the market participants."[842] This commenter further reasoned that, "[r]ather than each SRO separately maintaining its own surveillance staff and surveillance programs that are

838 See Rule 613(a)(1)(ix).

839 See Proposing Release, supra note 4, at 32595.

840 See SIFMA Letter, p. 2.

841 Id.

842 See FINRA Letter, p. 2.

searching for the same behavior, and thus creating redundancies, certain technology and staff resources can be consolidated into a single enterprise with costs equitably allocated across all SROs."[843] However, the commenter also pointed out that "[s]uch consolidation, of course, would not preclude individual SROs from conducting surveillance for unique attributes and rules of its marketplace, ensuring that specialized market expertise continues to inform surveillance and oversight of trading on that market."[844]

Many other commenters shared similar opinions with regards to the efficiency effects that a consolidated audit trail would have on market participants and their requirements to provide data to regulators. One commenter, for example, listed as one of seven benefits of a consolidated audit trail that "it would reduce the time and resources required by market participants to respond to case-by-case requests from regulators."[845] Another commenter stated that it "agrees with the Commission that the implementation of the proposed consolidated audit trail would likely render unnecessary existing audit trails and data obtained through the equity blue sheets system."[846] Similarly, another commenter also "agree[d] with the Commission that in calculating the total cost to the industry of the audit trail it is important to consider offsetting savings from the retirement of redundant data feeds such as OATS, OTS, COATS, ISG Equity Audit Trail, and EBS. In addition, the industry may be able to avoid the cost of compliance with the

843 Id. at p. 2-3.

844 See FINRA/NYSE Euronext Letter, p. 4.

845 See Liquidnet Letter, p. 1.

846 See BATS Letter, p. 4. See also FIA Letter, p. 1; FIF Letter II, p. 2.

Commission's proposed Large Trader Reporting System if the consolidated audit trail contains sufficient information to meet those requirements."[847]

The Commission recognizes that the creation of a consolidated audit trail could result in efficiency gains for market participants with respect to their regulatory data reporting requirements and for regulators with respect to their surveillance activities. The Commission also recognizes that the consolidated audit trail could render existing rules and systems that contain the same requirements as the consolidated audit trail redundant. While the Commission is not at this time requiring that existing rules and systems be eliminated, the Rule requires that the NMS plan provide a plan to eliminate existing rules and systems (or components thereof), including identification of such rules and systems (or components thereof). Further, to the extent that any existing rules or systems related to monitoring quotes, orders, and executions provide information that is not rendered duplicative by the consolidated audit trail, such plan must also include an analysis of (1) whether the collection of such information remains appropriate, (2) if still appropriate, whether such information should continue to be separately collected or should instead be incorporated into the consolidated audit trail, and (3) if no longer appropriate, how the collection of such information could be efficiently terminated. Finally, such plan must also provide the steps the plan sponsors propose to take to seek Commission approval for the elimination of such rules and systems (or components thereof); and a timetable for such elimination, including a description of how the plan sponsors propose to phase in the consolidated audit trail and phase out such existing rules and systems (or components thereof).

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847 See Nasdaq Letter I, p. 11. The Commission notes that this comment letter was submitted prior to the adoption of the Large Trader Reporting Rule. See note 1, supra, and accompanying text.

The Commission believes that the implementation of a plan to eliminate duplicative existing rules, systems, and/or components of such rules and systems, will result in increased efficiency to market participants who need to comply with the disparate reporting requirements for orders and with repeated requests for data by regulators who cannot obtain the data they need from existing sources of information.

- Rule 613(a)(1)(x)

Rule 613(a)(1)(x) requires the NMS plan to include "[o]bjective milestones to assess progress toward the implementation of the national market system plan."

The creation of a consolidated audit trail is crucial to the effective oversight of the U.S. securities markets, but at the same time is an initiative of substantial scope and complexity. Accordingly, to ensure that the consolidated audit trail is established in a timely and logical manner, and that the SROs can be held accountable for maintaining a workable implementation schedule, the NMS plan submitted is required to set forth a series of detailed objective milestones, with projected completion dates, toward implementation of the consolidated audit trail. In addition to being useful for the Commission in its evaluation of the NMS plan, the milestones will be used by the Commission in its supervision of the implementation of the consolidated audit trail. Such milestones could include, but are not limited to: publication and implementation of the methods for obtaining a CAT-Reporter-ID and the Customer-ID database, testing of the collection of order and execution data from a representative subset of broker-dealers, initial access to the central repository for regulators, demonstration of linking the full lifecycle of events for select test orders, cancels, modifications, and executions, and integration of trade and quote data as currently reported by trading venues into the central repository.

v. Commission Review

The Commission believes these considerations represent fundamental characteristics of a meaningful plan to establish an effective and efficient consolidated audit trail. The Commission will assess the NMS plan's discussion of the considerations described as part of its evaluation of the NMS plan.[848] The Commission notes that, if the NMS plan submitted does not comply with the requirements of the Rule, or if the Commission determines changes are necessary or appropriate, the Commission may amend the NMS plan pursuant to Rule 608(b)(2) of Regulation NMS with such changes or subject to such conditions as the Commission may deem necessary or appropriate, taking into account the considerations contemplated in Rule 613(a)(1).[849] In addition, should the NMS plan and the consolidated audit trail not keep pace with market or technological developments, such that its efficiency or effectiveness becomes impaired,[850] the Commission itself may, pursuant to Rule 608(b), propose an amendment to the NMS plan.[851]

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848 To further facilitate this review, the Commission expects that the plan sponsors would keep minutes of their meetings to formulate the NMS plan, and that such minutes would be readily reviewable by the Commission.

849 17 CFR 242.608(b)(2). To approve such a plan, the Commission must find that such plan or amendment is necessary or appropriate in the public interest, for the protection of investors and the maintenance of fair and orderly markets, to remove impediments to, and perfect the mechanisms of, a national market system, or otherwise in furtherance of the purposes of the Act.

850 See Rules 613(a)(1)(v), (b)(6), (d)(2). See also Sections III.B. and III.C.2.a.i., supra (discussing the consideration of flexibility and scalability of the systems used by the central repository; the requirement that the NMS plan require the plan sponsors to provide a written assessment with an evaluation of, and a detailed plan to improve, the performance of the consolidated audit trail at least every two years; and the requirement to annually evaluate the clock synchronization and time stamp standards).

851 17 CFR 242.608(a)(2). For example, if the requirements of the plan are not amended after the annual evaluation of the clock synchronization and time stamp standards to be consistent with changes in the industry standards, the Commission has the authority and means to propose an amendment to those requirements of the plan. The Commission can approve an amendment to an effective national market system plan that was initiated by the Commission, by rule. 17 CFR 242.608(b)(2).

b. **Regulator Use Cases**

In light of the comments recommending that the Commission undertake an RFP process and provide more "business requirements"[852] the Commission believes that it is useful to provide further details about how it envisions regulators would use, access, and analyze consolidated audit trail data through a number of "use cases," as might typically be found in an RFP. These "use cases" and accompanying questions set forth below are derived directly from the considerations described in adopted Rule 613(a)(1), which, as discussed in Section III.C.2.a., originated from key principles of the consolidated audit trail that had been highlighted by the Commission in the Proposing Release. Specifically, these "use cases" describe the various ways in which, and purposes for which, regulators would likely use, access, and analyze consolidated audit trail data. By describing how regulators would use the consolidated audit trail data, the "use cases" and the related questions are meant to elicit a level of detail about the considerations that should help the SROs prepare an NMS plan that better addresses the requirements of the adopted Rule. They should also aid the Commission and the public in gauging how well the NMS plan will address the need for a consolidated audit trail. In particular, the "use cases" will assist in gauging how well the NMS plan will specifically address the needs outlined in this Rule, by describing the features, functions, costs, benefits, and implementation times of the plan.

The Commission notes that it is not including these "use cases" and accompanying questions to endorse a particular technology or approach to the consolidated audit trail; rather, these "use cases" and accompanying questions are designed to aid the SROs' understanding of the types of useful specific information that the NMS plan could contain that would assist the Commission in its evaluation of the NMS plan. The Commission also notes that its description

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852 See FIF Letter, p. 1, 9; FIF Letter II, p. 1-2; Direct Edge Letter, p. 2-3, 5; Section III.C.1.a., supra.

of "use cases" includes a non-exclusive list of factors that SROs could consider when developing the NMS plan. The SROs also may include in the NMS plan submitted to the Commission for its consideration any other information regarding how data would be stored or accessed that the SROs believe the Commission or the public may find useful in evaluating the NMS plan submitted.

1. Analyses Related to Investigations and Examinations

The Commission expects that the consolidated audit trail will provide regulators the ability to more efficiently conduct targeted investigations and examinations. These generally require being able to conduct several types of queries on large amounts of data and extract targeted segments of such data. These targeted segments are likely to be much smaller than the bulk extractions discussed in Section III.C.2.b.2., below.

Off-Line Analysis. Regulators are likely to frequently require the extraction of relatively small amounts of select data from the consolidated audit trail database at the central repository for their own "off-line" analyses.[853] For example, a regulator may need to extract data on all orders in a particular stock, by a particular customer, on a particular day, or based on any other combination of fixed search criteria.[854] Though the total data extracted may be small, the number of records that need to be searched to find such data may be enormous.

853 For purposes of these use-cases, an "off-line" analysis is defined to be any analysis performed by a regulator based on data that is extracted from the consolidated audit trail database, but that uses the regulator's own analytical tools, software, and hardware.

854 Fixed search criteria are those that are based on specific pre-defined data elements that are stored in the consolidated audit trail database. In contrast, dynamic search criteria are those that are based on numerical levels, thresholds, or other combinations of mathematical formula or logic that would require some amount of additional calculations to be performed on, and derived from, pre-defined data elements already stored in the database to complete the search operation and return to the user the data that meets the requested criteria.

i. What technical or procedural mechanisms will regulators be required to use to request data extractions? Does the NMS plan provide for a front-end user interface to perform search and extractions? If not, what types of tools or technologies would regulators need to implement to send search and extract requests to the database? Would regulators be permitted to write and submit their own queries (e.g., Structure Query Language or "SQL") to the database directly? Would the central repository write and submit queries on behalf of a regulator at the regulator's request?

ii. What response times should regulators expect from search and extract requests? Would a search for all trades in a given security by a given customer over a specified period of time return a response with all requested data in one minute? One hour? Overnight? How would this response time scale with the amount of data requested? With the amount of data being searched?

iii. How would the database effectively process simultaneous requests by multiple users at one or more regulators? Will each request be queued serially? Can they be processed in parallel? What is the effect of simultaneous requests on response times? Would there be limits to the number of search queries that can be performed at the same time? Would there be limitations on the size of the extractions from such queries?

iv. A wide range of users at regulators may need to search and extract data for analysis. How are users to be administered? If the NMS plan contemplates a front-end user interface, what validation and security mechanisms will ensure that only permitted users will have access to such data? If the plan contemplates direct access through a means other than a front-end user interface, what security and validation mechanisms would regulators need to deploy to interact with the database?

Dynamic Search and Extraction. At times, regulators may need to identify and extract small amounts of data from the database based on dynamic search criteria that might require the database to perform calculations on stored data to meet the specified criteria. A few examples of dynamic criteria are: searching for trades with trade sizes above a certain threshold, searching for trades in securities with execution prices that change more than a certain percentage in a given period of time, and searching for orders that are canceled within a certain period of time.

i. Does the NMS plan contemplate allowing for dynamic search criteria to operate directly on the database? If so, how would the dynamic search criteria be specified and run? What, if any, limitations would there be on the types of search criteria that can be requested? What are the implications for response times? If the plan contemplates a front-end user interface, will dynamic search criteria be included? If the plan allows for dynamic search criteria through a means other than a front-end user interface, what types of tools or technologies would regulators need to implement to request dynamic searches? Have the plan sponsors considered whether such tools or technologies and the personnel to use them are currently available to the regulators?

ii. If the NMS plan does not contemplate dynamic search criteria, please explain how regulators would be able to use the consolidated audit trail data to perform such searches. Would data need to be downloaded in bulk by the regulators to accomplish these types of searches off-line (see below for related questions)?

2. Analyses Related to Monitoring, Surveillance, and Reconstruction

In addition to targeted analysis of select data from the consolidated audit trail database, regulators will also require the analysis of data in bulk form. For example, the Commission is likely to use consolidated audit trail data to calculate detailed statistics on order flow, order sizes, market depth and rates of cancellation, to monitor trends and inform SRO and Commission rulemaking. To satisfy the surveillance requirements of Rule 613(f), regulators may want the ability to feed consolidated audit trail data into analytical "alert" programs designed to screen for potential illegal activities such as insider trading or spoofing. Surveillances might also benefit if regulators are able to link consolidated audit trail data with databases on certain types of material news events or market participants. This would allow regulators to isolate and aggregate data on trading in advance of those news events or by those participants. If preliminary analyses showed problems, the regulators could then request significant amounts of data for a more thorough and detailed follow-up analysis. In the event of a large scale market event like the May 6, 2010 "flash crash," regulators are likely to use consolidated audit trail data to reconstruct market events on the day of the event, including but not limited to reconstructing entire order books and trading sequences.

i. What, if any, SRO surveillance data could be replaced by the consolidated audit trail while still improving SROs' ability to surveil?

ii. How will the NMS plan allow regulators to address these types of large-scale, on-going data analyses?

iii. In addition to providing regulators with the ability to search and extract data, will the NMS plan provide regulators with access to any plan-hosted applications or interfaces (i.e., those that operate on plan-based systems and resources) that would enable users to perform data analyses on, or create reports or graphs from, data stored in the database (such application or interfaces collectively known as "hosted analytical tools")? If so, how would regulators use and access such tools? What are the limitations of such tools? Would the tools allow regulators to perform the analyses discussed in the examples presented above?

iv. If the NMS plan does not provide regulators with hosted analytical tools, how would regulators be expected to use their own resources, software, and hardware to perform such analyses? Would the plan provide regulators with an application programming interface ("API") that allows regulators to develop their own tools that interact directly with the consolidated audit trail database? If so, what will the form of such API be? Are there limitations to the number of systems that could connect to the database? How will the plan negotiate priorities for connectivity, searches and queries done via the API? Will there be limitations to the types of queries that could be performed through the API? What types of in-house technologies and systems would be required for regulators to connect to the consolidated audit trail in this fashion?

v. If the NMS plan does not provide regulators with analytical tools and services and does not provide an API for regulators to connect their own analytics systems to the database, what mechanism would the plan provide to regulators for accessing bulk data in a way that allows for large-scale analyses? Would the plan allow for end-of-day downloads of an entire day's activity so that regulators could load this information into their own systems for such analysis? If so, how is access to such a download to be controlled and implemented? How long would it take to transmit an entire day's worth of consolidated audit trail data to each of the regulators that requires such access? 10 minutes? One hour? Multiple hours? Longer than overnight? Do these time estimates reflect that multiple regulators are likely to simultaneously download consolidated audit trail data each night? What types of technologies or systems would be required for regulators to download this data? What are the expected sizes of such a data download? What type of systems would each regulator need to deploy to store and analyze this data? Have the plan sponsors considered whether such systems and the personnel to operate them are currently available to the regulators?

vi. Does the plan contemplate data streaming as a method of transmitting bulk data to each regulator? If so, what is the form and mechanism of such data streaming? Would the streaming occur intraday as data is reported to, and processed by, the database, or would the streaming occur after all (or a majority of, or such other criteria) data was reported to, and processed by the database (e.g. overnight streaming)? How would intraday streaming impact the accuracy or completeness of the data received by regulators? Would data be transmitted through different methods or with varying delays by different SROs?

vii. If the plan does not contemplate any bulk data analyses or means of transmitting data to regulators on a bulk overnight basis or in an intraday or overnight streaming fashion, describe what alternative mechanisms, if any, could be used to enable regulators to perform the types of analyses described at the beginning of the section (b), as well as the various examples described throughout this document of how regulators would make use of consolidated audit trail data.

3. Order Tracking and Time Sequencing

As discussed in detail throughout this Release, one of the key requirements of the consolidated audit trail is to provide regulators with a complete record of all of the events that stem from a particular order, from routing to modification, cancellation, or execution. In addition, these events must be stored by the central repository in a linked manner – using either a unique order identifier or a series of unique order identifiers, as discussed in Section III.B.1.d.iv. – so that regulators can quickly and accurately extract a time-sequenced history of each event related to an order.

i. What methods will the plan use to create the linkages for order events as described above? How will regulators access and search on data in a linked fashion?

ii. What is the technical form of the order identifier(s) that broker-dealers will be required to send to the consolidated audit trail database so that these linkages can be created? To what extent will broker-dealers be able to generate such identifier(s) using their current systems? To what extent will broker-dealers need to collect or track new data, or modify their systems, to generate such identifier(s)?

iii. Will the transmission of economic data (such as a price) be sent separately, or via a different technical mechanism, from noneconomic data (such as the identity of a customer)?

iv. What other changes, if any, will be required of systems typically in use by broker-dealers to provide such data? To what extent can existing broker-dealer systems be employed? What modifications will be necessary? What are the costs and technological ramifications of such changes?

v. What changes, if any, will be required of the systems currently in use by regulators to receive such data? To what extent can existing regulatory systems be employed? What modifications will be necessary? What are the costs and technological ramifications of such changes?

vi. If data reformatting is required, how much must be done by each broker-dealer using its own systems and resources prior to sending data to the central repository, versus being done on the receiving end by the central repository using plan-based systems and resources?

vii. If multiple methods for collecting and aggregating are contemplated by the NMS plan, what are the pros and cons of each method?

viii. How will the plan ensure orders and subsequent events are properly time-sequenced? At what level of granularity will time stamps be stored for each event? Milliseconds? Microseconds? Picoseconds? Describe any differences in the accuracy at which events originating in the same broker-dealer system can be sequenced versus events across different systems at the same broker-dealer, or systems at different broker-dealers. What type of synchronization of clocks will be employed to minimize inter-system timing inaccuracies?

ix. If time stamps are not stored at a sufficient level of granularity to properly sequence events, what other data or mechanisms will the NMS plan provide to meet the requirement that regulators be able to time-sequence events?

x. Even if time stamps are sufficiently granular to meet the time-sequencing requirements of today, how would the plan contemplate increasing that granularity as the speed of trading increases?

4. Database Security, Contingency Planning, and Prospects for Growth

The data stored in the consolidated audit trail database will contain confidential detailed records of trade and order flow by customer.

i. How will the plan ensure the security of the database in a way that provides for flexible access by permitted users at multiple regulators (i.e., the Commission and the SROs), but denies access to all other non-permitted users?

ii. What are the plan's policies and procedures with regards to security? Will the plan make use of any specific national or international security standards? If so, which ones? Will the plan make use of third-party reviews of its security procedures?

iii. What types of contingency and backup plans will be employed by the plan to safeguard against the loss of data due to technical failures? Will the plan make use of live failover mechanisms so that data being sent to the database is not inadvertently lost in the event of a failure? Will contingency plans provide regulators with uninterrupted access to the database? If not, what are the expectations for recovery times under different failure scenarios?

iv. As order and trade volumes increase, how does the plan contemplate handling the need for increased capacity and throughput? Would the plan be able to accommodate a doubling in daily volume without materially altering the basic technologies and architecture? A ten-time increase? A 100-times increase?

5. Database Access

As part of an investigation or examination, regulators may need to analyze historical trades and orders in the database maintained by the central repository (though not trade and order events occurring prior to the implementation of the consolidated audit trail).

i. How much historical data will be stored "on-line" in the database and be available for immediate search and extraction?

ii. How will data be archived if it is no longer stored on-line? How will regulators access and search data that has been archived?

iii. Will third parties have access to historical data? How will this access differ from the regulatory access?

c. Extension of time for submission of NMS plan

Proposed Rule 613 required the SROs to jointly file the NMS plan within 90 days from approval of Rule 613. The Commission received a comment letter specifically suggesting that a six-month period, rather than the 90-day period originally proposed, would be more appropriate for the submission of the NMS plan to ensure that the NMS plan is drafted with an informed understanding of how order and trade processing works so that the consolidated audit trail systems are capable of achieving the Commission's objectives.[855] To this end the commenter recommended that the Rule mandate the formation of cross-market participant working groups; outline the objectives of consolidated audit trail rather than identify technical requirements; and allow six months for the cross-participant working groups to perform a requirements analysis as part of the development of the NMS plan.[856]

In response to this commenter and other commenters that suggested that the Commission rely on an industry working group to create the consolidated audit trail[857] and to provide sufficient time for the SROs to draft the additional provisions required by the Rule[858] and to prepare responses to the considerations and the use cases for inclusion in the NMS plan,[859] the Commission is extending the timeframe for the submission of the NMS plan from 90 days from

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855 See FIF Letter II, p. 2. See also STA Letter, p. 2 (stating "[t]he SEC should allow six months for the CAT selection process rather than the two months currently identified in the proposed release").

856 See FIF Letter II, p. 3.

857 See Direct Edge Letter, p. 2-3, 5. See also STA Letter, p. 1-3.

858 These additional provisions relate to: (1) the security and confidentiality of the central repository (see Rule 613(e)(4)(i)(A) through (D) and Section III.B.2.e., supra); (2) error rates (see Rule 613(e)(6) and Section III.B.2.c., supra); (3) an Advisory Committee (see Rule 613(b)(7) and Section III.B.3.b., supra); (4) a retrospective assessment of the performance of the consolidated audit trail, as well as a plan to improve its performance (see Rule 613(b)(6)(i) through (iv) and Section III.B.3.b., supra); and (5) potential penalties (see Rule 613(h)(3) and Section III.B.3.a.1., supra).

859 See Sections III.C.2.a. and c., supra.

approval of Rule 613 to 270 days from the date of publication of the Adopting Release in the Federal Register.[860]

3. NMS Plan Costs

a. NMS Plan Cost Estimates

This section sets forth the Commission's estimates of the costs to prepare and file the NMS plan. As noted above, as part of the multi-step process for developing and approving an NMS plan that will govern the creation, implementation, and maintenance of a consolidated audit trail, the Commission is deferring its economic analysis of the consolidated audit trail (other than with respect to the NMS plan) until after the NMS plan, together with its detailed information and analysis, has been submitted by the SROs to the Commission for its consideration and there has been an opportunity for public comment.[861] The Commission believes that an economic analysis of the consolidated audit trail is more appropriately performed once the SROs narrow the expanded array of choices they have and developed a detailed NMS plan.[862] At that time, the Commission will have available to it detailed information provided by the SROs, and any additional information provided by commenters once the NMS plan is published for comment. The cost estimates set forth below, therefore, only reflect the Commission's estimates as to the costs to the SROs for developing an NMS plan to be submitted to the Commission. These cost estimates do not reflect the much more significant initial and ongoing costs that would be incurred if such NMS plan were approved by the

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860 See Section I., supra. See also Section III.D., infra, for a discussion of the timelines pertaining to the implementation of the consolidated audit trail.

861 See Section I., supra. See also Rule 613(a)(5) (providing, in part, that the Commission "shall consider the impact of the national market system plan, or amendment, as applicable, on efficiency, competition, and capital formation").

862 See Section I., supra.

Commission and the implementation of the consolidated audit trail begins.

The Commission notes that the requirement to develop and submit the NMS plan also is a collection of information within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[863] Section IV. below describes in detail the burdens associated with the requirement that the SROs develop and submit an NMS plan.

i. Preliminary Cost Estimates from Proposing Release

In the Proposing Release, the Commission estimated that each SRO, on average, would incur an aggregate one-time cost of approximately $234,000[864] to prepare and file the NMS plan, for an estimated aggregate cost of about $3.5 million.[865]

In making these estimates, the Commission assumed that the cost of developing and filing the NMS plan pursuant to the proposed Rule would be comparable to the cost to create other existing NMS plans.[866] Underlying the Commission's estimates were estimates of the

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863 44 U.S.C. 3501 et. seq.

864 Commission staff estimated that each SRO would expend (400 Attorney hours x $305 per hour) + (100 Compliance Manager hours x $258 per hour) + (220 Programmer Analyst hours x $193 per hour) + (120 Business Analyst hours x $194 per hour) = $213,540 per SRO to prepare and file the NMS plan. Commission staff also estimated that each SRO would outsource, on average, 50 hours of legal work, at an average hourly rate of $400, for a total of $20,000 per SRO, for an aggregate one-time cost to prepare and file an NMS plan of $233,540 per SRO. See Proposing Release, supra note 4, at 32596.

The $305 per hour figure for an Attorney; the $258 per hour figure for a Compliance Manager; the $193 per hour figure for a Programmer Analyst; and the $194 per hour figure for a Business Analysis (Intermediate) were from SIFMA's Management & Professional Earnings in the Securities Industry 2008, modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead. Based on industry sources, the Commission estimated that the hourly rate for outsourced legal services in the securities industry is $400 per hour.

865 Commission staff estimated that the SROs would incur an aggregate one-time cost of ($233,540 per SRO) x (15 SROs) = $3,518,100 to prepare and file an NMS plan.

866 See Proposing Release, supra note 4, at note 299.

amount of time the Commission believed would likely be spent by Programmer Analysts, Business Analysts, Attorneys, and Compliance Managers. The Commission did not receive any comments on these specific cost estimates.

ii. **Revised Cost Estimates**

As noted above, the Commission based its original estimates of the cost to prepare and file the NMS plan on the costs incurred with existing NMS plans. The adopted Rule, however, has been modified from the proposed Rule in several significant ways that differentiate the costs to prepare the NMS plan from all other existing NMS plans. These modifications require the SROs to: (1) provide additional information and analysis while addressing the considerations that are set forth in Rule 613(a)(1);[867] (2) include additional provisions that were not required by the proposed Rule relating to enforcement mechanisms,[868] security and confidentiality,[869] and the preparation of a document every two years that contains a retrospective assessment of the performance of the consolidated audit trail, as well as a plan to improve its performance;[870] (3) address error rates;[871] and (4) provide for the creation of an Advisory Committee.[872]

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867 See Rule 613(a)(1)(i) through (xii); Section III.C.2.a., supra.

868 See Rule 613(h)(3); Section III.B.3.a.1., supra.

869 See, e.g., Rule 613(e)(4)(i)(A) through (D). For example, Rule 613(e)(4)(i)(A) requires that the NMS plan require that all plan sponsors and their employees, as well as all employees of the central repository, agree to use appropriate safeguards to ensure the confidentiality of such data and not use such data for purposes other than surveillance or regulatory purposes. Additionally, Rule 613(e)(4)(i)(B) requires the NMS plan to require that each SRO adopt and enforce rules that: (1) require information barriers between regulatory staff and non-regulatory staff with regard to access and use of data in the central repository and (2) permit only persons designated by plan sponsors to have access to the data in the central repository. See Section III.B.2.e., supra.

870 See Rule 613(b)(6)(i) through (iv). See Section III.B.3.b., supra.

871 See Rule 613(e)(6)(i) through (ii). See Section III.B.2.c., supra. See also Rule 613(e)(6)(iii) through (iv).

872 See Rule 613(b)(7).

(A) Revised Initial Costs to Create and File the NMS Plan

In light of these modifications to the proposed Rule, the Commission no longer believes that the cost of developing and filing the NMS plan pursuant to the proposed Rule would be sufficiently comparable to the cost to create other existing NMS plans to use those costs as a basis for developing a cost estimate for the NMS plan required by Rule 613. Instead, as discussed in more detail below, the Commission is increasing its estimated costs for the development and filing of the NMS plan due to the increases in the hours that likely would be spent to create the NMS plan by the SROs.[873] The Commission also is adjusting its preliminary cost estimate for the creation and filing of an NMS plan to reflect updated 2011 wage figures, as well as the registration of two additional SROs, since the preliminary estimates were developed.[874] Specifically, the Commission now estimates that the aggregate one-time cost for creating and filing an NMS plan would be approximately $718,000 per SRO,[875] or approximately

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873 Commission staff now estimates that each SRO would expend 700 Attorney hours, 300 Compliance Manager hours, 880 Programmer Analyst hours, and 880 Business Analyst hours.

874 The $378 per-hour figure for an Attorney; the $279 per hour figure for a Compliance Manager; the $196 per hour figure for a Programmer Analyst; and the $201 per hour figure for a Business Analyst (Intermediate) are from SIFMA's Management & Professional Earnings in the Securities Industry 2011, 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. At the time the Proposing Release was published, there were 14 national securities exchanges. On August 13, 2010, the Commission granted the application of BATS-Y Exchange for registration as a national securities exchange. See Securities Exchange Act Release No. 62719, 75 FR 51295 (August 19, 2010). Additionally, on April 27, 2012, the Commission granted the application of BOX Options Exchange for registration as a national securities exchange. See Securities Exchange Act Release No. 66871, 77 FR 26323 (May 3, 2012).

875 Commission staff estimates that each SRO would incur an aggregate one-time cost of (700 Attorney hours x $378 per hour) + (300 Compliance Manager hours x $279 per hour) + (880 Programmer Analyst hours x $196 per hour) + (880 Business Analyst hours x $201 per hour) = $697,660 per SRO to prepare and file an NMS plan. In addition, Commission staff estimates that each SRO would incur a one-time external cost of (50

$12.2 million in the aggregate,[876] compared to an initial estimate of $234,000 per SRO, or approximately $3.5 million in the aggregate, to prepare and file an NMS plan.[877]

The Commission believes that these revised estimates, which include internal SRO personnel time and external legal costs, are appropriate based on the impact of the modifications to the proposed Rule on each of the job categories underlying the estimates. The Commission believes that the modifications to the proposed Rule will require SRO Programmer Analysts, Business Analysts, Attorneys, and Compliance Managers to expend additional time to address the requirements of the Rule. As discussed in more detail below, the Commission anticipates that the SROs will spend additional time on many activities, including: (1) research; (2) discussions with members, committees and with industry associations; (3) vendor negotiations; (4) making decisions regarding the various options and increased flexibility provided by the adopted Rule;[878] (5) reviewing alternative NMS plans; (6) choosing between alternative plans and negotiating to reach a consensus on a single NMS plan; (7) providing a detailed estimate of the costs associated with that NMS plan; and (8) drafting the NMS plan. The Commission also believes that these increased estimates are appropriate in light of the comments, including the comment that the Commission underestimated the time the SROs would spend on business analyses to be performed in designing the NMS plan based on the experience of broker-dealers,

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legal hours x $400 per hour) = $20,000. As a result, the Commission staff estimates that the aggregate one-time cost to each SRO to prepare and file an NMS plan, including external costs, would be ($20,000 in external costs) + ($697,660 in aggregate internal costs) = $717,660 per SRO to prepare and file an NMS plan.

876 Commission staff estimates that the SROs would incur an aggregate one-time cost of ($717,660 per SRO) x (17 SROs) = $12,200,200 to prepare and file an NMS plan.

877 See Proposing Release, supra note 4, at 32596.

878 See Section I., supra.

vendors and SROs when OATS was expanded to all NMS stocks.[879] In response, as discussed below, the Commission is increasing its estimated Programmer Analyst, Business Analyst, Attorney, and Compliance Manager hours.

The Commission notes that the average hourly and cost estimates per SRO for creating and filing the NMS plan likely overestimated the costs for some of SROs and underestimated the costs for other SROs. The Commission also believes that certain SROs, particularly those SROs under the same holding company, may decide to collaborate and realize some cost savings on a per SRO basis. On balance, however, the Commission believes that, these hours and cost estimates are reasonable on average even if they may not be precise for any specific SRO.

(i) Programmer Analyst

The Commission is increasing its Programmer Analyst hour estimates from 220 hours to 880 hours per SRO. As discussed in more detail below in Section IV.D.2.a.i., the Commission anticipates that a Programmer Analyst would need to spend substantially more time to address the considerations included in the Rule and the "use cases." Programmer Analysts may be involved in the NMS plan research, any industry discussions, negotiations with vendors and SROs, and in developing cost estimates for the consolidated audit trail. Thus, for these reasons, the Commission believes it appropriate to increase substantially its estimate of the number of hours expended by Programmer Analysts in the creation and filing of the NMS plan.

(ii) Business Analyst

The Commission is increasing its Business Analyst hour estimates from 360 hours to 880 hours per SRO. As discussed in more detail below in Section IV.D.2.a.ii., the Commission anticipates that a Business Analyst would spend substantially more time to address the

879 See FIF Letter II, p. 2-3. See also STA Letter, p. 2-3.

considerations and the "use cases," and overall, an amount of time that is comparable to the time that would likely be spent by Programmer Analysts because Business Analysts will likely be involved in many of the same tasks as Programmer Analysts, but have separate responsibilities as well.

(iii) Attorney

The Commission is increasing its estimates for the hours an Attorney would likely spend to prepare and file an NMS plan from 400 hours to 700 hours per SRO. As discussed in more detail in Section IV.D.2.a.iii. below, the Commission anticipates that an Attorney would spend substantially more time than previously estimated to draft the NMS plan.

(iv) Compliance Manager

The Commission is increasing its Compliance Manager hour estimate from 100 hours to 300 hours per SRO. As discussed in more detail below in Section IV.D.2.a.iv., the Commission anticipates that a Compliance Manager would spend substantially more time than previously estimated to draft the NMS plan.

4. Consideration of Burden on Competition and Promotion of Efficiency, Competition, and Capital Formation

Section 3(f) of the Exchange Act requires the Commission, whenever it engages in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, to also consider, in addition to the protection of investors, whether the action would promote efficiency, competition, and capital formation. Further, Section 23(a)(2) of the Exchange Act requires the Commission, when making rules under the Exchange Act, to consider the impact such rules would have on competition. Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

The Commission has focused its economic analysis in this Release on the requirement that the SROs develop an NMS plan, rather than on the actual creation, implementation, and maintenance of a consolidated audit trail itself, and is deferring its economic analysis of the actual creation, implementation, and maintenance of a consolidated audit trail itself until such time as it may approve the NMS plan submitted to the Commission for its consideration. The Commission's consideration of the Rule's impact on efficiency, competition, and capital formation is consistent with this approach. Because the Rule focuses only on the process and the requirement of the development of an NMS plan, the Commission believes that the adopted Rule will have minimal, if any, impact on efficiency, competition, and capital formation.

The Commission regards the adopted Rule as only a step in the multi-step process of developing and approving an NMS plan that will govern the creation, implementation, and maintenance of a consolidated audit trail and the Commission recognizes that the creation, implementation, and maintenance of a consolidated audit trail itself could potentially have effects on efficiency, competition, and capital formation. Therefore, Rule 613(a)(5) specifically provides that the Commission will consider the impact of the NMS plan submitted to the Commission for its consideration on efficiency, competition, and capital formation in determining whether to approve the plan or any amendment thereto. A complete consideration of the impact of the NMS plan, or any amendment thereto, on efficiency, competition, and capital formation, however, requires information that will not be known until the SROs submit their NMS plan or any amendment thereto. Accordingly, the Commission is deferring this analysis until such time as it may approve the NMS plan, or any amendment thereto, submitted by the SROs. To facilitate the consideration of such possible impacts, the Rule requires SROs to provide their own analysis of the plan's potential impact on efficiency, competition, and capital formation.

D. Implementation of Rule 613 after Approval of the NMS Plan

Proposed Rule 613(a)(3) sets forth a timetable for the implementation of the consolidated audit trail once the Commission has approved an NMS plan. The Commission proposed that the data collection and submission requirements would have applied first to the national securities exchanges and FINRA, and then to their individual members.[880] Specifically, proposed Rule 613(a)(3)(iii) would have required the plan sponsors to provide to the central repository the data to be required by the Rule within one year after effectiveness of the NMS plan. Members of the exchanges and FINRA would have been required to begin providing to the central repository the data required by the proposed Rule two years after the effectiveness of the NMS plan.[881] This phased approach was intended to allow members additional time to implement the systems changes necessary to begin providing the information to the central repository, including developing procedures to capture any new information required, such as the unique customer and order identifiers.

Additionally, proposed Rule 613(g)(1) would have required each SRO to file a proposed rule change with the Commission on or before 120 days from approval of Rule 613 to require its members to comply with Rule 613. Further, proposed Rule 613(i) would have required the plan sponsors to jointly provide to the Commission, within two months after effectiveness of the NMS plan, a document outlining how the plan sponsors would propose to incorporate into the consolidated audit trail information with respect to equity securities that are not NMS securities, debt securities, primary market transactions in NMS stocks, primary market transactions in

[880] See proposed Rule 613(a)(3)(iii).

[881] See proposed Rule 613(a)(3)(v).

equity securities that are not NMS securities, and primary market transactions in debt securities, including details for each order and reportable event that would be required to be provided, which market participants would be required to provide the data, an implementation timeline, and a cost estimate.

Although one commenter agreed that the consolidated audit trail could be implemented according to the timeline originally proposed,[882] and another urged the Commission to expedite implementation of Rule 613,[883] several commenters stated that more time would be necessary to develop and implement the NMS plan.[884] Many commenters suggested extended timelines for various aspects of the consolidated audit trail.[885] Two commenters, however, argued that the timetable for implementation should be shortened,[886] and one of the commenters suggested that the Commission use existing infrastructure, naming OATS as an example, as the basis of the audit trail to save implementation time.[887] Another commenter requested that the Commission move the deadline for submission of the joint document from the SROs outlining a proposal of how an expansion could occur from two months, as proposed, to one year after approval of the NMS plan, to allow time to choose a technology provider and build the infrastructure of the

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882 See Nasdaq Letter I, p. 3.

883 See Bean Letter, p. 1.

884 See FINRA/NYSE Euronext Letter, p. 8; FINRA Letter, p. 15; Scottrade Letter, p. 1; CBOE Letter, p. 7; FIF Letter, p. 8; FIF Letter II, p. 2-3; STA Letter, p. 2-3; Nasdaq Letter I, p. 6-7; Wells Fargo Letter, p. 2-3; Direct Edge Letter, p. 2-3.

885 See CBOE Letter, p. 6; Thomson Reuters Letter, p. 3; Liquidnet Letter, p. 2-3, 9; Ameritrade Letter, p. 3; Nasdaq Letter I, p. 7-9; Scottrade Letter, p. 1; SIFMA Letter, p. 13. See also FIF Letter, p. 8; FIF Letter II, p. 2-3; STA Letter, p. 2-3; Wells Fargo Letter, p. 2-3; FINRA/NYSE Euronext Letter, p. 8; FINRA Letter, p. 15.

886 See Kaufman Letter, Attachment p. 1; Schumer Letter, p. 1.

887 See Schumer Letter, p. 1.

system, stating that "[i]t would be far better to develop the design for the initial products and leverage this knowledge to later phases."[888]

The Commission also received two comment letters recommending that the Rule contain an exemption to accommodate the business model of small broker-dealers.[889]

After considering the comments regarding the proposed timeline for implementation of the Rule, the Commission is adopting Rule 613 with changes to the proposed Rule. First, the Commission is adopting a deadline of 60 days from effectiveness of the NMS plan (rather than 120 days from approval of the Rule, as originally proposed) by when each SRO must file with the Commission proposed rule changes to require its members to comply with the requirements of the Rule and the adopted NMS plan,[890] so that SROs can sequence their efforts by acting first on developing the NMS plan to be submitted to the Commission for its consideration, and then on proposed rules requiring compliance by their members. Second, in response to the commenter that advocated extending the deadline for the plan sponsors for submission of the joint document outlining how an expansion could occur from two months, as proposed, to one year after effectiveness of the approved NMS plan, the Commission is modifying the proposed Rule so that the document will be due to the Commission within six months (rather than two months as proposed) after the approval of the NMS plan. The Commission believes that this additional four months will provide the time necessary after the submission of the NMS plan to the Commission for the SROs to plan how to expand the consolidated audit trail to capture orders

888 See Nasdaq Letter I, p. 7.

889 See FINRA Proposal Letter, p. 5-6; and Wachtel Letter, p. 1.

890 See Rule 613(g)(1).

and trading in these additional securities.[891]

The Commission has considered the comment letters that requested an exemption from the proposed Rule for small broker-dealers,[892] but, as discussed above,[893] does not believe that it is appropriate to completely exempt smaller broker-dealers from the requirements of the consolidated audit trail. While the Commission does not believe that it is appropriate to completely exempt smaller broker-dealers from the Rule, the Commission, in response to commenters' concerns regarding the potential difficulties for small broker-dealers, is modifying the time by when the NMS plan may require small broker-dealers to comply with Rule 613. The Commission is permitting the SROs in the NMS plan to allow small broker-dealers up to three years after effectiveness, rather than two years as proposed, to begin reporting data to the central repository in recognition that some of these firms may still be handling orders manually and thus will need additional time to upgrade to an electronic method.[894] Additionally, because many of these broker-dealers may have limited resources, the Commission encourages plan sponsors to propose in the NMS plan a requirement that small broker-dealers report data to the central repository within three years after effectiveness of the NMS plan, as the Commission believes that providing small broker-dealers a longer implementation time should assist such broker-dealers in identifying the most cost-effective and the most efficient manner in which to procure third-party software or make any systems modifications or other changes to comply with Rule 613.

Rule 613(a)(3)(vi) uses the definition of "small broker-dealer" contained in Exchange

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891 The Commission notes that the SROs could begin drafting the document even before an NMS plan is approved by the Commission.

892 See FINRA Proposal Letter, p. 5-6; Wachtel Letter, p. 1.

893 See Section III.B.1.c., supra.

894 See Rule 613(a)(3)(vi); see also Rule 613(a)(3)(v).

Act Rule 0-10: "Small entities under the Securities Exchange Act for purposes of the Regulatory Flexibility Act."[895] Rule 0-10(c) defines a "small broker-dealer" as a broker or dealer that: (1) had total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to 240.17a5(d) or, if not required to file such statements, a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than $500,000 on the last business day of the preceding fiscal year (or in the time that it has been in business, if shorter); and (2) is not affiliated with any person (other than a natural person) that is not a small business or small organization as defined in this section.[896] The Commission believes that applying this definition is appropriate because it is an existing regulatory standard that is an indication of small entities for which regulators should be sensitive when imposing regulatory burdens.

The Commission notes that not all of the timeframes for implementation are being revised.[897] As discussed in Section III.B.1.f., above, the Commission has learned through the

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895 17 CFR 240.0-10.

896 17 CFR 240.0-10(c).

897 Pursuant to Rules 613(a)(3)(i) through (vi), the NMS plan must require the SROs to meet the following implementation deadlines: (1) within two months after effectiveness of the national market system plan jointly (or under the governance structure described in the plan) select a person to be the plan processor; (2) within four months after effectiveness of the national market system plan synchronize their business clocks and require members of each such exchange and association to synchronize their business clocks in accordance with Rule 613(d); (3) within one year after effectiveness of the national market system plan provide to the central repository the data specified in Rule 613(c); (4) within fourteen months after effectiveness of the national market system plan implement a new or enhanced surveillance system(s) as required by Rule 613(f); (5) within two years after effectiveness of the NMS plan, require members of each such exchange and association (except those that qualify as small broker-dealers as defined in § 240.0-10(c)) to provide to the central repository the data specified in Rule 613(c); and (6) within three years after effectiveness of the national market system plan require members of each such exchange and association that qualify as small broker-dealers as defined in § 240.0–10(c) to provide to the central repository the data specified in Rule 613(c).

comment process that technology exists today to "normalize" information collected for the consolidated audit trail into a uniform electronic format, which will allow the required data to be captured and reported to the central repository more readily than the Commission originally anticipated. Accordingly, the Commission believes the remaining proposed implementation timeframes are reasonable and is adopting them as proposed.

IV. Paperwork Reduction Act

Certain provisions of the Rule contain "collection of information requirements" within the meaning of the PRA. The Commission published notice requesting comment on the collection of information requirements in the Proposing Release and submitted the proposed collection to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507 and 5 CFR 1320.11. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. The control number for Rule 613 is OMB Control No. 3235-0671 and the title of the new collection of information is "Creation of a Consolidated Audit Trail Pursuant to Section 11A of the Securities Exchange Act of 1934 and Rules thereunder."

This Release includes the Commission's estimates of the costs to create and file the NMS plan.[898] As noted above, the Commission is deferring its economic analysis of the consolidated audit trail (other than with respect to the NMS plan) until after the NMS plan, including the detailed information and analysis, has been submitted by the SROs and there has been an opportunity for public comment.[899] Similarly, the Commission is discussing below its estimates of the burden hours associated with the development and filing of the NMS plan but is deferring

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898 See Section III.C.3., supra.

899 See Rule 613(a)(5) (providing, in part, that the Commission "shall consider the impact of the national market system plan on efficiency, competition, and capital formation"). See also Section I., supra.

its discussion of the much more significant burden hours associated with the other paperwork requirements of the consolidated audit trail. The Commission also is deferring its discussion of the ongoing burden hours associated with the NMS plan because such ongoing burdens would only be incurred if the Commission approves the NMS plan. Instead, the Commission will defer these discussions until after the NMS plan, including the detailed information and analysis, has been submitted by the SROs and there has been an opportunity for public comment.

A. Summary of Collection of Information under Rule 613

Rule 613 requires the SROs to develop and file an NMS plan to govern the creation, implementation, and maintenance of a consolidated audit trail and central repository for the collection of information for NMS securities.[900] The NMS plan must require each SRO and its respective members to provide certain data to the central repository in compliance with Rule 613.[901] The NMS plan also must include a discussion of specified considerations,[902] and certain provisions related to administration and operation of the plan[903] and the operation of the central

900 See Rule 613(a)(1).

901 See Rule 613(c).

902 See Rule 613(a)(1)(i) through (xii).

903 For example, the NMS plan must include provisions: (1) to ensure fair representation of the plan sponsors; (2) for administration of the central repository, including selection of the plan processor; (3) addressing the requirements for admission of new plan sponsors and withdrawal of existing plan sponsors; (4) addressing the percentage of votes required by the plan sponsors to effectuate amendments to the plan; (5) addressing the manner in which the costs of operating the central repository would be allocated among the SROs that are sponsors of the plan, including a provision addressing the manner in which costs would be allocated to new sponsors to the plan; (6) requiring the appointment of a Chief Compliance Officer to regularly review the operation of the central repository to assure its continued effectiveness, and make any appropriate recommendations for enhancements to the nature of the information collected and the manner in which it is processed; and (7) including an enforcement mechanism to ensure that each SRO and member is collecting and providing to the central repository the information required. See Rule 613(b), 613(g)(4), and 613(h)(3).

repository.[904] Further, the NMS plan is required to include certain provisions related to compliance by the SROs and their members with the requirements of the Rule and the NMS plan.[905]

The Commission believes that requiring an NMS plan imposes a paperwork burden on the SROs associated with preparing and filing the joint NMS plan.

B. Use of Information

The information contained in the NMS plan submitted to the Commission for its consideration will provide the Commission and the public with detailed information regarding how the consolidated audit trail will be created, implemented, and maintained in order for the Commission and the public to be able to carefully consider all aspects of the NMS plan. Further,

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904 For example, the NMS plan must include a provision requiring the creation and maintenance by the plan processor of a method of access to the data stored in the central repository, that includes the ability to run searches and generate reports. See Rule 613(e)(3). Additionally, the NMS plan is required to include policies and procedures, including standards, to be used by the plan processor to: (1) ensure the security and confidentiality of all information submitted to the central repository; (2) ensure the timeliness, accuracy, integrity and completeness of the data provided to the central repository; (and (3) ensure the accuracy of the consolidation by the plan processor of the data provided to the central repository. See Rule 613(e)(4). The NMS plan also must include a provision requiring the plan sponsors to provide to the Commission, at least every two years after effectiveness of the national market system plan, a written assessment of the operation of the consolidated audit trail. See Rule 613(b)(6). The NMS plan is also required to include an Advisory Committee to advise the plan sponsors on the implementation, operation and administration of the central repository. See Rule 613(b)(7). Further, the NMS plan must specify a maximum error rate to be tolerated by the central repository for the data it collects, and processes for identifying and correcting errors in the data, for notifying the entities responsible for the reporting of the erroneous data, and for disciplining those who repeatedly report erroneous data. See Rule 613(e)(6)(i) through(iv). The NMS plan must also specify as a time by which the corrected data will be available to regulators. See Rule 613(e)(6)(iv).

905 The NMS plan must include: (1) a provision that makes each SRO that sponsors the plan responsible for enforcing compliance by its members with the provisions of the plan; and (2) mechanisms to ensure that plan sponsors and their members comply with the requirements of the plan. See Rules 613(g)(3), 613(g)(4), and 613(h)(3).

the information contained in the NMS plan should facilitate an analysis of how well the NMS plan will allow regulators to effectively and efficiently carry out their responsibilities.

C. Respondents

Rule 613 applies to the 16 national securities exchanges and to one national securities association (FINRA) currently registered with the Commission.[906]

D. Total Annual Reporting and Recordkeeping Burden for the Creation and Filing of the NMS Plan

1. Preliminary Burden Hour Estimates from Proposing Release

In the Proposing Release, the Commission estimated that each SRO, on average, would spend approximately 840 hours of legal, compliance, information technology, and business operations time to prepare and file the NMS plan. All together the SROs would spend an estimated 12,600 hours.[907] The Commission's 840 hour estimate included internal personnel time and external legal costs - 400 Attorney hours, 100 Compliance Manager hours, 220 Programmer Analyst hours, and 120 Business Analyst hours. Commission staff also estimated that each SRO would outsource, on average, 50 hours of legal time to develop and draft the NMS

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906 At the time the Proposing Release was published, there were 14 national securities exchanges. On August 13, 2010, the Commission granted the application of BATS-Y Exchange for registration as a national securities exchange. See Securities Exchange Act Release No. 62719, 75 FR 51295 (August 19, 2010). Additionally, on April 27, 2012, the Commission granted the application of BOX Options Exchange for registration as a national securities exchange. See Securities Exchange Act Release No. 66871, 77 FR 26323 (May 3, 2012).

907 Commission staff estimated that each SRO would spend an aggregate one-time amount of (400 Attorney hours) + (100 Compliance Manager hours) + (220 Programmer Analyst hours) + (120 Business Analyst hours) x (15 SROs) = 12,600 burden hours to prepare and file the NMS plan.

plan, at an average hourly rate of $400, for a total external cost of $20,000 per SRO.[908] All together, the SROs would spend an estimated $300,000 in external costs.[909]

In making these estimates, the Commission assumed that the burden hours necessary for preparing and filing the NMS plan pursuant to the proposed Rule would be comparable to the burden hours needed to create other existing NMS plans.[910] The Commission's estimates included anticipated work hours for Programmer Analysts, Business Analysts, Attorneys and Compliance Managers. The Commission did not receive comments on any of these burden estimates.

2. Revised Burden Hour Estimates

As noted above, the Commission based its original estimates of SRO burden hours to prepare and file the NMS plan on the burden hours spent for existing NMS plans. The Commission, however, has modified the proposed Rule in several significant ways that differentiate the burden hours to prepare the NMS plan from all other existing NMS plans. These modifications require the SROs to expand the NMS plan in the following four ways: (1) provide additional information and analysis to address the considerations that are set forth in Rule 613(a)(1);[911] (2) include additional provisions that were not required by the proposed Rule relating to enforcement mechanisms,[912] security and confidentiality,[913] and the preparation of a

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908 Based on industry sources, the Commission estimated that the hourly rate for outsourced legal services in the securities industry is $400 per hour.

909 Commission staff estimated that the SROs would spend ($20,000 per SRO) x (15 SROs) = $300,000 in external costs to develop and draft the NMS plan.

910 See Proposing Release, supra note 4, at 32596.

911 See Rule 613(a)(1)(i) through (xii); Section III.C.2.a., supra.

912 See Rule 613(h)(3); Section III.B.3.a.1., supra.

913 See, e.g., Rule 613(e)(4)(i)(A) through (D). For example, Rule 613(e)(4)(i)(A) requires that the NMS plan require that all plan sponsors and their employees, as well as all

document every two years that contains a retrospective assessment of the performance of the consolidated audit trail, as well as a plan to improve its performance;[914] (3) address error rates;[915] and (4) provide for the creation of an Advisory Committee.[916]

a. Revised Initial Burden Hours Needed to Prepare and File the NMS Plan

In light of these modifications to the proposed Rule, the Commission is increasing substantially its estimated burden hours needed for the development and filing of the NMS plan. The Commission also is adjusting its preliminary burden hour estimates for the preparation and filing of an NMS plan to reflect the registration of two additional SROs after it issued the preliminary estimates.[917] The Commission now estimates that the aggregate one-time burden hour amount for preparing and filing an NMS plan would be approximately 2,760 burden hours with $20,000 in external costs per SRO,[918] or approximately 46,920 burden hours and $340,000

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employees of the central repository, agree to use appropriate safeguards to ensure the confidentiality of such data and not use such data for purposes other than surveillance or regulatory purposes. Additionally, Rule 613(e)(4)(i)(B) requires the NMS plan to require that each SRO adopt and enforce rules that: (1) require information barriers between regulatory staff and non-regulatory staff with regard to access and use of data in the central repository and (2) permit only persons designated by plan sponsors to have access to the data in the central repository. See Section III.B.2.e., supra.

914 See Rule 613(b)(6)(i) through (iv). See Section III.B.3.b., supra.

915 See Rule 613(e)(6)(i) through (ii). See Section III.B.2.c., supra. See Rule 613(e)(6)(iii) through (iv).

916 See Rule 613(b)(7).

917 See note 906, supra.

918 Commission staff estimates that each SRO would spend an aggregate one-time amount of (700 Attorney hours) + (300 Compliance Manager hours) + (880 Programmer Analyst hours) + (880 Business Analyst hours) = 2,760 burden hours per SRO to prepare and file an NMS plan. In addition, Commission staff estimates that each SRO would incur a one-time external cost of (50 legal hours x $400 per hour) = $20,000.

in external costs in the aggregate,[919] compared to an initial estimate of 840 burden hours per SRO with $20,000 in external costs, or approximately 12,600 burden hours in the aggregate and $300,000 in external costs, to prepare and file an NMS plan.[920]

The Commission believes that these revised estimates, which include internal SRO personnel time and external legal costs, are appropriate based on the Commission's analysis, set forth below, of the impact of the modifications to the proposed Rule on each of the job categories underlying the estimates. The Commission believes that the modifications to the proposed Rule will require SRO Programmer Analysts, Business Analysts, Attorneys, and Compliance Managers to expend additional time to address the requirements of the Rule. As discussed in more detail below, the Commission anticipates that the SROs will spend additional time on many activities, including: (1) research; (2) discussions with members, committees and with industry associations; (3) vendor negotiations; (4) making decisions regarding the various options and increased flexibility provided by the adopted Rule;[921] (5) reviewing alternative NMS plans; (6) choosing between alternative plans and negotiating to reach a consensus on a single NMS plan; (7) providing a detailed estimate of the costs associated with that NMS plan; and (8) drafting the NMS plan. The Commission also believes that these increased estimates are appropriate in light of the comments, including the comment that asserted that the Commission underestimated the time the SROs would spend on the business analyses to be performed in designing the NMS plan, based on the experience of broker-dealers, vendors and SROs when OATS was expanded

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919 Commission staff estimates that the SROs would incur an aggregate one-time amount of (2,760 burden hours per SRO) x (17 SROs) = 46,920 burden hours to prepare and file an NMS plan. Commission staff estimates that ($20,000 per SRO) x (17 SROs) = $340,000 in external costs to prepare and file the NMS plan.

920 See Proposing Release, supra note 4, at 32596.

921 See Section I., supra.

to all NMS stocks.[922] In response, as discussed in more detail below, the Commission is increasing its estimated Programmer Analyst, Business Analyst, Attorney and Compliance Manager hours.

The Commission notes that these revised average hourly and cost estimates per SRO for creating and filing the NMS plan likely overestimated the costs for some of SROs and underestimated the costs for other SROs. The Commission also believes that certain SROs, particularly those SROs under the same holding company, may decide to collaborate and realize some cost savings on a per SRO basis. On balance, however, the Commission believes that, these revised hours and cost estimates are reasonable on average even if they may not be precise for any specific SRO.

(i) Programmer Analyst

The Commission is increasing its estimates for the hours a Programmer Analyst would likely spend with respect to the preparation and filing of the NMS plan from 220 hours, as originally estimated, to 880 hours per SRO. The Commission anticipates that a Programmer Analyst would need to spend substantially more time to address the considerations included in the Rule and the "use cases." Specifically, the SROs will need to rely on Programmer Analysts to help address many of the considerations, as many of those are of a technical nature. For example, several of the considerations relate to the specific features and details of the NMS plan. Programmer Analysts likely will be consulted when the SROs are considering the specific features and details of the NMS plan. The Programmer Analysts likely will provide guidance and information regarding whether a particular feature or detail is technologically possible. The SROs also likely will consult Programmer Analysts when drafting the additional provisions

922 See FIF Letter II, p. 2-3. See also STA Letter, p. 2-3.

required by the Rule. For example, in drafting the security and confidentiality provisions, Programmer Analysts, who may have knowledge about the information security practices and issues, may be consulted to provide input on a draft provisions in light of technologies with respect to security and confidentiality. Programmer Analysts also may be consulted with respect to addressing errors rates because such analysts may have a technical understanding of trading and reporting systems and be able to provide recommendations on how errors that are introduced can be addressed. In each of these instances, Programmer Analysts may be involved in the NMS plan research, any industry discussions, negotiations with vendors and SROs, and in developing cost estimates for the consolidated audit trail. Thus, for these reasons, the Commission believes it appropriate to increase its estimate of the number of hours expended by Programmer Analysts in the creation and filing of the NMS plan.

(ii) Business Analyst

The Commission is increasing its estimates for the hours a Business Analyst would likely spend with respect to the preparation and filing of an NMS plan from 360 hours per SRO, as originally estimated, to 880 hours per SRO. The Commission anticipates that a Business Analyst would spend substantially more time to address the considerations and the "use cases." Overall, the Commission anticipates that this amount of additional time will be comparable to the additional time that would likely be spent by Programmer Analysts for the same reasons because Business Analysts will likely be involved in many of the same tasks as Programmer Analysts, albeit with separate responsibilities. The SROs will need to rely on Business Analysts to help address many technical considerations that have relevance to the business and operations of SROs. The Commission also believes that the SROs will need to rely on Business Analysts to work with the Programmer Analysts and the Compliance Managers to analyze the business impact of particular features and details of the NMS plan. Because Rule 613 is less prescriptive than the proposed Rule, Business Analysts may have a larger role in helping to determine which option the NMS plan will propose. Business Analysts also will likely be involved in determining the cost estimates and in analyzing the NMS plan's impact on efficiency, competition, and capital formation. The SROs also likely will consult with Business Analysts when drafting the responses to the considerations and the "use cases," as well as the additional provisions required by the Rule. For example, the SROs likely will consult with Business Analysts on the feasibility, benefits, and costs of any technological upgrades that may be required in order to provide the allocation information described in Rule 613(a)(1)(vi). Further, in drafting the security and confidentiality provisions, Business Analysts may have knowledge about the costs and the business risks of certain security and confidentiality decisions. Business Analysts also may be consulted with respect to addressing error rates because any decisions made may impact business operations and the cost estimates. Further, Business Analysts may likely be consulted by Attorneys with respect to the performance assessment and improvement plan. In each of these instances, Business Analysts may be involved in the NMS plan research, any industry discussions (particularly with members and other SROs), negotiations with vendors and SROs, and in developing cost estimates for the consolidated audit trail. Thus, for these reasons, the Commission believes it is appropriate to increase its estimate of the number of hours expended by Business Analysts in the creation and filing of the NMS plan.

(iii) Attorney

The Commission is increasing its Attorney hour estimates from 400 hours to 700 hours per SRO. The Commission now anticipates that an Attorney would spend substantially more time than the Commission had previously estimated to draft the NMS plan. The NMS plan that

Attorneys would draft must now include a discussion of the considerations and the additional provisions required by the Rule, and must reflect additional consultations with Programmer Analysts, Business Analysts and Compliance Managers. Further, the NMS plan drafted also would likely reflect additional consultation on the "use cases." The NMS plan proposal would also likely require Attorney work on the Advisory Committee requirement and on the NMS plan policies and procedures to be used by the plan processor[923] to ensure the security and confidentiality and accuracy of the information submitted to the central repository.[924] Attorney work would also be required on the mechanism to enforce compliance by plan sponsors with the NMS plan, as required by Rule 613(h)(3), including penalty provisions, if the plan sponsors deem appropriate. The Commission believes that an Attorney would also be involved in the NMS plan research, any industry discussions, negotiations with vendors, negotiations with SROs (in particular, to reach consensus on an NMS plan), and in developing cost estimates for the consolidated audit trail. Thus, for these reasons, the Commission believes it appropriate to increase its estimate of the number of hours expended by Attorneys in the creation and filing of the NMS plan.

(iv) Compliance Manager

The Commission is increasing its Compliance Manager hour estimates from 100 hours to 300 hours per SRO. The Commission now anticipates that a Compliance Manager would spend

923 See Rule 613(e)(4). The Commission believes that an outline or overview description of the policies and procedures, including standards, to be used by the plan processor that would be implemented under the NMS plan submitted to the Commission for its consideration would be sufficient to satisfy the requirement of the Rule. The Commission believes it is important for the NMS plan to establish the fundamental framework of these policies and procedures, but recognizes the utility of allowing the plan sponsors flexibility to subsequently delineate them in greater detail with the ability to make modifications as needed. See Section III.B.2.e., supra.

924 See Rule 613(e)(4)(i)(A) through (D).

substantially more time than the Commission had previously estimated to draft the NMS plan. Compliance Managers likely will help shape provisions of the NMS plan that deal with monitoring member and SRO compliance with the NMS plan's requirements. Compliance Managers likely will also be involved in the Advisory Committee requirement. They likely will also work on NMS plan policies and procedures to be used by the plan processor to ensure the security and confidentiality and accuracy of the information submitted to the central repository, and to ensure that these policies and procedures are feasible for SRO compliance and for member compliance.[925] They will likely also work on the mechanism to enforce compliance by plan sponsors with the NMS plan, as required by Rule 613(h)(3), including penalty provisions, if the plan sponsors deem appropriate. Further, Compliance Managers will also work on NMS plan provisions that address error rates and performance assessment and improvement. The Commission believes that Compliance Managers may also be involved in the NMS plan research and industry discussions (particularly with regard to SRO and member compliance issues). Thus, for these reasons, the Commission believes it is appropriate to increase its estimate of the number of hours expended by Compliance Managers in the creation and filing of the NMS plan.

E Collection of Information is Mandatory

The collection of information discussed above is a mandatory collection of information.

F. Confidentiality

The Rule requires that the data to be recorded and reported to the central repository will only be available to the SROs and the Commission for the purpose of performing their respective regulatory and oversight responsibilities pursuant to the federal securities laws, rules, and

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925 See Rule 613(e)(4)(i)(A) through (D).

regulations.[926] Further, the NMS plan submitted to the Commission for its consideration pursuant to the adopted Rule is required to include policies and procedures to ensure the security and confidentiality of all information submitted to the central repository, and to ensure that all plan sponsors and their employees, as well as all employees of the central repository, use appropriate safeguards to ensure the confidentiality of such data and shall agree not to use such data for any purpose other than surveillance and regulatory purposes.[927]

G. Retention Period of Recordkeeping Requirements

The SROs are required to retain records and information pursuant to Rule 17a-1 under the Exchange Act.[928] Members are required to retain records and information in accordance with Rule 17a-4 under the Exchange Act.[929]

V. Regulatory Flexibility Act Certification

The Regulatory Flexibility Act ("RFA")[930] requires Federal agencies, in promulgating rules, to consider the impact of those rules on small entities. Section 603(a) of the Administrative Procedure Act, as amended by RFA, generally requires the Commission to undertake a regulatory flexibility analysis of all proposed rules, or proposed rule amendments, to determine the impact of such rulemaking on "small entities."[931] Rule 605(b) of the RFA states

926 See Rule 613(e)(2).

927 See proposed Rule 613(e)(4)(i).

928 17 CFR 240.17a-1.

929 17 CFR 240.17a-4.

930 5 U.S.C. 601 et seq.

931 Although Section 601(6) of the RFA defines the term "small entity," the statute permits agencies to formulate their own definitions. The Commission has adopted definitions for the term "small entity" for the purposes of Commission rulemaking in accordance with the RFA. Those definitions, as relevant to this rulemaking, are set forth in Rule 0-10, 17 CFR 240.0-10. See Securities Exchange Act Release No. 18451 (January 28, 1982), 47 FR 5215 (February 4, 1982) (File No. AS-305).

that this requirement shall not apply to any proposed rule or proposed rule amendment, which if adopted, would not "have a significant economic impact on a substantial number of small entities."[932]

In the Proposing Release, the Commission requested comment on whether proposed Rule 613 would have a significant economic impact on a substantial number of small entities, and, if so, what would be the nature of any impact on small entities.[933] The Commission also requested that commenters provide empirical data to support the extent of such impact.[934] The Commission received two comments on the general anticipated effect of the proposed Rule on small-broker dealers; FINRA and a small broker-dealer that solely handles orders manually requested that an exemption from the proposed Rule be adopted to accommodate the business model of small broker-dealers.[935] In response to the commenters, the Commission amended the Rule as proposed to provide additional time for small broker-dealers to comply with the reporting requirements of Rule 613.[936] The Commission notes that none of the comment letters received specifically responded to the Commission's initial regulatory flexibility analysis.

As proposed and as adopted, Rule 613 requires the SROs to file an NMS plan to create, implement, and maintain the consolidated audit trail. In response to commenters and as discussed in this release, the Commission has modified the proposed Rule to provide the SROs with a range of options and greater flexibility for how they choose to meet the requirements of the Rule. As a result, the Commission will not know the specific requirements of the NMS plan

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932 5 U.S.C. 605(b).

933 See Proposing Release, supra note 4, at 32607.

934 Id.

935 See FINRA Proposal Letter, p. 5-6 and Wachtel Letter, p. 1.

936 See Rule 613(a)(3)(vi).

until it is filed with the Commission, and cannot analyze how the NMS plan will impact small entities until then. At this time, there are no small entities "subject to the requirements" of Rule 613.[937]

However, because Rule 613 requires that the national securities exchanges and national securities associations (i.e., FINRA) file an NMS plan with the Commission, for purposes of the RFA, the Commission is undertaking an analysis of how the NMS plan filing requirement will impact the exchanges and FINRA to ascertain whether the exchanges and FINRA are "small businesses." Paragraph (e) of Rule 0-10 provides that for the purposes of the RFA, an exchange is considered a "small business" if it has been exempted from the reporting requirements of Rule 601 of Regulation NMS,[938] and is not affiliated with any person (other than a natural person) that is not a small business or small organization as defined in Rule 0-10. Under this standard, none of the national securities exchanges subject to Rule 613 is a "small business" for purposes of the RFA. In addition, FINRA is not a small entity as defined in Rule 0-10.[939] Therefore, the Commission believes that Rule 613, which requires that the SROs file an NMS plan with the Commission to create, implement, and maintain the consolidated audit trail, will not have a significant economic impact on a substantial number of small entities because this requirement will only apply to the existing national securities exchanges and national securities associations, which do not qualify as small entities pursuant to the RFA.

For the foregoing reasons, the Commission hereby certifies that, pursuant to 5 U.S.C. 605(b), Rule 613 will not have a significant economic impact on a substantial number of small entities.

937 Section 604(a)(4) of the RFA.

938 17 CFR 242.601.

939 13 CFR 121.201.

VI. Statutory Authority

Pursuant to the Exchange Act and particularly, Sections 2, 3(b), 5, 6, 11A, 15, 15A, 17(a) and (b), 19, and 23(a) thereof, 15 U.S.C. 78b, 78c(b), 78e, 78f, 78k-1, 78o, 78o-3, 78q(a) and (b), 78s and 78w(a), the Commission is adopting Rule 613 of Regulation NMS, as set forth below.

Text of Rule

List of Subjects in 17 CFR Part 242

Brokers, Reporting and recordkeeping requirements, Securities.

In accordance with the foregoing, Title 17, Chapter II, of the Code of Federal Regulations is amended as follows.

PART 242 — REGULATIONS M, SHO, ATS, AC, AND NMS AND CUSTOMER MARGIN REQUIREMENTS FOR SECURITY FUTURES

1. The authority citation for part 242 continues to read as follows:

Authority: 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78g(c)(2), 78i(a), 78j, 78k-1(c), 78l, 78m, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd-1, 78mm, 80a-23, 80a-29, and 80a-37.

2. Add § 242.613 to read as follows:

§ 242.613 Consolidated Audit Trail.

(a) Creation of a National Market System Plan Governing a Consolidated Audit Trail.

(1) Each national securities exchange and national securities association shall jointly file on or before 270 days from the date of publication of the Adopting Release in the Federal Register a national market system plan to govern the creation, implementation, and maintenance of a consolidated audit trail and central repository as required by this section. The national market system plan shall discuss the following considerations:

(i) The method(s) by which data will be reported to the central repository including, but not limited to, the sources of such data and the manner in which the central repository will receive, extract, transform, load, and retain such data; and the basis for selecting such method(s);

(ii) The time and method by which the data in the central repository will be made available to regulators, in accordance with paragraph (e)(1) of this section, to perform surveillance or analyses, or for other purposes as part of their regulatory and oversight responsibilities;

(iii) The reliability and accuracy of the data reported to and maintained by the central repository throughout its lifecycle, including transmission and receipt from market participants; data extraction, transformation and loading at the central repository; data maintenance and management at the central repository; and data access by regulators;

(iv) The security and confidentiality of the information reported to the central repository;

(v) The flexibility and scalability of the systems used by the central repository to collect, consolidate and store consolidated audit trail data, including the capacity of the consolidated audit trail to efficiently incorporate, in a cost-effective manner, improvements in technology, additional capacity, additional order data, information about additional securities or transactions, changes in regulatory requirements, and other developments;

(vi) The feasibility, benefits, and costs of broker-dealers reporting to the consolidated audit trail in a timely manner:

(A) The identity of all market participants (including broker-dealers and customers) that are allocated NMS securities, directly or indirectly, in a primary market transaction;

(B) The number of such securities each such market participant is allocated; and

(C) The identity of the broker-dealer making each such allocation;

(vii) The detailed estimated costs for creating, implementing, and maintaining the consolidated audit trail as contemplated by the national market system plan, which estimated costs should specify:

(A) An estimate of the costs to the plan sponsors for establishing and maintaining the central repository;

(B) An estimate of the costs to members of the plan sponsors, initially and on an ongoing basis, for reporting the data required by the national market system plan;

(C) An estimate of the costs to the plan sponsors, initially and on an ongoing basis, for reporting the data required by the national market system plan; and

(D) How the plan sponsors propose to fund the creation, implementation, and maintenance of the consolidated audit trail, including the proposed allocation of such estimated costs among the plan sponsors, and between the plan sponsors and members of the plan sponsors;

(viii) An analysis of the impact on competition, efficiency and capital formation of creating, implementing, and maintaining of the national market system plan;

(ix) A plan to eliminate existing rules and systems (or components thereof) that will be rendered duplicative by the consolidated audit trail, including identification of such rules and systems (or components thereof); to the extent that any existing rules or systems related to monitoring quotes, orders, and executions provide information that is not rendered duplicative by the consolidated audit trail, an analysis of:

(A) Whether the collection of such information remains appropriate;

(B) If still appropriate, whether such information should continue to be separately collected or should instead be incorporated into the consolidated audit trail; and

(C) If no longer appropriate, how the collection of such information could be efficiently terminated; the steps the plan sponsors propose to take to seek Commission approval for the elimination of such rules and systems (or components thereof); and a timetable for such elimination, including a description of how the plan sponsors propose to phase in the consolidated audit trail and phase out such existing rules and systems (or components thereof);

(x) Objective milestones to assess progress toward the implementation of the national market system plan;

(xi) The process by which the plan sponsors solicited views of their members and other appropriate parties regarding the creation, implementation, and maintenance of the consolidated audit trail, a summary of the views of such members and other parties, and how the plan sponsors took such views into account in preparing the national market system plan; and

(xii) Any reasonable alternative approaches to creating, implementing, and maintaining a consolidated audit trail that the plan sponsors considered in developing the national market system plan including, but not limited to, a description of any such alternative approach; the relative advantages and disadvantages of each such alternative, including an assessment of the alternative's costs and benefits; and the basis upon which the plan sponsors selected the approach reflected in the national market system plan.

(2) The national market system plan, or any amendment thereto, filed pursuant to this section shall comply with the requirements in § 242.608(a), if applicable, and be filed with the Commission pursuant to § 242.608.

(3) The national market system plan submitted pursuant to this section shall require each national securities exchange and national securities association to:

(i) Within two months after effectiveness of the national market system plan jointly (or under the governance structure described in the plan) select a person to be the plan processor;

(ii) Within four months after effectiveness of the national market system plan synchronize their business clocks and require members of each such exchange and association to synchronize their business clocks in accordance with paragraph (d) of this section;

(iii) Within one year after effectiveness of the national market system plan provide to the central repository the data specified in paragraph (c) of this section;

(iv) Within fourteen months after effectiveness of the national market system plan implement a new or enhanced surveillance system(s) as required by paragraph (f) of this section;

(v) Within two years after effectiveness of the national market system plan require members of each such exchange and association, except those members that qualify as small broker-dealers as defined in § 240.0-10(c) of this chapter, to provide to the central repository the data specified in paragraph (c) of this section; and

(vi) Within three years after effectiveness of the national market system plan require members of each such exchange and association that qualify as small broker-dealers as defined in § 240.0-10(c) of this chapter to provide to the central repository the data specified in paragraph (c) of this section.

(4) Each national securities exchange and national securities association shall be a sponsor of the national market system plan submitted pursuant to this section and approved by the Commission.

(5) No national market system plan filed pursuant to this section, or any amendment thereto, shall become effective unless approved by the Commission or otherwise permitted in accordance with the procedures set forth in § 242.608. In determining whether to approve the national market system plan, or any amendment thereto, and whether the national market system plan or any amendment thereto is in the public interest under § 242.608(b)(2), the Commission shall consider the impact of the national market system plan or amendment, as applicable, on efficiency, competition, and capital formation.

(b) Operation and Administration of the National Market System Plan.

(1) The national market system plan submitted pursuant to this section shall include a governance structure to ensure fair representation of the plan sponsors, and administration of the central repository, including the selection of the plan processor.

(2) The national market system plan submitted pursuant to this section shall include a provision addressing the requirements for the admission of new sponsors of the plan and the withdrawal of existing sponsors from the plan.

(3) The national market system plan submitted pursuant to this section shall include a provision addressing the percentage of votes required by the plan sponsors to effectuate amendments to the plan.

(4) The national market system plan submitted pursuant to this section shall include a provision addressing the manner in which the costs of operating the central repository will be allocated among the national securities exchanges and national securities associations that are sponsors of the plan, including a provision addressing the manner in which costs will be allocated to new sponsors to the plan.

(5) The national market system plan submitted pursuant to this section shall require the appointment of a Chief Compliance Officer to regularly review the operation of the central repository to assure its continued effectiveness in light of market and technological developments, and make any appropriate recommendations for enhancements to the nature of the information collected and the manner in which it is processed.

(6) The national market system plan submitted pursuant to this section shall include a provision requiring the plan sponsors to provide to the Commission, at least every two years after effectiveness of the national market system plan, a written assessment of the operation of the consolidated audit trail. Such document shall include, at a minimum:

(i) An evaluation of the performance of the consolidated audit trail including, at a minimum, with respect to data accuracy (consistent with paragraph (e)(6) of this section), timeliness of reporting, comprehensiveness of data elements, efficiency of regulatory access, system speed, system downtime, system security (consistent with paragraph (e)(4) of this section), and other performance metrics to be determined by the Chief Compliance Officer, along with a description of such metrics;

(ii) A detailed plan, based on such evaluation, for any potential improvements to the performance of the consolidated audit trail with respect to any of the following: improving data accuracy; shortening reporting timeframes; expanding data elements; adding granularity and details regarding the scope and nature of Customer-IDs; expanding the scope of the national market system plan to include new instruments and new types of trading and order activities; improving the efficiency of regulatory access; increasing system speed; reducing system downtime; and improving performance under other metrics to be determined by the Chief Compliance Officer;

(iii) An estimate of the costs associated with any such potential improvements to the performance of the consolidated audit trail, including an assessment of the potential impact on competition, efficiency, and capital formation; and

(iv) An estimated implementation timeline for any such potential improvements, if applicable.

(7) The national market system plan submitted pursuant to this section shall include an Advisory Committee which shall function in accordance with the provisions set forth in this paragraph (b)(7). The purpose of the Advisory Committee shall be to advise the plan sponsors on the implementation, operation, and administration of the central repository.

(i) The national market system plan submitted pursuant to this section shall set forth the term and composition of the Advisory Committee, which composition shall include representatives of the member firms of the plan sponsors.

(ii) Members of the Advisory Committee shall have the right to attend any meetings of the plan sponsors, to receive information concerning the operation of the central repository, and to provide their views to the plan sponsors; provided, however, that the plan sponsors may meet without the Advisory Committee members in executive session if, by affirmative vote of a majority of the plan sponsors, the plan sponsors determine that such an executive session is required.

(c) Data Recording and Reporting.

(1) The national market system plan submitted pursuant to this section shall provide for an accurate, time-sequenced record of orders beginning with the receipt or origination of an order by a member of a national securities exchange or national securities association, and further documenting the life of the order through the process of routing, modification, cancellation, and execution (in whole or in part) of the order.

(2) The national market system plan submitted pursuant to this section shall require each national securities exchange, national securities association, and member to report to the central repository the information required by paragraph (c)(7) of this section in a uniform electronic format, or in a manner that would allow the central repository to convert the data to a uniform electronic format, for consolidation and storage.

(3) The national market system plan submitted pursuant to this section shall require each national securities exchange, national securities association, and member to record the information required by paragraphs (c)(7)(i) through (v) of this section contemporaneously with the reportable event. The national market system plan shall require that information recorded pursuant to paragraphs (c)(7)(i) through (v) of this section must be reported to the central repository by 8:00 a.m. Eastern Time on the trading day following the day such information has been recorded by the national securities exchange, national securities association, or member. The national market system plan may accommodate voluntary reporting prior to 8:00 a.m. Eastern Time, but shall not impose an earlier reporting deadline on the reporting parties.

(4) The national market system plan submitted pursuant to this section shall require each member of a national securities exchange or national securities association to record and report to the central repository the information required by paragraphs (c)(7)(vi) through (viii) of

this section by 8:00 a.m. Eastern Time on the trading day following the day the member receives such information. The national market system plan may accommodate voluntary reporting prior to 8:00 a.m. Eastern Time, but shall not impose an earlier reporting deadline on the reporting parties.

(5) The national market system plan submitted pursuant to this section shall require each national securities exchange and its members to record and report to the central repository the information required by paragraph (c)(7) of this section for each NMS security registered or listed for trading on such exchange or admitted to unlisted trading privileges on such exchange.

(6) The national market system plan submitted pursuant to this section shall require each national securities association and its members to record and report to the central repository the information required by paragraph (c)(7) of this section for each NMS security for which transaction reports are required to be submitted to the association.

(7) The national market system plan submitted pursuant to this section shall require each national securities exchange, national securities association, and any member of such exchange or association to record and electronically report to the central repository details for each order and each reportable event, including, but not limited to, the following information:

(i) For original receipt or origination of an order:

(A) Customer-ID(s) for each customer;

(B) The CAT-Order-ID;

(C) The CAT-Reporter-ID of the broker-dealer receiving or originating the order;

(D) Date of order receipt or origination;

(E) Time of order receipt or origination (using time stamps pursuant to paragraph (d)(3) of this section); and

(F) Material terms of the order.

(ii) For the routing of an order, the following information:

(A) The CAT-Order-ID;

(B) Date on which the order is routed;

(C) Time at which the order is routed (using time stamps pursuant to paragraph (d)(3) of this section);

(D) The CAT-Reporter-ID of the broker-dealer or national securities exchange routing the order;

(E) The CAT-Reporter-ID of the broker-dealer, national securities exchange, or national securities association to which the order is being routed;

(F) If routed internally at the broker-dealer, the identity and nature of the department or desk to which an order is routed; and

(G) Material terms of the order.

(iii) For the receipt of an order that has been routed, the following information:

(A) The CAT-Order-ID;

(B) Date on which the order is received;

(C) Time at which the order is received (using time stamps pursuant to paragraph (d)(3) of this section);

(D) The CAT-Reporter-ID of the broker-dealer, national securities exchange, or national securities association receiving the order;

(E) The CAT-Reporter-ID of the broker-dealer or national securities exchange routing the order; and

(F) Material terms of the order.

(iv) If the order is modified or cancelled, the following information:

(A) The CAT-Order-ID;

(B) Date the modification or cancellation is received or originated;

(C) Time the modification or cancellation is received or originated (using time stamps pursuant to paragraph (d)(3) of this section);

(D) Price and remaining size of the order, if modified;

(E) Other changes in material terms of the order, if modified; and

(F) The CAT-Reporter-ID of the broker-dealer or Customer-ID of the person giving the modification or cancellation instruction.

(v) If the order is executed, in whole or part, the following information:

(A) The CAT-Order-ID;

(B) Date of execution;

(C) Time of execution (using time stamps pursuant to paragraph (d)(3) of this section);

(D) Execution capacity (principal, agency, riskless principal);

(E) Execution price and size;

(F) The CAT-Reporter-ID of the national securities exchange or broker-dealer executing the order; and

(G) Whether the execution was reported pursuant to an effective transaction reporting plan or the Plan for Reporting of Consolidated Options Last Sale Reports and Quotation Information.

(vi) If the order is executed, in whole or part, the following information:

(A) The account number for any subaccounts to which the execution is allocated (in whole or part);

(B) The CAT-Reporter-ID of the clearing broker or prime broker, if applicable; and

(C) The CAT-Order-ID of any contra-side order(s).

(vii) If the trade is cancelled, a cancelled trade indicator.

(viii) For original receipt or origination of an order, the following information:

(A) Information of sufficient detail to identify the customer; and

(B) Customer account information.

(8) All plan sponsors and their members shall use the same Customer-ID and CAT-Reporter-ID for each customer and broker-dealer.

(d) Clock Synchronization and Time Stamps. The national market system plan submitted pursuant to this section shall require:

(1) Each national securities exchange, national securities association, and member of such exchange or association to synchronize its business clocks that are used for the purposes of recording the date and time of any reportable event that must be reported pursuant to this section to the time maintained by the National Institute of Standards and Technology, consistent with industry standards;

(2) Each national securities exchange and national securities association to evaluate annually the clock synchronization standard to determine whether it should be shortened, consistent with changes in industry standards; and

(3) Each national securities exchange, national securities association, and member of such exchange or association to utilize the time stamps required by paragraph (c)(7) of this section, with at minimum the granularity set forth in the national market system plan submitted

pursuant to this section, which shall reflect current industry standards and be at least to the millisecond. To the extent that the relevant order handling and execution systems of any national securities exchange, national securities association, or member of such exchange or association utilize time stamps in increments finer than the minimum required by the national market system plan, the plan shall require such national securities exchange, national securities association, or member to utilize time stamps in such finer increments when providing data to the central repository, so that all reportable events reported to the central repository by any national securities exchange, national securities association, or member can be accurately sequenced. The national market system plan shall require the sponsors of the national market system plan to annually evaluate whether industry standards have evolved such that the required time stamp standard should be in finer increments.

(e) Central Repository.

(1) The national market system plan submitted pursuant to this section shall provide for the creation and maintenance of a central repository. Such central repository shall be responsible for the receipt, consolidation, and retention of all information reported pursuant to paragraph (c)(7) of this section. The central repository shall store and make available to regulators data in a uniform electronic format, and in a form in which all events pertaining to the same originating order are linked together in a manner that ensures timely and accurate retrieval of the information required by paragraph (c)(7) of this section for all reportable events for that order.

(2) Each national securities exchange, national securities association, and the Commission shall have access to the central repository, including all systems operated by the central repository, and access to and use of the data reported to and consolidated by the central

repository under paragraph (c) of this section, for the purpose of performing its respective regulatory and oversight responsibilities pursuant to the federal securities laws, rules, and regulations. The national market system plan submitted pursuant to this section shall provide that such access to and use of such data by each national securities exchange, national securities association, and the Commission for the purpose of performing its regulatory and oversight responsibilities pursuant to the federal securities laws, rules, and regulations shall not be limited.

(3) The national market system plan submitted pursuant to this section shall include a provision requiring the creation and maintenance by the plan processor of a method of access to the consolidated data stored in the central repository that includes the ability to run searches and generate reports.

(4) The national market system plan submitted pursuant to this section shall include policies and procedures, including standards, to be used by the plan processor to:

(i) Ensure the security and confidentiality of all information reported to the central repository by requiring that:

(A) All plan sponsors and their employees, as well as all employees of the central repository, agree to use appropriate safeguards to ensure the confidentiality of such data and agree not to use such data for any purpose other than surveillance and regulatory purposes, provided that nothing in this paragraph (A) shall be construed to prevent a plan sponsor from using the data that it reports to the central repository for regulatory, surveillance, commercial, or other purposes as otherwise permitted by applicable law, rule, or regulation;

(B) Each plan sponsor adopt and enforce rules that:

(1) Require information barriers between regulatory staff and non-regulatory staff with regard to access and use of data in the central repository; and

(2) Permit only persons designated by plan sponsors to have access to the data in the central repository;

(C) The plan processor:

(1) Develop and maintain a comprehensive information security program for the central repository, with dedicated staff, that is subject to regular reviews by the Chief Compliance Officer;

(2) Have a mechanism to confirm the identity of all persons permitted to access the data; and

(3) Maintain a record of all instances where such persons access the data; and

(D) The plan sponsors adopt penalties for non-compliance with any policies and procedures of the plan sponsors or central repository with respect to information security.

(ii) Ensure the timeliness, accuracy, integrity, and completeness of the data provided to the central repository pursuant to paragraph (c) of this section; and

(iii) Ensure the accuracy of the consolidation by the plan processor of the data provided to the central repository pursuant to paragraph (c) of this section.

(5) The national market system plan submitted pursuant to this section shall address whether there will be an annual independent evaluation of the security of the central repository and:

(i) If so, provide a description of the scope of such planned evaluation; and

(ii) If not, provide a detailed explanation of the alternative measures for evaluating the security of the central repository that are planned instead.

(6) The national market system plan submitted pursuant to this section shall:

(i) Specify a maximum error rate to be tolerated by the central repository for any data reported pursuant to paragraphs (c)(3) and (c)(4) of this section; describe the basis for selecting such maximum error rate; explain how the plan sponsors will seek to reduce such maximum error rate over time; describe how the plan will seek to ensure compliance with such maximum error rate and, in the event of noncompliance, will promptly remedy the causes thereof;

(ii) Require the central repository to measure the error rate each business day and promptly take appropriate remedial action, at a minimum, if the error rate exceeds the maximum error rate specified in the plan;

(iii) Specify a process for identifying and correcting errors in the data reported to the central repository pursuant to paragraphs (c)(3) and (c)(4) of this section, including the process for notifying the national securities exchanges, national securities association, and members who reported erroneous data to the central repository of such errors, to help ensure that such errors are promptly corrected by the reporting entity, and for disciplining those who repeatedly report erroneous data; and

(iv) Specify the time by which data that has been corrected will be made available to regulators.

(7) The national market system plan submitted pursuant to this section shall require the central repository to collect and retain on a current and continuing basis and in a format compatible with the information consolidated and stored pursuant to paragraph (c)(7) of this section:

(i) Information, including the size and quote condition, on the national best bid and national best offer for each NMS security;

(ii) Transaction reports reported pursuant to an effective transaction reporting plan filed with the Commission pursuant to, and meeting the requirements of, § 242.601; and

(iii) Last sale reports reported pursuant to the Plan for Reporting of Consolidated Options Last Sale Reports and Quotation Information filed with the Commission pursuant to, and meeting the requirements of, § 242.608.

(8) The national market system plan submitted pursuant to this section shall require the central repository to retain the information collected pursuant to paragraphs (c)(7) and (e)(7) of this section in a convenient and usable standard electronic data format that is directly available and searchable electronically without any manual intervention for a period of not less than five years.

(f) Surveillance. Every national securities exchange and national securities association subject to this section shall develop and implement a surveillance system, or enhance existing surveillance systems, reasonably designed to make use of the consolidated information contained in the consolidated audit trail.

(g) Compliance by Members.

(1) Each national securities exchange and national securities association shall file with the Commission pursuant to section 19(b)(2) of the Act (15 U.S.C. 78s(b)(2)) and § 240.19b-4 of this chapter on or before 60 days from approval of the national market system plan a proposed rule change to require its members to comply with the requirements of this section and the national market system plan approved by the Commission.

(2) Each member of a national securities exchange or national securities association shall comply with all the provisions of any approved national market system plan applicable to members.

(3) The national market system plan submitted pursuant to this section shall include a provision requiring each national securities exchange and national securities association to agree to enforce compliance by its members with the provisions of any approved plan.

(4) The national market system plan submitted pursuant to this section shall include a mechanism to ensure compliance with the requirements of any approved plan by the members of a national securities exchange or national securities association.

(h) Compliance by National Securities Exchanges and National Securities Associations.

(1) Each national securities exchange and national securities association shall comply with the provisions of the national market system plan approved by the Commission.

(2) Any failure by a national securities exchange or national securities association to comply with the provisions of the national market system plan approved by the Commission shall be considered a violation of this section.

(3) The national market system plan submitted pursuant to this section shall include a mechanism to ensure compliance by the sponsors of the plan with the requirements of any approved plan. Such enforcement mechanism may include penalties where appropriate.

(i) Other Securities and Other Types of Transactions. The national market system plan submitted pursuant to this section shall include a provision requiring each national securities exchange and national securities association to jointly provide to the Commission within six months after effectiveness of the national market system plan a document outlining how such exchanges and associations could incorporate into the consolidated audit trail information with respect to equity securities that are not NMS securities, debt securities, primary market transactions in equity securities that are not NMS securities, and primary market transactions in debt securities, including details for each order and reportable event that may be required to be provided, which market participants may be required to provide the data, an implementation timeline, and a cost estimate.

(j) Definitions.

(1) The term CAT-Order-ID shall mean a unique order identifier or series of unique order identifiers that allows the central repository to efficiently and accurately link all reportable events for an order, and all orders that result from the aggregation or disaggregation of such order.

(2) The term CAT-Reporter-ID shall mean, with respect to each national securities exchange, national securities association, and member of a national securities exchange or national securities association, a code that uniquely and consistently identifies such person for purposes of providing data to the central repository.

(3) The term customer shall mean:

(i) The account holder(s) of the account at a registered broker-dealer originating the order; and

(ii) Any person from whom the broker-dealer is authorized to accept trading instructions for such account, if different from the account holder(s).

(4) The term customer account information shall include, but not be limited to, account number, account type, customer type, date account opened, and large trader identifier (if applicable).

(5) The term Customer-ID shall mean, with respect to a customer, a code that uniquely and consistently identifies such customer for purposes of providing data to the central repository.

(6) The term error rate shall mean the percentage of reportable events collected by the central repository in which the data reported does not fully and accurately reflect the order event that occurred in the market.

(7) The term material terms of the order shall include, but not be limited to, the NMS security symbol; security type; price (if applicable); size (displayed and non-displayed); side (buy/sell); order type; if a sell order, whether the order is long, short, short exempt; open/close indicator; time in force (if applicable); if the order is for a listed option, option type (put/call), option symbol or root symbol, underlying symbol, strike price, expiration date, and open/close; and any special handling instructions.

(8) The term order shall include:

(i) Any order received by a member of a national securities exchange or national securities association from any person;

(ii) Any order originated by a member of a national securities exchange or national securities association; or

(iii) Any bid or offer.

(9) The term reportable event shall include, but not be limited to, the original receipt or origination, modification, cancellation, routing, and execution (in whole or in part) of an order, and receipt of a routed order.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Dated: July 18, 2012

Exhibit A

Key to Comment Letters Cited in Adopting Release
Proposal to Implement Consolidated Audit Trail
(File No. S7-11-10)

1. Letter from Rep. Melissa L. Bean, U.S. Congress, to Mary Schapiro, Chairman, Commission, dated May 20, 2010 ("Bean Letter").
2. Letter from Norris W. Beach to Elizabeth M. Murphy, Secretary, Commission, dated May 26, 2010 ("Beach Letter").
3. Letter from Steven Vannelli to Elizabeth M. Murphy, Secretary, Commission, dated May 26, 2010 ("Vannelli Letter").
4. Letter from Simhan Mandyam, Managing Partner, Triage Life Sciences LLC, to Elizabeth M. Murphy, Secretary, Commission, dated May 26, 2010 ("Triage Letter").
5. Letter from Paul Drescher, Registered Principal, Foothill Securities, Inc., to Elizabeth M. Murphy, Secretary, Commission, dated May 28, 2010 ("Foothill Letter").
6. Letter from Chandler Green to Elizabeth M. Murphy, Secretary, Commission, dated June 1, 2010 ("Green Letter").
7. Letter from Dan T. Nguyen, Wealth Management Company, to Elizabeth M. Murphy, Secretary, Commission, dated June 5, 2010 ("Wealth Management Letter").
8. Letter from Nicos Anastaspoulos to Elizabeth M. Murphy, Secretary, Commission, dated June 6, 2010 ("Anastaspoulos Letter").
9. Letter from Ning Wen, Sales Director, Know More Software, Inc., to Heather Seidel, Division of Trading and Markets, Assistant Director, Commission, dated June 9, 2010 ("Know More Letter").
10. Letter from John McCrary to Elizabeth M. Murphy, Secretary, Commission, dated June 11, 2010 ("McCrary Letter").
11. Letter from Howard Meyerson, General Counsel, and Vlad Khandros, Market Structure and Public Policy Analyst, Liquidnet, to Elizabeth M. Murphy, Secretary, Commission, dated July 19, 2010 ("Liquidnet Letter").
12. Letters from Justin S. Magruder, President, Noetic Partners, Inc., to Elizabeth M. Murphy, Secretary, Commission, dated July 22, 2010 and August 3, 2010 ("Noetic Partners Letter I" and "Noetic Partners Letter II).
13. Letter from Martin Koopman, Director, Aditat, to Elizabeth M. Murphy, Secretary, Commission, dated July 28, 2010 ("Aditat Letter").
14. Letter from Courtney Doyle McGuinn, FPL Operations Director, FIX Protocol Limited, to Elizabeth M. Murphy, Secretary, Commission, dated August 5, 2010 ("FIX Letter").
15. Letter from Senator Edward E. Kaufman, U.S. Senate, to Elizabeth M. Murphy, Secretary, Commission, dated August 5, 2010 ("Kaufman Letter").
16. Letter from Mahesh Kumaraguru to Elizabeth M. Murphy, Secretary, Commission, dated August 5, 2010 ("Kumaraguru Letter").
17. Letter from R. T. Leuchtkafer to Elizabeth M. Murphy, Secretary, Commission, dated August 5, 2010 ("Leuchtkafer Letter").
18. Letter from Horst Simon, Associate Laboratory Director for Computing Sciences and Division Director, Computational Research Department, and David Leinweber, Director, LBNL Center for Innovative Financial Technology Computing Sciences,

Lawrence Berkeley National Laboratory, to Elizabeth M. Murphy, Secretary, Commission, dated August 8, 2010 ("Berkeley Letter").

19. Letter from Peter A. Bloniarz, Dean, College of Computing & Information, University of Albany, George Berg, Associate Professor and Chair, Department of Computer Science, University of Albany, Sandor P. Schuman, Affiliated Faculty, Department of Informatics, University of Albany, to Elizabeth M. Murphy, Secretary, Commission, dated August 9, 2010 ("Albany Letter").
20. Letter from Christopher Nagy, Managing Director Order Strategy, Co-Head Government Relations, and John Markle, Deputy General Counsel, Co-Head Government Relations, TD AMERITRADE, Inc., to Elizabeth M. Murphy, Secretary, Commission, dated August 9, 2010 ("Ameritrade Letter").
21. Letter from James J. Angel, Associate Professor of Finance, Georgetown University, Commission, dated August 9, 2010 ("Angel Letter").
22. Letter from Eric J. Swanson, Senior Vice President and General Counsel, BATS Exchange, Inc., to Elizabeth M. Murphy, Secretary, Commission, dated August 9, 2010 ("BATS Letter").
23. Letter from Anthony D. McCormick, Chief Executive Officer, Boston Options Exchange Group, LLC, to Elizabeth M. Murphy, Secretary, Commission, dated August 9, 2010 ("BOX Letter").
24. Letter from Charlie J. Marchesani, President Broadridge Financial Solutions, Inc., to Elizabeth M. Murphy, Secretary, Commission, dated August 9, 2010 ("Broadridge Letter").
25. Letter from Eric W. Hess, General Counsel, Direct Edge Holdings, LLC, to Elizabeth M. Murphy, Secretary, Commission, dated August 9, 2010 ("Direct Edge Letter").
26. Letter from Marcia E. Asquith, Senior Vice President and Corporate Secretary, FINRA, to Elizabeth M. Murphy, Secretary, Commission, dated August 9, 2010 ("FINRA Letter").
27. Letter from Marcia E. Asquith, Senior Vice President and Corporate Secretary, FINRA, and Janet McGinness Kissane, Senior Vice President and Corporate Secretary, NYSE Euronext, to Elizabeth M. Murphy, Secretary, Commission, dated August 9, 2010 ("FINRA/NYSE Euronext Letter").
28. Letter from Ted Myerson, Chief Executive Officer, Doug Kittelsen, Chief Technology Officer, and M. Gary LaFever, General Counsel and Chief Corporate Development Officer, FTEN, to Elizabeth M. Murphy, Secretary, Commission, dated August 9, 2010 ("FTEN Letter").
29. Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Commission, dated August 9, 2010 ("ICI Letter").
30. Letter from Stuart J. Kaswell, Executive Vice President, Managing Director and General Counsel, Managed Funds Association, to Elizabeth M. Murphy, Secretary, Commission, dated August 9, 2010 ("Managed Funds Association Letter").
31. Letter from Dror Segal and Lou Pizzo, Mansfield Consulting, LLC, to Elizabeth M. Murphy, Secretary, Commission, dated August 9, 2010 ("Mansfield Letter").
32. Letter from Andrew C. Small, General Counsel, Scottrade, to Elizabeth M. Murphy, Secretary, Commission, dated August 9, 2010 ("Scottrade Letter").

33. Letter from Devin Wenig, Chief Executive Officer, Markets Division, Thomson Reuters, to Elizabeth M. Murphy, Secretary, Commission, dated August 9, 2010 ("Thomson Reuters Letter").
34. Letter from Jon Feigelson, Senior Vice President, General Counsel and Head of Corporate Governance, TIAA-CREF Individual and Institutional Services, LLC, to Elizabeth M. Murphy, Secretary, Commission, dated August 9, 2010 ("TIAA-CREF Letter").
35. Letter from Ronald C. Long, Director, Regulatory Affairs, Wells Fargo Advisors, to Elizabeth M. Murphy, Secretary, Commission, dated August 9, 2010 ("Wells Fargo Letter").
36. Letter from John A. McCarthy, General Counsel, GETCO, to Elizabeth M. Murphy, Secretary, Commission, dated August 10, 2010 ("GETCO Letter").
37. Letter from Michael Erlanger, Managing Principal, Marketcore, Inc., to Commission, dated August 10, 2010 ("Marketcore Letter").
38. Letter from Edward J. Joyce, President and Chief Operating Officer, Chicago Board Options Exchange, Inc., to Commission, dated August 11, 2010 ("CBOE Letter").
39. Letter from Leonard J. Amoruso, Senior Managing Director and General Counsel, Knight Capital Group, Inc., to Elizabeth M. Murphy, Secretary, Commission, dated August 11, 2010 ("Knight Letter").
40. Letter from Jose Manso, Executive Vice President, Sales and Marketing, Middle Office Solutions LLC, to Commission, dated August 11, 2010 ("Middle Office Letter").
41. Letter from Manisha Kimmel, Executive Director, Financial Information Forum, to Elizabeth M. Murphy, Secretary, dated August 12, 2010 ("FIF Letter").
42. Letter from John Harris, Chief Executive Officer, BondMart Technologies, Inc., to Commission, dated August 12, 2010 ("BondMart Letter").
43. Letter from Joan C. Conley, Senior Vice President and Corporate Secretary, NASDAQ OMX Group, Inc., to Elizabeth M. Murphy, Secretary, dated August 12, 2010 ("Nasdaq Letter I").
44. Letter from Patrick J. Healy, Chief Executive Officer, Issuer Advisory Group LLC, to Elizabeth M. Murphy, Secretary, Commission, dated August 15, 2010 ("IAG Letter").
45. Letter from James T. McHale, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association, to Elizabeth M. Murphy, Secretary, Commission, dated August 17, 2010 ("SIFMA Letter").
46. Letter from Mike Riley, Chief Executive Officer, Endace Technology Limited, to Elizabeth M. Murphy, Secretary, Commission, dated August 30, 2010 ("Endace Letter").
47. Letter from Terry Keene, Chief Executive Officer, Integration Systems LLC, to Elizabeth M. Murphy, Secretary, Commission, dated November 12, 2010 ("iSys Letter").
48. Letter from Bonnie K. Wachtel, Wachtel & Co., Inc., to Elizabeth M. Murphy, Secretary, Commission, dated November 24, 2010 ("Wachtel Letter").
49. Letter from Richard A. Ross to Elizabeth M. Murphy, Secretary, Commission, dated December 6, 2010 ("Ross Letter").
50. Letter from James T. McHale, Managing Director and Associated General Counsel, Securities Industry and Financial Markets Association, to David Shillman, Associate

Director, Division of Trading and Markets, Commission, dated January 12, 2011 ("SIFMA Drop Copy Letter").

51. Letter from Daniel J. Connell, Chief Executive Officer, Correlix, Inc., to Elizabeth M. Murphy, Secretary, Commission, dated February 4, 2011 ("Correlix Letter").
52. Letter from Richard A. Ross, Founder, High Speed Analytics, to Elizabeth M. Murphy, Secretary, Commission, dated February 9, 2011 ("High Speed Letter").
53. Letter from Michael Belanger, President, Jarg Corporation; Joseph Carrabis, Chief Regulatory Officer and Founder, NextStage Evolution; Wayne Ginion, Vice President, Enterprise Infrastructure Services; and David Morf, Partner, Senior Regional Economics Advisor, Founding Member, Center for Adaptive Solutions, to Elizabeth M. Murphy, Secretary, Commission, dated April 6, 2011 ("Belanger Letter") (note, this letter is an amended letter that replaces a letter submitted by the same parties on March 30, 2011).
54. Letter from Richard G. Ketchum, Chairman and Chief Executive Officer, FINRA, to Robert Cook, Director, Division of Trading and Markets, and Carlo DiFlorio, Director, Office of Compliance Inspections and Examinations, Commission, dated April 6, 2011 ("FINRA Proposal Letter").
55. Letter from Senator Charles E. Schumer, U.S. Senate, to Mary L. Schapiro, Chairman, Commission, dated May 9, 2011 ("Schumer Letter").
56. Letter from Joan C. Conley, Senior Vice President and Corporate Secretary, NASDAQ OMX Group, Inc., to Elizabeth M. Murphy, Secretary, Commission, dated November 18, 2011 ("Nasdaq Letter II").
57. Letter from Geraldine M. Lettieri to Elizabeth M. Murphy, Secretary, Commission, dated November 29, 2011 ("Lettieri Letter").
58. Letter from James T. McHale, Managing Director and Associated General Counsel, Securities Industry and Financial Markets Association, to Robert Cook, Director, Division of Trading and Markets, Commission, dated February 7, 2012 ("SIFMA February 2012 Letter").
59. Letter from John M. Damgard, President, Futures Industry Association, to Elizabeth M. Murphy, Secretary, Commission, dated February 22, 2012 ("FIA Letter").
60. Letter from Manisha Kimmel, Executive Director, Financial Information Forum, to Elizabeth M. Murphy, Secretary, Commission, dated March 2, 2012 ("FIF Letter II").
61. Letter from Jennifer Setzenfand, Chairman, Security Traders Association, dated March 7, 2012 ("STA Letter").
62. Letter from Dr. Gil Van Bokkelen, Chairman and Chief Executive Officer, Athersys, Inc., to Mary Schapiro, Chairman, Commission, dated March 14, 2012 ("Van Bokkelen Letter").

Commissioner Aguilar
Commissioner Gallagher
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9340 / July 18, 2012

SECURITIES EXCHANGE ACT OF 1934
Release No. 67455 / July 18, 2012

INVESTMENT COMPANY ACT OF 1940
Release No. 30140 / July 18, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14953

In the Matter of ALEXANDER V. REKEDA Respondent.	ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940, MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act") against Alexander V. Rekeda ("Rekeda").

II.

In anticipation of the institution of these proceedings, Rekeda 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, Rekeda consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Sections 15(b) of the Securities Exchange Act of 1934, and Sections 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 Rekeda's Offer, the Commission finds[1] that:

Summary

1. These proceedings arise out of the structuring, marketing and rating of a hybrid collateralized debt obligation ("CDO") called Delphinus CDO 2007-1 ("Delphinus"). Delphinus was a mezzanine CDO backed by subprime bonds, which means that the collateral held by Delphinus was largely composed of subprime Residential Mortgage Backed Securities ("RMBS") that were rated slightly higher than junk bonds, and credit default swaps referencing subprime RMBS. Mizuho Securities USA, Inc. ("Mizuho") structured, marketed and obtained ratings for this $1.6 billion CDO in mid-2007, when the housing market and the securities referencing it were showing signs of severe distress.

2. The marketing materials for Delphinus – including the Offering Memorandum – represented that the notes issued by the CDO would obtain certain specific ratings from three credit rating agencies, including Standard & Poor's ("S&P"). Receipt of those ratings was a condition precedent to Delphinus's closing and the sale of the CDO notes. Undisclosed to purchasers of Delphinus notes, however, certain of Mizuho's employees provided S&P inaccurate and misleading information. Investors were misled because notes were issued with ratings obtained by the deceptive conduct of Mizuho's employees. Rekeda was the head of the team at Mizuho responsible for the Delphinus CDO.

3. Delphinus resulted in approximately $10 million in structuring and marketing fees. Delphinus closed on July 19, 2007; on September 27, 2007, Fitch placed five classes of Delphinus on Rating Watch Negative. On January 2, 2008, Delphinus suffered an event of default.

Respondent

4. **Alexander V. Rekeda** was a registered representative and Head of Structured Credit, Americas, of Mizuho Securities USA Inc. during the relevant period. Rekeda, age 38, is a resident of Hoboken, New Jersey.

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

Other Relevant Entities

5. **Mizuho Securities USA Inc.**, a Delaware Corporation, is an indirect, majority-owned subsidiary of Mizuho Financial Group, Inc., a holding company headquartered in Tokyo, Japan. Mizuho is registered as a broker-dealer with the Commission.

Background

6. The Delphinus CDO consisted of the following twelve classes of securities (collectively, "Tranches") that were purchased by a Mizuho affiliate from the Co-Issuers at closing and were subsequently marketed and sold by Mizuho within the United States and a Mizuho affiliate abroad:

- $ 73,500,000 Class A-1A Sr. Floating Rate Notes due October 2047;
- $ 86,500,000 Class A-IB Sr. Floating Rate Notes due October 2047;
- $160,000,000 Class A-IC Sr. Floating Rate Notes due October 2047;
- $ 27,000,000 Class S Sr. Floating Rate Notes due October 2047;
- $144,500,000 Class A-2 Sr. Floating Rate Notes due October 2047;
- $138,500,000 Class A-3 Sr. Floating Rate Notes due October 2047;
- $131,000,000 Class B Sr. Floating Rate Notes due October 2047;
- $ 77,500,000 Class C Mezz. Floating Rate Deferrable Notes due October 2047;
- $ 48,000,000 Class D-1 Mezz. Floating Rate Deferrable Notes due October 2047;
- $ 30,500,000 Class D-2 Mezz. Floating Rate Deferrable Notes due October 2047;
- $ 15,000,000 Class D-3 Mezz. Floating Rate Deferrable Notes due October 2047;
- $ 15,000,000 Class E Mezz. Floating Rate Deferrable Notes due October 2047.

The notes were secured by an underlying portfolio of cash and synthetic RMBS, commercial mortgage backed securities ("CMBS") and other asset backed securities ("ABS") including other CDOs. The CDO also issued 40,000 preference shares, par value $0.01 per share, which were purchased by an equity holder.

7. As stated in the Delphinus CDO Offering Memorandum and the Indenture, each class of notes was required to be rated at closing by S&P, Fitch and Moody's (collectively, the "Rating Agencies"). It was a condition to the issuance of such notes that each class of securities obtain a specific rating from each rating agency. For example, the following ratings were required from S&P as a condition of closing:

- Class A-1A – "AAA"
- Class A-IB – "AAA"
- Class A-IC – "AAA"
- Class S – "AAA"
- Class A-2 – "AAA"
- Class A-3 – "AAA"
- Class B – "AA"
- Class C – "A"

- Class D-1 – "BBB+"
- Class D-2 – "BBB-"
- Class D-3 – "BBB-"
- Class E – "BB"

It was also a requirement that the notes be issued concurrently, meaning, if one class of notes failed to obtain the initial required agency rating, no class of notes could be issued. Preference shares were not rated.

8. Closing was also conditioned on, among other things, the Trustee's receipt of a certificate from the deal accountant ("Accountant") verifying that the collateral within the portfolio met certain requirements and limitations specified in the Indenture. Accountants performing such procedures routinely attach to the certificate a spreadsheet identifying the collateral assets comprising the portfolio at closing.

9. The Offering Memorandum and Indenture also expressly informed investors that, as of the closing date, each note would start to accrue interest at a specified rate ranging from LIBOR plus 0.60% (for Class A-1A Notes) to LIBOR plus 9.00% (for Class E Notes). Interest and principal were payable monthly on the Class A, S, B, C and D-1 Notes commencing October 11, 2007 and quarterly on the Class D-2, D-3 and E Notes commencing in October 2007. Certain administrative expenses received a payment priority over all note classes; in turn, the right of each note class to receive accrued interest and principal payments was senior to all lower note classes; and, preference shareholders, who were lowest on the priority scale, were entitled to payments only to the extent that all accrued and unpaid amounts on senior interests had been paid in full. Moreover, counterparties to CDSs and hedges were effectively senior in payment to all note classes by virtue of the fact that they had an earlier payment date. All payments, including payments of administrative fees, were to be made solely from the proceeds of the Delphinus CDO's collateral pool.

10. The Offering Memorandum and Indenture also expressly informed investors that the transaction was expected to close on July 19, 2007, and that the Delphinus CDO was expected to be fully-ramped or effective as of the closing date. According to the terms of the Offering Memorandum and Indenture, the CDO was considered to be fully-ramped and effective upon reaching, or entering into commitments to acquire, $1,600,113,711.44 par amount or notional amount of collateral assets. It was also a condition of closing that the Delphinus CDO have acquired or entered into commitments to acquire collateral assets with an aggregate notional value of $1,600,113,711.44.

11. The Indenture further provided that the Trustee was required to issue a certificate to the Rating Agencies when the portfolio became fully-ramped and effective. The certificate was required to confirm the assets within the portfolio on the effective date and to verify that the collateral pool met certain limitations and requirements contained in the Indenture. The Trustee was also required to obtain an accountant's certificate attesting to the requirements of the Indenture and to present it to the Rating Agencies.

12. Before proceeding to the initial payment date, the Delphinus CDO was required by the Indenture to request effective date Rating Agency confirmation ("Effective Date RAC") letters from S&P and Fitch. An Effective Date RAC, as defined in the Indenture, is a confirmation that, as of the effective date, the rating agency has not reduced or withdrawn the closing date rating assigned to each Class of Notes.

13. Investors were told that, in the event of a failure to obtain the required RAC letters within 30 days after the Effective Date ("Effective Date RAC Failure"), available funds (including amounts that would otherwise be used to pay interest to more junior classes of securities) would be applied instead to pay principal sequentially to each Class of Notes in the order of priority, until each class was paid in full, and until each rating agency was able to provide an Effective Date RAC. Absent an Effective Date RAC Failure, note holders would be paid on a pro rata basis. Investors were expressly told that the occurrence of an Effective Date RAC Failure might result in an early repayment of the Offered Securities and that there could be no assurance that the portfolio would ever generate sufficient funds to enable the rating agencies to issue an Effective Date RAC.

Closing Date Misconduct

14. Delphinus was scheduled to close on July 19, 2007. The ramping of the Delphinus CDO portfolio was completed on July 17, 2007. Rekeda knew that Delphinus was fully ramped on July 17, 2007.

15. Obtaining ratings from Rating Agencies – S&P, Fitch, and Moody's – was a condition precedent to Delphinus's closing, issuance of securities, and receipt of money from investors. Rekeda's team at Mizuho was responsible for obtaining those ratings.

16. At approximately noon on July 18, 2007, the day before Delphinus was scheduled to close, S&P announced changes to its CDO rating methodology in a press release. Rekeda was aware of S&P's change in methodology.

17. Under S&P's July 18 changed criteria, certain categories of RMBS which were commonly used in CDO collateral pools were required to be adjusted downward by as many as 2 notches for purposes of calculating their default probability in S&P's CDO Evaluator. Delphinus's fully ramped portfolio contained a substantial amount of the collateral that was subject to the downward ratings adjustment described in S&P's July 18 press release.

18. Prior to the publication of S&P's July 18 announcement, Mizuho had not notified S&P that the Delphinus portfolio was fully ramped.

19. On July 18, 2007, after S&P published its announcement, Mizuho employees, acting with Rekeda's knowledge and awareness, emailed multiple alternative portfolios to S&P throughout the evening of July 18. The alternative portfolios included so-called "dummy" assets, an industry term meaning hypothetical assets that will later be replaced by actual assets; however, in this case, the "dummy" assets were different from, and of a superior credit quality to, assets that had been actually acquired for the CDO. Mizuho employees did not provide S&P

with the collateral pool that was then in existence and had already been transferred to the Trustee.

20. The alternative portfolios sent to S&P on July 18 had certain factors in common, including, among other things, that: (a) they failed to disclose to S&P certain assets that had already been purchased for the fully-ramped portfolio; (b) they included dummy assets, thereby suggesting that the portfolio was not fully ramped and that Mizuho would purchase assets that matched the quality and characteristics of the dummy assets; (c) the dummy assets were coded as "prime" assets thereby making them more desirable under the changed S&P rating methodology, whereas the assets they substituted for were mostly coded as "subprime"; and (d) the dummy assets were, as a general matter, of a higher credit quality than the assets that had already been purchased for Delphinus. In an email that accompanied the final portfolio sent to S&P on the evening of July 18, one of Mizuho's employees responsible for the transaction stated that collateral manager would be asked to purchase assets to increase the Delphinus portfolio's diversification.

21. At no point prior to closing did any Mizuho employee send S&P the fully-ramped portfolio or provide S&P with notice that the portfolio was already fully ramped. Nor did any Mizuho employee make any effort to change the portfolio to conform the collateral to the portfolio that S&P actually rated on the evening of July 18. Specifically, there was no effort to provide the collateral manager with the portfolio that S&P actually rated, which included twenty six dummy assets, or otherwise inform the collateral manager that it needed to trade securities in order to conform the portfolio to the alternative portfolio that S&P had rated. Instead, a Mizuho employee told the collateral manager that S&P was prepared to issue the required ratings and that the transaction could proceed to closing.

22. The Delphinus transaction closed by mid-afternoon on July 19, 2007, with the S&P ratings that were obtained by the use of dummy assets, rather than the actual closing date portfolio. At closing, Mizuho sold securities based upon those ratings, which in turn misled investors to believe that the Delphinus notes were of higher credit quality. Investors were not aware that the actual portfolio at closing would have failed certain of S&P's quantitative tests. Additionally, between July 19, 2007 and November 9, 2007, there were numerous transactions in Delphinus notes in either the secondary market (for cash bonds) or the credit default swap market (credit default swaps written on Delphinus notes).

23. Mizuho did not provide Fitch or Moody's with a fully ramped portfolio prior to closing or otherwise provide notice that the portfolio had been fully-ramped as of closing. Hours after the closing on July 19, 2007, a Mizuho employee responded to a question from Moody's about the status of the portfolio and expressly misrepresented to Moody's that Delphinus was not fully ramped at closing.

Violations

24. Section 17(a)(2) of the Securities Act prohibits any person from "obtain[ing] money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under

which they were made, not misleading." Section 17(a)(3) prohibits any person from "engag[ing] in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

25. Scienter is not required under Sections 17(a)(2) and (3) where proof of negligence is sufficient. *Aaron v. SEC*, 446 U.S. 680, 696-97 (1980); *SEC v. First Jersey Secs., Inc.*, 101 F.3d 1450, 1466-67 (2d Cir. 1996); *SEC v. Merchant Capital, LLC*, 483 F.3d 747, 766 (11th Cir. 2007); *Weiss v. SEC*, 468 F.3d 849, 855 (D.C. Cir. 2006); *SEC v. Espuelus*, 579 F. Supp. 2d 461, 472 (S.D.N.Y. 2008). The relevant standard of care under the negligence-based provisions of Section 17(a) is "reasonable prudence" for which industry standards are a relevant but non-determinative factor. *See, e.g., SEC v. GLT Dain Rauscher, Inc.*, 254 F.3d 852, 853 (9th Cir. 2001) ("We hold that the standard of care for an underwriter of municipal offerings is one of reasonable prudence, for which the industry standard is one factor to be considered, but it is not the determinative factor").

26. As a result of the negligent conduct described above, Rekeda willfully[2] violated Sections 17(a)(2) and (3) of the Securities Act.

Undertakings

Rekeda has undertaken to provide to the Commission, within thirty (30) days after the end of the twelve (12) month suspension period described below, an affidavit that he has complied fully with the sanctions described in Section IV below.

IV.

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

Accordingly, pursuant to Section 8A of the Securities Act, Section 15(b) of the Exchange Act, and Section 9(b) of the Investment Company Act, it is hereby ORDERED that:

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

B. Rekeda be, and hereby is:

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

suspended from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization;

prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter; and

suspended 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.

for a period of twelve (12) months, effective on the second Monday following the entry of this Order.

C. Rekeda, within ten (10) days of the entry of this Order, pay a civil money penalty in the amount of $125,000 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Payment shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check, bank money order, or by credit or debit card via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to Enterprise Services Center, Accounts Receivable Branch, 6500 South MacArthur Boulevard, Oklahoma City, Oklahoma 73169; and (D) submitted under cover letter that identifies Rekeda 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 Kenneth R. Lench, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Mail Stop-6013 SP1, Washington, DC 20549.

D. Pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002, as amended, a Fair Fund is created for the penalties referenced in paragraph C above. The foregoing payments may be combined in a single Fair Fund for distribution to injured investors. Additional monies paid by any defendant or respondent in a related proceeding arising from the underlying conduct also may be added to this Fair Fund for distribution. Regardless of whether any such Fair Fund distribution is made, amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Rekeda agrees that in any Related Investor Action, he shall not argue that he is entitled to, nor shall he benefit by, offset or reduction of any award of compensatory damages by the amount of any part of Respondent's payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Rekeda agrees that he shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the United States Treasury or to a Fair Fund, as the Commission directs. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against Respondent by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

E. Rekeda shall comply with the undertaking enumerated above.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
July 19, 2012

In the Matter of

Alliance Bancshares California,
City Loan, Inc.,
Clear Choice Financial, Inc.,
CRC Crystal Research Corp.,
Cygne Designs, Inc., and
Davi Skin, Inc.,

File No. 500-1

ORDER OF SUSPENSION OF TRADING

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

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

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Clear Choice Financial, 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 CRC Crystal Research Corp. because it has not filed any periodic reports since the period ended September 30, 2009.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Cygne Designs, Inc. because it has not filed any periodic reports since the period ended October 31, 2008.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Davi Skin, Inc. because it has not filed any periodic reports since the period ended June 30, 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 July 19, 2012, through 11:59 p.m. EDT on August 1, 2012.

By the Commission.

Elizabeth M. Murphy
Secretary

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

Commissioner Aguilar
Commissioner Gallagher
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9339 / July 18, 2012

INVESTMENT ADVISERS ACT OF 1940
Release No. 3434 / July 18, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14952

In the Matter of

DELAWARE ASSET ADVISERS and WEI (ALEX) WEI

Respondents.

ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933 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 ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), and Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act"), against Delaware Asset Advisers ("DAA") and Section 8A of the Securities Act, and Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 against Wei (Alex) Wei ("Wei") (collectively, "Respondents").

II.

In anticipation of the institution of these proceedings, DAA has submitted an Offer of Settlement of Delaware Asset Advisers ("DAA Offer"), and Wei has submitted an Offer of Settlement of Wei (Alex) Wei ("Wei Offer"), both of which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 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 ("Order"), as set forth below.

III.

On the basis of this Order and Respondents' Offers, the Commission finds[1] that

Summary

1. This matter involves violations of federal securities laws by DAA, and Wei, who heads the Structured Credit Investment unit of DAA, in connection with the structuring, sales, and marketing of a $1.6 billion collateralized debt obligation ("CDO") known as Delphinus CDO 2007-1 Ltd. ("Delphinus"), which closed on July 19, 2007. Wei and DAA ensured that Delphinus complied with certain conditions of closing, including the purchase of collateral assets equal to the amount required for Delphinus to be "fully ramped" and effective at closing. Delphinus received closing date ratings from Standard & Poor's Ratings Services ("S&P"), Moody's Ratings Services ("Moody's") and Fitch Ratings ("Fitch").

2. DAA was the collateral manager, while Wei was the portfolio manager employed by DAA and assigned to Delphinus. As portfolio manager, Wei undertook various responsibilities on behalf of DAA. Those responsibilities included obtaining Effective Date Rating Agency Confirmation ("RAC") letters for Delphinus and providing that RAC to the Delphinus trustee.

3. Obtaining RAC was crucial to Delphinus; if Delphinus failed to obtain RAC, Delphinus would have been required to divert money from the less senior Delphinus notes and to use that money to pay down the senior notes, starting with the most senior class. This was a situation that CDO portfolio managers tried to avoid, because it would reflect badly on them, and because it would likely reduce their monthly fees from the transaction.

4. Delphinus encountered difficulties when it sought RAC from S&P and Fitch. In an attempt to overcome these difficulties, Wei and DAA provided, and participated in providing, inaccurate information to S&P and to Wells Fargo Bank N.A. ("Wells Fargo"), Delphinus's trustee.

5. With respect to S&P, Wei and DAA made and allowed others to make inaccurate representations to S&P that Delphinus's effective date was August 6, 2007. Wei and DAA engaged in this conduct despite the fact that they knew or should have known: (a) that Delphinus was effective at closing on July 19, 2007, and (b) that the effective date could not be changed under the circumstances. S&P accepted these inaccurate representations and provided Delphinus with RAC on September 14, 2007.

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

6. With respect to Wells Fargo, Wei and DAA learned that Fitch was not going to provide RAC, and was planning to put five classes of Delphinus notes on Ratings Watch Negative. Before Fitch could place those notes on Ratings Watch Negative, Wei printed out computer screen shots of Fitch's closing date ratings of Delphinus, and a DAA employee faxed them to Wells Fargo. The cover sheet for that fax read: "Confirmation for Fitch Ratings for All Classes of Delphinus 2007-1." Wells Fargo relied upon this inaccurate information to conclude that RAC had been received from Fitch.

Respondents

7. **Delaware Asset Advisers** is a series of Delaware Management Business Trust ("DMBT"), a statutory trust organized under the Delaware Statutory Trust Act. DMBT is an investment adviser registered with the Commission. DAA provides investment advisory services to private CDOs that are sold to large institutional investors. DAA is based in Philadelphia, Pennsylvania. DAA served as the collateral manager for the Delphinus transaction; following the closing DAA became the portfolio manager. During the relevant period, DMBT was a subsidiary of Delaware Management Holdings, Inc.

8. **Wei (Alex) Wei**, Ph.D., is Senior Vice President, Head of Structured Credit Investment, and Chief Quantitative Analyst for DAA. In that capacity, Wei managed DAA's CDO portfolio management business. Wei holds a Ph.D. in physics.

Relevant Entity

9. **Mizuho Securities USA Inc.** ("Mizuho"), a Delaware Corporation, is an indirect, majority-owned subsidiary of Mizuho Financial Group, Inc., a holding company headquartered in Tokyo, Japan. Mizuho is registered as a broker-dealer with the Commission. Mizuho was responsible for the structuring, sales and marketing of the Delphinus CDO.

Background

10. The Delphinus CDO was a $1.6 billon CDO whose collateral was comprised of mostly mezzanine sub-prime Residential Mortgage-Backed Securities ("RMBS") and CDOs of RMBS, in the form of both cash bonds and synthetic securities (credit default swaps). Like all CDOs, Delphinus was a legal entity that was designed to do two basic activities: (1) hold a portfolio of assets, and (2) issue certain interest-bearing liabilities, that is, securities, to investors. The stream of income required to pay interest to the investors who purchased the CDO's securities was to be generated by interest payments from the CDO's asset portfolio. The money to return the investors' principal was to be generated from repayments of principal from the CDO's asset portfolio.

11. Creation of a CDO generally required participation or assistance from a number of entities: an investment bank, a collateral manager, an accounting firm, a trustee, at least two rating agencies, and often, a sponsor. The collateral manager's role was to pick the assets to be held in the CDO's asset portfolio. The accounting firm's role was to provide independent certifications of

compliance with certain aspects of the CDO's indenture and other governing documents. The trustee's role was to act on behalf of the CDO, receive the CDO's asset portfolio upon the closing of the transaction, to receive monies generated by that portfolio and distribute those monies to holders of the CDO's securities on the payment dates.

12. The rating agencies' role was to issue ratings on the securities sold by the CDO. In essence, those ratings were the rating agencies' predictions about whether the CDO's assets would provide enough money to pay the investors who purchased the CDO's securities. Ratings were key to successfully selling securities issued by the CDO because many potential investors, such as insurance companies or pension funds, could only invest in securities that were rated at a certain level.

13. Ratings were typically issued in two parts – initial ratings were assigned at closing, and those ratings were to be confirmed as of the deal's effective date, which usually meant the first date on which the portfolio's collateral was fully ramped, or purchased. At both closing and the effective date, the independent accountant was to certify that the collateral met certain tests set forth in the indenture. Some CDOs, including Delphinus, were required by the indenture to be fully-ramped, or effective, at closing. The Delphinus indenture required as a condition of closing, that the issuer purchase or enter agreements to purchase, as evidenced by a trade confirmation, collateral assets having an aggregate principal balance of $1,600,113,711.44, which was equal to the expected effective date balance. Thus, the terms of the indenture required that Delphinus be fully ramped as a condition of closing, and therefore the CDO would also be effective at closing. In such cases the accountants could certify both the closing and effective date procedures in a single letter.

14. CDO indentures also generally required that following the effective date, the issuer (or the trustee on the issuer's behalf) was to obtain confirmation from the rating agencies that as of the effective date, the initial ratings had not been reduced or withdrawn; this effective date rating agency confirmation ("RAC") would be based on the actual as-purchased collateral pool. In particular, the Delphinus indenture required "[a] Confirmation from each Rating Agency (which must be written in the case of S&P) notifying the Issuer within 30 Days after the Effective Date, or such later date that such Rating Agency may determine, that it has not reduced or withdrawn the rating assigned by it to any Class of Notes on the Closing Date. . . ." A failure to obtain effective date ratings confirmations typically required the CDO to switch from a pro-rata payment where all investors received their expected quarterly payouts, to a sequential payoff, which would divert all of the money from junior noteholders and the equity investors to pay off noteholders in order of seniority, until rating agencies could confirm the ratings on the notes.

Effective Date Misconduct

15. Delphinus was structured and marketed by Mizuho. Wells Fargo served as the trustee for the Delphinus transaction. Wei was the DAA portfolio manager primarily responsible for the Delphinus transaction. Among other responsibilities, Wei selected assets to be held by Delphinus.

16. Pursuant to instructions from Mizuho, Wei and DAA ensured that all collateral to be held by Delphinus was purchased before Delphinus's closing date of July 19, 2007. The completion of the purchase of assets was known as being "fully ramped." Wei and DAA knew that Delphinus was fully ramped on July 17, 2007, when the last collateral bond was purchased.

17. Under the terms of the indenture, the amount of assets Delphinus was required to have at closing was $1,600,113,711.44. Also under the indenture, Delphinus's effective date was to be the date upon which it held assets totaling $1,600,113,711.44 Thus, Delphinus was designed to have its closing date and effective date be the same date.

18. On July 19, 2007, Delphinus closed and the notes issued by Delphinus were assigned closing date ratings by S&P, Moody's, and Fitch. Under the terms of the indenture, effective date RAC from S&P and Fitch was required for Delphinus to pay under the anticipated priority of payments hierarchy that included the junior-most noteholders and equity investors.

19. On July 31, 2007, in accordance with the terms of the indenture and at the prompting of Wei and DAA, Wells Fargo submitted a request for RAC by means of an email to S&P and Fitch announcing that Delphinus was fully ramped pursuant to the terms of the indenture.

20. Wells Fargo's emailed request for RAC was accompanied by two attachments. The first attachment was an Accountant's Certificate which, among other things, certified that Delphinus met all of the effective date tests set forth in the indenture. The Accountant's Certificate also attached an asset portfolio and described that portfolio as both the closing date and effective date portfolio. The Accountant's Certificate repeatedly referred to the closing date being July 19, 2007, and the effective date also being July 19, 2007. The second attachment was a spreadsheet showing the July 19, 2007 collateral pool created by Wells Fargo.

21. On July 31, 2007, an S&P analyst who received the request for RAC pointed out that the spreadsheet accompanying the request for RAC did not total $1.6 billion. Wei and DAA confirmed both that (a) the Delphinus portfolio was ready to go effective; and (b) that Delphinus had reached the covenanted par amount of $1.6 billion. In addition to assuring the S&P analyst that Delphinus was fully ramped, Wei and DAA also assisted in correcting the trustee's spreadsheet.

22. On August 24, 2007, the S&P analyst sent an email to Wei raising questions about Delphinus's effective date, the Accountant's Certificate, and the make-up of the closing date collateral pool. The S&P analyst specifically asked whether there was a mistake in dating the Accountant's Certificate, because the Certificate stated that Delphinus's closing date and its effective date were the same: July 19, 2007. Wei knew or should have known that Delphinus: (a) was fully ramped on July 17, 2007, and (b) was effective at closing on July 19, 2007. Wei also knew or should have known that July 19 was the effective date for Delphinus pursuant to the terms of the indenture. Rather than reply to the S&P analyst's question by stating that the Accountant's Certificate was correct, and that Delphinus's effective date was July 19, 2007, Wei sought direction from Mizuho. He then acquiesced in Mizuho's request to tell S&P that Delphinus's effective date was changed to August 6, 2007. Wei knew or should have known that S&P was

being misled when he agreed to tell S&P that the effective date for purposes of S&P's effective date RAC analysis of Delphinus was August 6, 2007.

23. In addition, an employee of DAA instructed the trustee to prepare a collateral spreadsheet for S&P using August 6, 2007 as the effective date for the Delphinus transaction. The total notional amount of the collateral pool on August 6 was the same as the total notional amount of the collateral pool on July 19. The composition was different by a few bonds amounting to $15 million. This is so because on August 1, 2007 DAA had Delphinus sell a $15 million credit card receivables bond, and had Delphinus purchase a total of $15 million assets issued by, or referencing, a certain mezzanine CDO security. In all other respects, the bonds comprising the Delphinus investment portfolio had not changed since July 19. The spreadsheet the trustee prepared at DAA's request, and with DAA's assistance, reflected the exchange of the credit card bond for the mezzanine CDO securities.

24. On August 24, 2007, Wei and DAA were informed by Mizuho that a new Accountant's Certificate would be prepared using August 6, 2007 as the Delphinus effective date, and incorporating the August 6, 2007 collateral portfolio that included the mezzanine CDO securities purchased after Delphinus closed. On August 27, 2007, Wei consented to the creation of a new Accountant's Certificate using August 6, 2007 as Delphinus's effective date. On August 31, 2007, Wei received a copy of the new Accountant's Certificate with August 6, 2007 as the effective date and on September 5, 2007, DAA and Wei approved sending the new certificate to S&P.

25. Wei knew or should have known that the second Accountant's Certificate was inaccurate regarding the date Delphinus became effective. He further knew or should have known that in connection with its procedures to determine whether to give Delphinus a RAC letter, S&P was being misled into believing that Delphinus was not effective at closing on July 19, but instead was effective on August 6, 2007. On September 14, 2007, S&P issued the effective date RAC letter to Delphinus, based on the assumed effective date of August 6, 2007.

The Failed Attempt to Obtain RAC from Fitch

26. On September 6, 2007, the day after the second Accountant's Certificate and trustee's portfolio were submitted to S&P, Wei and DAA turned their attention to obtaining a RAC letter from Fitch. In a series of emails on September 6, 2007, an employee of DAA determined that Fitch had been sent the first Accountant's Certificate and the trustee's portfolio, showing July 19, 2007 as both the closing and effective date. Wei and DAA made no effort to supply Fitch with the second Accountant's Certificate and trustee's portfolio.

27. On September 11 and September 17, 2007, Wei sent emails to Mizuho requesting updates about the Fitch RAC process. On September 24, 2007, Wei communicated with Fitch and learned that there were "issues" with obtaining a RAC letter from Fitch. On September 26, 2007, Wei had a telephone call with a Fitch analyst in which Fitch stated that it would not issue effective date RAC for the Delphinus notes, and that Fitch intended to put five classes of the Delphinus notes on Ratings Watch Negative. Wei also received, via email, a draft copy of a press release that

Fitch stated that it intended to publish, which was to announce the Ratings Watch Negative status for five classes of Delphinus notes.

28. Wei made efforts that evening and the next morning to have representatives of Fitch and the trustee speak to each other by phone, but he failed to ensure that they actually did so. Wei never communicated to the Delphinus trustee that Fitch was placing five classes of Delphinus notes on Rating Watch Negative, and would not issue effective date RAC for Delphinus.

29. Instead, on the morning of September 27, 2007, Wei emailed his Fitch website log-in information to a DAA employee, and directed that the DAA employee ask the trustee to log in to the Fitch website and print out the Delphinus ratings "first thing." Ultimately, Wei printed out screen shots of Fitch's website and Bloomberg's website showing the closing date Fitch ratings for Delphinus, and an employee at DAA faxed those screen shots to the trustee. The cover sheet for that fax read, "Confirmation for Fitch Ratings for All Classes of Delphinus 2007-1."

30. Later that morning, Fitch issued a press release (consistent with the draft provided to Wei the day before) announcing its Ratings Watch Negative determinations for the five classes of Delphinus notes. Following receipt of the S&P RAC letter and the DAA fax purporting to be a confirmation of the Fitch ratings for Delphinus, the trustee determined that Delphinus satisfied the conditions of the indenture to receive RAC letters from the rating agencies. On October 11, 2007, the date of the first Delphinus distribution, the trustee paid Delphinus investors. The trustee failed to follow provisions of the indenture which were intended to protect the most senior noteholders against losses in the event of a rating agency confirmation failure.

Violations

31. Section 206(2) of the Advisers Act prohibits investment advisers from "engage[ing] in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." Section 206(2) of the Advisers Act imposes a fiduciary duty on investment advisers obligating them to disclose all material information to their client. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194-97 (1963). Proof of scienter is not required to establish a violation of Section 206(2), but rather may rest on a finding of simple negligence. *SEC v. Steadman*, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992) (citing *Capital Gains*, 375 U.S. at 194-95.) *See also SEC v. Wash. Inv. Network*, 475 F.2d 392, 396 (D.C. Cir. 2007). Negligence is sufficient to establish liability for causing a primary violation that does not require scienter. *In the Matter of KPMG Peat Marwick LLP*, Admin. Proc. No. 3-9500 (2001).

32. Sections 17(a)(2) and (3) of the Securities Act prohibit fraud in the offer or sale of securities. Section 17(a)(2) prohibits any person from "obtain[ing] money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading." Section 17(a)(3) prohibits any person from "engag[ing] in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

33. Scienter is not required under Sections 17(a)(2) and (3) where proof of negligence is sufficient. *Aaron v. SEC*, 446 U.S. 680, 696-97 (1980); *SEC v. First Jersey Secs., Inc.*, 101 F.3d

1450, 1466-67 (2d Cir. 1996); *SEC v. Merchant Capital, LLC*, 483 F.3d 747, 766 (11th Cir. 2007); *Weiss v. SEC*, 468 F.3d 849, 855 (D.C. Cir. 2006); *SEC v. Espuelus*, 579 F. Supp. 2d 461, 472 (S.D.N.Y. 2008). The relevant standard of care under the negligence-based provisions of Section 17(a) is "reasonable prudence" for which industry standards are a relevant but non-determinative factor. *See, e.g., SEC v. GLT Dain Rauscher, Inc.*, 254 F.3d 852, 853 (9th Cir. 2001) ("We hold that the standard of care for an underwriter of municipal offerings is one of reasonable prudence, for which the industry standard is one factor to be considered, but it is not the determinative factor").

34. As a result of the negligent conduct described above, DAA willfully[2] violated Section 206(2) of Advisers Act and Sections 17(a)(2) and (a)(3) of the Securities Act and Wei willfully violated Sections 17(a)(2) and (a)(3) of the Securities Act and caused DAA's violations of Section 206(2) of Advisers Act.

Undertakings

Wei undertakes to provide to the Commission, within thirty (30) days after the end of the six (6) month suspension period described below, an affidavit that he has complied fully with the sanctions described in Section IV.E. below.

IV.

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

Accordingly, pursuant to Section 8A of the Securities Act and Sections 203(e), 203(f), and 203(k) of the Advisers Act, it is hereby ORDERED that:

A. Respondent Wei shall cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and (a)(3) of the Securities Act and Section 206(2) of the Advisers Act.

B. Respondent DAA shall cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and (a)(3) of the Securities Act and Section 206(2) of the Advisers Act.

C. Respondent DAA shall, within ten (10) days of the entry of this Order, pay disgorgement of $2,228,372, prejudgment interest of $357,776, and a civil money penalty of $2,228,372 to the Securities and Exchange Commission. If timely payment

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

is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. Payment shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check, bank money order, or by credit or debit card via Pay.gov through the SEC website at http://www.sec.gov/ about/offices/ofm.htm; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to Enterprise Services Center, Accounts Receivable Branch, 6500 South MacArthur Boulevard, Oklahoma City, Oklahoma 73169; and (D) submitted under cover letter that identifies Delaware Asset Advisers as 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 Kenneth R. Lench, Chief of the Structured and New Products Unit, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Mail Stop -6013 SP1, Washington, DC 20549.

D. Respondent Wei shall, within ten (10) days of the entry of this Order, pay a civil money penalty of $50,000 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. Payment shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check, bank money order, or by credit or debit card via Pay.gov through the SEC website at http://www.sec.gov/ about/offices/ofm.htm; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to Enterprise Services Center, Accounts Receivable Branch, 6500 South MacArthur Boulevard, Oklahoma City, Oklahoma 73169; and (D) submitted under cover letter that identifies Wei (Alex) Wei as 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 Kenneth R. Lench, Chief of the Structured and New Products Unit, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Mail Stop -6013 SP1, Washington, DC 20549.

E. Respondent Wei be, and hereby is, suspended from association with any investment adviser for a period of six (6) months, effective on the second Monday following the entry of this Order.

F. Pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002, as amended, a Fair Fund is created for the disgorgement, interest and penalties referenced in paragraphs IV.C. and IV.D., above. The foregoing payments may be combined in a single Fair Fund for distribution to injured investors. Additional monies paid by any defendant or respondent in a related proceeding arising from the underlying conduct also may be added to this Fair Fund for distribution. Regardless of whether any such Fair Fund distribution is made, amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondents agree that in any Related Investor Action, they shall not argue that they are entitled to, nor shall they benefit by, offset or reduction of any award of compensatory damages by the amount of any part of Respondents' payments of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Respondents agree that they shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the United States Treasury or to a Fair Fund, as the Commission directs. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against Respondent DAA or Respondent Wei (or both) by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

G. Respondent Wei shall comply with the Undertakings above.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Aguilar, Commissioner Gallagher not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9341 / July 18, 2012

SECURITIES EXCHANGE ACT OF 1934
Release No. 67456 / July 18, 2012

INVESTMENT COMPANY ACT OF 1940
Release No. 30141 / July 18, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14954

In the Matter of

XAVIER CAPDEPON and
GWEN SNORTELAND,

Respondents.

ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940, MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act") against Xavier Capdepon ("Capdepon") and Gwen Snorteland ("Snorteland") (collectively "Respondents").

II.

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

Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Sections 15(b) of the Securities Exchange Act of 1934, and Sections 9(b) of the Investment Company Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondents' Offers, the Commission finds[1] that:

Summary

1. These proceedings arise out of the structuring, marketing and rating of a hybrid collateralized debt obligation ("CDO") called Delphinus CDO 2007-1 ("Delphinus"). Delphinus was a mezzanine CDO backed by subprime bonds, which means that the collateral held by Delphinus was largely composed of subprime Residential Mortgage Backed Securities ("RMBS") that were rated slightly higher than junk bonds, and credit default swaps referencing subprime RMBS. Mizuho Securities USA, Inc. ("Mizuho") structured, marketed and obtained ratings for this $1.6 billion CDO in mid-2007, when the housing market and the securities referencing it were showing signs of severe distress.

2. The marketing materials for Delphinus – including the Offering Memorandum – represented that the notes issued by the CDO would obtain certain specific ratings from three credit rating agencies, including Standard & Poor's ("S&P"). Receipt of those ratings was a condition precedent to Delphinus's closing and the sale of the CDO notes. Undisclosed to purchasers of Delphinus notes, however, certain of Mizuho's employees, including Capdepon and Snorteland, provided S&P inaccurate and misleading information. Capdepon was the lead modeler, and Snorteland was the transaction manager, for Delphinus. Investors were misled because notes were issued with ratings obtained and maintained by their conduct.

3. Delphinus resulted in approximately $10 million in structuring and marketing fees for Mizuho. Delphinus closed on July 19, 2007; on September 27, 2007, Fitch placed five classes of Delphinus on Rating Watch Negative. On January 2, 2008, Delphinus suffered an event of default.

Respondents

4. **Xavier Capdepon** was an employee of Mizuho Securities USA Inc. during the relevant period. Capdepon, age 34, is a resident of New York, New York.

5. **Gwen Snorteland** was an employee of Mizuho Securities USA Inc. during the relevant period. Snorteland, age 37, is a resident of the Bronx, New York.

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

Other Relevant Entities

6. **Mizuho Securities USA Inc.**, a Delaware Corporation, is an indirect, majority-owned subsidiary of Mizuho Financial Group, Inc., a holding company headquartered in Tokyo, Japan. Mizuho is registered as a broker-dealer with the Commission.

Background

7. The Delphinus CDO consisted of the following twelve classes of securities (collectively, "Tranches") that were purchased by a Mizuho affiliate from the Co-Issuers at closing and were subsequently marketed and sold by Mizuho within the United States and a Mizuho affiliate abroad:

- $ 73,500,000 Class A-1A Sr. Floating Rate Notes due October 2047;
- $ 86,500,000 Class A-IB Sr. Floating Rate Notes due October 2047;
- $160,000,000 Class A-IC Sr. Floating Rate Notes due October 2047;
- $ 27,000,000 Class S Sr. Floating Rate Notes due October 2047;
- $144,500,000 Class A-2 Sr. Floating Rate Notes due October 2047;
- $138,500,000 Class A-3 Sr. Floating Rate Notes due October 2047;
- $131,000,000 Class B Sr. Floating Rate Notes due October 2047;
- $ 77,500,000 Class C Mezz. Floating Rate Deferrable Notes due October 2047;
- $ 48,000,000 Class D-1 Mezz. Floating Rate Deferrable Notes due October 2047;
- $ 30,500,000 Class D-2 Mezz. Floating Rate Deferrable Notes due October 2047;
- $ 15,000,000 Class D-3 Mezz. Floating Rate Deferrable Notes due October 2047;
- $ 15,000,000 Class E Mezz. Floating Rate Deferrable Notes due October 2047.

The notes were secured by an underlying portfolio of cash and synthetic RMBS, commercial mortgage backed securities ("CMBS") and other asset backed securities ("ABS") including other CDOs. The CDO also issued 40,000 preference shares, par value $0.01 per share, which were purchased by an equity holder.

8. As stated in the Delphinus CDO Offering Memorandum and the Indenture, each class of notes was required to be rated at closing by S&P, Fitch and Moody's (collectively, the "Rating Agencies"). It was a condition to the issuance of such notes that each class of securities obtain a specific rating from each rating agency. For example, the following ratings were required from S&P as a condition of closing:

- Class A-1A – "AAA"
- Class A-IB – "AAA"
- Class A-IC – "AAA"
- Class S – "AAA"
- Class A-2 – "AAA"
- Class A-3 – "AAA"
- Class B – "AA"

- Class C – "A"
- Class D-1 – "BBB+"
- Class D-2 – "BBB-"
- Class D-3 – "BBB-"
- Class E – "BB"

It was also a requirement that the notes be issued concurrently, meaning, if one class of notes failed to obtain the initial required agency rating, no class of notes could be issued. Preference shares were not rated.

9. Closing was also conditioned on, among other things, the Trustee's receipt of a certificate from the deal accountant ("Accountant") verifying that the collateral within the portfolio met certain requirements and limitations specified in the Indenture. Accountants performing such procedures routinely attach to the certificate a spreadsheet identifying the collateral assets comprising the portfolio at closing.

10. The Offering Memorandum expressly informed investors that, as of the closing date, each note would start to accrue interest at a specified rate ranging from LIBOR plus 0.60% (for Class A-1A Notes) to LIBOR plus 9.00% (for Class E Notes). Interest and principal were payable monthly on the Class A, S, B, C and D-1 Notes commencing October 11, 2007 and quarterly on the Class D-2, D-3 and E Notes commencing in October 2007. Certain administrative expenses received a payment priority over all note classes; in turn, the right of each note class to receive accrued interest and principal payments was senior to all lower note classes; and, preference shareholders, who were lowest on the priority scale, were entitled to payments only to the extent that all accrued and unpaid amounts on senior interests had been paid in full. Moreover, counterparties to CDSs and hedges were effectively senior in payment to all note classes by virtue of the fact that they had an earlier payment date. All payments, including payments of administrative fees, were to be made solely from the proceeds of the Delphinus CDO's collateral pool.

11. The Offering Memorandum also expressly informed investors that the transaction was expected to close on July 19, 2007, and that the Delphinus CDO was expected to be fully-ramped or effective as of the closing date. According to the Offering Memorandum and Indenture, the CDO was considered to be fully-ramped and effective upon reaching, or entering into commitments to acquire, $1,600,113,711.44 par amount or notional amount of collateral assets. It was also a condition of closing that the Delphinus CDO have acquired or entered into commitments to acquire collateral assets with an aggregate notional value of $1,600,113,711.44.

12. The Indenture further provided that the Trustee was required to issue a certificate to the Rating Agencies when the portfolio became fully-ramped and effective. The certificate was required to confirm the assets within the portfolio on the effective date and to verify that the collateral pool met certain limitations and requirements contained in the Indenture. The Trustee was also required to obtain an accountant's certificate attesting to the requirements of the Indenture and to present it to the Rating Agencies.

13. Before proceeding to the initial payment date, the Delphinus CDO was required by the Indenture to request effective date Rating Agency confirmation ("Effective Date RAC") letters from S&P and Fitch. An Effective Date RAC, as defined in the Indenture, is a confirmation that, as of the effective date, the rating agency has not reduced or withdrawn the closing date rating assigned to each Class of Notes.

14. Investors were told that, in the event of a failure to obtain the required RAC letters within 30 days after the Effective Date ("Effective Date RAC Failure"), available funds (including amounts that would otherwise be used to pay interest to more junior classes of securities) would be applied instead to pay principal sequentially to each Class of Notes in the order of priority, until each class was paid in full, and until each rating agency was able to provide an Effective Date RAC. Absent an Effective Date RAC Failure, note holders would be paid on a pro rata basis. Investors were expressly told that the occurrence of an Effective Date RAC Failure might result in an early repayment of the Offered Securities and that there could be no assurance that the portfolio would ever generate sufficient funds to enable the rating agencies to issue an Effective Date RAC.

Closing Date Misconduct

15. Delphinus was scheduled to close on July 19, 2007. The ramping of the Delphinus CDO portfolio was completed on July 17, 2007. Capdepon and Snorteland knew that Delphinus was fully ramped on July 17, 2007.

16. Obtaining ratings from Rating Agencies – S&P, Fitch, and Moody's – was a condition precedent to Delphinus's closing, issuance of securities, and receipt of money from investors. Capdepon and Snorteland, among others, were responsible for obtaining those ratings.

17. At approximately noon on July 18, 2007, the day before Delphinus was scheduled to close, S&P announced changes to its CDO rating methodology in a press release. Capdepon and Snorteland were aware of S&P's change in methodology.

18. Under S&P's July 18 changed criteria, certain categories of RMBS which were commonly used in CDO collateral pools were required to be adjusted downward by as many as 2 notches for purposes of calculating their default probability in S&P's CDO Evaluator. Delphinus's fully ramped portfolio contained a substantial amount of the collateral that was subject to the downward ratings adjustment described in S&P's July 18 press release.

19. Prior to the publication of S&P's July 18 announcement, Mizuho had not notified S&P that the Delphinus portfolio was fully ramped.

20. On July 18, 2007, after S&P published its announcement, Capdepon emailed multiple alternative portfolios to S&P throughout the evening with the knowledge and awareness of the other Mizuho employees responsible for the transaction. The alternative portfolios included so-called "dummy" assets, an industry term meaning hypothetical assets that will later be replaced by actual assets; however, in this case, the "dummy" assets were different from, and of a superior credit quality to, assets that had been actually acquired for the CDO. Mizuho

employees did not provide S&P with the collateral pool that was then in existence and had already been transferred to the Trustee in escrow.

21. The alternative portfolios sent to S&P on July 18 had certain factors in common, including, among other things, that: (a) they failed to disclose to S&P certain assets that had already been purchased for the fully-ramped portfolio; (b) they included dummy assets, thereby suggesting that the portfolio was not fully ramped and that Mizuho would purchase assets that matched the quality and characteristics of the dummy assets; (c) the dummy assets were coded as "prime" assets thereby making them more desirable under the changed S&P rating methodology, whereas the assets they substituted for were mostly coded as "subprime"; and (d) the dummy assets were, as a general matter, of a higher credit quality than the assets that had already been purchased for Delphinus. In an email that accompanied the final portfolio sent to S&P on the evening of July 18, one of Mizuho's employees responsible for the transaction stated that the collateral manager would be asked to purchase assets to increase the Delphinus portfolio's diversification.

22. At no point prior to closing did Capdepon or Snorteland, or any of the other Mizuho employees responsible for the transaction, send S&P the fully-ramped portfolio or provide S&P with notice that the portfolio was already fully ramped. Nor did Capdepon or Snorteland or other Mizuho employees make any effort to change the portfolio to conform the collateral to the portfolio that S&P actually rated on the evening of July 18. Specifically, there was no effort to provide the collateral manager with the portfolio that S&P actually rated, which included twenty six dummy assets, or otherwise inform the collateral manager that it needed to trade securities in order to conform the portfolio to the alternative portfolio that S&P had rated. Instead, a Mizuho employee told the collateral manager that S&P was prepared to issue the required ratings and that the transaction could proceed to closing.

23. Capdepon and Snorteland knew or should have known that, if they had supplied S&P with the actual portfolio on July 18, 2007, Delphinus would not have received the necessary ratings and thus could not have closed as planned.

24. The Delphinus transaction closed by mid-afternoon on July 19, 2007, with the S&P ratings that were obtained by the use of dummy assets, rather than the actual closing date portfolio. At closing, Mizuho sold securities based upon those ratings, which in turn misled investors to believe that the Delphinus notes were of higher credit quality. Investors were not aware that the actual portfolio at closing would have failed certain of S&P's quantitative tests. Additionally, between July 19, 2007 and November 9, 2007, there were numerous transactions in Delphinus notes in either the secondary market (for cash bonds) or the credit default swap market (credit default swaps written on Delphinus notes).

25. Mizuho did not provide Fitch or Moody's with a fully ramped portfolio prior to closing or otherwise provide notice that the portfolio had been fully-ramped as of closing. Shortly after the closing on July 19, 2007, Snorteland was asked by Moody's how ramped up Delphinus was at closing. Although she knew Delphinus was 100% ramped at closing, Snorteland responded that Delphinus was only 98.47% ramped, including commitments to purchase.

Effective Date Misconduct

26. Because Mizuho supplied S&P with a portfolio that failed to disclose that Delphinus was fully ramped, and S&P based its closing date ratings of Delphinus upon that portfolio, Mizuho was required to seek Effective Date RAC from S&P, meaning S&P was required to analyze the fully ramped portfolio and confirm that S&P had not reduced or withdrawn the rating it had assigned to each class of notes on the closing date.

27. Obtaining Effective Date RAC for Delphinus was of crucial importance. First, if not obtained, and Effective Date RAC Failure occurs, the manner in which Delphinus paid holders of its securities (and its service providers) would change. Instead of paying each tranche according to the anticipated "pro rata" method, in the event of Effective Date RAC Failure, Delphinus would shut off cash flow to all securities and pay down the senior-most securities according to the so-called "sequential payment" method until Effective Date RAC could be obtained. The cutting off of payments to Delphinus securities, in turn, would affect the market value of those securities.

28. On July 31, 2007, the Delphinus Trustee sent to S&P, and others, a request for Effective Date RAC for Delphinus. That request for Effective Date RAC included a copy of a letter from an accounting firm which, among other things, stated that Delphinus was effective at close and attached a copy of the asset portfolio that was actually transferred to Delphinus at close.

29. In the course of performing analytical work to determine whether RAC would be provided for Delphinus, S&P determined that on July 18, Mizuho employees had supplied, and S&P had rated, a portfolio that failed to accurately reflect the assets that had already been purchased for Delphinus. S&P also determined that, had Mizuho's employees instead supplied S&P with the actual closing date portfolio, Delphinus would not have obtained the necessary ratings from S&P and Delphinus would have been unable to close.

30. On August 23, 2007, S&P asked Mizuho – specifically, Snorteland – about whether there was an error in the accountant's letter. Before responding to S&P's inquiry, Snorteland instructed a Mizuho employee to obtain a second effective date letter from the accountants, this time with a different effective date. That Mizuho employee forwarded Snorteland's instruction to Capdepon, who wrote her an email explaining that her request posed certain problems. Among other things, Capdepon wrote that S&P had rated a portfolio that included dummy assets and that Delphinus was effective at close. Despite Capdepon's email, Snorteland continued to insist that a different effective date letter be obtained. Capdepon responded, "Ok."

31. The following morning, August 24, 2007, Snorteland told S&P that Delphinus was effective in August. Snorteland testified that she did not tell S&P that the accountant's letter was correct, and that S&P had rated the wrong portfolio because she did not "want to re-open the issue."

32. Snorteland arranged to have prepared and delivered to S&P: (a) a second effective date letter from the Accountant, and (b) a second effective date portfolio from the Trustee. Both the second effective date letter and the second effective date portfolio misrepresented that Delphinus's effective date was August 6, 2007, rather than July 19, 2007. Snorteland directed a Mizuho employee to deliver the Accountant's second effective date letter to S&P on September 5, 2007, and arranged to have the Trustee deliver the second effective date portfolio to S&P on September 5, 2007. These actions facilitated S&P's issuance of Effective Date RAC for Delphinus.

33. Ultimately, by letter dated September 12, 2007, S&P provided Effective Date RAC for Delphinus. Delphinus thus maintained its closing date ratings, and Delphinus paid noteholders pro rata, rather than switching to sequential payment. The closing date ratings continued to be relied upon by purchasers of Delphinus bonds, as well as parties entering into credit default swaps referencing Delphinus bonds. Between July 19 and November 9, 2007, there were numerous transactions in Delphinus notes in either the secondary market (for cash bonds) or the credit default swap market (credit default swaps written on Delphinus notes). Further, Mizuho continued to offer Delphinus notes for sale to investors in September and October 2007.

34. On September 6, 2007, just one day after having had the trustee and the accountants represent to S&P that Delphinus's effective date was July 19, 2007, Snorteland was asked by a Mizuho employee whether to send the new letter or the old letter to Fitch in connection with obtaining Effective Date RAC from Fitch, and she instructed that employee to send the letter representing that Delphinus's effective date was July 19, 2007. One day later, on September 7, 2007, in attempting to obtain RAC from Moody's, Snorteland directed a Mizuho employee to provide Moody's with the letter representing August 6, 2007 as the effective date. As described above, that representation was inaccurate.

Violations

35. Section 17(a)(1) of the Securities Act prohibits any person from "employ[ing] any device, scheme, or artifice to defraud." Section 17(a)(2) prohibits any person from "obtain[ing] money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading." Section 17(a)(3) prohibits any person from "engag[ing] in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

36. As a result of the conduct described above, Capdepon and Snorteland willfully violated Section 17(a) of the Securities Act.

IV.

Snorteland's Offer does not include an agreement to pay a penalty. As part of her Offer, Snorteland agrees that, if she fails to submit acceptable proof of her financial condition, then the Commission may reopen this proceeding against her for the purpose of resolving the penalty issue.

If the Commission reopens this proceeding, Snorteland agrees that she will not contest the findings of fact or law in this Order as a basis for any Commission determination to order a penalty that may be appropriate and in the public interest.

V.

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

Accordingly, pursuant to Section 8A of the Securities Act, Section 15(b) of the Exchange Act, and Section 9(b) of the Investment Company Act, it is hereby ORDERED that:

A. Capdepon and Snorteland cease and desist from committing or causing any violations and any future violations of Sections 17(a) of the Securities Act.

B. Capdepon and Snorteland be, and hereby are:

barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization;

prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter; and

suspended from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

with the right to reapply for reentry after one year to the appropriate self-regulatory organization, or if there is none, to the Commission.

C. Any reapplication for association by the Respondents 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. Capdepon shall, within ten (10) days of the entry of this Order, pay a civil money penalty in the amount of $125,000 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Payment shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check, bank money order, or by credit or debit card via Pay.gov through the SEC website at http://www.sec.gov/ about/offices/ofm. htm; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to Enterprise Services Center, Accounts Receivable Branch, 6500 South MacArthur Boulevard, Oklahoma City, Oklahoma 73169; and (D) submitted under cover letter that identifies Capdepon 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 Kenneth R. Lench, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Mail Stop-6013 SP1, Washington, DC 20549.

E. Pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002, as amended, a Fair Fund is created for the penalties referenced in paragraph D above. The foregoing payments may be combined in a single Fair Fund for distribution to injured investors. Additional monies paid by any defendant or respondent in a related proceeding arising from the underlying conduct also may be added to this Fair Fund for distribution. Regardless of whether any such Fair Fund distribution is made, amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Capdepon agrees that in any Related Investor Action, he shall not argue that he is entitled to, nor shall he benefit by, offset or reduction of any award of compensatory damages by the amount of any part of Capdepon's payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Capdepon agrees that he shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the United States Treasury or to a Fair Fund, as the Commission directs. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against Capdepon by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 67463 / July 19, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14956

In the Matter of **Alliance Bancshares California,** **City Loan, Inc.,** **Clear Choice Financial, Inc.,** **Community Bancorp,** **CRC Crystal Research Corp.,** **Cygne Designs, Inc., and** **Davi Skin, Inc.,** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

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

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Alliance Bancshares California ("ABNS") [1] (CIK No. 1140472) is a suspended California corporation located in Culver City, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). ABNS is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 2008, which reported a net loss of $28,589,000 for the prior nine months. On July 14, 2009, ABNS filed a Chapter 7 petition in the U.S. Bankruptcy Court for the Central District of California, which was still pending as of July 16, 2012. As of July 12, 2012, the common stock of ABNS was quoted on OTC Link formerly ("Pink Sheets") operated by

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

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

2. City Loan, Inc. ("CYLN") (CIK No. 799511) is a merged Delaware corporation located in Long Beach, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). CYLN is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 2008. As of July 12, 2012, the common stock of CYLN was quoted on OTC Link, had seven market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

3. Clear Choice Financial, Inc. ("CLCI") (CIK No. 1307431) is a revoked Nevada corporation located in Scottsdale, Arizona with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). CLCI 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 $3,428,588 for the prior three months. As of July 12, 2012, the common stock of CLCI 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. Community Bancorp ("CBONQ") (CIK No. 1304366) 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). CBONQ is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 2008, which reported a net loss of $4,904,000 for the prior nine months. On May 28, 2010, CBONQ filed a Chapter 7 petition in the U.S. Bankruptcy Court for the District of Nevada, which was still pending as of July 15, 2012. As of July 12, 2012, the common stock of CBONQ was traded on the over-the-counter markets.

5. CRC Crystal Research Corp. ("CYSA") (CIK No. 943690) is a Nevada corporation located in Mesa, Arizona with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). CYSA 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, 2009, which reported a net loss of $1,148,296 for the prior nine months. As of July 12, 2012, the common stock of CYSA 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. Cygne Designs, Inc. ("CYDS") (CIK No. 906782) is a forfeited Delaware corporation located in Culver City, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). CYDS is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended October 31, 2008, which reported a net loss of $21,607,000 for the prior nine months. As of July 12, 2012, the common stock of CYDS was quoted on OTC Link, had seven market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

7. Davi Skin, Inc. ("DAVNQ") (CIK No. 1059577) is a revoked Nevada corporation located in Los Angeles, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). DAVNQ 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 $1,311,014 for the prior six months. On June 14, 2010, DAVNQ filed a Chapter 7 petition in the U.S. Bankruptcy Court for the District of Nevada, which was closed on May 7, 2012. As of July 12, 2012, the common stock of DAVNQ 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

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

COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 1

RIN 3038-AD46

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 230, 240 and 241

Release No. 33-9338; 34-67453; File No. S7-16-11

RIN 3235-AK65

Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping

AGENCIES: Commodity Futures Trading Commission; Securities and Exchange Commission.

ACTION: Joint final rule; interpretations; request for comment on an interpretation.

SUMMARY: In accordance with section 712(a)(8), section 712(d)(1), sections 712(d)(2)(B) and (C), sections 721(b) and (c), and section 761(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") (collectively, "Commissions"), in consultation with the Board of Governors of the Federal Reserve System ("Board"), are jointly adopting new rules and interpretations under the Commodity Exchange Act ("CEA") and the Securities Exchange Act of 1934 ("Exchange Act") to further define the terms "swap," "security-based swap," and "security-based swap agreement" (collectively, "Product Definitions"); regarding "mixed swaps;" and governing books and records with respect to "security-based swap agreements." The CFTC requests comment on its interpretation concerning forwards with embedded volumetric optionality, contained in Section II.B.2.(b)(ii) of this release.

DATES: Effective date: [INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]. Compliance date: The applicable compliance dates are discussed in the section of the release titled "IX. Effective Date and Implementation". Comments on the interpretation regarding forwards with embedded volumetric optionality must be received on or before [INSERT DATE 60 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER].

ADDRESSES: You may submit comments, identified by RIN number 3038–AD46, by any of the following methods:

• *CFTC Web Site:* via its Comments Online process: http://comments.cftc.gov. Follow the instructions for submitting comments through the Web site.

• *Mail:* Address to David A. Stawick, Secretary of the Commission, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581.

• *Hand Delivery/Courier:* Same as mail above.

• *Federal eRulemaking Portal:* http://www.regulations.gov. Follow the instructions for submitting comments.

All comments must be submitted in English or, if not, accompanied by an English translation. Comments will be posted as received to http://www.cftc.gov. You should submit only information that you wish to make available publicly. If you wish the CFTC to consider information that is exempt from disclosure under the Freedom of Information Act, a petition for confidential treatment of the exempt information may be submitted according to the procedures established in § 145.9 of the CFTC's Regulations.[1]

The CFTC reserves the right, but shall have no obligation, to review, pre-screen, filter, redact, refuse or remove any or all of your submission from http://www.cftc.gov that it may deem to be inappropriate for publication, such as obscene language. All submissions that have been redacted or removed that contain comments on the merits of the interpretation will be

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1 17 CFR 145.9.

retained in the public comment file and will be considered as required under the Administrative Procedure Act and other applicable laws, and may be accessible under the Freedom of Information Act.

FOR FURTHER INFORMATION CONTACT: CFTC: Julian E. Hammar, Assistant General Counsel, at 202-418-5118, jhammar@cftc.gov, Lee Ann Duffy, Assistant General Counsel, at 202-418-6763, lduffy@cftc.gov; Mark Fajfar, Assistant General Counsel, at 202-418-6636, mfajfar@cftc.gov, or David E. Aron, Counsel, at 202-418-6621, daron@cftc.gov, Office of General Counsel, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581; SEC: Donna M. Chambers, Special Counsel, at 202-551-5870, or John Guidroz, Attorney-Adviser, at 202-551-5870, Division of Trading and Markets, or Andrew Schoeffler, Special Counsel, at 202-551-3860, Office of Capital Markets Trends, Division of Corporation Finance, or Wenchi Hu, Senior Special Counsel, at 202-551-5870, Office of Compliance, Inspections and Examinations, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

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I. Background

On July 21, 2010, President Obama signed the Dodd-Frank Act into law.[2] Title VII of the Dodd-Frank Act[3] ("Title VII") established a comprehensive new regulatory framework for swaps and security-based swaps. The legislation was enacted, among other reasons, to reduce risk, increase transparency, and promote market integrity within the financial system, including by: (i) providing for the registration and comprehensive regulation of swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants; (ii) imposing clearing and trade execution requirements on swaps and security-based swaps, subject to certain exceptions; (iii) creating rigorous recordkeeping and real-time reporting regimes; and (iv) enhancing the rulemaking and enforcement authorities of the Commissions with respect to, among others, all registered entities and intermediaries subject to the Commissions' oversight.

Section 712(d)(1) of the Dodd-Frank Act provides that the Commissions, in consultation with the Board, shall jointly further define the terms "swap," "security-based swap," and "security-based swap agreement" ("SBSA").[4] Section 712(a)(8) of the Dodd-Frank Act provides

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2 See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010). The text of the Dodd-Frank Act is available at http://www.cftc.gov/LawRegulation/OTCDERIVATIVES/index.htm.

3 Pursuant to section 701 of the Dodd-Frank Act, Title VII may be cited as the "Wall Street Transparency and Accountability Act of 2010."

4 In addition, section 719(d)(1)(A) of the Dodd-Frank Act requires the Commissions to conduct a joint study, within 15 months of enactment, to determine whether stable value contracts, as defined in section 719(d)(2) of the Dodd-Frank Act, are encompassed by the swap definition. If the Commissions determine that stable value contracts are encompassed by the swap definition, section 719(d)(1)(B) of the Dodd-Frank Act requires the Commissions jointly to determine whether an exemption for those contracts from the swap definition is appropriate and in the public interest. Section 719(d)(1)(B) also requires the Commissions to issue regulations implementing the determinations made under the required study. Until the effective date of such regulations, the requirements under Title VII do not apply to stable value contracts, and stable value contracts in effect prior to the effective date of such regulations are not considered swaps. See section 719(d) of the Dodd-Frank Act. The Commissions currently are conducting the required joint study and will consider whether to propose any implementing regulations

further that the Commissions shall jointly prescribe such regulations regarding "mixed swaps" as may be necessary to carry out the purposes of Title VII. In addition, sections 721(b) and 761(b) of the Dodd-Frank Act provide that the Commissions may adopt rules to further define terms included in subtitles A and B, respectively, of Title VII, and sections 721(c) and 761(b) of the Dodd-Frank Act provide the Commissions with authority to define the terms "swap" and "security-based swap," as well as the terms "swap dealer," "major swap participant," "security-based swap dealer," and "major security-based swap participant," to include transactions and entities that have been structured to evade the requirements of subtitles A and B, respectively, of Title VII.

Section 712(d)(2)(B) of the Dodd-Frank Act requires the Commissions, in consultation with the Board, to jointly adopt rules governing books and records requirements for SBSAs by persons registered as swap data repositories ("SDRs") under the CEA,[5] including uniform rules that specify the data elements that shall be collected and maintained by each SDR.[6] Similarly, section 712(d)(2)(C) of the Dodd-Frank Act requires the Commissions, in consultation with the Board, to jointly adopt rules governing books and records for SBSAs, including daily trading

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(including, if appropriate, regulations determining that stable value contracts: (i) are not encompassed within the swap definition; or (ii) are encompassed within the definition but are exempt from the swap definition) at the conclusion of that study.

5 7 U.S.C. 1 et seq.

6 The CFTC has issued final rules regarding SDRs and, separately, swap data recordkeeping and reporting. See Swap Data Repositories: Registration Standards, Duties and Core Principles, 76 FR 54538 (Sep. 1, 2011); Swap Data Recordkeeping and Reporting Requirements, 77 FR 2136 (Jan. 13, 2012). The SEC has also issued proposed rules regarding security-based swap data repositories ("SBSDRs"), including rules specifying data collection and maintenance standards for SBSDRs, as well as rules regarding security-based swap data recordkeeping and reporting. See Security-Based Swap Data Repository Registration, Duties, and Core Principles, 75 FR 77306 (Dec. 10, 2010); Regulation SBSR – Reporting and Dissemination of Security-Based Swap Information, 75 FR 75208 (Dec. 2, 2010).

records, for swap dealers, major swap participants, security-based swap dealers, and security-based swap participants.[7]

Under the comprehensive framework for regulating swaps and security-based swaps established in Title VII, the CFTC is given regulatory authority over swaps,[8] the SEC is given regulatory authority over security-based swaps,[9] and the Commissions shall jointly prescribe such regulations regarding mixed swaps as may be necessary to carry out the purposes of Title VII.[10] In addition, the SEC is given antifraud authority over, and access to information from,

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7 The CFTC has issued final rules regarding recordkeeping requirements for swap dealers and major swap participants. See Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants, 77 FR 20128 (Apr. 3, 2012).

8 Section 721(a) of the Dodd-Frank Act defines the term "swap" by adding section 1a(47) to the CEA, 7 U.S.C. 1a(47). This new swap definition also is cross-referenced in new section 3(a)(69) of the Exchange Act, 15 U.S.C. 78c(a)(69). Citations to provisions of the CEA and the Exchange Act, 15 U.S.C. 78a et seq., in this release refer to the numbering of those provisions after the effective date of Title VII, except as indicated.

9 Section 761(a) of the Dodd-Frank Act defines the term "security-based swap" by adding new section 3(a)(68) to the Exchange Act, 15 U.S.C. 78c(a)(68). This new security-based swap definition also is cross-referenced in new CEA section 1a(42), 7 U.S.C. 1a(42). The Dodd-Frank Act also explicitly includes security-based swaps in the definition of security under the Exchange Act and the Securities Act of 1933 ("Securities Act"), 15 U.S.C. 77a et seq.

10 Section 721(a) of the Dodd-Frank Act describes the category of "mixed swap" by adding new section 1a(47)(D) to the CEA, 7 U.S.C. 1a(47)(D). Section 761(a) of the Dodd-Frank Act also includes the category of "mixed swap" by adding new section 3(a)(68)(D) to the Exchange Act, 15 U.S.C. 78c(68)(D). A mixed swap is defined as a subset of security-based swaps that also are based on the value of 1 or more interest or other rates, currencies, commodities, instruments of indebtedness, indices, quantitative measures, other financial or economic interest or property of any kind (other than a single security or a narrow-based security index), or the occurrence, non-occurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence (other than the occurrence, non-occurrence, or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that such event directly affects the financial statements, financial condition, or financial obligations of the issuer).

certain CFTC-regulated entities regarding SBSAs, which are a type of swap related to securities over which the CFTC is given regulatory authority.[11]

To assist the Commissions in further defining the Product Definitions (as well as certain other definitions) and in prescribing regulations regarding mixed swaps as may be necessary to carry out the purposes of Title VII, the Commissions published an advance notice of proposed rulemaking ("ANPR") in the Federal Register on August 20, 2010.[12] The comment period for the ANPR closed on September 20, 2010.[13] The Commissions received comments addressing

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[11] Section 761(a) of the Dodd-Frank Act defines the term "security-based swap agreement" by adding new section 3(a)(78) to the Exchange Act, 15 U.S.C. 78c(a)(78). The CEA includes the definition of "security-based swap agreement" in subparagraph (A)(v) of the swap definition in CEA section 1a(47), 7 U.S.C. 1a(47). The only difference between these definitions is that the definition of SBSA in the Exchange Act specifically excludes security-based swaps (see section 3(a)(78)(B) of the Exchange Act, 15 U.S.C. 78c(a)(78)(B)), whereas the definition of SBSA in the CEA does not contain a similar exclusion. Instead, under the CEA, the exclusion for security-based swaps is placed in the general exclusions from the swap definition (see CEA section 1a(47)(B)(x), 7 U.S.C. 1a(47)(B)(x)). Although the statutes are slightly different structurally, the Commissions interpret them to have consistent meaning that the category of security-based swap agreements excludes security-based swaps.

[12] See Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act, 75 FR 51429 (Aug. 20, 2010). The ANPR also solicited comment regarding the definitions of the terms "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant," and "eligible contract participant." These definitions are the subject of a separate joint rulemaking by the Commissions. See Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 FR 30596 (May 23, 2012) ("Entity Definitions Release"). The Commissions also provided the public with the ability to present their views more generally on implementation of the Dodd-Frank Act through their websites, dedicated electronic mailboxes, and meetings with interested parties. See Public Comments on SEC Regulatory Initiatives Under the Dodd-Frank Act/Meetings with SEC Officials, located at http://www.sec.gov/spotlight/regreformcomments.shtml; Public Submissions, located at http://comments.cftc.gov/PublicComments/ReleasesWithComments.aspx; External Meetings, located at http://www.cftc.gov/LawRegulation/DoddFrankAct/ExternalMeetings/index.htm.

[13] Copies of all comments received by the SEC on the ANPR are available on the SEC's Internet website, located at http://www.sec.gov/comments/s7-16-10/s71610.shtml. Comments are also available for website viewing and printing in the SEC's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of all comments received by the CFTC on the ANPR are available on the CFTC's Internet website, located at http://www.cftc.gov/LawRegulation/DoddFrankAct/OTC_2_Definitions.html.

the Product Definitions and/or mixed swaps in response to the ANPR, as well as comments in response to the Commissions' informal solicitations,[14] from a wide range of commenters. Taking into account comments received on the ANPR, the Commissions published a notice of proposed rulemaking in the Federal Register on May 23, 2011.[15] The comment period for the Proposing Release closed on July 22, 2011.[16] Together, the Commissions received approximately 86 written comment letters in response to the Proposing Release.

The Commissions have reviewed and considered the comments received, and the staffs of the Commissions have met with many market participants and other interested parties to discuss the definitions.[17] Moreover, the Commissions' staffs have consulted extensively with each other as required by sections 712(a)(1) and (2) of the Dodd-Frank Act and have consulted with staff of the Board as required by section 712(d) of the Dodd-Frank Act.

Based on this review and consultation, the Commissions are adopting rules and interpretations regarding, among other things: (i) the regulatory treatment of insurance products; (ii) the exclusion of forward contracts from the swap and security-based swap definitions; (iii) the regulatory treatment of certain consumer and commercial contracts; (iv) the regulatory treatment of certain foreign-exchange related and other instruments; (v) swaps and security-based swaps involving interest rates (or other monetary rates) and yields; (vi) total return swaps

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14 See supra note 12.

15 See Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 76 FR 29818 (May 23, 2011) ("Proposing Release").

16 Id.

17 Information about meetings that CFTC staff have had with outside organizations regarding the implementation of the Dodd-Frank Act is available at http://www.cftc.gov/LawRegulation/DoddFrankAct/ExternalMeetings/index.htm. Information about meetings that SEC staff have had with outside organizations regarding the product definitions is available at http://www.sec.gov/comments/s7-16-10/s71610.shtml#meetings.

("TRS"); (vii) Title VII instruments based on futures contracts; (viii) the application of the definition of "narrow-based security index" in distinguishing between certain swaps and security-based swaps, including credit default swaps ("CDS") and index CDS; and (ix) the specification of certain swaps and security-based swaps that are, and are not, mixed swaps. In addition, the Commissions are adopting rules: (i) to clarify that there will not be additional books and records requirements applicable to SBSAs other than those required for swaps; (ii) providing a mechanism for requesting the Commissions to interpret whether a particular type of agreement, contract, or transaction (or class of agreements, contracts, or transactions) is a swap, security-based swap, or both (i.e., a mixed swap); and (iii) providing a mechanism for evaluating the applicability of certain regulatory requirements to particular mixed swaps. Finally, the CFTC is adopting rules to implement the anti-evasion authority provided in the Dodd-Frank Act.

Overall Economic Considerations

The Commissions are sensitive to the costs and benefits of their rules. In considering the adoption of the Product Definitions, the Commissions have been mindful of the costs and benefits associated with these rules, which provide fundamental building blocks for the Title VII regulatory regime. There are costs, as well as benefits, arising from subjecting certain agreements, contracts, or transactions to the regulatory regime of Title VII.[18] Additionally, there are costs that parties will incur to assess whether certain agreements, contracts, or transactions are indeed subject to the Title VII regulatory regime, and, if so, the costs to assess whether such Title VII instrument is subject to the regulatory regime of the SEC or the CFTC.[19]

18 The Commissions refer to these costs and benefits as programmatic costs and benefits.

19 The Commissions refer to these costs as assessment costs.

Title VII created a jurisdictional division between the CFTC and SEC. The costs and benefits flowing from an agreement, contract, or transaction being subject to the regulatory regime of the CFTC or the SEC may be impacted by similarities and differences in the Commissions' regulatory programs for swaps and security-based swaps. Title VII calls on the SEC and the CFTC to consult and coordinate for the purposes of assuring regulatory consistency and comparability to the extent possible.[20] Title VII also calls on the agencies to treat functionally or economically similar products or entities in a similar manner, but does not require identical rules.[21] Although the Commissions may differ on certain rulemakings, as the relevant products, entities and markets are different, the Commissions believe that, as the CFTC and SEC regulatory regimes share a statutory basis in Title VII, the costs and benefits of their respective regimes should be broadly similar and complementary.

In acknowledging the economic consequences of the final rules, the Commissions recognize that the Product Definitions do not themselves establish the scope or nature of those substantive requirements or their related costs and benefits. In determining the appropriate scope of these rules, the Commissions consider the types of agreement, contract, or transaction that should be regulated as a swap, security-based swap, or mixed swap under Title VII in light of the purposes of the Dodd-Frank Act. The Commissions have sought to further define the terms "swap," "security-based swap," and "mixed swap" to include agreements, contracts, and transactions only to the extent that capturing these agreements, contracts, and transactions is necessary and appropriate given the purposes of Title VII, and to exclude agreements, contracts, and transactions to the extent that the regulation of such agreements, contracts, and transactions

20 See sections 712(a)(1) and (a)(2) of the Dodd-Frank Act.

21 See sections 712(a)(7)(A) and (B) of the Dodd-Frank Act.

does not serve the statutory purposes of Title VII, so as not to impose unnecessary burdens for agreements, contracts, and transactions whose regulation may not be necessary or appropriate to further the purposes of Title VII.

II. Scope of Definitions of Swap and Security-Based Swap

A. Introduction

Title VII of the Dodd-Frank Act applies to a wide variety of agreements, contracts, and transactions classified as swaps or security-based swaps. The statute lists these agreements, contracts, and transactions in the definition of the term "swap."[22] The statutory definition of the term "swap" also has various exclusions,[23] rules of construction, and other provisions for the interpretation of the definition.[24] One of the exclusions to the definition of the term "swap" is for security-based swaps.[25] The term "security-based swap," in turn, is defined as an agreement, contract, or transaction that is a "swap" (without regard to the exclusion from that definition for security-based swaps) and that also has certain characteristics specified in the statute.[26] Thus, the statutory definition of the term "swap" also determines the scope of agreements, contracts, and transactions that could be security-based swaps.

The statutory definitions of the terms "swap" and "security-based swap" are detailed and comprehensive, and the Commissions believe that extensive "further definition" of the terms by rule is not necessary. Nevertheless, the definitions could be read to include certain types of agreements, contracts, and transactions that previously have not been considered swaps or

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22 See CEA section 1a(47)(A), 7 U.S.C. 1a(47)(A). This swap definition is also cross-referenced in new section 3(a)(69) of the Exchange Act, 15 U.S.C. 78c(a)(69).

23 See CEA section 1a(47)(B), 7 U.S.C. 1a(47)(B), clauses (i)-(x).

24 See CEA sections 1a(47)(C)-(F), 7 U.S.C. 1a(47)(C)-(F).

25 See CEA section 1a(47)(B)(x), 7 U.S.C. 1a(47)(B)(x).

26 See section 3(a)(68) of the Exchange Act, 15 U.S.C. 78c(a)(68).

security-based swaps, and nothing in the legislative history of the Dodd-Frank Act appears to suggest that Congress intended such agreements, contracts, or transactions to be regulated as swaps or security-based swaps under Title VII. The Commissions thus believe that it is important to further clarify the treatment under the definitions of certain types of agreements, contracts, and transactions, such as insurance products and certain consumer and commercial contracts.

In addition, commenters also raised questions regarding, and the Commissions believe that it is important to clarify: (i) the exclusion for forward contracts from the definitions of the terms "swap" and "security-based swap;" and (ii) the status of certain commodity-related products (including various foreign exchange products and forward rate agreements) under the definitions of the terms "swap" and "security-based swap." Finally, the Commissions are providing interpretations related to the definitions.[27]

B. Rules and Interpretations Regarding Certain Transactions outside the Scope of the Definitions of the Terms "Swap" and "Security-Based Swap"

1. Insurance Products

The statutory definition of the term "swap" includes, in part, any agreement, contract or transaction "that provides for any purchase, sale, payment or delivery (other than a dividend on

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27 In response to the ANPR, some commenters raised concerns regarding the treatment of inter-affiliate swaps and security-based swaps. See, e.g., Letter from Edward J. Rosen, Cleary Gottlieb Steen & Hamilton LLP, Sep. 21, 2010 ("Cleary ANPR Letter"); Letter from Coalition for Derivatives End Users, Sep. 20, 2010 ("CDEU ANPR Letter"); Letter from Robert Pickel, Executive Vice President, International Swaps and Derivatives Association, Inc. ("ISDA"), Sep. 20, 2010; Letter from Richard A. Miller, Vice President and Corporate Counsel, Prudential Financial Inc., Sep. 17, 2010; Letter from Richard M. Whiting, The Financial Services Roundtable, Sep. 20, 2010. A few commenters suggested that the Commissions should further define the term "swap" or "security-based swap" to exclude inter-affiliate transactions. See Cleary ANPR Letter and CDEU ANPR Letter. The Commissions are considering whether inter-affiliate swaps or security-based swaps should be treated differently from other swaps or security-based swaps in the context of the Commissions' other Title VII rulemakings.

an equity security) that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence."[28] As stated in the Proposing Release, the Commissions do not interpret this clause to mean that products historically treated as insurance products should be included within the swap or security-based swap definitions.[29] The Commissions are aware of nothing in Title VII to suggest that Congress intended for traditional insurance products to be regulated as swaps or security-based swaps. Moreover, the fact that swaps and insurance products are subject to different regulatory regimes is reflected in section 722(b) of the Dodd-Frank Act which, in new section 12(h) of the CEA, provides that a swap "shall not be considered to be insurance" and "may not be regulated as an insurance contract under the law of any State."[30] Accordingly, the Commissions believe that state or Federally regulated insurance

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28 CEA section 1a(47)(A)(ii), 7 U.S.C. 1a(47)(A)(ii).

29 See Proposing Release at 29821. The Commissions continue to believe that it was not the intent of Congress through the swap and security-based swap definitions to preclude the provision of insurance to individual homeowners and small businesses that purchase property and casualty insurance. See section 2(e) of the CEA, 7 U.S.C. 2(e), and section 6(l) of the Exchange Act, 15 U.S.C. 78f(l) (prohibiting individuals and small businesses that do not meet specified financial thresholds or other conditions from entering into swaps or security-based swaps other than on or subject to the rules of regulated futures and securities exchanges). Historically, insurance has not been regulated as such under the federal securities laws or under the CEA. See infra note 1283.

30 7 U.S.C. 16(h). Moreover, other provisions of the Dodd-Frank Act address the status of insurance more directly, and more extensively, than Title VII. For example, Title V of the Dodd-Frank Act requires the newly established Federal Insurance Office to conduct a study and submit a report to Congress, within 18 months of enactment of the Dodd-Frank Act, on the regulation of insurance, including the consideration of federal insurance regulation. Notably, the Federal Insurance Office's authority under Title V extends primarily to monitoring and information gathering; its ability to promulgate federal insurance regulation that preempts state insurance regulation is significantly restricted. See section 502 of the Dodd-Frank Act (codified in various sections of 31 U.S.C.). Title V also addressed non-admitted insurance and reinsurance. Title X of the Dodd-Frank Act also specifically excludes the business of insurance from regulation by the Bureau of Consumer Financial Protection. See section 1027(m) of the Dodd-Frank Act, 12 U.S.C. 5517(m) ("The [Bureau of Consumer Financial Protection] may not define as a financial product or service, by regulation or otherwise, engaging in the business of insurance."); section 1027(f) of the Dodd-Frank Act, 12 U.S.C. 5517(f) (excluding persons regulated by a state insurance regulator, except to the extent they are engaged in the offering or provision of

products that are provided by persons that are subject to state or Federal insurance supervision, that otherwise could fall within the definitions should not be considered swaps or security-based swaps so long as they satisfy the requirements of the Insurance Safe Harbor (as defined below). At the same time, however, the Commissions are concerned that certain agreements, contracts, or transactions that are swaps or security-based swaps might be characterized as insurance products to evade the regulatory regime under Title VII of the Dodd-Frank Act.

Accordingly, the Commissions are adopting final rules that (i) clarify that certain agreements, contracts, or transactions that satisfy the requirements of the Insurance Safe Harbor will not be considered to be swaps or security-based swaps, and (ii) provide an Insurance Grandfather exclusion from the swap and security-based swap definitions for any agreement, contract, or transaction entered into on or before the effective date of the Product Definitions, provided that, when the parties entered into such agreement, contract, or transaction, it was provided in accordance with the Provider Test (as defined below), including a requirement that an agreement, contract or transaction that is provided in accordance with the first prong of the Provider Test must be regulated as insurance under applicable state law or the laws of the United States.

The final rules contain four subparts: the first subpart addresses the agreement, contract, or transaction; the second subpart addresses the person[31] providing that agreement, contract, or

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consumer financial products or services or otherwise subject to certain consumer laws as set forth in Title X of the Dodd-Frank Act).

31 In response to commenters, the Commissions are changing the word "company" from the proposal to "person." Each of the CEA, the Securities Act, and the Exchange Act contains a definition of a "person." See, e.g., Letter from Carl B. Wilkerson, Vice President & Chief Counsel, American Council of Life Insurers ("ACLI"), dated July 22, 2011 ("ACLI Letter") and Letter from John P. Mulhern, Dewey & LeBoeuf LLP ("D&L"), dated July 22, 2011 ("D&L Letter").

transaction; the third subpart includes a list of traditional insurance products that do not have to meet the requirements set out in the first subpart; and the fourth subpart contains the Insurance Grandfather exclusion (as defined below).

More specifically, with respect to the first subpart, the Commissions are adopting paragraph (i)(A) of rule 1.3(xxx)(4) under the CEA and paragraph (a)(1) of rule 3a69-1 under the Exchange Act (the "Product Test") as proposed, with certain modifications to respond to commenters' concerns. As adopted, the Product Test provides that the terms "swap" and "security-based swap" will not include an agreement, contract, or transaction that, by its terms or by law, as a condition of performance:

- Requires the beneficiary of the agreement, contract, or transaction to have an insurable interest that is the subject of the agreement, contract, or transaction and thereby carry the risk of loss with respect to that interest continuously throughout the duration of the agreement, contract, or transaction;
- Requires that loss to occur and be proved, and that any payment or indemnification therefor be limited to the value of the insurable interest;
- Is not traded, separately from the insured interest, on an organized market or over the counter; and
- With respect to financial guaranty insurance only, in the event of payment default or insolvency of the obligor, any acceleration of payments under the policy is at the sole discretion of the insurer.

The Commissions are also adopting paragraph (i)(B) of rule 1.3(xxx)(4) under the CEA and paragraph (a)(2) of rule 3a69-1 under the Exchange Act (the "Provider Test") as proposed, with certain modifications to respond to commenters' concerns. As adopted, the Provider Test requires that an agreement, contract, or transaction that satisfies the Product Test must be provided:

- By a person that is subject to supervision by the insurance commissioner (or similar official or agency) of any state[32] or by the United States or an agency or instrumentality[33] thereof, and such agreement, contract, or transaction is regulated as insurance under applicable state law[34] or the laws of the United States (the "first prong");
- (i) Directly or indirectly by the United States, any state or any of their respective agencies or instrumentalities, or (ii) pursuant to a statutorily authorized program thereof ((i) and (ii) together, the "second prong"); or
- In the case of reinsurance only[35] by a person to another person that satisfies the Provider Test, provided that:

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32 The term "State" is defined in section 3(a)(16) of the Exchange Act, 15 U.S.C. 78c(a)(16), to mean "any State of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, or any other possession of the United States." The CFTC is incorporating this definition into rule 1.3(xxx)(4) for purposes of ensuring consistency between the CFTC and SEC rules further defining the terms "swap" and "security-based swap."

33 For purposes of this release, the term "instrumentality" includes publicly supported, state operated or quasi-state operated insurance programs that may not be subject to state regulatory oversight, such as the Illinois Mine Subsidence Insurance Fund and the Florida Hurricane Catastrophe Fund.

34 For purposes of this release, the Commissions anticipate that the parties to an agreement, contract, or transaction will evaluate which state law applies prior to entering into such agreement, contract, or transaction. The Commissions do not anticipate that the parties' analysis of which state law applies will change as a result of the adoption of the Insurance Safe Harbor. In addition, the Commissions will analyze which state law applies (if necessary, in consultation with state insurance regulatory authorities) if and when such issues arise that the Commissions determine to address. The Commissions note that courts routinely determine what is the "applicable state law" when adjudicating disputes involving insurance.

35 For purposes of this release, the term "reinsurance" means the assumption by an insurer of all or part of a risk undertaken originally by another insurer.

(i) such person is not prohibited by applicable state law or the laws of the United States from offering such agreement, contract, or transaction to such person that satisfies the Provider Test;

(ii) the agreement, contract, or transaction to be reinsured satisfies the Product Test or is one of the Enumerated Products (as defined below); and

(iii) except as otherwise permitted under applicable state law, the total amount reimbursable by all reinsurers[36] for such agreement, contract, or transaction may not exceed the claims or losses paid by the cedant[37] ((i), (ii), and (iii), collectively, the "third prong"); or

- In the case of non-admitted insurance[38] by a person who:

(i) is located outside of the United States and listed on the Quarterly Listing of Alien Insurers as maintained by the International Insurers Department of the National Association of Insurance Commissioners; or

(ii) meets the eligibility criteria for non-admitted insurers[39] under applicable state law ((i) and (ii) together, the "fourth prong").

In response to commenters' requests that the Commissions codify the proposed interpretation regarding certain enumerated types of traditional insurance products in the final

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36 For purposes of this release, the term "reinsurer" means any person who provides reinsurance.

37 For purposes of this release, the term "cedant" means the person writing the risk being ceded or transferred to a reinsurer.

38 For purposes of this release, the term "non-admitted insurance" means any property and casualty insurance permitted to be placed directly or through a surplus lines broker with a non-admitted insurer eligible to accept such insurance.

39 For purposes of this release, the term "non-admitted insurer" means, with respect to any State, an insurer not licensed to engage in the business of insurance in such State, but does not include a risk retention group, as that term is defined in section 2(a)(4) of the Liability Risk Retention Act of 1986, 15 U.S.C. 3901(a)(4).

rules,[40] the Commissions are also adopting paragraph (i)(C) of rule 1.3(xxx)(4) under the CEA and paragraph (a)(3) of rule 3a69-1 under the Exchange Act. In addition, in response to comments, the Commissions are expanding and revising the enumerated types of traditional insurance products. As adopted, the rule provides that the terms "swap" and "security-based swap" will not include an agreement, contract, or transaction that is provided in accordance with the Provider Test and is any one of the following (collectively, "Enumerated Products"): surety bonds; fidelity bonds; life insurance; health insurance; long-term care insurance; title insurance; property and casualty insurance; annuities; disability insurance; insurance against default on individual residential mortgages (commonly known as private mortgage insurance, as distinguished from financial guaranty of mortgage pools); and reinsurance (including retrocession) of any of the foregoing. The Commissions note that the inclusion of reinsurance (including retrocession) as an Enumerated Product is meant to apply to traditional reinsurance and retrocession contracts. Specifically, traditional reinsurance and retrocession contracts that reinsure risks ceded under traditional insurance products included in the Enumerated Product list and provided in accordance with the Provider test do not fall within the swap or security-based swap definitions. An agreement, contract, or transaction that is labeled as "reinsurance" or "retrocession", but is executed as a swap or security-based swap or otherwise is structured to evade Title VII of the Dodd-Frank Act, would not satisfy the Insurance Safe Harbor, and would be a swap or security-based swap.[41]

40 See infra notes 88, 89, and 90 and accompanying text.

41 For example, if a person uses a weather derivative or catastrophe swap to assume all or part of the risks contained in a portfolio of property and casualty insurance policies, that weather derivative or catastrophe swap would be a Title VII instrument that is subject to regulation under Title VII.

In order for an agreement, contract, or transaction to qualify under the final rules as an insurance product that would not be a swap or security-based swap: (i) the agreement, contract, or transaction must satisfy the criteria in the Product Test or be one of the Enumerated Products and (ii) the person providing the agreement, contract or transaction must satisfy one prong of the Provider Test.[42] The fact that an agreement, contract, or transaction satisfies the Product Test or is one of the Enumerated Products does not exclude it from the swap or security-based swap definitions if it is not provided by a person that satisfies the Provider Test; nor does the fact that a product is provided by a person that satisfies the Provider Test exclude the product from the swap or security-based swap definitions if the agreement, contract, or transaction does not satisfy the criteria set forth in the Product Test or is not one of the Enumerated Products.[43]

Further, in response to commenters' concerns,[44] the Commissions are confirming that the Product Test, the Provider Test and the Enumerated Products represent a non-exclusive safe harbor. None of the Product Test, the Provider Test, or the Enumerated Products (collectively, the "Insurance Safe Harbor") implies or presumes that an agreement, contract, or transaction that does not meet any of their respective requirements is a swap or security-based swap. Such an

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42 As was discussed in the Proposing Release, see Proposing Release at 29822 n. 31, certain variable life insurance products and annuities are securities and therefore are excluded from the swap and security-based swap definitions regardless of whether they meet the requirements under the final rules. See section 1a(47)(B)(v) of the CEA, 7 U.S.C. 1a(47)(B)(v). These securities would not be swaps or security-based swaps whether or not required to be registered under the Securities Act. See SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967) (holding that the accumulation provisions of a "flexible fund" annuity contract were not entitled to exemption under section 3(a)(8) of the Securities Act, 15 U.S.C. 77c(a)(8), for insurance and annuities); SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959) (holding that a variable annuity was not entitled to exemption under section 3(a)(8) of the Securities Act).

43 For the purpose of determining whether an agreement, contract or transaction falls within the Insurance Safe Harbor, Title VII provides the Commissions with flexibility to address the facts and circumstances of new products that may be marketed or sold as insurance, through joint interpretations pursuant to section 712(d)(4) of the Dodd-Frank Act.

44 See infra notes 178 and 179 and accompanying text.

agreement, contract, or transaction will require further analysis of the applicable facts and circumstances, including the form and substance of such agreement, contract, or transaction, to determine whether it is insurance, and thus not a swap or security-based swap.

However, future market conditions or other developments may prompt the Commissions to reconsider whether a particular product that satisfies the requirements of the Insurance Safe Harbor should instead fall within the swap or security-based swap definition. Because a determination that such a product is a swap or security-based swap could potentially have an unsettling effect on the domestic insurance or financial markets, the Commissions would only consider making a determination that such a product is a swap or security-based swap through a rulemaking[45] process that would provide market participants with an opportunity to comment.[46]

a) Types of Insurance Products

Final Rules

Product Test

The Commissions are adopting the Product Test as proposed, with certain modifications to respond to commenters' concerns. The Product Test sets forth four criteria for an agreement, contract, or transaction to be considered insurance. First, the final rules require that the beneficiary have an "insurable interest" underlying the agreement, contract, or transaction and thereby carry the risk of loss with respect to that interest continuously throughout the duration of the agreement, contract, or transaction. The requirement that the beneficiary be at risk of loss

45 The Commissions can engage in rulemakings in a variety of ways including an advanced notice of proposed rulemaking, a notice of proposed rulemaking, or an interim final rule.

46 When determining whether a particular product is a swap or security-based swap instead of insurance, if such product does not meet the requirements set out in the Insurance Safe Harbor, the Commissions will consider prior regulation as an insurance contract as one factor in their respective facts and circumstances analysis.

(which could be an adverse financial, economic, or commercial consequence) with respect to the interest that is the subject of the agreement, contract, or transaction continuously throughout the duration of the agreement, contract, or transaction will ensure that an insurance contract beneficiary has a stake in the interest on which the agreement, contract, or transaction is written.[47] Similarly, the requirement that the beneficiary have the insurable interest continuously throughout the duration of the agreement, contract, or transaction is designed to ensure that payment on the insurance product is inextricably connected to both the beneficiary and the interest on which the insurance product is written. In contrast to insurance, a credit default swap ("CDS") (which may be a swap or a security-based swap) does not require the purchaser of protection to hold any underlying obligation issued by the reference entity on which the CDS is written.[48] One commenter identified the existence of an insurable interest as a material element to the existence of an insurance contract.[49] Because neither swaps nor security-based swaps require the presence of an insurable interest at all (although an insurable interest may sometimes be present coincidentally), the Commissions continue to believe that whether an insurable interest is present continuously throughout the duration of the agreement, contract, or transaction is a meaningful way to distinguish insurance from swaps and security-based swaps.

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47 Requiring that a beneficiary of an insurance policy have a stake in the interest traditionally has been justified on public policy grounds. For example, a beneficiary that does not have a property right in a building might have an incentive to profit from arson.

48 Standard CDS documentation stipulates that the incurrence or demonstration of a loss may not be made a condition to the payment on the CDS or the performance of any obligation pursuant to the CDS. See, e.g., ISDA, 2003 ISDA Credit Derivatives Definitions, art. 9.1(b)(i) (2003) ("2003 Definitions") (stating that "the parties will be obligated to perform . . . irrespective of the existence or amount of the parties' credit exposure to a Reference Entity, and Buyer need not suffer any loss nor provide evidence of any loss as a result of the occurrence of a Credit Event").

49 See D&L Letter.

Second, the requirement that a loss occur and be proved similarly ensures that the beneficiary has a stake in the insurable interest that is the subject of the agreement, contract, or transaction. If the beneficiary can demonstrate loss, that loss would "trigger" performance by the insurer on the agreement, contract, or transaction such that, by making payment, the insurer is indemnifying the beneficiary for such loss. In addition, limiting any payment or indemnification to the value of the insurable interest aids in distinguishing swaps and security-based swaps (where there is no such limit) from insurance.[50]

Third, the final rules require that the insurance product not be traded, separately from the insured interest, on an organized market or over the counter. As the Commissions observed in the Proposing Release, with limited exceptions,[51] insurance products traditionally have not been entered into on or subject to the rules of an organized exchange nor traded in secondary market transactions (i.e., they are not traded on an organized market or over the counter). While swaps and security-based swaps also generally have not been tradable at will in secondary market transactions (i.e., on an organized market or over the counter) without counterparty consent, the Commissions understand that all or part of swaps and security-based swaps are novated or assigned to third parties, usually pursuant to industry standard terms and documents.[52] In

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50 To the extent an insurance product provides for such items as, for example, a rental car for use while the car that is the subject of an automobile insurance policy is being repaired, the Commissions would consider such items as constituting part of the value of the insurable interest.

51 See, e.g., "Life Settlements Task Force, Staff Report to the United States Securities and Exchange Commission" ("In an effort to help make the bidding process more efficient and to facilitate trading of policies after the initial settlement occurs, some intermediaries have considered or instituted a trading platform for life settlements."), available at http://www.sec.gov/news/studies/2010/lifesettlements-report.pdf (July 22, 2010).

52 See, e.g., ISDA, 2005 Novation Protocol, available at http://www.isda.org/2005novationprot/docs/NovationProtocol.pdf (2005); ISDA, ISDA Novation Protocol II, available at http://www.isda.org/isdanovationprotII/docs/NPII.pdf (2005); 2003 Definitions, Exhibits E (Novation Agreement) and F (Novation Confirmation).

response to commenter concerns,[53] the Commissions are clarifying when assignments of insurance contracts and trading on "insurances exchanges" do not constitute trading the contract separately from the related insurable interest, and thus would not violate the Product Test. The Commissions do not interpret the assignment of an insurance contract as described by commenters[54] to be "trading" as that term is used in the Product Test.[55] Nor do the Commissions find that the examples of exchanges offered by commenters[56], such as Federal Patient Protection and Affordable Care Act "exchanges,"[57] are exchanges as that term is used in the Product Test, e.g., a national securities exchange or designated contract market. Mandated insurance exchanges are more like marketplaces for the purchase of insurance, and there is no trading of insurance policies separately from the insured interest on these insurance exchanges. Thus, the assignment of an insurance contract as permitted or required by state law, or the purchase or assignment of an insurance contract on an insurance exchange or otherwise, does not constitute trading an agreement, contract, or transaction separately from the insured interest and would not violate the trading restriction in the Product Test. For the foregoing reasons as clarified, the

53 See infra notes 74 and 75 and accompanying text.

54 See, e.g., Letter from Kim O'Brien, President & CEO, National Association for Fixed Annuities ("NAFA"), dated July 21, 2011 ("NAFA Letter"); Letter from Robert Pickel, Executive Vice Chairman, ISDA, dated July 22, 2011 ("ISDA Letter"); ACLI Letter; and Letter from Letter from Stephen E. Roth, Frederick R. Bellamy and James M. Cain, Sutherland Asbill & Brennan LLP on behalf of the Committee of Annuity Insurers ("CAI"), dated July 22, 2011 ("CAI Letter").

55 The assignment of the benefits or proceeds of an insurance contract by an owner or beneficiary does not violate the trading restriction in the Product Test. This interpretation does not extend to "stranger originated" products. The transfer of obligations for policyholder benefits between two insurance companies, such as would occur in connection with an insurance company merger or acquisition, also does not violate the trading restriction contained in the Product Test.

56 See Letter from Susan E. Voss, Commissioner Iowa Insurance Division & National Association of Insurance Commissioners ("NAIC") President, and Therese M. Vaughan, NAIC Chief Executive Officer, dated July 22, 2011 ("NAIC Letter").

57 See Patient Protection and Affordable Care Act; Establishment of Exchanges and Qualified Health Plans, 76 FR 41866 (Jul. 15, 2011) (proposed).

Commissions continue to believe that lack of trading separately from the insured interest is a feature of insurance that is useful in distinguishing insurance from swaps and security-based swaps.

Fourth, the final rules provide that in the case of financial guaranty insurance policies, also known as bond insurance or bond wraps, any acceleration of payment under the policy must be at the sole discretion of the provider of the financial guaranty insurance policy in order to satisfy the Product Test.[58] Although such products can be economically similar to products such as CDS, they have certain key characteristics that distinguish them from swaps and security-based swaps.[59] For example, under a financial guaranty policy, the insurer typically is required to make timely payment of any shortfalls in the payment of scheduled interest to the holders of the underlying guaranteed obligation. Also, for particular bonds that are covered by a financial guaranty policy, the indenture, related documentation, and/or the financial guaranty policy will provide that a default in payment of principal or interest on the underlying bond will not result in acceleration of the obligation of the insurer to make payment of the full amount of principal on the underlying guaranteed obligation unless the insurer, in its sole discretion, opts to make payment of principal prior to the final scheduled maturity date of the underlying guaranteed

58 Financial guarantee policies are used by entities such as municipalities to provide greater assurances to potential purchasers of their bonds and thus reduce their interest costs. See "Report by the United States Securities and Exchange Commission on the Financial Guarantee Market: The Use of the Exemption in section 3(a)(2) of the Securities Act for Securities Guaranteed by Banks and the Use of Insurance Policies to Guarantee Debt Securities" (Aug. 28, 1987).

59 See, e.g., Letter from Sean W. McCarthy, Chairman, Association of Financial Guaranty Insurers on the ANPR, dated Sept. 20, 2010 (explaining the differences between financial guaranty policies and CDS); Letter from James M. Michener, General Counsel, Assured Guaranty on the ANPR, dated Dec. 14, 2010 (noting that the Financial Accounting Standards Board has issued separate guidance on accounting for financial guaranty insurance and CDS); Letter from Ernest C. Goodrich, Jr., Managing Director—Legal Department, Deutsche Bank AG on the ANPR, dated Sept. 20, 2010 (noting that financial guaranty policies require the incurrence of loss for payment, whereas CDS do not).

obligation. Conversely, under a CDS, a protection seller frequently is required to make payment of the relevant settlement amount to the protection buyer upon demand by the protection buyer after any credit event involving the issuer.[60]

As noted in the Proposing Release, the Commissions do not believe that financial guaranty policies, in general, should be regulated as swaps or security-based swaps. However, because of the close economic similarity of financial guaranty insurance policies guaranteeing payment on debt securities to CDS, in addition to the criteria noted above with respect to insurance generally, the final rules require that, in order to satisfy the Product Test, financial guaranty policies also must satisfy the requirement that they not permit the beneficiary of the policy to accelerate the payment of any principal due on the debt securities. This requirement further distinguishes financial guaranty policies from CDS because, as discussed above, the latter generally requires payment of the relevant settlement amount on the CDS after demand by the protection buyer.

Finally, in response to comments,[61] the Commissions are clarifying that reinsurance and retrocession transactions fall within the scope of the Product Test. The Commissions find that these transactions have insurable interests, as the Commissions interpret such interests in this context, if they have issued insurance policies covering the risks that they wish to insure (and reinsure). Moreover, the Commissions find that retrocession transactions are encompassed within the Product Test and the Provider Test because retrocession is reinsurance of reinsurance

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60 While a CDS requires payment in full on the occurrence of a credit event, the Commissions recognize that there are other financial instruments, such as corporate guarantees of commercial loans and letters of credit supporting payments on loans or debt securities, that allow for acceleration of payment obligations without such guarantees or letters of credit being swaps or security-based swaps.

61 See infra note 105 and accompanying text.

(provided the retrocession satisfies the other requirements of both tests). In addition, reinsurance (including retrocession) of certain types of insurance products is included in the list of Enumerated Products.[62]

Requiring all of the criteria in the Product Test will help to limit the application of the final rules to agreements, contracts, and transactions that are appropriately regulated as insurance, and help to assure that agreements, contracts, and transactions appropriately subject to the regulatory regime under Title VII of the Dodd-Frank Act are regulated as swaps or security-based swaps. As a result, the Commissions believe that these requirements will help prevent the final rules from being used to circumvent the applicability of the swap and security-based swap regulatory regimes under Title VII.

Enumerated Products

In the Proposing Release, the Commissions proposed an interpretation that certain enumerated types of insurance products would be outside the scope of the statutory definitions of swap and security-based swap under the Dodd-Frank Act if provided in accordance with the Provider Test and regulated as insurance. Based on comments received,[63] the Commissions are adding three products to the list of products as proposed (fidelity bonds, disability insurance and insurance against default on individual residential mortgages), adding reinsurance (including retrocession) of any of the traditional insurance products included in the list, deleting a requirement applicable to annuities, and codifying the Enumerated Products in the final rules. The revised list of Enumerated Products is: surety bonds, fidelity bonds, life insurance, health insurance, long-term care insurance, title insurance, property and casualty insurance, annuities,

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62 See supra note 41 and accompany text.

63 See infra notes 93 and 94 and accompanying text.

disability insurance, insurance against default on individual residential mortgages (commonly known as private mortgage insurance, as distinguished from financial guaranty of mortgage pools), and reinsurance (including retrocession) of any of the foregoing.[64] The Commissions believe that the Enumerated Products, as traditional insurance products, are not the types of agreements, contracts, or transactions that Congress intended to subject to the regulatory regime for swaps and security-based swaps under the Dodd-Frank Act. Codifying the Enumerated Products in the final rules appropriately places traditional insurance products outside the scope of the swap and security-based swap definition so long as such Enumerated Products are provided in accordance with the Provider Test, including a requirement that an Enumerated Product that is provided in accordance with the first prong of the Provider Test must be regulated as insurance under applicable state law or the laws of the United States.

Comments

Insurable Interest

Six commenters objected to the requirement in the Product Test that the beneficiary have an insurable interest continuously throughout the duration of the contract.[65] These commenters noted that, under state law, an insurable interest may not always be required to be present continuously throughout the duration of the policy. For example, commenters noted that life insurance may only require an insurable interest at the time the policy is executed;[66] and some

64 See supra note 41 and accompanying text.

65 See ACLI Letter; CAI Letter; ISDA Letter (objecting to the requirement that the risk of loss be held continuously throughout the contact); NAFA Letter; NAIC Letter; and Letter from Kenneth F. Spence III, Executive Vice President & General Counsel, The Travelers Companies, Inc. ("Travelers"), dated Nov. 14, 2011 ("Travelers Letter").

66 See ACLI Letter; CAI Letter; ISDA Letter; NAIC Letter; and Travelers Letter. The Commissions understand that some states may define what constitutes an insurable interest with

property and casualty or liability insurance may only require an insurable interest at the time a loss occurs.[67] Commenters also noted that annuities and health insurance do not require the existence of an insurable interest at all.[68] Another commenter suggested that the Commissions modify the Product Test to indicate that annuities would not need to satisfy the "insurable interest" component, or to use terminology other than insurable interest to make clear that annuities are not swaps.[69]

As discussed above, the Commissions are retaining the insurable interest requirement of the Product Test. The Commissions continue to believe that this requirement is a useful tool to distinguish insurance from swaps and security-based swaps, because swaps and security-based swaps do not require the presence of an insurable interest (or require either counterparty to bear any risk of loss) at any time during the term of the agreement, contract, or transaction. While the Commissions acknowledge commenters who argued that products such as life insurance, property and casualty insurance, and annuities may fail the Product Test because of the insurable interest requirement, the Commissions do not interpret any such failure to mean that life insurance, property and casualty insurance, and annuities are not insurance products. To the contrary, as discussed above, these products are included in the list of Enumerated Products that are excluded from the swap and security-based swap definitions so long as they are provided in

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reference to personal or emotional consequence in addition to the financial, economic, or commercial consequence mentioned in the statutory swap definition.

67 See NAIC Letter and Travelers Letter. However, one commenter noted that the Product and Provider Tests, as proposed, should be an effective means of helping to distinguish between those contracts that qualify for exclusion from the definition of swap and security-based swap from those contracts that will not. See Letter from Michael A. Bell, Senior Counsel, Financial Policy, The Property Casualty Insurers Association of America, dated July 22, 2011.

68 See CAI Letter; ISDA Letter; NAFA Letter; and NAIC Letter.

69 See Letter from Nicholas D. Latrenta, Executive Vice President and General Counsel, Metropolitan Life Insurance Companies and its insurance affiliates ("MetLife"), dated July 22, 2011 ("MetLife Letter").

accordance with the Provider Test. If a life insurance, property and casualty insurance, or annuity is provided in accordance with the Provider Test, such product is not a swap or security-based swap, whether or not an insurable interest is present at all times during the term of the contract.

Indemnification for Loss

Five commenters objected to the requirement in the Product Test that a loss occur and be proven, and that any payment be limited to the value of the insurable interest, because payment under many insurance products may not be directly based upon actual losses incurred.[70] Two commenters argued that annuities do not provide indemnification for loss and that life insurance products are not constrained by the value of the insurable interest.[71] Another argued that many insurance policies pay fixed amounts upon the occurrence of a loss without a requirement that the loss be tied to the value of an insurable interest.[72] Disability insurance and long-term care insurance are other products that commenters indicate would not be able to satisfy this requirement of the Product Test.[73]

As discussed above, the Commissions are retaining the requirement in the Product Test that a loss occur and be proven and that any payment for such loss be limited to the value of the insurable interest. The Commissions continue to believe that this requirement is a useful tool to distinguish insurance from swaps and security-based swaps, because payments under swaps and security-based swaps may be required when neither party incurs a loss, nor is the amount of payment limited by any such loss. While the Commissions acknowledge commenters who

70 See ACLI Letter; CAI Letter; ISDA Letter; NAFA Letter; and Travelers Letter.

71 See ACLI Letter and Travelers Letter.

72 See Travelers Letter.

73 See, e.g., ACLI Letter and CAI Letter.

identified various products that may fail this part of the Product Test, the Commissions do not interpret any such failure to mean that products such as annuities, disability insurance, and long-term care insurance are not insurance products. To the contrary, as discussed above, these products are included in the list of Enumerated Products that are excluded from the swap and security-based swap definitions so long as they are provided in accordance with the Provider Test. If long-term care insurance, disability insurance, or an annuity is provided in accordance with the Provider Test, such product is not a swap or a security-based swap, whether or not a loss occurs, is proven, or indemnification for loss is limited to the value of the insurable interest.

Not Traded Separately

Six commenters stated that the proposed requirement that the agreement, contract, or transaction not be traded, separately from the insured interest, on an organized market or over the counter, is not an effective criterion in determining whether a product is insurance.[74] According to commenters, this criterion is ineffective and should be deleted from the Product Test because many conventional insurance products, such as annuities, are assignable (and therefore tradable), which may violate the trading restriction.[75] Two commenters observed that the trading of insurance policies has already occurred and is expected to increase.[76] One commenter stated that a number of states have "insurance exchanges" that sell reinsurance and excess or surplus lines, and that the Patient Protection and Affordable Care Act requires states or the federal government

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74 See ACLI Letter; Letter from Chris Barnard ("Barnard"), dated June 28, 2011 ("Barnard Letter"); CAI Letter; NAFA Letter; NAIC Letter; and ISDA Letter.

75 Id. ACLI stated that many conventional insurance products, particularly annuities, can be assigned by the owner, and often state insurance law requires such assignability as a condition for approval of the product for sale under applicable insurance law. ACLI also stated that insurance policies are frequently assigned among family members, to third parties as collateral for loans, and in a host of other situations, and does not believe that these common kinds of assignment should cause an insurance product to be characterized as a swap.

76 See Barnard Letter and NAIC Letter.

to establish health benefit "insurance exchanges" through which insurers will sell health insurance to individuals and small groups.[77] One commenter recommended that the trading restriction apply only to trading by the policyholder or beneficiary of an insurance policy.[78]

The Commissions are retaining the requirement in the Product Test that the agreement, contract, or transaction not be traded separately from the insured interest, on an organized market or over the counter, and as discussed above have provided a clarification regarding assignments and trading on insurance exchanges. The Commissions continue to believe that using this criterion is an effective way to distinguish insurance from swaps and security-based swaps because swaps and security-based swaps are traded on organized markets and over the counter.

As stated above, the Commissions do not interpret the assignment of an insurance contract as described by commenters to be "trading" as that term is used in the Product Test.[79] Nor do the Commissions find that the examples of exchanges offered by commenters, such as Federal Patient Protection and Affordable Care Act "exchanges," are exchanges as that term is used in the Product Test, e.g., a national securities exchange or designated contract market.[80] Mandated insurance exchanges are more like marketplaces for the purchase of insurance, and there is no trading of insurance policies separately from the insured interest on these insurance exchanges. Thus, the assignment of an insurance contract as permitted or required by state law, or the purchase or assignment of an insurance contract on an insurance exchange or otherwise,

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77 See NAIC Letter. The commenter explained that the "insurance exchanges" mandated by the Patient Protection and Affordable Care Act would be marketplaces for insurance policies. The commenter described them as "cooperatives" where people could go to buy insurance policies with standardized terms/actuaries. The commenter noted that the insurable interest would not "trade" separately from the insurance policy in these cooperatives.

78 See Travelers Letter.

79 See supra notes 54 and 55.

80 See supra notes 56 and 57.

does not constitute trading an agreement, contract, or transaction separately from the insured interest and would not violate the trading restriction in the Product Test.

Acceleration

Three commenters believed that the proposed requirement that, in the event of payment default or insolvency of the obligor, any acceleration of payments under a financial guaranty insurance policy be at the sole discretion of the insurer, is not an effective criterion in determining whether financial guaranty insurance falls outside the swap and security-based swap definitions and should be deleted from the Product Test.[81] However, one commenter supported its inclusion, observing that the proposed requirement is "firmly based on substantive business realities."[82] Two commenters believed that the acceleration of payments requirement is not useful in distinguishing between financial guaranty insurance and swaps or security-based swaps because it is designed to protect financial guaranty insurers from insolvency.[83] They noted that the criterion is a regulatory requirement imposed by state insurance commissioners that is subject to change, and that a state could not change this regulatory requirement without converting the financial guaranty policy into a swap or security-based swap.[84] One commenter stated that the acceleration of payments criterion has been the subject of significant analysis and interpretation by state insurance regulators, and including the requirement in the rules could result in

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81 See Letter from Bruce E. Stern, Chairman, Association of Financial Guaranty Insurers ("AFGI"), dated July 20, 2011 ("AFGI Letter"); ISDA Letter; and Letter from Kimberly M. Welsh, Vice President and Assistant General Counsel, Reinsurance Association of America ("RAA"), dated July 22, 2011 ("RAA Letter").

82 See Letter from Dennis M. Kelleher, President & CEO, Better Markets Inc., dated July 22, 2011 ("Better Markets Letter").

83 See ISDA Letter and RAA Letter.

84 Id.

conflicting interpretations and additional legal uncertainty.[85] This commenter also stated that this uncertainty will impose significant burdens on financial guaranty insurers that insure municipal bonds.[86]

The Commissions are retaining the requirement that acceleration be at the sole option of the provider of the financial guaranty insurance policy in the Product Test. In response to commenter concerns, the Commissions are clarifying that they plan to interpret the acceleration limitation in accordance with applicable state law to the extent that it does not contradict the Commissions' rules, interpretations and/or guidance regarding what is a swap or security-based swap.[87] The Commissions continue to believe that, for purposes of further defining swaps and security-based swaps, this criterion is useful to distinguish between financial guaranty insurance on the one hand, and swaps and security-based swaps, such as CDS, on the other because, as discussed above, the latter generally requires payment of the relevant settlement amount on the CDS after demand by the protection buyer.

Enumerated Products

The Commissions proposed an interpretation that certain enumerated types of insurance products would be outside the scope of the statutory definitions of swap and security-based

85 See AFGI Letter.

86 Id. The commenter argued that these burdens would (a) increase instability in the currently fragile municipal bond market and (b) decrease the availability or attractiveness of bond insurance to municipal issuers that would otherwise save money by employing bond insurance. The Commissions understand that only one member of AFGI is currently active in the municipal bond insurance market.

87 One commenter noted that "financial guarantors, for some time and in full compliance with state insurance laws, have issued insurance policies that contemplate acceleration upon events unrelated to an issuer default, e.g., upon the downgrade of the insurer." See AFGI Letter. In response to this comment, the Commissions note that the acceleration requirement in the Product Test refers only to "payment default or insolvency of the obligor" (emphasis added), without precluding other triggers.

swap. Several commenters stated that the list of enumerated insurance products should be codified in order to enhance legal certainty.[88] In particular, one commenter stated that it is important for the Commissions to codify the interpretation because the traditional insurance products included in the enumerated list may not satisfy the Product Test.[89] The commenter also expressed concern that insurance companies and state insurance regulators would face the possibility that the Commissions could revise or withdraw the interpretation in the future, with or without undergoing a formal rulemaking process.[90] As noted above, in response to commenters' concerns, the Commissions are codifying the Enumerated Products in the final rules.

One commenter further argued that the enumerated types of insurance products included in the list should not have to additionally satisfy the requirements that the person offering such product be a U.S. domiciled insurer and that the product be regulated in the U.S. as insurance.[91] The commenter argued that this additional requirement would result in the Insurance Safe Harbor not applying to traditional insurance products offered by insurers domiciled outside of the U.S. or by insurers that are not organized as insurance companies. The Commissions are retaining the requirement that the Enumerated Products be provided in accordance with the Provider Test. The Commissions also note that, in response to commenters' concerns, the Commissions have revised the first prong of the Provider Test so that it is not limited to insurance companies or to entities that are domiciled in the U.S. A product that need not satisfy the Product Test must be provided in accordance with the Provider Test, including a requirement

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88 See ACLI Letter; NAIC Letter; RAA Letter; AIA Letter; NAFA Letter; and Letter from Mark R. Thresher, Executive Vice President, Nationwide, dated July 19, 2011 ("Nationwide Letter").

89 See Travelers Letter.

90 Id.

91 See D&L Letter.

that products provided in accordance with the first prong of the Provider Test must be regulated as insurance.[92]

Five commenters addressed the treatment of annuities in the proposed interpretive guidance, with all recommending that all annuities be excluded from the swap and security-based definitions regardless of their status under the tax laws.[93] In response to the comments, the Commissions are eliminating the proposed requirement that annuities comply with section 72 of the Internal Revenue Code in order to qualify as an Enumerated Product. The Commissions are persuaded that the proposed reference to the Internal Revenue Code is unnecessarily limiting and does not help to distinguish insurance from swaps and security-based swaps.

Other commenters suggested adding other products to the list of enumerated types of insurance products,[94] with one suggesting that the Commissions' interpretation cover all transactions currently reportable as insurance in the provider's regulatory and financial reports under a state's or a foreign jurisdiction's insurance laws.[95] One commenter noted that the list of enumerated types of insurance products does not include other state-regulated products such as

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92 See infra notes 147 and 148 and accompanying text.

93 See ACLI Letter; CAI Letter; MetLife Letter; Nationwide Letter; and RAA Letter.

94 See ACLI Letter; AIA Letter; CAI Letter; D&L Letter; NAIC Letter; Letter from Michael A. Bell, Senior Counsel, Financial Policy, RAA Letter; and Letter from Robert J. Duke, The Surety & Fidelity Association of America ("SFAA"), dated July 13, 2011, ("SFAA Letter"). ACLI, CAI and RAA requested the addition of other types of annuity and pension plan products, such as group annuity contracts, guaranteed investment contracts, funding agreements, structured settlements, deposit administration contracts, and immediate participation guarantee contracts. D&L requested the addition of reinsurance of any of the enumerated types of traditional insurance products. NAIC requested the addition of mortgage guaranty, accident, and disability insurance. SFAA request the addition of surety and fidelity bonds.

95 See Letter from J. Stephen Zielezienski, Senior Vice President & General Counsel, American Insurance Association ("AIA"), dated July 22, 2011 ("AIA Letter").

service contracts, that may not satisfy the Product Test.[96] In response to requests to expand the list of enumerated products, the Commissions are adding fidelity bonds,[97] disability insurance, and insurance against default on individual residential mortgages (commonly known as private mortgage insurance, as distinguished from financial guaranty of mortgage pools) to the list of Enumerated Products. The Commissions agree that these are traditional insurance products, and thus their inclusion in the list of Enumerated Products is appropriate. The Commissions have also added reinsurance (including retrocession) of any of the traditional insurance products to the list of Enumerated Products.[98] However, the Commissions decline at this time to expand the list of Enumerated Products to include other types of contracts such as, guaranteed investment contracts ("GICs"), synthetic GICs, funding agreements, structured settlements, deposit administration contracts, immediate participation guaranty contracts, industry loss warrants, and catastrophe bonds.[99] These products do not receive the benefit of state insurance guaranty funds;

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96 See NAIC Letter. The Commissions note that service contracts, although regulated as insurance in some states, comprise consumer warranties, extended service plans, and buyer protection plans of the sort purchased with major appliances, electronics, and the like. The Commissions are addressing these contracts in their interpretation regarding consumer/commercial transactions. See infra part II.B.3.

97 SFAA requested that the Commissions issue specific guidance that surety and fidelity bonds are insurance products rather than swaps, noting that all states include surety and fidelity bonds as lines of insurance subject to state oversight. Surety bonds were already included in the list of enumerated insurance products contained in the Proposing Release.

98 See supra note 41 and accompanying text.

99 See, e.g., RAA Letter; CAI Letter; Letter from Ian K. Shepherd, Managing Director, Alice Corp. Pty Ltd ("Alice Corp."), dated July 22, 2011. Alice Corp. stated that industry loss warrants are a contingent instrument with a somewhat illiquid secondary market but "are currently treated as a reinsurance product and require an insurable interest." Alice Corp. also stated that "[c]atastrophe bonds may reference a specific insured portfolio or a set of parameters and may be traded in a secondary market and behave like a coupon bond if there is no triggering event but have a contingent element since some or all of the principal may be lost if the referenced event or loss occurs." Id. The Commissions note that catastrophe bonds are "securities" under the federal securities laws and decline to provide an interpretation regarding industry loss warrants because it is inappropriate to determine whether a complex and novel product is a swap or a security-based swap in a general definitional rulemaking.

their providers are not limited to insurance companies. The Commissions received little detail on sales of these other products, and do not believe it is appropriate to determine whether particular complex, novel or still evolving products are swaps or security-based swaps in the context of a general definitional rulemaking. Rather these products should be considered in a facts and circumstances analysis. With respect to GICs, the Commissions have published a request for comment regarding the study of stable value contracts.[100]

Reliance on State Law Concepts

Two commenters noted that the Product Test relies on concepts derived from state law, such as "insurable interest" and "indemnification for loss," which do not have uniform definitions.[101] This would require the Commissions to analyze state insurance law, as well as to determine which state law should apply.[102] One of these commenters also requested that such concepts be applied consistently with the historical interpretation by the applicable state.[103]

100 See Acceptance of Public Submissions Regarding the Study of Stable Value Contracts, 76 FR 53162 (Aug. 25, 2011).

101 See ACLI Letter and AFGI Letter. Some states define concepts such as "insurable interest" in statute; in other states definitions have developed through common law. The Commissions recognize that the terms denoting such concepts may vary from state to state; for instance, what one state calls an "insurable interest" may be referred to as a "material interest" in another. See, e.g., New York Insurance Law Section 1101 ("material interest"). The Commissions believe, however, that both the concepts and their labels are well understood by insurance professionals and that any such variations would not impede market participants from interpreting or applying the final rules. Indeed, one commenter acknowledged this and applied the concepts, labeled differently, to particular products. "The terms used in the rule's criteria are different from the terms used with respect to a surety bond. For example, the bond is generally not referred to as a 'policy.' In addition, the beneficiary of a bond typically is known as the 'obligee.' Further, the bond's limit is referred to as the 'penal sum.' Nevertheless, the criteria can be applied to surety bonds and fidelity bonds, and such application would exclude bonds from the statutory definition of swaps." See SFAA Letter.

102 See ACLI Letter and AFGI Letter.

103 See AFGI Letter.

State law differences regarding these concepts should not impede the ability of market participants from interpreting or applying the final rules to distinguishing between insurance and swaps or security-based swaps, and thus the Commissions are retaining these concepts in the Product Test. The Commissions intend to interpret these concepts consistently with the existing and developing laws of the relevant state(s) governing the agreement, contract, or transaction in question. However, the Commissions note their authority to diverge from state law if the Commissions become aware of evasive conduct.[104]

Inclusion of Reinsurance and Retrocession Transactions

Several commenters suggested that the Commissions amend the Product Test to explicitly address reinsurance and retrocession (i.e., reinsurance of reinsurance) transactions.[105]

In response to these comments, the Commissions are clarifying that reinsurance and retrocession transactions may fall within the Insurance Safe Harbor, thus, it is unnecessary for the Product Test to be modified as suggested by these commenters. In addition, the Commissions have modified the final rules to include reinsurance (including retrocession) of certain types of insurance products in the list of Enumerated Products. Reinsurance or

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104 The Commissions may also diverge from interpretations or determinations of state law based on an analysis of applicable facts and circumstances when determining whether a particular product is a swap or security-based swap.

105 See ACLI Letter; CAI Letter; D&L Letter; ISDA Letter; NAFA Letter; Nationwide Letter; and RAA Letter. ACLI noted that the Product Test does not include a reference to reinsurance and that the "insurable interest" requirement under state insurance law generally does not apply to reinsurance products which, therefore, would not satisfy the Product Test. ACLI and CAI state that reinsurance in a chain of reinsurance also should not be considered a swap or security-based swap. In addition to expressly referencing reinsurance and retrocession transactions, ACLI believes that the Product Test should be expanded to include reinsurance and retrocession of insurance risks ceded by non-U.S. insurance companies to domestic insurance companies. RAA recommended adding a new clause to the Product Test to provide that "[a]ny agreement, contract, or transaction which reinsures any agreement, contract, or transaction meeting the criteria of paragraph (xxx)(4)(i)(A) – (C) of this section is also an insurance product."

retrocession of these Enumerated Products will fall within the Insurance Safe Harbor so long as such reinsurance or retrocession is provided in accordance with the Provider Test.[106]

Payment Based on the Price, Rate, or Level of a Financial Instrument

In the Proposing Release, the Commissions requested comment on whether, in order for an agreement, contract, or transaction to be considered insurance under the Product Test, the Commissions should require that payment not be based on the price, rate, or level of a financial instrument, asset, or interest or any commodity. The Commissions also requested comment on whether variable annuity contracts (where the income is subject to tax treatment under section 72 of the Internal Revenue Code) and variable life insurance should be excepted from such a requirement, if adopted.[107]

Eight commenters stated that it is inappropriate to include such a requirement in the final rules because a number of traditional insurance products would not satisfy the requirement and suggested that the Commissions should instead consider whether the agreement, contract, or transaction transfers risk and argued that such a requirement is not a useful marker for distinguishing insurance from swaps and security-based swaps.[108] Several commenters also

106 See supra note 41 and accompanying text.

107 See Proposing Release at 29824. See also id. at 29825, Request for Comment 7.

108 See ACLI Letter; AIA Letter; AFGI Letter; CAI Letter; ISDA Letter; NAFA Letter; NAIC Letter; and Nationwide Letter (concurring with ACLI's comments).

Commenters cited several examples of products that would fail a requirement that payment not be based on the price, rate, or level of a financial instrument, asset, or interest or any commodity. ACLI, CAI and NAFA cited registered and unregistered variable annuities and variable life insurance, and certain fixed annuities and equity indexed annuities, stating that these could be construed as being based on, or related to, a price, rate or level of a financial asset. ACLI also cited financial guaranty insurance, and replacement value property and casualty insurance, where the insurer's payment obligation may be based on the current price of the insured property or adjusted to reflect inflation. ACLI and ISDA cited crop insurance, because it could call for payment to be based in some way on the market price of the covered crop on the date of loss. ISDA and RAA cited "dual trigger" insurance (such as replacement power insurance); property believed that the addition to the Product Test of the criterion that payment not be based on the price, rate, or level of a financial instrument, asset, or interest or any commodity would contribute to greater legal uncertainty.[109]

Two commenters agreed that such a requirement should be included in the final rules.[110] One commenter argued that any insurance instrument that provides for payment based on the price, rate, or level of a financial instrument, asset, or interest in any commodity is in substance a swap or security-based, regardless of its label, and should be regulated as such.[111] One of these commenters further recommended that the Commissions exclude annuity and variable universal life insurance from this requirement because these products were investments with some minimal level of life insurance cover or investment guarantee rider on top.[112]

The Commissions are not adopting an additional requirement for the Product Test that payment not be based on the price, rate, or level of a financial instrument, asset, or interest or any commodity because the Commissions find the requirement to be unsuitable for distinguishing insurance from swaps and security-based swaps. While the provision might work for property and casualty insurance, as many commenters noted, it is not an effective distinction for a number of other traditional insurance products.

Accounting Standards

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and casualty policies purchased by some commodity producers (e.g., oil refineries, copper mines) with deductibles that increase or decrease based on the price of the commodity that the company produces; event cancellation insurance that uses commodity indices to determine claims; and weather insurance and malpractice insurance. NAIC cited guaranteed investment contracts, financial guaranty insurance, and mortgage guaranty insurance

109 See AIA Letter and AFGI Letter.

110 See Barnard Letter and Better Markets Letter.

111 See Better Markets Letter.

112 See Barnard Letter.

In the Proposing Release, the Commissions requested comment on whether the proposed rules relating to insurance should include a provision related to whether a product is recognized at fair value on an ongoing basis with changes in fair value reflected in earnings under U.S. generally accepted accounting principles.[113]

Three commenters argued that the proposed rules should not include a provision that an insurance product is recognized at fair value under generally accepted accounting principles.[114] One commenter argued that the determinants of what is an insurance product should be the existence of an insurable interest, transfer of risk, and indemnification of covered loss.[115] Another argued that factoring accounting standards into the analysis of whether a product is a swap or insurance will introduce unnecessary complexity in most cases but that the examination of accounting standards would be useful in cases where the classification of a product as insurance or swap is unclear.[116]

After considering these comments, the Commissions are not including a reference to accounting standards in the Product Test.

b) Providers of Insurance Products

Under the first prong of the Provider Test, the agreement, contract, or transaction must be provided by a person that is subject to supervision by the insurance commissioner (or similar official or agency) of any state[117] or by the United States.[118] In addition, such agreement,

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113 See Proposing Release at 29827, Request for Comment 17.

114 See AFGI Letter; D&L Letter; and ISDA Letter.

115 See D&L Letter.

116 See ISDA Letter.

117 See supra note 32, regarding the definition of "State" contained in the Proposing Release.

118 This requirement in the final rules is substantially similar to the requirement included in section 3(a)(8) of the Securities Act, 15 U.S.C. 77c(a)(8).

contract, or transaction also must be regulated as insurance under applicable state law[119] or the laws of the United States.

The Commissions have revised the first prong of the Provider Test from the proposal. As proposed, the first prong of the Provider Test could only be satisfied by a company that was organized as an insurance company whose primary and predominant business activity was the writing of insurance or the reinsuring of risks underwritten by insurance companies.[120] The Commissions have revised this prong of the Provider Test to address commenters' concerns that the proposed rules would exclude insurers that were not organized as "insurance companies," as well as insurers that were domiciled outside of the United States.[121] As adopted, the first prong of the Provider Test can be satisfied by any person that is subject to state or federal insurance supervision, regardless of that person's corporate structure or domicile. The Commissions understand that, with the exception of non-admitted insurers,[122] foreign insurers are subject to supervision in the states in which they offer insurance products. The treatment of non-admitted insurers is addressed in the fourth prong of the Provider Test.

The Commissions believe that the requirement that the agreement, contract, or transaction be provided by a person that is subject to state or federal insurance supervision should help prevent regulatory gaps that otherwise might exist between insurance regulation and the regulation of swaps and security-based swaps by ensuring that products provided by persons

119 See supra note 34.

120 See Proposing Release at 29824.

121 See infra notes 139, 140, and 141 and accompanying text.

122 The Commissions understand that the surplus lines brokers who place insurance on behalf of non-admitted insurers are subject to supervision in the states in which they offer non-admitted insurance products.

that are not subject to state or federal insurance supervision are not able to be offered by persons that avoid regulation under Title VII of the Dodd-Frank Act as well.

The first prong of the Provider Test also requires that the agreement, contract, or transaction being provided is "regulated as insurance" under applicable state law or the laws of the United States. As stated in the Proposing Release, the purpose of this requirement is that an agreement, contract, or transaction that satisfies the other conditions of the final rules must be subject to regulatory oversight as an insurance product. The Commissions believe that this condition will help prevent products that are not regulated as insurance in the states in which they are offered, and that are swaps or security-based swaps, from being characterized as insurance products in order to evade the regulatory regime under Title VII of the Dodd-Frank Act. As noted by commenters,[123] the Commissions recognize that the "regulated as insurance" limitation means that it is possible that a particular product that may not be regulated as insurance in a particular state may not qualify for the Insurance Safe Harbor.[124]

As stated in the Proposing Release, the Commissions believe that it is appropriate to exclude, from regulation under Title VII, insurance that is issued by the United States or any of its agencies or instrumentalities, or pursuant to a statutorily authorized program thereof, from regulation as swaps or security-based swaps.[125] Such insurance includes, for example, federal insurance of funds held in banks, savings associations, and credit unions; catastrophic crop insurance; flood insurance; federal insurance of certain pension obligations; and terrorism risk

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123 See infra notes 145 and 146 and accompanying text.

124 See infra notes 147 and 148 and accompanying text.

125 See Proposing Release at 29824.

insurance. At the request of commenters,[126] the Commissions are persuaded that it is also appropriate to provide a similar exclusion to insurance that is issued by a state or any of its agencies or instrumentalities, or pursuant to a statutorily authorized program thereof. Accordingly, the Commissions have revised the second prong of the Provider Test to provide that products meeting the Product Test are excluded from the swap and security-based swap definitions if they are provided (i) directly or indirectly by the federal government or a state or (ii) pursuant to a statutorily authorized program of either[127].

As stated in the Proposing Release, the Commissions believe that where an agreement, contract, or transaction qualifies for the safe harbor and therefore is considered insurance excluded from the swap and security-based swap definitions, the lawful reinsurance of that agreement, contract, or transaction similarly should be excluded.[128] Accordingly, the Commissions are adopting the third prong of the Provider Test as proposed, with certain modifications, to provide that an agreement, contract, or transaction of reinsurance will be excluded from the swap and security-based swap definitions, provided that: (i) the person offering such reinsurance is not prohibited by applicable state law or the laws of the United States from offering such reinsurance to a person that satisfies the Provider Test; (ii) the agreement, contract, or transaction to be reinsured meets the requirements under the Product Test or is one of the Enumerated Products; and (iii) except as otherwise permitted under applicable

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126 See Ex Parte Communication between NAIC and CFTC and SEC Staff on October 5, 2011, at http://sec.gov/comments/s7-16-11/s71611-61.pdf.

127 The Commissions understand that certain types of federal and state insurance programs, including crop insurance, are administered by third parties; as a result, the Commissions have added "directly or indirectly" to the second prong of the Provider Test to clarify that it can be satisfied even if the agreement, contract, or transaction is not provided directly by the federal government or a state. See Id.

128 See Proposing Release at 29825.

state law, the total amount reimbursable by all reinsurers for such insurance product cannot exceed the claims or losses paid by the cedant.

In response to commenters' concerns,[129] the Commissions have revised the third prong of the Provider Test from that contained in the Proposing Release. As adopted, the third prong of the Provider Test encompasses all reinsurers wherever incorporated or organized, and not just those based outside of the United States. The Commissions also have revised the third prong of the Provider Test to clarify that the total amount reimbursable by all reinsurers may not exceed the claims or losses paid by the cedant, unless otherwise permitted by applicable state law. It is not the Commissions' intent to impose requirements that conflict with state law regarding the calculation of amounts reimbursable under reinsurance contracts.

The Commissions have added a fourth prong to the Provider Test to address commenters' concerns that the proposed Provider Test excluded entities issuing insurance products on a non-admitted basis through surplus lines brokers.[130] Non-admitted insurance is typically property and casualty insurance that is permitted to be placed through a surplus lines broker[131] by an insurer that is not licensed to do business in the state where the product is offered.[132] In practice, a provider of non-admitted insurance may not satisfy the first prong of the Provider Test because it may not be subject to state or federal insurance supervision. The Commissions understand that

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129 See infra notes 150, 151, 152, and 153 and accompanying text.

130 See infra note 146 and accompanying text.

131 For the purposes of this release, the term "surplus lines broker" means an individual, firm, or corporation that is licensed in a state to sell, solicit, or negotiate insurance on properties, risks, or exposures located or to be performed in a state with non-admitted insurers.

132 See supra note 39. With respect to domestic reinsurance, state insurance regulators do retain the authority to prevent or allow a non-admitted company from participating in a state market. Some states compile a list of companies that may sell as non-admitteds; other states list non-admitted companies that may not sell.

non-admitted insurance plays a very important role in the insurance marketplace. In addition, Congress has explicitly recognized non-admitted insurance products as insurance and specified that a state cannot prohibit certain types of entities from offering non-admitted insurance products.[133] Because Congress recognized that certain persons qualify as non-admitted insurers, the Commissions find that it is appropriate to add the fourth prong to the Provider Test.

A person will qualify under the fourth prong of the Provider Test if it satisfies any one of the following two requirements:

- it is located outside of the United States and listed on the Quarterly Listing of Alien Insurers that is compiled and maintained by the International Insurers Department of the National Association of Insurance Commissioners;[134] or
- it meets the eligibility criteria for non-admitted insurers under applicable state law.

Comments

General

The Commissions received ten comment letters that addressed the Provider Test.[135] A few commenters recommended that the Commissions retract the Provider Test.[136] These

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133 See Subtitle B of Title V of the Dodd-Frank Act.

134 Section 524 of the Nonadmitted and Reinsurance Reform Act of 2010 (15 U.S.C. 8204) provides that a state cannot prohibit a surplus lines broker from placing non-admitted insurance with a non-admitted insurer that is listed on the Quarterly Listing of Alien Insurers. According to the NAIC the non-admitted alien insurers whose names appear in the Quarterly Listing of Alien Insurers have filed financial statements, copies of auditors' reports, the names of their U.S. attorneys or other representatives, and details of U.S. trust accounts with the NAIC's International Insurers Department and, based upon those documents and other information, appear to fulfill the criteria set forth in the International Insurers Department Plan of Operation for Listing of Alien Nonadmitted Insurers.

135 See ACLI Letter; AIA Letter; CAI Letter; D&L Letter; ISDA Letter; NAIC Letter; NAFA Letter; Nationwide Letter; RAA Letter; and Travelers Letter.

commenters argued that if a product is subject to regulation as insurance in the United States, the regulated status of the insurer is irrelevant.[137] The Commissions are retaining the Provider Test with modifications as discussed above. The Commissions believe that insurance products should fall outside the swap or security-based swap definitions only if they are offered by persons subject to state or federal insurance supervision or by certain reinsurers.[138] The Provider Test will help to prevent products that are swaps or security-based swaps from being characterized as insurance in order to evade the regulatory regime under Title VII of the Dodd-Frank Act. Other commenters suggested various modifications to the Provider Test and those comments are discussed in more detail below.

"Insurance Company" Limitation

Several commenters recommended that the Commissions expand the first prong of the Provider Test so that it is not limited to "insurance companies," but to all insurers because not all insurers are organized as "insurance companies,"[139] to accommodate insurers and reinsurers that are domiciled outside of the United States,[140] and to cover domestic and foreign insurance companies and other entities that issue insurance products on a non-admitted basis through surplus lines brokers.[141]

The Commissions have revised the first prong of the Provider Test to remove the "insurance company" limitation and to clarify that any person that is subject to state or federal

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136 See AIA Letter; D&L Letter; and ISDA Letter.

137 Id.

138 See infra notes 147 and 148 and accompanying text.

139 See AIA Letter; D&L Letter; ISDA Letter; RAA Letter; NAIC Letter; and Travelers Letter.

140 See AIA Letter; D&L Letter; RAA Letter; and Travelers Letter.

141 See RAA Letter and Travelers Letter.

insurance supervision will qualify under the first prong of the Provider Test. As noted above, the Commissions also believe that this revision should address commenters' concerns that the proposed rules could have excluded some foreign insurers since the revised test does not require that a person be domiciled in the United States; it only requires that the person be subject to state or federal insurance supervision.

Several commenters suggested that the proposed Provider Test would permit an insurer that is not organized as an insurance company to evade state insurance oversight by deliberately failing the exemption for insurance products (that is, by issuing a contract that would fail the proposed rules because it would not be issued by an insurance company).[142] These commenters were concerned that if a product were to be considered a swap merely because it was not issued by an insurance company, this would render the regulation of such products outside of the scope of state insurance laws due to the federal preemption of swaps regulation.[143] Commenters noted that a likely consequence of this preemption would be that the same product would be subject to substantially different regulation within a state's jurisdiction based solely on the nature of the issuing person.[144]

The Commissions have revised the first prong of Provider Test to address commenters' concerns that providers of insurance products could evade state insurance regulation by intentionally failing the Provider Test, i.e., marketing the insurance products as swaps or security-based swaps in order to avoid state insurance supervision. As adopted, any person that provides insurance products (and therefore should be subject to state or federal insurance

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142 See ACLI Letter; CAI Letter; NAFA Letter; Nationwide Letter; RAA Letter; and Travelers Letter.

143 Id.

144 Id.

supervision) must, in fact, be subject to state or federal insurance supervision in order to satisfy the first prong of the Provider Test. Persons that are organized as insurance companies or whose business activity is predominantly insurance or reinsurance, but who are not in fact subject to state or federal insurance supervision, would not satisfy the first prong of the Provider Test.

Finally, as discussed below, the Commissions have added a fourth prong to the Provider Test to provide relief for persons that provide insurance products on a non-admitted basis through surplus lines brokers.

"Regulated as Insurance" Limitation

Two commenters recommended that the Commissions remove the provision in the first prong of the Provider Test that states "and such agreement, contract, or transaction is regulated as insurance under the laws of such state or of the United States."[145] These commenters argued that the provision should be deleted because it was redundant with the Product Test and may exclude certain reinsurers and non-admitted insurers, as well as products that may not be specifically "regulated as insurance" in all states.[146]

The Commissions have retained the requirement in the first prong of the Provider Test that an insurance product must be regulated as insurance, but have revised the provision to clarify that an insurance product must be regulated as insurance under applicable state law or the laws of the United States. As discussed above, the Commissions believe that this condition will help prevent products that are not regulated as insurance and are swaps or security-based swaps

145 See RAA Letter and Travelers Letter.

146 Id. These commenters also recommended the addition of a new prong to the Provider Test to cover domestic or foreign entities that issue insurance products on a non-admitted basis through surplus lines brokers. See discussion below. The Commissions note that the first prong of the Provider Test does not apply to reinsurance contracts and the third prong of the Provider Test, which does apply to reinsurance contracts, does not contain the "regulated as insurance" limitation.

from being characterized as insurance products in order to evade the regulatory regime under the Dodd-Frank Act.

The Commissions have received conflicting comments regarding whether surety bonds are currently offered by persons who do not satisfy the Provider Test, in particular the "regulated as insurance" requirement.[147] If a person who does not satisfy the Provider Test sells a surety bond incidental to other business activity and is not subject to state or federal insurance supervision, it does not mean that such surety bond is a swap or security-based swap. The surety bond may not satisfy the Insurance Safe Harbor, but it would be subject to a facts and circumstances analysis. Similarly, one commenter indicated that title insurance is not always subject to state insurance regulation.[148] Title insurance sold in a state that does not regulate title insurance as insurance would be in the list of Enumerated Products but would not satisfy the Provider Test and, thus would not qualify for the Insurance Safe Harbor. However, this does not mean that title insurance sold in a state that does not regulate title insurance as insurance is a swap or security-based swap. The title insurance may not satisfy the Insurance Safe Harbor, but it would be subject to a facts and circumstances analysis. The Commissions anticipate that many factors would militate against a determination that such a surety bond or title insurance that fails the Provider Test, because it cannot meet the "regulated as insurance" requirement, is a swap or security-based swap rather than insurance.

The Commissions agree that the inclusion of the "regulated as insurance" requirement in the first prong of the Provider Test will have the effect of causing non-admitted insurance

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147 See SFAA Letter. SFAA stated that all states include surety and fidelity bonds as lines of insurance subject to state oversight. However, Travelers stated that surety bonds may not be "specifically" regulated as insurance. See Travelers Letter.

148 See ACLI Letter

products to fall within the swap and security-based swap definitions. In response to commenters' concerns about the ability of non-admitted insurers to qualify under the Provider Test, the Commissions have added a fourth prong to the Provider Test to address providers of non-admitted insurance products.[149]

Providers of Reinsurance

Several commenters recommended that the Commissions expand the third prong of the Provider Test to include domestic reinsurers.[150] One commenter requested that the Commissions remove the third prong of the Provider Test from the final rules because it appears to prohibit a reinsurer from offering a product in a state where it is permitted if any other state prohibits that product.[151] Two commenters requested revisions to the portion of the third prong of the Provider Test that addresses a cedant's reimbursable losses.[152] One commenter argued this portion of the third prong of the Provider Test may conflict with the state-based insurance receivership law.[153]

As noted above, the Commissions have revised the third prong of the Provider Test to remove the limitation that a reinsurance provider has to be located outside of the United States, and thereby address commenters' concerns that domestic reinsurers would not qualify under the reinsurance prong. In addition, in response to commenters' concerns, the Commissions have clarified the third prong of the Provider Test so that it does not prohibit a reinsurer from offering

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149 See supra notes 130, 131, and 132 and accompanying text.

150 See ACLI Letter; CAI Letter; NAIC Letter; and RAA Letter.

151 See RAA Letter. The commenter argued that one state's prohibition on a reinsurance product should not affect the ability of the reinsurer to offer the product in a state where it is permitted.

152 See RAA Letter and Travelers Letter. Both commenters suggested specific edits to the proposed rules.

153 See RAA Letter. RAA stated that in an insurance receivership reinsurers are required to comply with the reinsurance contract and pay all amounts due and owing to the estate of the insolvent cedant even if the estate of the cedant may not necessarily pay the full amount of the underlying claims to the applicable policyholders.

a product in a state where it is permitted, even if that product is prohibited in another state, and have revised the portion of the third prong of the Provider Test that addresses a cedant's reimbursable losses to make it subject to applicable state law so that it does not conflict with state-based insurance receivership law.

c) Grandfather Provision for Existing Insurance Transactions

In the Proposing Release, the Commissions asked whether the proposed rules should include a provision similar to section 302(c)(1) of the Gramm-Leach-Bliley Act that any product regulated as insurance before the date the Dodd-Frank Act was signed into law and provided in accordance with the Provider Test would be considered insurance and not fall within the swap or security-based swap definitions.

In response to comments,[154] the Commissions are adding a new paragraph (ii) to rule 1.3(xxx)(4) under the CEA and new paragraph (b) to rule 3a69-1 under the Exchange Act that provides that an agreement, contract, or transaction entered into on or before the effective date of the Product Definitions will be considered insurance and not fall within the swap and security-based swap definitions, provided that, at such time it was entered into, such agreement, contract, or transaction was provided in accordance with the Provider Test (the "Insurance Grandfather").

As stated in the Proposing Release, the Commissions are aware of nothing in Title VII to suggest that Congress intended for traditional insurance products to be regulated as swaps or security-based swaps.[155] The Commissions have designed the Insurance Safe Harbor to provide greater assurance to market participants that traditional insurance products that were regulated as insurance prior to the Dodd-Frank Act will fall outside the swap and security-based swap

154 See infra notes 157, 158, 159, and 160 and accompanying text.

155 See Proposing Release at 29821.

definitions. Nevertheless, after considering comments received, the Commissions believe that it is appropriate to adopt the Insurance Grandfather in order to assure market participants that those agreements, contracts, or transactions that meet the conditions set out in the Insurance Grandfather will not fall within the swap or security-based swap definitions.

In order to qualify for the Insurance Grandfather an agreement, contract, or transaction must meet two requirements. First, it must be entered into on or before the effective date of the Product Definitions. The Commissions are linking the Insurance Grandfather to the effective date of the Product Definitions, rather than the date that the Dodd-Frank Act was signed into law, in order to avoid unnecessary market disruption.[156] Second, such agreement, contract, or transaction must be provided in accordance with the Provider Test. In other words, the provider must be subject to state or federal insurance supervision or be a non-admitted insurer or a reinsurer that satisfies the conditions for non-admitted insurers and reinsurers that are set out in the Provider Test. The Commissions note that an agreement, contract or transaction that is provided in accordance with the first prong of the Provider Test must also be regulated as insurance under applicable state law or the laws of the United States.

By adopting the Insurance Grandfather and the Insurance Safe Harbor, the Commissions are excluding agreements, contracts, and transactions for which the Commissions have found no evidence that Congress intended them to be regulated as swaps or security-based swaps, and are providing greater certainty regarding the treatment of agreements, contracts, and transactions currently regulated as insurance.

<u>Comments</u>

156 The Commissions believe that 60 days after publication of this release should be sufficient time for market participants to enter into pending agreements, contracts, or transactions for which the Insurance Grandfather may provide relief.

Four commenters addressed whether the final rules should include a grandfather provision that would exclude certain insurance products from the swap or security-based swap definitions.[157] Two commenters suggested that a grandfather provision for all products that were regulated as insurance before the Dodd-Frank Act was signed into law would be appropriate, stating that it would reduce confusion and uncertainty in applying the swap and security-based swap definitions to products that are traditionally regulated as insurance while addressing the Commissions' stated concern that products might be structured as insurance products to evade Dodd-Frank Act requirements.[158] These commenters also stated that it is necessary to add an effective date-based grandfather provision to the final rule providing that any contract or transaction subject to state insurance regulation and entered into prior to any final rules necessary to implement Title VII, including the Product Definitions, are not swaps or security-based swaps.[159] These commenters noted that a grandfather provision based on effective date of all the Title VII rules was needed to address product development and variation that occurred between the date the Dodd-Frank Act was enacted and the effective date of the rules mandated under that statute.[160]

The Commissions believe that the combination of the Insurance Grandfather along with the Insurance Safe Harbor provides market participants with increased legal certainty with

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157 See ACLI Letter; AFGI Letter; CAI Letter; and D&L Letter.

158 See ACLI Letter and CAI Letter. ACLI and CAI argued that products that were regulated as insurance prior to the effective date of the Dodd-Frank Act clearly were not characterized as insurance to avoid the Title VII regulatory regime. See also AFGI Letter; AFGI argued that all insurance contracts issued by state-regulated insurance companies should be excluded from the swap definition but in the alternative, all insurance products regulated as insurance before July 21, 2010 should be grandfathered. See also D&L Letter. D&L stated that prior regulation of insurance products before July 21, 2010 could be a consideration, but not an absolute determinant for exclusion from the swap or security-based swap definitions.

159 See ACLI Letter and CAI Letter.

160 Id.

respect to existing agreements, contracts, transactions, and products. In addition, the fact that the Commissions are linking the Insurance Grandfather to the effective date of the Product Definitions, rather than the date that the Dodd-Frank Act was signed into law, takes into account product development and innovation that may have occurred between the date the Dodd-Frank Act was signed into law at the effective date of the Product Definitions. Further, the Commissions believe that a grandfather provision that would exclude all products regulated as insurance before the Dodd-Frank Act was signed into law, as recommended by some commenters,[161] is unnecessary because non-grandfathered regulated insurance transactions generally should fall within the Insurance Safe Harbor. The Commissions believe that market participants could be incentivized to use such a broader grandfather provision to create new swap or security-based swap products with characteristics similar to those of existing categories of regulated insurance contracts for the purpose of evading the Dodd-Frank Act regulatory regime. The Commissions also believe that a broader grandfather provision would be contrary to the explicit direction of sections 722(b) and 767 of the Dodd-Frank Act which provide that swaps and security-based swaps may not be regulated as insurance contracts by any state.[162]

One commenter argued that the Provider Test should not apply to grandfathered contracts. The commenter stated that it should be enough that the product is regulated as

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161 See ACLI Letter; AGFI Letter; and CAI Letter.

162 Section 722(b) of the Dodd-Frank Act provides, (B) Regulation of Swaps Under Federal and State Law.—Section 12 of the Commodity Exchange Act (7 U.S.C. 16) is amended by adding at the end the following: "(h) Regulation of Swaps as Insurance Under Federal and State Law.—A swap—(1) shall not be considered to be insurance; and (2) may not be regulated as an insurance contract under the law of any State."

Section 767 of the Dodd-Frank Act amended section 28(a) of the Exchange Act, 15 U.S.C. 78bb(a), to provide, "A security-based swap may not be regulated as an insurance contract under any provision of State law."

insurance.[163] As described above, the grandfather provision will apply only to agreements, contracts, and transactions that are entered into prior to the effective date of the Product Definitions if they were provided in accordance with the Provider Test, including a requirement that an agreement, contract or transaction that is provided in accordance with the first prong of the Provider Test must be regulated as insurance under applicable state law or the laws of the United States. As the Commissions discussed in the Proposing Release, and above in describing the Provider Test, the Commissions believe the requirement that the agreement, contract, or transaction be provided in accordance with the Provider Test should help ensure that persons who are not subject to state or federal insurance supervision are not able to avoid the oversight provided for under Title VII of the Dodd-Frank Act.

d) Alternative Tests

A number of commenters proposed that the Commissions adopt alternative tests to distinguish insurance from swaps and security-based swaps.[164] After considering each of these alternatives, the Commissions are not adopting them.

Several commenters suggested that the sole test for determining whether an agreement, contract, or transaction is insurance should be whether it is subject to regulation as insurance by the insurance commissioner of the applicable state(s).[165] The Commissions find this alternative to be unworkable because it does not provide a sufficient means to distinguish agreements, contracts and transactions that are insurance from those that are swaps or security-based swaps.

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163 See CAI Letter. CAI suggested that for a product to be regulated as insurance it means that it was provided by an insurance company. See supra part II.B.1.b) for a discussion of the need for the Provider Test portion of the Insurance Safe Harbor.

164 See ACLI Letter; AIA Letter; AFGI Letter; CAI Letter; MetLife Letter; NAFA Letter; NAIC Letter; Nationwide Letter; and Travelers Letter.

165 See ACLI Letter; AIA Letter; AFGI Letter; MetLife Letter; and Travelers Letter.

Section 712(d) of the Dodd-Frank Act directs the Commissions to "further define" the terms swap and security-based swap. Neither swaps nor security-based swaps may be regulated as insurance contracts under the laws of any state.[166] While insurance contracts have long been subject to state regulation, swaps and security-based swaps were largely unregulated. Since the Dodd-Frank Act created a new regulatory regime for swaps and specifically provides that "swaps may not be regulated as an insurance contract under the law of any state,[167] the Commissions believe that it is important to have a test that distinguishes insurance from swaps and security-based swaps without relying entirely on the regulatory environment prior to the enactment of the Dodd-Frank Act. The Product Test is an important element of the Insurance Safe Harbor.

Several commenters suggested an approach in which insurance products that qualify for the exclusion contained in section 3(a)(8) of the Securities Act[168] would be excluded from the swap definition.[169] One commenter argued that "Section 3(a)(8) has long been recognized as the definitive provision as to where Congress intends to separate securities products that are subject to SEC regulation from 'insurance' and 'annuity' products that are to be left to state insurance regulation" and that the section 3(a)(8) criteria are well understood and have a long history of interpretation by the SEC and the courts.[170] Other commenters suggest that because section

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166 See section 12(h) of the CEA, 7 U.S.C. 16(h) (regarding swaps) and section 28(a)(4) of the Exchange Act, 15 U.S.C. 78bb(a)(4) (regarding security-based swaps).

167 See section 12(h)(2) of the CEA, 7 U.S.C. 16(h)(2).

168 Section 3(a)(8) of the Securities Act excludes the following from all provisions of the Securities Act: Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia.

See infra note 1283 and accompanying text.

169 See ACLI Letter; CAI Letter; NAFA Letter; and Nationwide Letter.

170 See NAFA Letter.

3(a)(8) includes both a product and a provider requirement, if the Commissions include it in their final rules, it should be a requirement separate from the Product Test and the Provider Test, and should extend to insurance products that are securities.[171]

While the Commissions agree that the section 3(a)(8) criteria have a long history of interpretations by the SEC and the courts, the Commissions find that it is inappropriate to apply the section 3(a)(8) criteria in this context. Although section 3(a)(8) contains some conditions applicable to insurance providers that are similar to the prongs of the Provider Test, it does not contain any conditions that are similar to the prongs of the Product Test. Moreover, section 3(a)(8) provides an exclusion from the Securities Act and the CFTC has no jurisdiction under the federal securities laws. Congress directed both agencies to further define the terms "swap" and "security-based swap." As such, the Commissions find that it is more appropriate to have a standalone rule that incorporates features that distinguish insurance products from swaps and security-based swaps and over which both Commissions will have joint interpretative authority.

One commenter suggested yet another approach, recommending that insurance be defined as an agreement, contract, or transaction that by its terms:

- Exists for a specified period of time;
- Where the party (the "insured") to the contract promises to make one or more payments such as money, goods or services;
- In exchange for another party's promise to provide a benefit of pecuniary value for the loss, damage, injury, or impairment of an identified interest of the insured as a result of the occurrence of a specified event or contingency outside of the parties' control; and

171 See ACLI Letter and CAI Letter.

- Where such payment is related to a loss occurring as a result of a contingency or specified event.[172]

The Commissions do not find this alternative preferable to the Commissions' proposal for two reasons. First, the requirements of a specified term and the promise to make payments are present in both insurance products and in agreements, contracts, or transactions that are swaps or security-based swaps and therefore do not help to distinguish between them. A test based solely on these requirements, then, could be over-inclusive and exclude from the Dodd-Frank Act regulatory regime agreements, contracts, and transactions that have not traditionally been considered insurance. Further, the third and fourth requirements of this alternative test collapse into the Product Test's requirement that the loss must occur and be proved, and any payment or indemnification therefor must be limited to the value of the insurable interest.

One commenter suggested a three-part test in lieu of the Product and Provider Tests. Under this test, the terms "swap" and "security-based swap" would exclude any agreement, contract, or transaction that:

- Is issued by a person who is or is required to be organized as an insurance company and subject to state insurance regulation;
- Is the type of contract issued by insurance companies; and
- Is not of the type that the Commissions determine to regulate.[173]

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172 See NAIC Letter.

173 See ACLI Letter (Appendix 1). See also CAI Letter. CAI stated that it believes that the approach and test recommended by ACLI is a fundamentally sound method for determining those insurance products that are not swaps or security-based swaps and that should remain subject to state regulation, and is more appropriate than the Commissions' proposals. Nationwide suggested a three-part test to differentiate insurance products from swaps and security-based swaps similar to the test proposed by ACLI. See also Nationwide Letter.

This commenter stated that its approach does not contain a definition of insurance, and believes that is preferable to the Commissions' approach, which it believes creates legal uncertainty because any attempted definition of insurance has the potential to be over- or under-inclusive.[174] As discussed above, the Commissions' rules and interpretations are not intended to define insurance. Rather, they provide a safe harbor for certain types of traditional insurance products by reference to factors that may be used to distinguish insurance from swaps and security-based swaps, and a list of products that do not have to satisfy a portion of the safe harbor factors. Agreements, contracts, and transactions that do not qualify for the Insurance Safe Harbor may or may not be insurance, depending upon the facts and circumstances regarding such agreements, contracts and transactions. The Commissions find the first two requirements of the commenter's three-part test to be tautologous, and the third provides no greater certainty than the Commissions' facts and circumstances approach. In addition, the Commissions find that this alternative test could exclude from the Dodd-Frank Act regulatory regime agreements, contracts, and transactions that have not traditionally been considered insurance.

Another commenter proposed different approaches for existing products and new products.[175] Specifically, if an existing type of agreement, contract or transaction is currently reportable as insurance in the provider's regulatory and financial reports under a state or foreign jurisdiction's insurance laws, then that agreement, contract, or transaction would be insurance rather than a swap or security-based swap. On the other hand, for new products, if this approach were inconclusive, this commenter recommended that the Commissions use the Product Test of

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174 See ACLI Letter.

175 See AIA Letter.

the Commissions' rules only.[176] As discussed above, rather than treating existing products and new products differently, the Commissions are providing "grandfather" protection for agreements, contracts, and transactions entered into prior to the effective date of the Products Definitions.[177] Moreover, this commenter's test would eliminate the Provider Test for new products, which the Commissions believe is important to help prevent products that are swaps or security-based swaps from being characterized as insurance.

In sum, the Commissions find that each of the alternatives proposed by commenters could exclude from the Dodd-Frank Act regulatory regime agreements, contracts, and transactions that have not historically been considered insurance, and that should, in appropriate circumstances, be regulated as swaps or security-based swaps. Accordingly, the Commissions do not find these alternatives to be appropriate for delineating the scope of the Insurance Safe Harbor from the swap and security-based swap definitions.

e) "Safe Harbor"

Five commenters recommended that the Product Test, the Provider Test, and related interpretations should be structured as a "safe harbor" so that they do not raise any presumption or inference that products that do not meet the Product Test, Provider Test and related interpretations are necessarily swaps or security-based swaps.[178] One commenter suggested that this safe harbor approach could be modeled after Rule 151 under the Securities Act.[179]

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176 Id.

177 See supra part II.B.1.c)

178 See ACLI Letter; CAI Letter; NAFA Letter (concurring with ACLI and CAI); Nationwide Letter; and Travelers Letter.

179 See ACLI Letter.

As discussed above, the Commissions do not intend to create a presumption that agreements, contracts, or transactions that do not fall within the Insurance Safe Harbor are necessarily swaps or security-based swaps. As stated above, the Commissions are instead adopting final rules that clarify that certain agreements, contracts, or transactions meeting the requirements of a non-exclusive "safe harbor" established by such rules will not be considered to be swaps or security-based swaps. An agreement, contract, or transaction that does not fall within the Insurance Safe Harbor will require further analysis of the applicable facts and circumstances to determine whether it is insurance, and thus not a swap or security-based swap.

f) Applicability of Insurance Exclusion to Security-Based Swaps

Four commenters expressed concerns that the proposed rules were unclear in their application to both swaps and security-based swaps.[180] These commenters argued that the proposed rules do not directly exclude insurance products from the term "security-based swap" because the rules explicitly state that "[t]he term 'swap' does not include" the products that meet the Product and Provider Tests, but do not make the same statement as to the term "security-based swap."[181]

The Commissions have revised rule 1.3(xxx)(4) under the CEA and rule 3a69-1 under the Exchange Act to clarify that the exclusion contained therein applies to both swaps and security-based swaps.

g) Guarantees

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180 See ACLI Letter; CAI Letter; NAFA Letter (concurring with ACLI and CAI); and Nationwide Letter (concurring the ACLI and CAI).

181 Id. The commenters suggested that this ambiguity could be resolved by making it clear in the final rules that an excluded product is neither a swap nor a security-based swap.

In the Proposing Release, the Commissions requested comment on whether insurance of an agreement, contract, or transaction that falls within the swap or security-based swap definitions should itself be included in the swap or security-based swap definition. The Commissions also requested comment on whether the Commissions should provide guidance as to whether swap or security-based swap guarantees offered by non-insurance companies should be considered swaps or security-based swaps.[182]

Guarantees of Swaps.[183]

No commenter identified any product that insures swaps (that are not security-based swaps or mixed swaps) other than financial guaranty insurance. The CFTC finds that insurance of an agreement, contract, or transaction that falls within the swap definition (and is not a security-based swap or mixed swap) is functionally or economically similar to a guarantee of a swap (that is not a security-based swap or mixed swap) offered by a non-insurance company.[184] Therefore, the CFTC is treating financial guaranty insurance of swaps (that are not security-based swaps or mixed swaps) the same way it is treating all other guarantees of swaps (that are not security-based swaps or mixed swaps), as discussed below.[185]

The CFTC is persuaded that when a swap has the benefit of a guarantee,[186] the guarantee is an integral part of that swap. The CFTC finds that a guarantee of a swap (that is not a

182 See Proposing Release at 29827.

183 The discussion in this subsection relates only to swaps that are not security-based swaps or mixed swaps and has no effect on the laws or regulations applicable to security-based swaps or mixed swaps.

184 The Commissions did not express a view regarding whether financial guaranty insurance is a swap or security-based swap in the Entities Release. See Entities Release at 30689, n.1132.

185 Subsequent references to "guarantees" in this discussion shall thus be deemed to include "financial guaranty insurance policies."

186 For purposes of this release, the CFTC views a guarantee of a swap to be a collateral promise by a guarantor to answer for the debt or obligation of a counterparty obligor under a swap. A

security-based swap or mixed swap) is a term of that swap that affects the price or pricing attributes of that swap.[187] When a swap counterparty typically provides a guarantee as credit support for its swap obligations, the market will not trade with that counterparty at the same price, on the same terms, or at all without the guarantee. The guarantor's resources are added to the analysis of the swap; if the guarantor is financially more capable than the swap counterparty, the analysis of the swap becomes more dependent on the creditworthiness of the guarantor. Therefore, the CFTC is interpreting the term "swap" (that is not a security-based swap or mixed swap) to include a guarantee of such swap, to the extent that a counterparty to a swap position would have recourse to the guarantor in connection with the position.[188] The CFTC anticipates

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guarantee of a swap does not include for purposes of this release: (i) a "guarantee agreement" as defined in CFTC regulation § 1.3(nn), 17 CFR 1.3(nn); (ii) any assumption by a clearing member of financial or performance responsibility to a derivatives clearing organization ("DCO") for swaps cleared by a DCO; or (iii) any guarantee by a DCO with respect to a swap that it clears.

187 E.g., a swap counterparty may specify that a guarantee is a Credit Support Document under an ISDA Master Agreement. If the guarantor fails to comply with or perform under such guarantee, such guarantee expires or terminates, or if such guarantee ceases to be in full force and effect, the "Credit Support Default" Event of Default under the ISDA Master Agreement would generally be triggered, potentially bringing down the entire swap trading relationship between the parties to the ISDA Master Agreement. See generally the standard 1992 ISDA Master Agreement and 2002 ISDA Master Agreement. However, the CFTC finds the presence of a guarantee to be an integral part of a swap and that affects the price or pricing attributes of a swap whether or not such guarantee is a Credit Support Document under an ISDA Master Agreement.

188 This interpretation is consistent with the interpretations of the Commissions in the Entity Definitions Release. See, e.g., Entity Definitions Release at 30689 ("[A]n entity's swap or security-based swap positions in general would be attributed to a parent, other affiliate or guarantor for purposes of major participant analysis to the extent that counterparties to those positions would have recourse to that other entity in connection with the position. Positions would not be attributed in the absence of recourse."). A swap backed by a partial or limited recourse guarantee will include the guarantee to the extent of such partial or limited recourse; a blanket guarantee that supports both swap and non-swap obligations will be treated as part of the guaranteed swap only to the extent that such guarantee backstops obligations under a swap or swaps.

In the Entity Definitions Release, the Commissions stated, "we do not believe that it is necessary to attribute a person's swap or security-based swap positions to a parent or other guarantor if the person is already subject to capital regulation by the CFTC or SEC (i.e., swap dealers, security-based swap dealers, major swap participants, major security-based swap participants, FCMs and that a "full recourse" guarantee would have a greater effect on the price of a swap than a "limited" or "partial recourse" guarantee; nevertheless, the CFTC is determining that the presence of any guarantee with recourse, no matter how robust, is price forming and an integral part of a guaranteed swap.

The CFTC's interpretation of the term "swap" to include guarantees of swaps does not limit or otherwise affect in any way the relief provided by the Insurance Grandfather. In a separate release, the CFTC will address the practical implications of interpreting the term "swap" to include guarantees of swaps (the "separate CFTC release").[189]

Comments

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broker-dealers) or if the person is a U.S. entity regulated as a bank in the United States. Positions of those regulated entities already will be subject to capital and other requirements, making it unnecessary to separately address, via major participant regulations, the risks associated with guarantees of those positions." Id. In a footnote, the Commissions continued, "As a result of this interpretation, holding companies will not be deemed to be major swap participants as a result of guarantees to certain U.S. entities that are already subject to capital regulation." Id.

As a result of interpreting the term "swap" (that is not a security-based swap or mixed swap) to include a guarantee of such swap, to the extent that a counterparty to a swap position would have recourse to the guarantor in connection with the position, and based on the reasoning set forth above from the Entity Definitions Release in connection with major swap participants, the CFTC will not deem holding companies to be swap dealers as a result of guarantees to certain U.S. entities that are already subject to capital regulation. It may, however, be appropriate to regulate as a swap dealer a parent or other guarantor who guarantees swap positions of persons who are not already subject to capital regulation by the CFTC (i.e., who are not swap dealers, major swap participants or FCMs). The CFTC is addressing guarantees provided to non-U.S. entities, and guarantees by non-U.S. holding companies, in its proposed interpretive guidance and policy statement regarding the cross-border application of the swaps provisions of the CEA, 77 FR 41214 (Jul. 12, 2012).

189 Briefly, in the separate CFTC release the CFTC anticipates proposing reporting requirements with respect to guarantees of swaps under Parts 43 and 45 of the CFTC's regulations and explaining the extent to which the duties and obligations of swap dealers and major swap participants pertaining to guarantees of swaps, as an integral part of swaps, are already satisfied to the extent such obligations are satisfied with respect to the related guaranteed swaps. The CFTC also anticipates addressing in the separate CFTC release the effect, if any, of the interpretation regarding guarantees of swaps on position limits and large trader reporting requirements.

Three commenters provided comments regarding the treatment of guarantees. Two commenters[190] opposed treating insurance or guarantees of swaps as swaps. Suggesting that the products are not economically similar, one commented that insurance wraps of swaps do not "necessarily replicate the economics of the underlying swap, and only following default could the wrap provider end up with the same payment obligations as a wrapped defaulting swap counterparty."[191] This commenter also stated that the non-insurance guarantees are not swaps because the result of most guarantees is that the guarantor is responsible for monetary claims against the defaulting party, which in this commenter's view is a different obligation than the arrangement provided by the underlying swap itself.[192]

One commenter supported treating financial guaranty insurance of a swap or security-based swap as itself a swap or a security-based swap. This commenter argued that financial guaranty insurance of a swap or security-based swap transfers the risk of counterparty non-performance to the guarantor, making it an embedded and essential feature of the insured swap or security-based swap. This commenter further argued that the value of such swap or security-based swap is largely determined by the likelihood that the proceeds from the financial guaranty insurance policy will be available if the counterparty does not meet its obligations.[193] This commenter maintained that financial guaranty insurance of swaps and security-based swaps serves a very similar function to credit default swaps in hedging counterparty default risk.[194]

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190 See AFGI Letter and ISDA Letter.

191 ISDA Letter.

192 Id.

193 See Better Markets Letter.

194 See Better Markets Letter.

The CFTC is persuaded that when a swap (that is not a security-based swap or mixed swap) has the benefit of a guarantee, the guarantee and related guaranteed swap must be analyzed together. The events surrounding the failure of AIG Financial Products ("AIGFP") highlight how guarantees can cause major risks to flow to the guarantor.[195] The CFTC finds that the regulation of swaps and the risk exposures associated with them, which is an essential concern of the Dodd-Frank Act, would be less effective if the CFTC did not interpret the term "swap" to include a guarantee of a swap.

Two commenters cautioned against unnecessary and duplicative regulation. One commented that, because the underlying swap, and the parties to it, will be regulated and reported to the extent required by Title VII, there is no need for regulation of non-insurance guarantees.[196] The other commented that an insurance policy on a swap would be subject to state regulation; without addressing non-insurance guarantees, this commenter stated that additional federal regulation would be duplicative.[197] The CFTC disagrees with these arguments. As stated above, the CFTC is treating financial guaranty insurance of swaps and all other guarantees of swaps in a similar manner because they are functionally or economically similar products. If a guarantee of a swap is not treated as an integral part of the underlying swap, price forming terms of swaps and the risk exposures associated with the guarantees may remain hidden from regulators and may not be regulated appropriately. Moreover, treating guarantees of swaps as part of the underlying swaps ensures that the CFTC will be able to take appropriate action if,

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195 "AIGFP's obligations were guaranteed by its highly rated parent company . . . an arrangement that facilitated easy money via much lower interest rates from the public markets, but ultimately made it difficult to isolate AIGFP from its parent, with disastrous consequences." Congressional Oversight Panel, The AIG Rescue, Its Impact on Markets, and the Government's Exit Strategy 20 (2010).

196 See ISDA Letter.

197 See AFGI Letter.

after evaluating information collected with respect to the guarantees and the underlying swaps, such guarantees of swaps are revealed to pose particular problems in connection with the swaps markets. In the separate CFTC release, the CFTC will clarify the limited practical effects of the CFTC's interpretation, which should address concerns regarding duplicative regulation.

One commenter also argued that regulating financial guaranty of swaps as swaps would cause monoline insurers to withdraw from the market, which could adversely affect the U.S. and international public finance, infrastructure and structured finance markets, given that insuring a related swap often is integral to the insurance of municipal bonds and other securities.[198] The CFTC finds this argument unpersuasive. The CFTC understands that the 2008 global financial crisis severely affected most monolines and only one remains active in U.S. municipal markets. Thus, it appears that the monolines have, for the most part, already exited these markets. In addition, as stated above, the CFTC will clarify in the separate CFTC release the limited practical effects of the CFTC's interpretation, which should address these concerns.

Guarantees of Security-Based Swaps

The SEC believes that a guarantee of an obligation under a security-based swap, including financial guaranty insurance of a security-based swap, is not a separate security-based swap. Further, the SEC is not adopting an interpretation that a guarantee of a security-based swap is part of the security-based swap. Instead, the SEC will consider requiring, as part of its rulemaking relating to the reporting of security-based swaps,[199] the reporting of information about any guarantees and the guarantors of obligations under security-based swaps in connection with the reporting of the security-based swap transaction itself. In addition, the SEC will

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198 See AFGI Letter. Of the members of AFGI, only Assured Guaranty (or its affiliates) is currently writing financial guaranty insurance policies on U.S. municipal obligations.

199 See Regulation SBSR Proposing Release infra note 1231.

consider issues involving cross-border guarantees of security-based swaps in a separate release addressing the cross-border application of Title VII. The SEC notes that security-based swaps are included in the definition of "security" contained in the Securities Act and the Exchange Act.[200] Under the Securities Act, a guarantee of a security also is a "security."[201] Therefore, a guarantee of a security-based swap is a security subject to federal securities law regulation.[202]

2. The Forward Contract Exclusion

As the Commissions explained in the Proposing Release, the definitions of the terms "swap" and "security-based swap" do not include forward contracts.[203] These definitions exclude "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled."[204] The Commissions provided an interpretation in the Proposing Release regarding the applicability of the exclusion from the swap and security-based swap definition for forward contracts with respect to nonfinancial commodities[205] and securities. The Commissions are restating this interpretation as set forth in the Proposing Release with certain modifications in response to commenters.

a) Forward Contracts in Nonfinancial Commodities

The CFTC provided an interpretation in the Proposing Release regarding the forward contract exclusion for nonfinancial commodities and is restating this interpretation with certain

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200 See sections 768(a)(1) and 761(a)(2) of the Dodd-Frank Act (amending sections 2(a)(1) of the Securities Act, 15 U.S.C. 77b(a)(1), and 3(a)(10) of the Exchange Act, 15 U.S.C. 78c(a)(10), respectively).

201 See section 2(a)(1) of the Securities Act, 15 U.S.C. 77b(a)(1).

202 The SEC has previously addressed the treatment of financial guaranty insurance under the federal securities laws. See supra note 58.

203 See Proposing Release at 29827.

204 CEA section 1a(47)(B)(ii), 7 U.S.C. 1a(47)(B)(ii).

205 The discussion in subsections (a) and (b) of this section applies solely to the exclusion of nonfinancial commodity forwards from the swap definition in the CEA.

modifications in response to commenters. These clarifications include that the CFTC will interpret the forward contract exclusion consistent with the entire body of CFTC precedent.[206] The CFTC is also clarifying what "commercial participant" means under the "Brent Interpretation."[207] In addition, while the CFTC is withdrawing its 1993 "Energy Exemption"[208] as proposed, it is clarifying that certain alternative delivery procedures will not disqualify a transaction from the forward contract exclusion. In response to comments, the CFTC is providing a new interpretation regarding book-out documentation, as well as additional factors that may be considered in its "facts and circumstances" analysis of whether a particular contract is a forward.

i) Forward Exclusion from the Swap and Future Delivery Definitions

(A) Consistent Interpretation

The wording of the forward contract exclusion from the swap definition with respect to nonfinancial commodities is similar, but not identical, to the forward exclusion from the definition of the term "future delivery" that applies to futures contracts, which excludes "any sale of any cash commodity for deferred shipment or delivery."[209]

In the Proposing Release, the CFTC proposed an interpretation clarifying the scope of the exclusion of forward contracts for nonfinancial commodities from the swap definition and from the "future delivery" definition in a number of respects. After considering the comments

206 See infra part II.B.2(a)(i)(F).

207 Statutory Interpretation Concerning Forward Transactions, 55 FR 39188 (Sep. 25, 1990) ("Brent Interpretation").

208 Exemption for Certain Contracts Involving Energy Products, 58 FR 21286-02 (Apr. 20, 1993) ("Energy Exemption").

209 CEA section 1a(27), 7 U.S.C. 1a(27).

received, the CFTC is restating substantially all of its interpretation regarding these forward exclusions set forth in the Proposing Release, but with several clarifications in response to commenters.

The CFTC is restating from the Proposing Release that the forward exclusion for nonfinancial commodities in the swap definition will be interpreted in a manner consistent with the CFTC's historical interpretation of the existing forward exclusion with respect to futures contracts, consistent with the Dodd-Frank Act's legislative history.[210] In addition, in response to a commenter, the CFTC is clarifying that the entire body of CFTC precedent regarding forwards should apply to the forward exclusions from the swap and future delivery definitions.[211]

The CFTC's historical interpretation has been that forward contracts with respect to nonfinancial commodities are "commercial merchandising transactions."[212] The primary

210 See 156 Cong. Rec. H5248-49 (June 30, 2010) (introducing into the record a letter authored by Senator Blanche Lincoln, Chairman of the U. S. Senate Committee on Agriculture, Nutrition and Forestry, and Christopher Dodd, Chairman U. S. Senate Committee on Banking, Housing, and Urban Affairs, stating that the CFTC is encouraged "to clarify through rulemaking that the exclusion from the definition of swap for 'any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled' is intended to be consistent with the forward contract exclusion that is currently in the [CEA] and the CFTC's established policy and orders on this subject, including situations where commercial parties agree to 'book-out' their physical delivery obligations under a forward contract."). See also 156 Cong. Rec. H5247 (June 30, 2010) (colloquy between U. S. House Committee on Agriculture Chairman Collin Peterson and Representative Leonard Boswell during the debate on the Conference Report for the Dodd-Frank Act, in which Chairman Peterson stated: "Excluding physical forward contracts, including book-outs, is consistent with the CFTC's longstanding view that physical forward contracts in which the parties later agree to book-out their delivery obligations for commercial convenience are excluded from its jurisdiction. Nothing in this legislation changes that result with respect to commercial forward contracts.").

211 See Letter from Craig Donahue, Chief Executive Officer, CME Group Inc. ("CME"), dated July 22, 2011 ("CME Letter") (requesting this clarification). But see below regarding the CFTC's response to CME's comment concerning the Brent Interpretation that it may be inconsistent, in CME's view, with more recent CFTC adjudicatory decisions.

212 See, e.g., Brent Interpretation, supra note 207.

purpose of a forward contract is to transfer ownership of the commodity and not to transfer solely its price risk. As the CFTC has noted and reaffirms today:

> The underlying postulate of the [forward] exclusion is that the [CEA's] regulatory scheme for futures trading simply should not apply to private commercial merchandising transactions which create enforceable obligations to deliver but in which delivery is deferred for reasons of commercial convenience or necessity.[213]

As noted in the Proposing Release, because a forward contract is a commercial merchandising transaction, intent to deliver historically has been an element of the CFTC's analysis of whether a particular contract is a forward contract.[214] In assessing the parties' expectations or intent regarding delivery, the CFTC consistently has applied a "facts and circumstances" test.[215] Therefore, the CFTC reads the "intended to be physically settled"

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213 See Brent Interpretation, supra note 207. The CFTC has reiterated this view in more recent adjudicative orders. See, e.g., In re Grain Land Coop., [2003-2004 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 29,636 (CFTC Nov. 25, 2003); In re Competitive Strategies for Agric., Ltd., [2003-2004 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 29,635 (CFTC Nov. 25, 2003). Courts have expressed this view as well. See, e.g., Salomon Forex, Inc. v. Tauber, 8 F.3d 966, 971 (4th Cir. 1993) ("[C]ash forwards are generally individually negotiated sales . . . in which actual delivery of the commodity is anticipated, but is deferred for reasons of commercial convenience or necessity."); CFTC v. Int'l Fin. Serv. (N.Y.), 323 F. Supp. 2d 482, 495 (S.D.N.Y. 2004). See also CFTC v. Co Petro Mktg. Grp., Inc., 680 F.2d 573, 579-580 (9th Cir. 1982); CFTC v. Noble Metals Int'l, Inc., 67 F.3d 766, 772-773 (9th Cir. 1995; CFTC v. Am. Metal Exch. Corp., 693 F. Supp. 168, 192 (D.N.J. 1988); CFTC v. Morgan, Harris & Scott, Ltd., 484 F. Supp. 669, 675 (S.D.N.Y. 1979) (forward contract exclusion does not apply to speculative transactions in which delivery obligations can be extinguished under the terms of the contract or avoided for reasons other than commercial convenience or necessity).

214 The CFTC observed in its decision in In re Wright that "it is well-established that the intent to make or take delivery is the critical factor in determining whether a contract qualifies as a forward." In re Wright, CFTC Docket No. 97-02, 2010 WL 4388247 at *3 (CFTC Oct. 25, 2010) (citing In re Stovall, et al., [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) 20,941 (CFTC Dec. 6, 1979); Brent Interpretation, supra note 207). In Wright, the CFTC noted that "[i]n distinguishing futures from forwards, the [CFTC] and the courts have assessed the transaction as a whole with a critical eye toward its underlying purpose. Such an assessment entails a review of the overall effect of the transaction as well as a determination as to what the parties intended." Id. at *3 (quoting Policy Statement Concerning Swap Transactions, 54 FR 30694 (Jul. 21, 1989) ("Swap Policy Statement") (citations and internal quotations omitted)).

215 In Wright, the CFTC applied its facts and circumstances test in an administrative enforcement action involving hedge-to-arrive contracts for corn, and observed that "[o]ur views of the

language in the swap definition with respect to nonfinancial commodities to reflect a directive that intent to deliver a physical commodity be a part of the analysis of whether a given contract is a forward contract or a swap, just as it is a part of the CFTC's analysis of whether a given contract is a forward contract or a futures contract.

(B) Brent Interpretation

In this interpretation, the CFTC is restating, with certain clarifications in response to commenters, its interpretation from the Proposing Release that the principles underlying the CFTC's "Brent Interpretation" regarding book-outs developed in connection with the forward exclusion from futures apply to the forward exclusion from the swap definition as well. Book-out transactions meeting the requirements specified in the Brent Interpretation that are effectuated through a subsequent, separately negotiated agreement qualify for the safe harbor under the forward exclusions.

As was noted in the Proposing Release, the issue of book-outs first arose in 1990 in the Brent Interpretation[216] because the parties to the crude oil contracts in that case could individually negotiate cancellation agreements, or "book-outs," with other parties.[217] In describing these transactions, the CFTC stated:

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appropriateness of a multi-factor analysis remain unchanged." Wright, note 214, supra, n.13. The CFTC let stand the administrative law judge's conclusion that the hedge-to-arrive contracts at issue in the case were forward contracts. Id. at **5-6. See also Grain Land, supra note 213; Competitive Strategies for Agric., supra note 213.

216 See Brent Interpretation, supra note 207. The CFTC issued the Brent Interpretation in response to a federal court decision that held that certain 15-day Brent system crude oil contracts were illegal off-exchange futures contracts. See Transnor (Bermuda) Ltd. v. BP N. Am. Petroleum, 738 F. Supp. 1472 (S.D.N.Y. 1990). The Brent Interpretation provided clarification that the 15-day Brent system crude oil contracts were forward contracts that were excluded from the CEA definition of "future delivery," and thus were not futures contracts. See Brent Interpretation, supra note 207.

217 The Brent Interpretation described these "book-outs" as follows: "In the course of entering into 15-day contracts for delivery of a cargo during a particular month, situations often arise in which

> It is noteworthy that while such [book-out] agreements may extinguish a party's delivery obligation, they are separate, individually negotiated, new agreements, there is no obligation or arrangement to enter into such agreements, they are not provided for by the terms of the contracts as initially entered into, and any party that is in a position in a distribution chain that provides for the opportunity to book-out with another party or parties in the chain is nevertheless entitled to require delivery of the commodity to be made through it, as required under the contracts.[218]

Thus, in the scenario at issue in the Brent Interpretation, the contracts created a binding obligation to make or take delivery without providing any right to offset, cancel, or settle on a payment-of-differences basis. The "parties enter[ed] into such contracts with the recognition that they may be required to make or take delivery."[219]

On these facts, the Brent Interpretation concluded that the contracts were forward contracts, not futures contracts:

> Under these circumstances, the [CFTC] is of the view that transactions of this type which are entered into between commercial participants in connection with their business, which create specific delivery obligations that impose substantial economic risks of a commercial nature to these participants, but which may involve, in certain circumstances, string or chain deliveries of the type described . . . are within the scope of the [forward contract] exclusion from the [CFTC's] regulatory jurisdiction.[220]

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two counterparties have multiple, offsetting positions with each other. These situations arise as a result of the effectuation of multiple, independent commercial transactions. In such circumstances, rather than requiring the effectuation of redundant deliveries and the assumption of the credit, delivery and related risks attendant thereto, the parties may, but are not obligated to and may elect not to, terminate their contracts and forego such deliveries and instead negotiate payment-of-differences pursuant to a separate, individually-negotiated cancellation agreement referred to as a 'book-out.' Similarly, situations regularly arise when participants find themselves selling and purchasing oil more than once in the delivery chain for a particular cargo. The participants comprising these 'circles' or 'loops' will frequently attempt to negotiate separate cancellation agreements among themselves for the same reasons and with the same effect described above." Brent Interpretation, supra note 207, at 39190.

218 Id. at 39192.

219 Id. at 39189.

220 Id. at 39192.

Although the CFTC did not expressly discuss intent to deliver, the Brent Interpretation concluded that transactions retained their character as commercial merchandising transactions, notwithstanding the practice of terminating commercial parties' delivery obligations through "book-outs" as described. At any point in the chain, one of the parties could refuse to enter into a new contract to book-out the transaction and, instead, insist upon delivery pursuant to the parties' obligations under their contract.

The CFTC also is clarifying that commercial market participants that regularly make or take delivery of the referenced commodity in the ordinary course of their business meet the commercial participant standard of the Brent Interpretation.[221] The CFTC notes that the Brent Interpretation applies to "commercial participants in connection with their business."[222] The CFTC intends that the interpretation in this release be consistent with the Brent Interpretation, and accordingly is adding "commercial" before "market participants" in this final interpretation. Such entities qualify for the forward exclusion from both the future delivery and swap definitions for their forward transactions in nonfinancial commodities under the Brent Interpretation even if they enter into a subsequent transaction to "book out" the contract rather than make or take delivery. Intent to make or take delivery can be inferred from the binding delivery obligation for the commodity referenced in the contract and the fact that the parties to the contract do, in fact, regularly make or take delivery of the referenced commodity in the ordinary course of their business.

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221 See CME Letter (noting that, although the Brent Interpretation applies to "commercial market participants," the proposed guidance in the Proposing Release was described as applying to "market participants" (omitting the word "commercial") who "regularly make or take delivery of the referenced commodities . . . in the ordinary course of business." See also Proposing Release at 29829.

222 Brent Interpretation, supra note 207, at 39192.

Further, in this final interpretation, the CFTC clarifies, in response to a comment received, that an investment vehicle taking delivery of gold as part of its investment strategy would not be engaging in a commercial activity within the meaning of the Brent Interpretation.[223] By contrast, were the investment vehicle, for example, to own a gold mine and sell the output of the gold mine for forward delivery, or own a chain of jewelry stores that produces its own jewelry from raw materials and purchase a supply of gold from another entity's gold mine in order to provide raw materials for its jewelry stores, such contracts could qualify as forward contracts under the Brent Interpretation--provided that such contracts otherwise satisfy the terms thereof.

In sum, the CFTC is interpreting the term "commercial" in the context of the Brent Interpretation in the same way it has done since 1990: "related to the business of a producer, processor, fabricator, refiner or merchandiser."[224] While a market participant need not be solely

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223 See CME Letter. In connection with its comment regarding "market participants" described above, see supra note 221, the CME further requests confirmation that the CFTC intends to apply the Brent Interpretation to market participants who can demonstrate that they meet the standard in the guidance as proposed, but are not themselves commercial actors:

> Because the Commission's interpretation does not explicitly refer to commercial market participants, it would seem to cover financial players as long as those entities regularly make or take delivery of the underlying commodity in connection with their business. Examples of such entities would be hedge funds or other investment vehicles that regularly make or take delivery of commodities (e.g. gold) in conjunction with their line of business – that is, as part of their investment strategies. [CME] asks that the [CFTC] confirm that the Brent safe harbor would be available to these types of market participants that technically are not "commercial" actors.

See CME Letter.

224 Brent Interpretation, supra note 207, at 39191. See also dissent of Commissioner Fowler West (stating that commercial means "in the traditional sense of those who produce, process, use or . . . handle the underlying commodity."). Note that being a commercial market participant with respect to an agreement, contract or transaction in one commodity, or grade of a commodity, neither makes an entity, nor precludes an entity from being, a commercial market participant with respect to an agreement, contract or transaction in a different grade of the commodity or a different commodity. For example, a West Texas Intermediate oil producer may or may not also be a commercial with respect to Brent. Similarly, that same West Texas Intermediate oil

engaged in "commercial" activity to be a "commercial market participant" within the meaning of the Brent Interpretation under this interpretation, the business activity in which it makes or takes delivery must be commercial activity for it to be a commercial market participant. A hedge fund's investment activity is not commercial activity within the CFTC's longstanding view of the Brent Interpretation.

In addition, the CFTC is expanding the Brent Interpretation, which applied only to oil, to all nonfinancial commodities, as proposed.[225] As a result, book-outs are permissible (where the conditions of the Brent Interpretation are satisfied) for all nonfinancial commodities with respect to the exclusions from the definition of the term "swap" and the definition of the term "future delivery" under the CEA.[226]

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producer may or may not have commercial corn operations. In determining whether an entity is a commercial market participant with respect to an agreement, contract or transaction in a commodity, the CFTC will consider the facts and circumstances, though it is not unlikely that an entity that is a commercial market participant with respect to one commodity may also be a commercial market participant with respect to either a different grade of the commodity or a closely related commodity.

225 See infra part II.B.2(a)(ii), with respect to the CFTC's interpretation concerning nonfinancial commodities.

226 The CFTC reminds market participants that this does not mean, as was noted in the Brent Interpretation, that these transactions or persons who engage in them are wholly outside the reach of the CEA for all purposes. See, e.g., CEA section 8(d), 7 U.S.C. 12(d), which directs the CFTC to investigate the marketing conditions of commodities and commodity products and byproducts, including supply and demand for these commodities, cost to the consumer, and handling and transportation charges; CEA sections 6(c), 6(d) and 9(a)(2), 7 U.S.C. 9, 13b, and 13(a)(2), which proscribe any manipulation or attempt to manipulate the price of any commodity in interstate commerce; and CEA section 6(c) as amended by section 753 of the Dodd-Frank Act, which contains prohibitions regarding manipulation and false reporting with respect to any commodity in interstate commerce, including prohibiting any person to (i) "use or employ, or attempt to use or employ . . . any manipulative or deceptive device or contrivance" (section 6(c)(1)); (ii) "to make any false or misleading statement of material fact" to the CFTC or "omit to state in any such statement any material fact that is necessary to make any statement of material fact made not misleading in any material respect" (section 6(c)(2)); and (iii) "manipulate or attempt to manipulate the price of any swap, or of any commodity in interstate commerce . . ." (section 6(c)(3)). See also Rule 180.1(a) under the CEA, 17 CFR 180.1(a) (broadly prohibiting in connection with a commodity in interstate commerce manipulation, false or misleading statements or omissions of material fact to the Commission, fraud or deceptive practices or

(C) Withdrawal of the Energy Exemption

Because the CFTC has expanded the Brent Interpretation to nonfinancial commodities in this final interpretation, the CFTC also has determined to withdraw the Energy Exemption as proposed. In response to comments received, the CFTC is clarifying that certain alternative delivery procedures discussed in the Energy Exemption[227] will not disqualify a transaction from the Brent Interpretation safe harbor.

In the Proposing Release, the CFTC proposed to withdraw the Energy Exemption, which, among other things, expanded the Brent Interpretation to energy commodities other than oil, on the basis that the exemption was no longer necessary in light of the extension of the Brent Interpretation to nonfinancial commodities.[228] The Energy Exemption, like the Brent Interpretation, requires binding delivery obligations at the outset, with no right to cash settle or offset transactions.[229] Each requires that book-outs be undertaken pursuant to a subsequent, separately negotiated agreement.

As discussed above, the CFTC is extending the Brent Interpretation to the swap definition and applying it to all nonfinancial commodities for both the swap and future delivery definitions, but is withdrawing the Energy Exemption. With regard to netting agreements that were expressly permitted by the Energy Exemption,[230] the CFTC clarifies that a physical netting

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courses of business, and false reporting).

227 These include pre-transaction netting agreements that result in offsetting physical delivery obligations, "bona fide termination rights," and certain other methods by which parties may settle their delivery obligations. See Energy Exemption, supra note 208, at 21293.

228 See Proposing Release at 29829. The CFTC also noted that, to avoid any uncertainty, the Dodd-Frank Act supersedes the Swap Policy Statement. Id. at 29829 n. 74. The CFTC reaffirms that such is the case.

229 Compare Energy Exemption, supra note 208, at 21293 with Brent Interpretation, supra note 207, at 39192.

230 See Energy Exemption, supra note 208, at 21293.

agreement (such as, for example, the Edison Electric Institute Master Power Purchase and Sale Agreement) that contains a provision contemplating the reduction to a net delivery amount of future, unintentionally offsetting delivery obligations, is consistent with the intent of the book out provision in the Brent Interpretation--provided that the parties had a bona fide intent, when entering into the transactions, to make or take delivery (as applicable) of the commodity covered by those transactions.

The CFTC also has determined that, notwithstanding the withdrawal of the Energy Exemption, a failure to deliver as a result of the exercise by a party of a "bona fide termination right" does not render an otherwise binding delivery obligation as non-binding.[231] In the Energy Exemption, the CFTC provided the following examples of bona fide termination rights: force majeure provisions and termination rights triggered by events of default, such as counterparty insolvency, default or other inability to perform.[232] The CFTC confirms that market participants who otherwise qualify for the forward exclusion may continue to rely on the bona fide termination right concept as set forth in this interpretation, although, as was stated in the Energy Exemption, such right must be bona fide and not for the purpose of evasion. In this regard, the CFTC further clarifies, consistent with the Energy Exemption, that a bona fide termination right must be triggered by something not expected by the parties at the time the contract is entered into.[233]

The Energy Exemption also discussed a number of methods by which parties to energy contracts settle their obligations, including: the seller's passage of title and the buyer's payment

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231 See also infra part II.B.2(b)(v) for a discussion of liquidated damages.

232 Energy Exemption, supra note 208, at 21293.

233 Id.

and acceptance of the underlying commodity; taking delivery of the commodity in some instances and in others instead passing title to another intermediate purchaser in a chain; and physically exchanging (i.e., delivering) one quality, grade or type of physical commodity for another quality, grade or type of physical commodity.[234] The CFTC clarifies that these settlement methods generally[235] are not inconsistent with the Brent Interpretation.[236]

(D) Book-out Documentation

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234 Id.

235 The CFTC will carefully scrutinize whether market participants are legitimately relying on the Brent Interpretation safe harbor. For example, if non-commercial market participants are intermediate purchasers in a delivery chain, then the transaction is not actually a commercial merchandising transaction, and the parties cannot rely on the Brent Interpretation safe harbor.

236 By definition, if two parties exchange (i.e., physically deliver) one physical commodity for another physical commodity in settlement of the parties' delivery obligations, each seller has delivered the commodity that is the subject of its delivery obligation under the relevant agreement, contract or transaction. Depending on the settlement timing, such transactions, which resemble barter transactions, would be spot transactions or forward transactions. While the most common forward transaction involves an exchange of a physical commodity for cash, neither the Brent Interpretation nor any other CFTC authority requires payment for a forward delivery to be made in cash. Thus, a physical exchange of one quality, grade or type of physical commodity for another quality, grade, or type of physical commodity does not affect the characterization of the transaction as a spot or forward transaction. As for the sellers passing title and buyers, instead of taking delivery of the commodity, passing title to another intermediate purchaser in a chain, this is consistent with the description of Brent transactions in the Brent Interpretation, provided that, as set forth therein, delivery is required and "the delivery obligations create substantial economic risk of a commercial nature to the parties required to make or take delivery . . . includ[ing, without limitation,] demurrage, damage, theft or deterioration." That description was based on the industry delivery structure as it existed prior to the Brent Interpretation. To the extent other industries are similarly structured for commercial reasons, the delivery-by-title-and-related-bill-of-lading-transfer delivery method would be able to rely on the Brent Interpretation if it otherwise satisfied the terms thereof. However, to the extent persons seek to establish such a delivery structure for new products and markets (e.g., not actually delivering the commodity to most of the participants in a chain), that could, depending on the applicable facts and circumstances, be viewed as outside the Brent Interpretation safe harbor or evasion. The CFTC expects that the limitation of counterparties eligible to rely on the Brent Interpretation to those with a commercial purpose for entering into the transaction should limit the development of such markets to those with commercial reasons for such a delivery structure.

The CFTC has taken into consideration comments regarding the documentation of book-outs.[237] Under the Brent Interpretation, what is relevant is that the book out occur through a subsequent, separately negotiated agreement. While the CFTC is sensitive to existing recordkeeping practices for book-outs, in order to prevent abuse of the safe harbor, the CFTC clarifies that in the event of an oral agreement, such agreement must be followed in a commercially reasonable timeframe by a confirmation in some type of written or electronic form.

(E) Minimum Contract Size and Other Contextual Factors

In the Proposing Release, the CFTC requested comment about potentially imposing additional conditions (such as, for example, a minimum contract size) in order for a transaction to qualify as a forward contract under the Brent Interpretation with respect to the future delivery and swap definitions.[238] The CFTC has determined that a minimum contract size should not be required in order for a contract to qualify as a forward contract under the Brent Interpretation.[239]

237 See Letter from R. Michael Sweeney, Jr., Hunton & Williams LLP, on behalf of the Working Group of Commercial Energy Firms ("WGCEF"), dated July 22, 2011 ("WGCEF Letter").

238 See Proposing Release at 29831, Request for Comment 27.

239 Most commenters opposed adding a minimum contract size or other conditions to the CFTC's interpretation of the forward exclusion. One commenter argued that such an approach would be inconsistent with CFTC precedent, citing the fact that neither the Brent Interpretation nor subsequent CFTC precedent interpreting the forward exclusion mention contract size. See CME Letter. Another commenter pointed out that Congress did not impose such a requirement, and thus believes that the CFTC should not do so. See Letter from David M. Perlman, Partner, Bracewell & Giuliani LLP, Counsel to the Coalition of Physical Energy Companies ("COPE"), dated July 22, 2011 ("COPE Letter"). Similarly, a third commenter argued that the only condition Congress placed on the forward exclusion is intent to physically settle, and contract size is not relevant to such intent. See Letter from Natural Gas Supply Association/National Corn Growers Association ("NGSA/NCGA"), dated July 22, 2011 ("NGSA/NCGA Letter").

Two commenters questioned the reasonableness in instituting a minimum contract size below which a transaction would become regulated, but otherwise would not. See Letter from Craig G. Goodman, Esq., President, The National Energy Marketers Association ("NEMA"), dated July 21, 2011, ("NEMA Letter") and Letter from Phillip G. Lookadoo on behalf of the International Energy Credit Association ("IECA"), dated July 28, 2011 ("IECA Letter"). Two commenters believed that such an approach would be contrary to the purposes of Dodd-Frank in regulating

However, as suggested by a commenter, the CFTC may consider contract size as a contextual factor in determining whether a particular contract is a forward.[240] Moreover, the CFTC may consider other contextual factors when determining whether a contract qualifies as a forward, such as a demonstrable commercial need for the product, the underlying purpose of the contract (e.g. whether the purpose of the claimed forward was to sell physical commodities, hedge risk, or speculate), the regular practices of the commercial entity with respect to its general commercial business and its forward and swap transactions more specifically, or whether the absence of physical settlement is based on a change in commercial circumstances. These contextual factors are consistent with the CFTC's historical facts-and-circumstances approach to the forward contract exclusion outside of the Brent Interpretation safe harbor.

Comments

Several commenters believed that the CFTC should codify its proposed interpretation regarding the Brent Interpretation in rule text to provide greater legal certainty.[241] One

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transactions that would affect systemic risk. See NEMA Letter and Letter from Dan Gilligan and Michael Trunzo, Petroleum Marketers Association of America and New England Fuel Institute ("PMAA/NEFI"), dated July 22, 2011 ("PMAA/NEFI Letter"). One commenter urged that the Brent Interpretation be applied with minimal restrictive overlay. It believed that contract size is a "contextual factor" that may be considered in evaluating the existence of intent to deliver, but should not be viewed as an independent determinant. See ISDA Letter.

One commenter argued that the forward exclusion should be strengthened with additional conditions to preclude evasion. Its suggested conditions include defining the required regularity of delivery (such as a predominance, or "more often than not" standard); providing a quantitative test of bona fide intent to deliver (such as a demonstrable commercial need for the product and justifying non-physical settlement based on a change in commercial circumstances); and re-evaluating the book-outs aspect of the Brent Interpretation. See Better Markets Letter.

240 See ISDA Letter.

241 See Letter from Lisa Yoho, Director, Regulatory Affairs, BGA, dated July 22, 2011) ("BGA Letter"); COPE Letter; Letter from Michael Bardee, General Counsel, Federal Energy Regulatory Commission ("FERC"), dated July 22, 2011 ("FERC Staff Letter"); Letter from Stephanie Bird, Chief Financial Officer, Just Energy, dated July 22, 2011 ("Just Energy Letter"); Letter from the Electric Trade Associations (the Electric Power Supply Association, National Rural Electric

commenter further commented that the Dodd-Frank Act's legislative history expressly directed the CFTC to clarify through rulemaking that the nonfinancial commodity forward contract exclusion from the swap definition is intended to be consistent with the forward contract exclusion from the term "future delivery."[242] The commenter also stated its view that the interpretation as proposed does not provide notice to the electricity industry as to how to determine whether a nonfinancial commodity agreement is a swap or a nonfinancial commodity forward contract, nor as to which factors the CFTC would consider in distinguishing between swaps and nonfinancial forward contracts.[243] Moreover, another commenter suggested that the CFTC should include in regulatory text a representative, non-exhaustive list of the kinds of contracts that are excluded from the swap definition.[244]

The CFTC has determined not to codify its interpretation in rule text. The CFTC has never codified its prior interpretations of the forward contract exclusion with respect to the future delivery definition as a rule or regulation;[245] thus, providing an interpretation is consistent with the manner in which the CFTC has interpreted the forward exclusion in the past, which in turn is

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Cooperative Association, Large Public Power Council, Edison Electric Institute and American Power Association) ("ETA Letter"), dated July 22, 2011.

242 See ETA Letter (citing the "Lincoln-Dodd Letter" printed at 156 Cong. Rec. H5248-249).

243 See ETA Letter. The commenter requests that the CFTC "further define the statutory term 'swap' by defining relevant terms in the Dodd-Frank Act, reconciling the wording used in the various provisions in the CEA as amended by the Dodd-Frank Act, and setting forth in the [CFTC's] rules the factors that are determinative in drawing the distinction between a 'swap' and a 'nonfinancial commodity forward contract.'" The commenter suggests rule text to codify the CFTC's interpretation regarding the exclusion of nonfinancial commodity forward contracts. Id.

244 See FERC Staff Letter.

245 See, e.g. Brent Interpretation, supra note 207; Energy Exemption, supra note 208; Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options, 50 FR 39656 (Sep. 30, 1985) ("1985 CFTC OGC Interpretation").

consistent with the Dodd-Frank Act legislative history.[246] Moreover, Congress did not direct the CFTC to write rules regarding the forward exclusion. The Dodd-Lincoln letter, cited by a commenter in support of its argument, "encourages" the CFTC to clarify the forward exclusion "through rulemaking" in the generic sense of that term (i.e., through the rulemaking process of notice and comment), not specifically through rule text.[247] Similarly, the CFTC is not providing in rule text a representative list of contracts in nonfinancial commodities that are excluded from the swap definition as forwards.

The CFTC believes that its interpretation provides sufficient clarity with respect to the forward contract exclusion from the swap and future delivery definitions.[248] The CFTC also believes that the interpretation provides sufficient notice to the public regarding how the forward exclusions from the swap and future delivery definitions will be interpreted. As noted above, the CFTC's historical approach to the forward contract exclusion from the future delivery definition developed on a case-by-case basis, not by rule.

Commenters generally supported applying the Brent Interpretation to the forward exclusion from the swap definition and expanding it to all nonfinancial commodities for purposes of the forward exclusion from both the definitions of the terms "future delivery" and "swap."[249] However, in addition to the requests for clarification to which the CFTC has

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246 See supra note 210 and accompanying text.

247 See 156 Cong. Rec. H5248-49 (June 30, 2010).

248 This is particularly true given that the CFTC intends to interpret the forward exclusion from the swap definition consistently with its interpretation of the forward exclusion from the term "future delivery," with which market participants have had decades of experience.

249 See BGA Letter; COPE Letter; ISDA Letter; IECA Letter; Letter from Stuart J. Kaswell, Executive Vice President & Managing Director, Managed Funds Association ("MFA"), dated July 22, 2011 ("MFA Letter"); NGSA/NCGA Letter; Letter from Charles F. Conner, President and CEO, National Council of Farmer Cooperatives ("NCFC"), dated July 22, 2011 ("NCFC Letter"); NEMA Letter; PMAA/NEFI Letter; WGCEF Letter.

responded in its final interpretation provided above, commenters raise other requests for clarification. One commenter,[250] for example, believed that the CFTC's adjudicatory decisions in Grain Land[251] and Wright[252] should be construed to have expanded the Brent Interpretation's safe harbor. This commenter stated its view that in Grain Land, the CFTC recognized that cancellation provisions or an option to roll the delivery date within flexible hedge-to-arrive contracts did not render the transactions futures contracts, as opposed to forwards. As such, this commenter believed this case may be at odds with the literal terms of the Brent Interpretation regarding book-outs, which required that, to be a forward contract, any cancellation of delivery must be effected through a subsequent, separately negotiated agreement. The commenter argued that cases subsequent to the Brent Interpretation, such as Grain Land and Wright, recognized the need for flexibility and innovation in the commercial merchandising transactions that are eligible for the forward exclusion. Therefore, this commenter requested that the CFTC consider the body of forward contract precedent as a whole and extend the Brent Interpretation's safe harbor to situations like those presented in Grain Land, notwithstanding the absence of a subsequent, separately-negotiated agreement.[253]

While, as noted above, the CFTC has clarified that the entire body of its precedent applies to its interpretation of the forward exclusion for nonfinancial commodities in the swap definition, the CFTC does not believe that there is a conflict between the Brent Interpretation and the Grain Land or Wright cases. In Grain Land, the CFTC concluded that the fact that a contract includes a termination right, standing alone, is not determinative of whether the contract is a

[250] See CME Letter.

[251] Grain Land, supra note 213.

[252] Wright, supra note 214.

[253] See CME Letter.

forward. Rather, as the CFTC has always interpreted the forward exclusion, it looks to the facts and circumstances of the transaction. Similarly in Wright, which cited Grain Land with approval, the CFTC stated that "[i]n assessing the parties' expectations or intent regarding delivery, the Commission applies a 'facts and circumstances' test rather than a bright-line test focused on the contract's terms . . . ." In contrast, the Brent Interpretation is a safe harbor that assures commercial parties that book-out their contracts through a subsequent, separately negotiated agreement that their contracts will not fall out of the forward exclusion. The CFTC's conclusion that application of its facts-and-circumstances approach demonstrated that the particular contracts at issue in Grain Land and Wright were forwards did not expand the scope of the safe harbor afforded by the Brent Interpretation.[254]

Several commenters suggested that the Energy Exemption should not be withdrawn. One commenter noted that the Energy Exemption, along with the Brent Interpretation, should inform the CFTC's interpretation of the forward exclusion.[255] Another commenter believed that the Energy Exemption appears entirely consistent with the Dodd-Frank Act and should be included in the rules as a non-exclusive exemption to ensure continued clarity.[256] A third commenter requested clarification that revoking the Energy Exemption will not harm market participants, stating that the Proposing Release did not sufficiently explain the rationale for withdrawing the Energy Exemption or the possible consequences for energy market participants. This commenter sought confirmation that, despite the withdrawal of the Energy Exemption, market participants will be permitted to rely on the Brent Interpretation, as expanded by the Energy Exemption,

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254 As described above in the interpretation, the CFTC has addressed CME's other comments on the forward exclusion, including the interpretation's applicability to commercial market participants and CME's hedge fund example.

255 See COPE Letter Appendix.

256 See IECA Letter.

particularly as it relates to alternative delivery procedures.[257] This commenter expressed concern that by withdrawing the Energy Exemption, the CFTC would be revoking the ability of market participants to rely on pre-transaction netting agreements to offset physical delivery obligations as an alternative to separately negotiating book-outs after entering into the transactions.[258] As discussed above, the CFTC has determined to withdraw the Energy Exemption as proposed, but has provided certain clarifications to address commenters' concerns.

One commenter suggested the deletion of "commercial merchandising transaction" as a descriptive term in the interpretation. Although recognizing its provenance from the Brent Interpretation, this commenter believed that the phrase was anachronistic at that time, and that it is misleading and narrow in the current evolving commercial environment.[259] Contrary to this commenter's suggestion, the CFTC has determined to retain the phrase "commercial merchandising transaction" in its final interpretation regarding forward contracts. The CFTC characterized forward transactions in this manner in the Brent Interpretation, as well as in its subsequent adjudications. Courts also have characterized forwards as commercial merchandising transactions or cited the CFTC's characterization with approval.[260] Accordingly, the CFTC believes that "commercial merchandising transaction" continues to be an accurate descriptive term for characterizing forward transactions.

Another commenter requested that the CFTC clarify that a subsequent, separately-negotiated agreement to effectuate a book-out under the Brent Interpretation may be oral or

257 See MFA Letter.

258 Ex Parte Communication between MFA and CFTC Staff on September 15, 2011, at http://comments.cftc.gov/PublicComments/ViewExParte.aspx?id=387&SearchText= .

259 See ISDA Letter.

260 See, e.g., In re Bybee, 945 F.2d 309, 315 (9th Cir. 1991).

written. This commenter noted that the pace at which certain energy markets transact and the frequency with which book-outs may sometimes occur, makes formal written documentation of all book-outs impracticable.[261] The CFTC has provided an interpretation above regarding the documentation of book-outs in response to this commenter's concerns.

ii) Nonfinancial Commodities

In response to commenters,[262] the CFTC is providing an interpretation regarding the scope of the term "nonfinancial commodity" in the forward exclusion from the swap definition.[263]

The CFTC interprets the term "nonfinancial commodity" to mean a commodity that can be physically delivered and that is an exempt commodity[264] or an agricultural commodity.[265]

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261 See WGCEF Letter.

262 The Commissions requested comment in the Proposing Release on whether they should provide guidance regarding the scope of the term "nonfinancial commodity" and, if so, how and where the line should be drawn between financial and nonfinancial commodities. See Proposing Release at 29832.

263 As noted above, the CEA definition of the term "swap" excludes "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled." CEA section 1a(47)(B)(ii), 7 U.S.C. 1a(47)(B)(ii). Thus, the forward exclusion from the swap definition is limited to transactions in nonfinancial commodities. To the extent the CFTC uses the term "nonfinancial commodity" in other contexts in this release, such as in connection with the Brent Interpretation (including as it applies with respect to the "future delivery" definition), the term will have the same meaning as discussed in this section in those contexts.

264 The CEA defines an "exempt commodity" as "a commodity that is not an excluded commodity or an agricultural commodity." CEA section 1a(20), 7 U.S.C. 1a(20). A security is an excluded commodity as discussed below, and therefore is not an exempt commodity.

265 The CFTC has defined the term "agricultural commodity" in its regulations as follows: (zz) Agricultural commodity. This term means: (1) The following commodities specifically enumerated in the definition of a ''commodity'' found in section 1a of the Act: Wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, but not onions; (2) All other commodities that are, or once were, or are derived from, living organisms, including plant, animal and aquatic life, which are generally fungible, within their

Unlike excluded commodities, which generally are financial,[266] exempt and agricultural commodities by their nature generally are nonfinancial. The requirement that the commodity be able to be physically delivered is designed to prevent market participants from relying on the forward exclusion to enter into swaps based on indexes of exempt or agricultural commodities outside of the Dodd-Frank Act and settling them in cash, which would be inconsistent with the historical limitation of the forward exclusion to commercial merchandising transactions. However, to the extent that a transaction is intended to be physically settled, otherwise meets the terms of the forward contract exclusion and uses an index merely to determine the price to be paid for the nonfinancial commodity intended to be delivered, the transaction may qualify for the forward exclusion from the swap definition.

In addition, the CFTC is providing an interpretation that an intangible commodity (that is not an excluded commodity) which can be physically delivered qualifies as a nonfinancial commodity if ownership of the commodity can be conveyed in some manner and the commodity

respective classes, and are used primarily for human food, shelter, animal feed or natural fiber; (3) Tobacco, products of horticulture, and such other commodities used or consumed by animals or humans as the Commission may by rule, regulation or order designate after notice and opportunity for hearing; and (4) Commodity-based indexes based wholly or principally on underlying agricultural commodities.

Rule 1.3(zz) under the CEA, 17 CFR 1.3(zz). See Agricultural Commodity Definition, 76 FR 41048 (Jul. 13, 2011).

266 The CEA defines an "excluded commodity" as: (i) an interest rate, exchange rate, currency, security, security index, credit risk or measure, debt or equity instrument, index or measure of inflation, or other macroeconomic index or measure; (ii) any other rate, differential, index, or measure of economic or commercial risk, return, or value that is— (I) not based in substantial part on the value of a narrow group of commodities not described in clause (i); or (II) based solely on one or more commodities that have no cash market; (iii) any economic or commercial index based on prices, rates, values, or levels that are not within the control of any party to the relevant contract, agreement, or transaction; or (iv) an occurrence, extent of an occurrence, or contingency (other than a change in the price, rate, value, or level of a commodity not described in clause (i)) that is— (I) beyond the control of the parties to the relevant contract, agreement, or transaction; and (II) associated with a financial, commercial, or economic consequence.

CEA section 1a(19), 7 U.S.C. 1a(19).

can be consumed. One example of an intangible nonfinancial commodity that qualifies under this interpretation, as discussed in greater detail below, is an environmental commodity, such as an emission allowance, that can be physically delivered and consumed (e.g., by emitting the amount of pollutant specified in the allowance).[267] The interpretation provided herein recognizes that transactions in intangible commodities can, in appropriate circumstances, qualify as forwards, while setting forth certain conditions to assure that the forward exclusion may not be abused with respect to intangible commodities.

Comments

Several commenters believed that the CFTC should provide an interpretation regarding the meaning of the term "nonfinancial commodity" to provide clarity to market participants on the applicability of the forward exclusion.[268] The CFTC is providing the interpretation discussed above to address these commenters' concerns but, contrary to one commenter's request, declines to adopt a regulation.[269]

iii) Environmental Commodities

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267 See supra part II.B.2.a)iii), regarding environmental commodities. An emission allowance buyer also can consume the allowance by retiring it without emitting the permitted amount of pollutant.

268 See Letter from Steven J. Mickelsen, Counsel, 3Degrees Group, Inc., dated July 22, 2011 ("3Degrees Letter"); ETA Letter; and Letter from Kari S. Larsen, General Counsel, Chief Regulatory Officer, Green Exchange LLC, dated July 22, 2011 ("GreenX Letter"). Each of these commenters proposed its own definition of "nonfinancial commodity." The interpretation above incorporates many of their suggestions.

269 See ETA Letter. This is consistent with CFTC practice in providing an interpretation rather than regulations where warranted. In this context, the CFTC is providing an interpretation rather than rule text because the CFTC is not limiting the definition of "nonfinancial commodity" to exempt and agricultural commodities (the latter category includes agricultural commodity indexes (see 17 C.F.R. 1.3(zz)(4))). The definition also requires physical deliverability and, with respect to intangible commodities, ownership transferability and consumability. Whether a commodity has these features may require interpretation. In any case, courts can rely on agency interpretations.

The Commissions requested comment on whether environmental commodities should fall within the forward exclusion from the swap definition and, if so, subject to what parameters.[270] In response to commenters, the CFTC is providing an interpretation regarding the circumstances under which agreements, contracts or transactions in environmental commodities will satisfy the forward exclusion from the swap definition.[271] The CFTC did not propose a definition of the term "environmental commodity" in the Proposing Release and is not doing so in this release.[272] The CFTC believes it is not necessary to define the term "environmental commodity" because any intangible commodity – environmental or otherwise – that satisfies the terms of the interpretation provided herein is a nonfinancial commodity, and thus an agreement, contract or transaction in such a commodity is eligible for the forward exclusion from the swap definition.[273] The forward exclusion from the swap definition does not apply to commodities themselves, but to certain types of agreements, contracts or transactions in a specified type of commodity (i.e., a

270 See Proposing Release at 29832, Request for Comment 32, asked: Should the forward contract exclusion from the swap definition apply to environmental commodities such as emissions allowances, carbon offsets/credits, or renewable energy certificates? If so, please describe these commodities, and explain how transactions can be physically settled where the commodity lacks a physical existence (or lacks a physical existence other than on paper)? Would application of the forward contract exclusion to such environmental commodities permit transactions that should be subject to the swap regulatory regime to fall outside the Dodd-Frank Act?

271 Because the CFTC has determined, as discussed elsewhere in this release, to interpret the forward exclusion from the swap definition consistently with the forward exclusion from the "future delivery" definition, the discussion in this section applies equally to the forward exclusion from future delivery.

272 See also Letter from Gene Grace, Senior Counsel, American Wind Energy Association ("AWEA"), dated July 22, 2011 ("AWEA Letter") (providing a general description of renewable energy credits ("RECs"), emission allowances, and offsets, which the commenter collectively termed "environmental commodities" for purposes of its letter).

273 Thus, market participants should apply the interpretation to their facts to determine whether their specific circumstances support reliance on the forward exclusion from the swap definition.

"nonfinancial" commodity).[274] Environmental commodities that meet the interpretation regarding nonfinancial commodities discussed in subsection (ii) above are nonfinancial commodities and, therefore, a sale for deferred shipment or delivery in such a commodity, so long as the transaction is intended to be physically settled, may qualify for the forward exclusion from the swap definition.

The intangible nature of environmental, or other, commodities does not disqualify contracts based on such commodities from the forward exclusion from the swap definition, notwithstanding that the core of the forward exclusion is intent to deliver the underlying commodity.[275] As commenters noted, securities are intangible (with the exception of the rare certificated security) and yet they are expressly permitted by CEA section 1a(47)(B)(ii)[276] to be the subject of the forward exclusion; this reflects recognition by Congress that the forward exclusion can apply to intangible commodities.[277]

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274 Several commenters appear to have confused these concepts. The term "commodity" is defined in CEA section 1a(9), 7 U.S.C. 1a(9). The forward exclusion in CEA section 1a(47)(B)(ii), 7 U.S.C. 1a(47)(B)(ii), excludes from the swap definition "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled."

275 See supra part II.B.2.a)i)(A).

276 7 U.S.C. 1a(47)(B)(ii).

277 As commenters also note, each Commission or its staff has previously indicated that environmental commodities, in the CFTC's case, and securities, in the SEC's case, can be physically settled. See Letter from Kyle Danish, Van Ness Feldman, P.C., on behalf of Coalition for Emission Reduction Policy ("CERP"), dated July 18, 2011 ("CERP Letter") and 3Degrees Letter. Also, the recent Carbon Report suggested that the forward exclusion could apply to agreements, contracts or transactions in environmental commodities. See Interagency Working Group for the Study on Oversight of Carbon Markets ("Interagency Working Group"), Report on the Oversight of Existing and Prospective Carbon Markets (January 2011) ("Carbon Report"). The Carbon Report specifically stated that - [n]o set of laws currently exist that apply a comprehensive regulatory regime – such as that which exists for derivatives – specifically to secondary market trading of carbon allowances and offsets. Thus, for the most part, absent specific action by Congress, a secondary market for carbon allowances and offsets may operate outside the routine oversight of any market regulator.

The CFTC understands that market participants often engage in environmental commodity transactions in order to transfer ownership[278] of the environmental commodity (and not solely price risk),[279] so that the buyer can consume the commodity in order to comply with the terms of mandatory or voluntary environmental programs.[280] Those two features – ownership transfer and consumption – distinguish such environmental commodity transactions from other types of intangible commodity transactions that cannot be delivered, such as temperatures and interest rates. The ownership transfer and consumption features render such environmental commodity transactions similar to tangible commodity transactions that clearly can be delivered, such as wheat and gold.[281]

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278 One commenter maintains that a transaction in an environmental allowance represents a physically-settled transaction because its primary purpose is to transfer ownership of the right to emit a specified unit of pollution. See Letter from Andrew K. Soto, American Gas Association ("AGA"), dated July 22, 2011 ("AGA Letter"). Compare to Proposing Release at 29828 (stating that "[t]he primary purpose of the contract is to transfer ownership of the commodity").

279 Another commenter states that, from a practical standpoint, the buyer must take delivery to satisfy a compliance obligation, which typically requires surrender of allowances and offset credits, and likens such transactions to forward sales of more tangible commodities, noting they are not devices for transferring price risk. See CERP Letter. Compare to Proposing Release at 29828 (stating that "[t]he primary purpose of the contract is . . . not to transfer solely . . . price risk"). This commenter also advises that delivery of RECs and offsets is typically deferred for commercial convenience, consistent with the Brent Interpretation, because "not all of the purchased RECs and offsets are generated at the time of the transaction" and "long-term contracts with deferred delivery are important for renewable energy projects to ensure a consistent revenue stream over a long period of time." See CERP Letter.

280 Consumption also can be part of a commercial merchandising transaction in the chain of commerce. See, e.g., Brent Interpretation, supra note 207 (dissent of Commissioner Fowler West) (citing the 1985 CFTC OGC Interpretation and cases cited therein for the proposition that "parties to forward contracts . . . seek to profit in their businesses from producing, processing, distributing, storing, or consuming the commodity").

281 Similarly, the settlement method for the types of environmental commodity transactions described by commenters such as RECs, emission allowances, and offsets are equivalent to that of physical commodities where ownership is transferred by delivering a warehouse receipt from the seller to the buyer, thereby indicating the presence in the warehouse of the contracted for commodity volume. See GreenXLetter. See also REMA letter (averring that "[i]n effect, the REC is an intangible contract right or interest in that specific quantity of energy; thus, it is quite analogous to a warehouse receipt that represents title to a physical commodity"). Another

For such transactions, in addition to the factors discussed above, intent to deliver is readily determinable,[282] delivery failures generally result from frustration of the parties' intentions,[283] and cash-settlement is insufficient because delivery of the commodity is necessary for compliance purposes.[284] For the foregoing reasons, environmental commodities can be nonfinancial commodities that can be delivered through electronic settlement or contractual attestation. Therefore, an agreement, contract or transaction in an environmental commodity may qualify for the forward exclusion from the swap definition if the transaction is intended to be physically settled.

Comments

Several commenters responded to the Commission's request for comment regarding the applicability of the forward exclusion from the swap definition for agreements, contracts and transactions in environmental commodities.[285]

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similarity between these environmental commodity transactions and tangible commodities is that it is possible to manipulate the deliverable supply of an environmental commodity just as it is for a tangible commodity. The CFTC reminds market participants of its continuing authority over forwards under the CEA's anti-manipulation provisions prohibiting manipulation, making false and misleading statements and omissions of material fact to the CFTC, fraud and deceptive practices, and false reporting. See supra note 226.

282 See Letter from Jennifer Martin, Executive Director, Center for Research Solutions ("CRS"), dated July 22, 2011 ("CRS Letter").

283 See 3Degrees Letter.

284 See GreenX Letter.

285 One commenter provided a general description of renewable energy credits ("RECs"), emission allowances, offsets, (which the commenter collectively termed "environmental commodities" for purposes of its letter), and related transactions. See AWEA Letter. According to the commenter, RECs are created by state regulatory bodies in conjunction with the production of electricity from a qualifying renewable energy facility. The forward sale of a REC transfers ownership of the REC from the producing entity to another entity that can use the REC for compliance with an obligation to sell a certain percentage of renewable energy. Many times, this forward sale takes place prior to the construction of a project to enable developers to secure related project financing. See AWEA Letter. See also Letter from Mary Anne Mason, HoganLovells LLP on behalf of Southern California Edison Company, Pacific Gas and Electric Company and San

Most commenters responding to the Commissions' request for comment concerning the appropriate treatment of agreements, contracts or transactions in environmental commodities asserted that emission allowances, carbon offsets/credits, or RECs should be able to qualify for the forward exclusion from the swap definition. In support of this view, several commenters explained that the settlement process for environmental commodity transactions generally involves "the transfer of title via a tracking system, registry or contractual attestation, in exchange for a cash payment."[286] One commenter stated that this form of settlement demonstrates that the lack of physical existence of a commodity is not relevant to whether a

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Diego Gas and Electric Company ("California Utilities"), dated July 22, 2011 ("California Utilities Letter") (stating that the California Utilities transact in allowances, under the EPA's and anticipated California cap-and-trade programs, as well as in RECs, in order to comply with or participate in various regulatory and voluntary programs).

The CFTC understands that, in the United States, emission allowances and offsets are issued by the U.S. Environmental Protection Agency ("EPA"), state government entities and private entities. Emission allowances and offsets are transferred between counterparties, often through forward contracts, with the purchasing party obtaining the ability to use the allowances or offsets for compliance with clean air or greenhouse gas regulations. The forward sale of allowances and offsets allows market participants to hedge the compliance obligations associated with expected emissions, or to meet a voluntary emissions reduction commitment or make an environmental claim. See, e.g., AWEA Letter; Letter from Henry Derwent, President and CEO, International Emissions Trading Association, dated July 22, 2011 (defining a carbon offset as a "credit[] granted by a state or regional governmental body or an independent standards organization in an amount equal to the generation of electricity from a qualifying renewable energy facility.").

286 See 3Degrees Letter. See also WGCEF Letter (advising that "physical delivery takes place the moment that title and ownership in the environmental commodity itself is transferred from the seller to the buyer[,] whether through the execution of a legally binding contract or attestation, or submission of records to a centralized data base, such as a registry"); Letter from the Hons. Jeffrey A. Merkley, Sherrod Brown and Jeanne Shaheen, U.S. Senators, dated January 13, 2012 ("Senators Letter") (relaying that "[t]he purchase or sale of a REC is settled through the transfer of title to the REC, either electronically over a tracking system or via a paper attestation"); Letter from Harold Buchanan, Chief Executive Officer, CE2 Carbon Capital, LLC ("CE2"), dated July 22, 2011 ("CE2 Letter"); Letter from Jason M. Rosenstock, ML Strategies LLC on behalf of The Business Council for Sustainable Energy ("BCSE"), dated January 24, 2012 ("BCSE Letter"); NEMA Letter (stating that RECs must be physically settled through a REC registry, which "ensures that there is a physical megawatt hour from a green generator behind the REC").

transaction in the commodity physically settles for purposes of the forward exclusion.[287] Another commenter contended that title transfer constitutes physical delivery because the settlement results in the environmental commodity being consumed to meet an environmental obligation or goal, which occurs through "retirement" of the environmental commodity.[288] Other commenters compared the settlement of a transaction in an environmental commodity through an electronic registry system to a warehouse receipt that represents title to a physical commodity.[289]

A few commenters also analogized environmental commodities to securities, which (with the exception of certificated securities) are intangible. Some commenters, for example, asserted that the language of the forward exclusion from the swap definition means that non-physical items can be physically settled because the exclusion, which references securities, "implies that securities – which lack a strict physical existence – may be physically settled."[290]

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287 See 3Degrees Letter. See also GreenX Letter (stating that environmental commodities share the same characteristics as tangible physical commodities "in all key respects," including that they are in limited supply).

288 See CRS Letter. CRS explains that retirement occurs through a registry or electronic tracking system by transfer into a retirement account (or, alternatively, an exchange of paperwork) and that, once retired, an environmental commodity cannot be resold. The CRS also argues that such environmental commodity transactions are commercial merchandising transactions, and thus may be forward contracts, because the primary purpose of the transactions is to transfer ownership so that the purchaser may comply with an applicable environmental program. See also 3Degrees Letter and AWEA Letter.

289 See Letter from Josh Lieberman, General Manager, Renewable Energy Markets Association ("REMA"), dated July 22, 2011 ("REMA Letter") (distinguishing RECs, which allow the buyer to own environmental attributes, from a pure financial swap, where only price risk is transferred); See also GreenX Letter (likening the settlement of an environmental commodity transaction (where delivery typically would take place by electronic delivery from the registry account of the seller to the registry account of the buyer) to that of transactions in many tangible physical commodities, such as agricultural commodities and metals, where settlement is evidenced by an electronic transfer of a warehouse receipt in the records of the warehouse and the underlying commodity does not move — it remains in the warehouse or vault — but its ownership changes)).

290 See CRS Letter. See also CERP Letter (claiming that Congress did not intend for the phrase "physically settled" in the forward exclusion to be limited to tangible commodities because, like environmental commodities, securities only exist "on paper."). See also AWEA Letter.

Some commenters assured the Commissions that applying the forward exclusion to transactions in environmental commodities would not permit transactions that should be subject to the swap regulatory regime to fall outside it. One commenter submitted that intent to deliver with respect to environmental commodities will be readily determinable.[291] Another commenter contended that: environmental commodity contracts almost universally require delivery and that failure to do so is an event of default; to the best of its knowledge, it is rare for such a contract to include the right to unilaterally terminate an agreement under a pre-arranged contractual provision permitting financial settlement;[292] and defaults generally are the result of something frustrating parties' intentions.[293] Still other commenters distinguished environmental commodities from other intangible commodities, such as the nonfinancial commodities (such as interest rates and temperatures) that the CFTC referred to in its Adaptation Notice of Proposed Rulemaking,[294] because RECs and emissions allowances or offsets can be physically transferred from one account to another, whereas "it is not possible to move and physically transfer an interest rate or a temperature reading."[295]

As discussed above, the CFTC has addressed the foregoing concerns of commenters by providing an interpretation that agreements, contracts and transactions in environmental commodities may qualify for the forward exclusion from the swap definition.

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291 See CRS Letter ("unlike a stock or a bond, which can be resold for its cash value, purchasers of environmental commodities intend to take delivery of RECs or carbon offsets for either compliance purposes or in order to make an environmental claim regarding their renewable energy use or carbon footprint."). See also GreenX Letter.

292 Such a provision would preclude reliance on the forward exclusion.

293 See 3Degrees Letter.

294 See Adaptation of Regulations to Incorporate Swaps, 76 FR 33066, June 7, 2011.

295 See California Utilities Letter.

One commenter stated its view that the forward exclusion from the swap definition should not be available for carbon transactions because they should be standardized and conducted on open, transparent and regulated exchanges.[296] This commenter acknowledged the possibility that carbon transactions can be physically settled (as the statute requires of excluded forward contracts) but argued that, in light of the fact that there is no cost associated with making or taking delivery of carbon, there is no cost to store it, and there is no delay in delivering it, a forward exclusion for carbon transactions may allow financial speculators to escape regulation otherwise required by the Dodd-Frank Act. The CFTC believes that if a transaction satisfies the terms of the statutory exclusion, the CFTC lacks the authority to deprive the transaction of the exclusion, absent evasion.[297]

One commenter stated that "[i]n the solar industry, RECs are often traded by an individual consumer as an assignment of a right owned by that consumer."[298] This commenter also advised that many individual consumers transact forward contracts through solar REC ("SREC") aggregators at a fixed price. The CFTC notes[299] that a transaction entered into by a

296 See Letter from Michelle Chan, Director, Economic Policy Programs, Friends of the Earth, dated July 22, 2011.

297 While the commenter contended that "the intangible nature of carbon makes it much easier for speculators or those simply seeking to hedge carbon price risk to take delivery of the carbon itself rather than enter into a derivatives transaction," as the CFTC states in section VII.A.2.c), infra, deciding to enter into a forward transaction rather than a swap does not constitute evasion. Thus, if the transaction in question is a forward contract, that is the end of the analysis, absent the presence of other factors that may indicate evasion. See AWEA Letter.

298 See Letter from Katherine Gensler, Director, Regulatory Affairs, SEIA, dated August 5, 2011 ("SEIA Letter").

299 See Proposing Release at 29832 n.104.

consumer cannot be a forward transaction, and accordingly should not be the subject of an interpretation of the forward exclusion.[300]

One commenter takes the position that, because EPA emission allowances are issued in transactions with the EPA, only resales of such allowances (secondary market transactions) could be swaps because the EPA's initial issuance of allowances would be excluded from the swap definition under CEA section 1a(47)(B)(ix).[301] The CFTC declines to address the commenter's legal conclusion regarding the application of CEA section 1a(47)(B)(ix), but agrees that an emission allowance created by the EPA is a nonfinancial commodity and that agreements, contracts and transactions in such allowances may fall within the forward exclusion from the swap definition.

iv) Physical Exchange Transactions

The Commissions received a comment letter seeking clarification that physical exchange transactions are forward contracts excluded from the swap definition.[302] As described by the commenter, physical exchange transactions involve "a gas utility entering into a transaction with another gas utility or other market participant to take delivery of natural gas at one delivery point in exchange for the same quantity of gas to be delivered at an alternative delivery point . . . for the primary purpose of transferring ownership of the physical commodity in order to rationalize the delivery of physical supplies to where they are needed" at a price "generally reflecting the

300 However, in section II.B.3., infra, the Commissions provide an interpretation regarding the applicability of the swap definition to consumer transactions.

301 See Letter from Lauren Newberry, Jeffrey C. Fort, Jeremy D. Weinstein, and Christopher B. Berendt, Environmental Markets Association, dated July 21, 2011.

302 See AGA Letter.

difference in value at the delivery points."[303] This commenter stated that "exchange transactions create binding obligations on each party to make and take delivery of physical commodities [, i]n essence constituting paired forward contracts that are intended to go to physical delivery."[304] The commenter added that, to the extent an exchange transaction payment is based on an index price, such pricing is not severable from the physical exchange.[305]

The CFTC interprets the exchange transactions described by the commenter, to the extent they are for deferred delivery, as examples of transactions in nonfinancial commodities that are within the forward exclusion from the definition of the terms "swap" and "future delivery." Based on the information supplied by the commenter, they are commercial merchandising transactions, the primary purpose of which is to transfer ownership of natural gas between two parties who intend to physically settle such transactions. That exchange transactions may involve, in addition to gas deliveries at two separate delivery points, a cash payment by one party to the other reflecting the difference in value of the gas at different delivery points, or that such payment may be based on an index, does not necessarily affect the nature of the transactions as forward transactions.[306] For an exchange transaction to fall within the forward exclusion, though, the parties to the transaction must intend for the transaction to be physically settled, and

303 Id. This commenter noted that gas utilities often can receive gas at more than one interconnection or delivery point on a pipeline.

304 Id.

305 Id.

306 However, if such payment stems from an embedded option, the interpretation set forth in the embedded option section of this release, see infra part II.B.2(b)(v), also would be relevant to determining whether an exchange transaction were covered by the forward exclusion from the swap definition.

the exchange transaction must satisfy all applicable interpretations set forth herein, including that relating to book-outs.[307]

v) Fuel Delivery Agreements

The CFTC understands that fuel delivery agreements can generally be described as agreements whereby two or more parties agree to divide the cost of acquiring fuel for generation facilities based on some formula or factors, which can include, for example, their respective financial contributions to developing the source of the fuel (e.g., a natural gas field). One example of a fuel delivery agreement could involve a joint power agency providing to a municipal utility a long-term supply of natural gas from a natural gas project developed by the joint power agency and other entities to provide fuel for, among others, the joint power agency's and the municipal utility's natural gas-fired electric generating facilities. The municipal utility would pay the joint power agency through direct capital contributions to the entity formed to develop the natural gas project for the cost of developing it. In addition, the municipal utility would pay the joint power agency a monthly fee for the natural gas supplied from the natural gas project. The monthly fee would be composed of an operating cost fee component, an interstate pipeline transportation cost fee component and an operating reserve cost fee component. The municipal utility's natural gas-fired electric generating facility would be used to supply a portion of its expected retail electric load.

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307 While the commenter also states that "[g]as utilities contract with interstate pipelines for capacity rights to have their gas supplies delivered to specific delivery points," its discussion of exchange transactions appears unrelated to such capacity rights. Therefore, the CFTC's guidance on exchange transactions does not address exchange transactions with capacity elements, which, depending on their structures, may be covered by the guidance set forth in the embedded option section of this release or by the CFTC's recent Commodity Options release. See infra note 317. Conversely, that parties to an exchange transaction separately enter into a capacity transaction with a pipeline operator to transport natural gas delivered via an exchange transaction is not relevant to today's guidance regarding exchange transactions.

Such agreements are forward transactions if they otherwise meet the interpretation set forth in this release regarding the forward exclusions (e.g., no optionality other than as permitted by the interpretation). Monthly or other fees that are not in the nature of option premiums do not convert the transactions from forwards to options. Because the transactions as described above do not appear to exhibit optionality as to delivery, and no other aspect of the transactions as described above seem to exhibit optionality, the fees would not seem to resemble option premiums.[308]

vi) Cleared/Exchange-Traded Forwards

In the Proposing Release, the Commissions requested comment regarding whether forwards executed on trading platforms should fall within the forward exclusion from the swap definition and, if so, subject to what parameters.[309] One commenter requested that the CFTC adopt a non-exclusive safe harbor providing that exchange-traded contracts with respect to which more than 50 percent of contracts, on average on a rolling three-month basis, go to delivery and where 100 percent of the counterparties are commercial counterparties, are neither futures nor swaps ("50/100 Forward Safe Harbor").[310] This commenter further requested that the CFTC provide an appropriate transition period once those thresholds are breached. This commenter contended that two hallmarks of the exchange-traded forward markets, which it characterized as

308 This interpretation is limited to the facts and circumstances described herein; the CFTC is not opining on different facts or circumstances, which could change the CFTC's interpretation.

309 See Proposing Release at 29831-29832, Request for Comment 30.

310 See Letter from Peter Krenkel, President and CEO, NGX, dated Nov. 4, 2010, resubmitted by email to CFTC staff on Sept. 14, 2011 ("NGX Letter"). One other commenter addressed a related issue, asserting that the Commissions should clarify that cleared forwards between commercial participants should be permitted under the forward contract exclusion. See Ex Parte Communication among Evolution Markets Inc. ("Evolution"), Ogilvy Government Relations ("Ogilvy") and CFTC staff on May 18, 2011 at http://comments.cftc.gov/PublicComments/ViewExParte.aspx?id=197&SearchText=.

"a relatively new development," are that the participants generally are commercials and a high percentage of contracts go to delivery, notwithstanding netting of delivery obligations.[311] This commenter added that, while parties to such contracts intend to go to delivery when they enter into them, their delivery needs may change as time passes.

The CFTC declines to address this request for the 50/100 Forward Safe Harbor, which raises policy issues that are beyond the scope of this rulemaking. Should the CFTC consider the implications of the requested 50/100 Forward Safe Harbor, including possible additional conditions for relief, it would be appropriate for the CFTC to obtain further comment from the public on this discrete proposal. For the same reasons, the CFTC declines to address at this time the comment requesting that the CFTC take the view that cleared forwards between commercial participants fall within the scope of the forward contract exclusion.

b) Commodity Options and Commodity Options Embedded in Forward Contracts

i) Commodity Options[312]

The CFTC noted in the Proposing Release[313] that the statutory swap definition explicitly provides that commodity options are swaps, that it had proposed revisions to its existing options rules in parts 32 and 33 of its regulations[314] with respect to the treatment of commodity options under the Dodd-Frank Act, and that it had requested comment on those proposed revisions in that

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311 Id.

312 As used in this release, the term "commodity option" refers to an option that is subject to the CEA.

313 See Proposing Release at 29829-30.

314 17 CFR Parts 32 and 33.

rulemaking proceeding.[315] Accordingly, the CFTC did not propose an additional interpretation in the Proposing Release with respect to commodity options.

The CFTC reaffirms that commodity options are swaps under the statutory swap definition, and is not providing an additional interpretation regarding commodity options in this release. The CFTC recently addressed commodity options in the context of a separate final rulemaking and interim final rulemaking, under its plenary options authority in CEA section 4c(b).[316] There, the CFTC adopted a modified trade option exemption, and has invited public comment on the interim final rules.[317]

Comments

Several commenters in response to the Proposing Release argued that commodity options should not be regulated as swaps.[318] In general, these commenters believed that commodity options should qualify for the forward exclusion from the swap definition, emphasizing similarities between commodity options and forward contracts on nonfinancial commodities.[319]

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315 See Commodity Options and Agricultural Swaps, 76 FR 6095 (Feb. 3, 2011) (proposed).

316 7 U.S.C. 6c(b).

317 See Commodity Options, 77 FR 25320 (Apr. 27, 2012).

318 See Letter from Brian Knapp, Policy Advisor, American Petroleum Institute ("API"), dated January 31, 2012 ("API Letter"); BGA Letter; COPE Letter; ETA Letter; Just Energy Letter; NGSA/NCGA Letter; and WGCEF Letter.

319 For example, one commenter asserted that, similar to a forward contract on a nonfinancial commodity, a commodity option conveys no ability for a party to unilaterally require a financial settlement. Reasoning that both commodity options and forward contracts on nonfinancial commodities are intended to settle by physical delivery, this commenter contended that they should have the same regulatory treatment. See COPE Letter. Similarly, another commenter argued that the forward exclusion "plainly covers" commodity options because they are: (i) contracts for the sale of physical, nonfinancial commodities, (ii) for deferred delivery, and (iii) intended to be physically settled, given that purchasers have an absolute right to physical delivery and sellers have an absolute obligation to physically deliver the amounts called for by the purchasers if the option is exercised. See NGSA/NCGA Letter. A third commenter recommended that the CFTC interpret the forward exclusion "broadly" to include options that, if exercised, become forwards in nonfinancial commodities in light of the particular circumstances

The CFTC is not providing an interpretation that commodity options qualify as forward contracts in nonfinancial commodities. Such an approach would be contrary to the plain language of the statutory swap definition, which explicitly provides that commodity options are swaps.[320] This approach also would be a departure from the CFTC's and its staff's longstanding interpretation of the forward exclusion with respect to the term "future delivery,"[321] which the CFTC has determined above to apply to the forward exclusion from the swap definition as well.[322] Further, the CFTC notes that it has recently issued final and interim final rules adopting a modified version of the CFTC's existing trade option exemption.[323]

ii) Commodity Options Embedded in Forward Contracts

The CFTC is restating the interpretation regarding forwards with embedded options from the Proposing Release, but with certain modifications based on comments received. The CFTC is providing additional interpretations regarding forwards with embedded volumetric optionality, optionality in the form of evergreen and renewal provisions, and optionality with respect to delivery points and delivery dates.

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of the electricity industry, where electric companies use commodity options to efficiently meet the demands of electric customers by hedging or mitigating commercial risks due to seasonal and geographically unique weather and load patterns and fluctuations. See ETA letter. In the alternative, a fourth commenter requested that the CFTC exercise its plenary options authority under CEA section 4c(b), 7 U.S.C. 6c(b), to establish a separate regulatory regime for commodity options analogous to the trade option exemption under former CFTC Rule 32.4. See WGCEF Letter. See 17 CFR 32.4 (2011).

320 See CEA section 1a(47)(A)(i), 7 U.S.C. 1a(47)(A)(i) (defining a swap as, among other things, "a put, call . . . or option of any kind . . .for the purchase or sale . . . of . . . commodities") and CEA section 1a(47)(B), 7 U.S.C. 1a(47)(B) (not excluding commodity options from the swap definition).

321 See 1985 CFTC OGC Interpretation, supra note 245. In this regard, an option cannot be a forward under the CFTC's precedent, because under the terms of the contract the optionee has the right, but not the obligation, to make or take delivery, while under a forward contract, both parties must have binding delivery obligations: one to make delivery and the other to take delivery.

322 See supra part II.B.2(a)(i)(A).

323 See supra note 317.

As was noted in the Proposing Release, the question of the application of the forward exclusion from the swap definition with respect to nonfinancial commodities, where commodity options are embedded in forward contracts (including embedded options to cash settle such contracts), is similar to that arising under the CEA's existing forward contract exclusion from the definition of the term "future delivery."[324] The CFTC's Office of General Counsel addressed forward contracts that contained embedded options in the 1985 CFTC OGC Interpretation,[325] which recently was adhered to by the CFTC in its adjudicatory Order in the Wright case.[326] While both were issued prior to the effective date of the Dodd-Frank Act, the CFTC believes that, as was stated in the Proposing Release, it is appropriate to apply this interpretation to the treatment of forward contracts in nonfinancial commodities that contain embedded options under the Dodd-Frank Act.[327]

In Wright, the CFTC stated that it traditionally has engaged in a two-step analysis of "embedded options" in which the first step focuses on whether the option operates on the price or the delivery term of the forward contract and the second step focuses on secondary trading.[328] As was stated in the Proposing Release, these same principles can be applied with respect to the

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324 See Proposing Release at 29830.

325 See 1985 CFTC OGC Interpretation, supra note 245.

326 Wright, supra note 214.

327 See Proposing Release at 29830.

328 Wright, supra note 214, at n.5. In Wright, the CFTC affirmed the Administrative Law Judge's holding that an option embedded in a hedge-to-arrive contract did not violate CFTC rules regarding the sale of agricultural trade options. The CFTC first concluded that the puts at issue operated to adjust the forward price and did not render the farmer's overall obligation to make delivery optional. Then, turning to the next step of the analysis, the CFTC explained that "the put and [hedge-to-arrive contract] operated as a single contract, and in most cases were issued simultaneously . . . .We do not find that any put was severed from its forward or that either of [the put or the hedge-to-arrive contract] was traded separately from the other. We hold that in these circumstances, no freestanding option came into being . . . ." Id. at *7.

forward contract exclusion from the swap definition for nonfinancial commodities in the Dodd-Frank Act, too.[329] Utilizing these principles, the CFTC is providing a final interpretation that a forward contract that contains an embedded commodity option or options[330] will be considered an excluded nonfinancial commodity forward contract (and not a swap) if the embedded option(s):

1. may be used to adjust the forward contract price,[331] but do not undermine the overall nature of the contract as a forward contract;
2. do not target the delivery term, so that the predominant feature of the contract is actual delivery; and
3. cannot be severed and marketed separately from the overall forward contract in which they are embedded.[332]

In evaluating whether an agreement, contract, or transaction qualifies for the forward contract exclusions from the swap definition for nonfinancial commodities, the CFTC will look to the specific facts and circumstances of the transaction as a whole to evaluate whether any embedded optionality operates on the price or delivery term of the contract, and whether an embedded

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329 See Proposing Release at 29830.

330 Options in the plural would include, for example, a situation in which the embedded optionality involves option combinations, such as costless collars, that operate on the price term of the agreement, contract, or transaction.

331 For example, a forward with an embedded option with a formulaic strike price based on an index value that may not be known until after exercise would be a forward if it meets the rest of the 3 components of this interpretation. Triggering an option to buy or sell one commodity based on the price of a different commodity reaching a specified level, such as in a cross-commodity transaction, does not constitute an adjustment to the forward contract price within the meaning of this 3-part interpretation.

332 See Wright, supra note 214, at **6-7.

commodity option is marketed or traded separately from the underlying contract.[333] Such an approach will help assure that commodity options that should be regulated as swaps do not circumvent the protections established in the Dodd-Frank Act through the forward contract exclusion for nonfinancial commodities instead.

The CFTC also is providing an interpretation, in response to commenters,[334] with respect to forwards with embedded volumetric optionality.[335] Several commenters asserted that agreements, contracts, and transactions that contain embedded "volumetric options," and that otherwise satisfy the terms of the forward exclusions, should qualify as excluded forwards, notwithstanding their embedded optionality.[336] The CFTC believes that agreements, contracts,

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[333] This facts and circumstances approach to determining whether a particular embedded option takes a transaction out of the forward contract exclusion for nonfinancial commodities is consistent with the CFTC's historical approach to determining whether a particular embedded option takes a transaction out of the forward contract exclusion from the definition of the term "future delivery" in the CEA. See id. at *5 ("As we have held since Stovall, the nature of a contract involves a multi-factor analysis . . . .").

[334] The CFTC requested comment on, among other things: whether there are other factors that should be considered in determining how to characterize forward contracts with embedded options with respect to nonfinancial commodities; and whether there are provisions in forward contracts with respect to nonfinancial commodities, other than delivery and price, containing embedded optionality. See Proposing Release at 29832.

[335] One commenter characterized "volumetric optionality" as the optionality in a contract settling by physical delivery and used to meet varying customer demand for a commodity." See WGCEF Letter. See also BGA Letter (stating that "it is commonplace for energy suppliers to enter into commercial transactions with customers (local distribution companies, electric utility companies, industrial, commercial and residential customers, power plants, etc.), which provide volumetric, price and delivery-related flexibility and variability"). BGA claims that commercial transactions containing embedded volumetric optionality "include, but are not limited to, full requirements contracts, interruptible load agreements, capacity contracts, tolling agreements, energy management agreements, natural gas transportation contracts and natural gas storage contracts." Id.

[336] See, e.g., WGCEF Letter (submitting that "'volumetric optionality' is [a] separate and distinct concept from 'deliverability optionality'"); BGA Letter; AGA Letter; Letter from Jeffrey Perryman, Director, Contracts and Compliance, Atmos Energy Holdings, Inc. ("Atmos"), dated July 22, 2011 ("Atmos Letter"); NGSA/NCGA Letter; Letter from Paul M. Architzel, Wilmer Hale LLP on behalf of ONEOK, Inc. ("ONEOK"), dated July 22, 2011 ("ONEOK Letter"); COPE Letter.

and transactions with embedded volumetric optionality may satisfy the forward exclusions from the swap and future delivery definitions under certain circumstances. Accordingly, the CFTC is providing an interpretation that an agreement, contract, or transaction falls within the forward exclusion from the swap and future delivery definitions, notwithstanding that it contains embedded volumetric optionality, when:

1. the embedded optionality does not undermine the overall nature of the agreement, contract, or transaction as a forward contract;
2. the predominant feature of the agreement, contract, or transaction is actual delivery;
3. the embedded optionality cannot be severed and marketed separately from the overall agreement, contract, or transaction in which it is embedded;[337]
4. the seller of a nonfinancial commodity underlying the agreement, contract, or transaction with embedded volumetric optionality intends, at the time it enters into the agreement, contract, or transaction to deliver the underlying nonfinancial commodity if the optionality is exercised;
5. the buyer of a nonfinancial commodity underlying the agreement, contract or transaction with embedded volumetric optionality intends, at the time it enters into the agreement, contract, or transaction, to take delivery of the underlying nonfinancial commodity if it exercises the embedded volumetric optionality;
6. both parties are commercial parties;[338] and

337 When a forward contract includes an embedded option that is severable from the forward contract, the forward can remain subject to the forward contract exclusion, if the parties document the severance of the embedded option component and the resulting transactions, i.e. a forward and an option. Such an option would be subject to the CFTC's regulations applicable to commodity options.

7. the exercise or non-exercise of the embedded volumetric optionality is based primarily on physical factors,[339] or regulatory requirements,[340] that are outside the control of the parties and are influencing demand for, or supply of, the nonfinancial commodity.[341]

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338 See discussion in section II.B.2.(a)(i)(B), supra.

339 See, e.g., BGA Letter (advising that "[v]ariability associated with an energy customer's physical demand is influenced by factors outside the control of . . . energy suppliers (and sometimes . . . consumers) . . . including, but not limited to, load growth, weather and certain operational considerations (e.g., available transportation capacity to deliver physical natural gas purchased on the spot market)").

340 Volumetric optionality in this category would include, for example, a supply contract entered into to satisfy a regulatory requirement that a supplier procure, or be able to provide upon demand, a specified volume of commodity (e.g., electricity). To the extent the optionality covers an amount of the commodity in excess of the regulatory requirement, such optionality would not necessarily be covered by this aspect of the guidance, though it may nevertheless be covered by the guidance if such excess volumetric optionality is based on physical factors within the meaning of the guidance. For example, the California Utilities explained that the California Public Utilities Commission ("CPUC") requires them to file a supply plan with the CPUC demonstrating that they have procured sufficient capacity resources (including reserves) needed to serve their aggregate system load on a monthly and yearly basis. See California Utilities Letter. Each utility's system requirement is 100 percent of its peak-hourly forecast load plus a 15-17 percent reserve margin. The California Utilities enter into resource adequacy agreements to procure electric power generating capacity to meet these requirements. The ability to call on the additional 15 to 17% reserve reflected in such an agreement is covered by the regulatory requirements part of this element. To the extent the California Utilities may have a business need to procure additional capacity resources beyond the foregoing regulatory requirement (e.g., because they wish to maintain a slightly larger reserve margin than required due to a recent upswing in unscheduled plant outages due to aging plants), that may be covered under the interpretation if the additional capacity is required due to physical factors beyond the control of the parties (i.e., the unscheduled outage, in the foregoing example).

341 In other words, the predominant basis for failing to exercise the option would be that the demand or supply (as applicable) that the optionality was intended to satisfy, if needed, never materialized, materialized at a level below that for which the parties contracted or changed due to physical factors or regulatory requirements outside the parties' control. Such failure to exercise, or an exercise for a reduced amount of the underlying commodity, could, for example, be due to colder than expected weather during the summer decreasing demand for air conditioning, in turn decreasing demand for power to run the air conditioning. The Commission does not interpret this to mean that absolutely all factors involved in the decision to exercise an option must be beyond the parties' control, but rather the decision must be predominantly driven by factors affecting supply and demand that are beyond a parties control. This also means that the forward contract with embedded volumetric optionality needs to be a commercially appropriate method for securing the purchase or sale of the nonfinancial commodity for deferred shipment at the time it is

The first two elements of the interpretation for embedded volumetric optionality, which mirror the CFTC's historical embedded option interpretation discussed above, have been modified to reflect that embedded volumetric optionality relates to delivery rather than price. As noted above, the predominant feature of a forward contract is a binding, albeit deferred, delivery obligation. It is essential that any embedded option in a forward contract as to volume must not undermine a forward contract's overall purpose.[342] The CFTC recognizes that the nature of commercial operations are such that supply and demand requirements cannot always be accurately predicted and that forward contracts that allow for some optionality as to the amount of a nonfinancial commodity actually delivered offer a great deal of value to commercial participants. Where an agreement, contract, or transaction requires delivery of a non-nominal volume of a nonfinancial commodity, even if an embedded volumetric option is exercised, the CFTC believes that the predominant feature of the contract, notwithstanding the embedded volumetric optionality, is actual delivery. This is the case in many forward contracts that have an embedded option that allows a party to buy or sell an additional amount of a commodity beyond the fixed amount called for in the underlying forward contract. For instance, a forward contract could call for the delivery of 10,000 bushels of wheat and include an option for an additional 5,000 bushels of wheat.[343]

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entered into. The CFTC cautions market participants that, to the extent a party relies on the forward exclusion from the swap or future delivery definitions, notwithstanding that there is volumetric optionality, if that volumetric optionality is inconsistent with the seventh element of the interpretation, the agreement, contract or transaction may be an option.

342 See discussion in part II.B.2.(a)(i)(B), supra. See also supra note 321.

343 In evaluating whether the predominant feature of a transaction is actual delivery, the CFTC will look at the contract as a whole. Thus, with respect to this contract, the CFTC would consider the intent element of the forward exclusions to be satisfied because the contract requires the seller to deliver a non-nominal volume of a commodity (i.e., 10,000 bushels of wheat), viewing the contract as a whole. As a result, if the other elements of the guidance above are satisfied, this

The third element is substantially the same as the third element of the interpretation above with respect to commodity options embedded in forward contracts generally.

The fourth and fifth elements are designed to ensure that both parties intend to make or take delivery (as applicable), subject to the relevant physical factors or regulatory requirements, which may lead the parties to deliver more or less than originally intended. This distinguishes a forward contract from a commodity option, where only the option seller must at all times be prepared to deliver during the term of the option. The sixth element is intended to ensure that the interpretation is not abused by market participants not engaged in a commercial business involving the nonfinancial commodity underlying the embedded volumetric optionality.[344]

The seventh element is based on comments stating that parties to agreements, contracts, and transactions with embedded volumetric optionality intend to make or take delivery (as applicable) of a commodity, and that it is merely the volume of a commodity that would be required to be delivered if the option is exercised, that varies. It is designed to ensure that the volumetric optionality is primarily driven by physical factors or regulatory requirements that influence supply and demand and that are outside the parties' control, and that the optionality is a

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contract would be a forward contract, even if the party did not exercise the option for the additional 5,000 bushels.

344 The fact that the CFTC is expressly including the fourth through sixth elements in the embedded optionality guidance for volumetric options but not elsewhere does not mean that intent to deliver and the ability to make or take delivery expressed in these elements are not part of the facts and circumstances the CFTC will consider in the context of determining whether other agreements, contracts, and transactions qualify for the forward exclusions. Intent to deliver and the ability to make or take delivery have long been a part of the CFTC's facts-and-circumstances approach to making that determination, and they remain so. The CFTC is emphasizing these elements in this guidance because the CFTC has not previously expressed the view that an agreement, contract, or transaction with embedded volumetric optionality which affects the delivery term may qualify as a forward if these facts and circumstances are present.

commercially reasonable way to address uncertainty associated with those factors.[345] Element seven must be interpreted with the other elements set forth here. For instance, even if the optionality is consistent with element seven, such optionality cannot undermine the overall nature of the contract as a forward contract as discussed above.

As discussed in the interpretation regarding forwards with embedded optionality discussed above, in evaluating whether an agreement, contract or transaction with embedded volumetric optionality qualifies for the forward exclusions, the CFTC will look to the relevant facts and circumstances of the transaction as a whole to evaluate whether the transaction qualifies for the forward exclusions from the definitions of the terms "swap" and "future delivery."

The CFTC is providing further interpretations to explain how it would treat some of the specific contracts described in the comment letters. According to one commenter, a "full requirements contract" can be described as a "contract where the seller agrees to provide all requirements for a specific customer's location or delivery point."[346] According to another commenter, "[a] full requirements contract . . . is a well-established concept in contract law" and

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345 See, e.g., AGA Letter (advising that "[i]n general, retail demand for natural gas is weather driven . . . as a result [of which], a gas utility's peaking supplies must have significant flexibility . . . [and g]as utilities . . . use a variety of contracts with gas suppliers to physically deal with peak periods of demand"); BGA Letter (citing gas supply curtailment due to a pipeline outage and power generation curtailment by an Independent System Operator for operational reasons as factors outside the control of energy suppliers and which could impact the amount of a commodity delivered). The CFTC understands BGA's comment to address involuntary curtailments, but also recognizes that power buyers may agree in advance that the relevant Regional Transmission Organization or Independent System Operator may, in order to maintain system reliability, curtail power deliveries to the buyers. While voluntary curtailments are within the control of the power buyer, the potential system reliability issue is not. Therefore, such voluntary curtailments would be within the guidance because, if triggered, they would be based on a physical factor (e.g., supply constraints).

346 See Letter from Keith M. Sappenfield, II, Director, US Regulatory Affairs, Encana Marketing (USA) Inc. ("Encana"), dated July 22, 2011 ("Encana Letter").

"[i]n a requirements contract, the purchaser . . . deals exclusively with one supplier."[347] This commenter added that, while the amount of commodity delivered can vary, it is based on an objective need and that the Uniform Commercial Code imposes on the buyer "an obligation to act in good faith with respect to the varying amount that is called for delivery."[348] Based upon this description, the CFTC believes that a going commercial concern with an exclusive supply contract has no option but to get its supply requirements met through that exclusive supplier consistent with the terms of the contract. Any instance where nominal or zero delivery occurred would have to be because the commercial requirements changed or did not materialize. Furthermore, any variability in delivery amounts under the contract appears to be driven directly by the buyer's commercial requirements and is not dependent upon the exercise of any commodity option by the contracting parties.

Accordingly, full requirements contracts, as described above, appear not to contain embedded volumetric options. Therefore, a full requirements contract may qualify for the forward exclusion under the same facts and circumstances analysis applicable to all other

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347 See ONEOK Letter. The CFTC notes that this commenter discussed full requirements contracts in the context of supply agreements between one of its affiliates and retail customers. If such customers are non-commercial customers, such contracts are not forwards, but nevertheless they may not be swaps under the Commissions' guidance regarding the non-exhaustive list of consumer transactions, or otherwise if they have characteristics or factors described under the consumer transaction interpretation, see infra part II.B.3.

348 See, e.g., NY UCC § 2-306(1) (stating that "[a] term which measures the quantity by the output of the seller or the requirements of the buyer means such actual output or requirements as may occur in good faith . . . ."). This commenter cited Corbin on Contracts for the proposition that the mere fact that the quantity term of the contract is "the buyer's needs or requirements" does not render the requirements contract "a mere options contract" because "the buyer's promise is not illusory . . . [but] is conditional upon the existence of an objective need for the commodity." See ONEOK Letter (citing Corbin on Contracts § 6.5 at 240-53 (1995)).

agreements, contracts, and transactions that might be forwards. The same analysis would apply to an output contract satisfying the terms of this interpretation.[349]

With respect to capacity contracts, transmission (or transportation) services agreements, and tolling agreements, the CFTC understands that: (i) capacity contracts are generally products designed to ensure that sufficient physical generation capacity is available to meet the needs of an electrical system;[350] (ii) transmission (or transportation) services agreements are generally agreements for the use of electricity transmission lines (or gas pipelines) that allow a power generator to transmit electricity (or gas supplier to transport gas) to a specific location;[351] and (iii) tolling agreements, as described by commenters, provide a purchaser the right to the capacity, energy, ancillary services and any other product derived from a specified generating unit, all based upon a delivered fuel price and agreed heat rate.[352]

Such agreements, contracts and transactions, may have features that will satisfy the "forwards with embedded volumetric optionality" interpretation discussed above, or, like full requirements contracts, may not contain embedded volumetric options and may satisfy other portions of the forward interpretations herein. For example, according to one commenter, the delivery obligations in some tolling agreements are not optional which is indicative that the predominant feature of such tolling agreements is actual delivery.[353] It is also possible, based on

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349 See Letter from Phillip G. Lookadoo, Esq., Reed Smith LLP and Jeremy D. Weinstein, Esq. on behalf of IECA dated May 23, 2012 (suggesting that output contracts, in addition to full requirements contracts, should be within the forward exclusion). An output contract has been defined as "a contract pursuant to which the obligor's duty to supply the promised commodity is quantified (and therefore limited) by reference to its production thereof." See Boyd v. Kmart Corp., 110 F.3d 73 (10th Cir. 1997).

350 See California Utilities Letter.

351 See NEMA Letter.

352 See California Utilities Letter.

353 Id.

descriptions provided to the CFTC, that tolling agreements could fit within the interpretation concerning certain physical agreements, contracts, or transactions,[354] or other interpretations herein.

Some commenters focused on forwards with embedded volumetric optionality in the natural gas industry. For example, one commenter stated that "peaking supply" natural gas contracts do not render delivery optional. Although the purchaser has the option to specify when and if the quantity of gas will be delivered on any given day, this commenter asserted that there is no cash settlement alternative. If the purchaser does not exercise the right to purchase, then the right is terminated. The seller under the transaction must deliver the entire quantity of gas that the purchaser specifies, or pay liquidated damages. Moreover, the option is not severable and cannot be marketed separately from the supply agreement itself.[355] Similarly, another commenter said that there is no ability to sever an embedded option from a natural gas forward contract. Moreover, it stated that the ability for a gas purchaser to specify a quantity of gas for a certain day is not to encourage speculative activity; rather, it is because the exact quantity of gas to be needed on that future day is unknown, and many gas purchasers have weather-dependent needs that cannot accurately be predicted in advance.[356]

Depending on the relevant facts and circumstances, these types of agreements, contracts, and transactions – capacity contracts, transmission (or transportation) services agreements, tolling agreements, and peaking supply contracts – may satisfy the elements of the "forwards with embedded volumetric options" interpretation set forth above , or may satisfy other portions

[354] See infra part II.B.2.(b)(iii).

[355] See AGA Letter.

[356] See Atmos Letter.

of this interpretation. If they do, they would fall within the forward exclusions from the swap and future delivery definitions.

In addition, the CFTC is providing an interpretation in response to a comment that contracts with evergreen or extension terms should be considered forwards.[357] The CFTC is clarifying that an extension term in a commercial contract, such as a renewal term in a five year power purchase agreement (which, due to the renewal, would require additional deliveries), is not an option on the delivery term within the meaning of the CFTC's interpretation, and consequently would not render such a contract ineligible for the forward exclusions from the definitions of the terms "swap" and "future delivery." Similarly, an evergreen provision, which automatically renews a contract (and, as such, would require additional deliveries)[358] absent the parties affirmatively terminating it, would not render such a contract ineligible for the forward exclusions from the swap or future delivery definitions.[359] When the Proposing Release stated that a forward contract containing an embedded option that does not "target the delivery term" is an excluded forward contract,[360] it meant that the embedded option does not affect the delivery amount.[361]

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357 See IECA Letter.

358 The CFTC refers in this and the prior sentence to "additional deliveries" because the IECA's example involves an agreement calling for delivery of a physical nonfinancial commodity.

359 Using extension or evergreen provisions to avoid delivery, however, as was the case with the "rolling spot" contracts at issue in CFTC v. Zelener, 373 F.3d 861 (7th Cir. 2004), could constitute evasion or violate other provisions of the CEA (e.g., CEA section 4(a), 7 U.S.C. 6(a)). This interpretation does not limit the CFTC's other interpretations in this release regarding when delivery does not occur (e.g., the Brent Interpretation).

360 See NGSA/NCGA Letter (requesting clarification of the phrase "target the delivery term.").

361 See Proposing Release at 29830, n.81.

Also, in response to a commenter,[362] the CFTC clarifies that embedded optionality as to delivery points and delivery dates will not cause a transaction that otherwise qualifies as a forward contract to be considered a swap. The CFTC emphasizes, however, that delivery must occur at some delivery point and on some date, or the lack of delivery must be due to the transaction being booked out or otherwise be consistent with the CFTC's interpretation regarding the forward exclusions from the swap and future delivery definitions.

Comments

Commenters generally supported the CFTC's proposed interpretation regarding forwards with embedded options, but many believed that it should be modified or expanded. As noted above, several commenters believed that forward contracts with embedded options that contain optionality as to the quantity/volume of the nonfinancial commodity to be delivered should qualify as forwards, and that the CFTC's proposed interpretation (which only mentions price optionality) should be modified accordingly.[363] In this regard, several commenters focused on forwards with embedded volumetric options in the natural gas industry.[364] One commenter noted that, although the 1985 CFTC OGC Interpretation distinguishes forward contracts from trade options, it is based on a limited number of agricultural contract examples, so additional guidance is needed, particularly in light of the wide range of cash market and commercial merchandising contracting practices in which delivery terms and amounts vary.[365]

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362 See COPE Letter.

363 See AGA Letter; API Letter; Atmos Letter; ONEOK Letter; NGSA/NCGA Letter; WGCEF Letter.

364 See AGA Letter; Atmos Letter.

365 See ONEOK Letter. This commenter noted that it offers its customers a number of types of contracts for delivery of natural gas under which the amount called for delivery may vary. In each of these types of contracts, this commenter stated that both parties intend the contracts to result in delivery of the commodity, as needed. The purpose of these contracts is to ensure that

In addition, another commenter requested more generally that any embedded option (for example, price, quantity, delivery point, delivery date, contract term) that does not permit a unilateral election of financial settlement based upon the value change in an underlying cash market should not render the contract a swap.[366]

As discussed above, the CFTC has provided an additional interpretation with respect to forwards with embedded volumetric options to address commenters' concerns. The CFTC also has provided an interpretation above, regarding price optionality, optionality with respect to delivery points and delivery dates specifically in response to this commenter, and optionality as to certain contract terms (such as evergreen and renewal provisions) to address particular concerns raised by commenters. The CFTC declines to adopt a more expansive approach with respect to "any" embedded option.

One commenter requested that an option to purchase or sell a physical commodity, whether embedded in a forward contract or stand alone, should either (i) fall within the statutory forward exclusion from the swap definition, or (ii) alternatively, if deemed by the CFTC to be a swap, should be exempt from the swap definition pursuant to a modified trade option exemption pursuant to CEA section 4c(b).[367] The CFTC has modified its proposed interpretation regarding forwards with embedded options as discussed above; contracts with embedded options that are

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customers, most of which are gas or electric utilities, have an adequate supply of natural gas regardless of day-to-day changes in demand that may be caused by variation in weather, operational considerations, or other factors. They are not designed for one-way price protection as would be the case with an option. See ONEOK Letter.

366 See COPE Letter, Appendix.

367 See WGCEF Letter; 7 U.S.C. 6c(b).

swaps under this final interpretation may nevertheless qualify for the modified trade option exemption recently adopted by the CFTC and discussed above.[368]

Another commenter urged the CFTC to broadly exempt commercial forward contracting from swap regulation by generally excluding from the swap definition any forward contract with embedded optionality between end users "whose primary purpose is consistent with that of an 'end user', and in which any embedded option is directly related to 'end use.'"[369] The CFTC believes that this interpretation is vague and overbroad, and declines to adopt it.

Another commenter believed that the CFTC's "facts and circumstances" approach to forwards with embedded options does not provide the legal certainty required by nonfinancial entities engaging in commercial contracts in the normal course of business.[370] This commenter further argued that many option-like contract terms could be determined to "target the delivery term" under a facts and circumstances analysis.[371]

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368 77 FR 25320 (Aug. 27, 2012). Encana believed that the guidance on forwards with embedded options should include embedded physical delivery options because it asserted that many of the contracts currently used by participants in the wholesale natural gas market contain an option for the physical delivery of natural gas. See Encana Letter. To the extent that Encana's comment goes beyond volumetric optionality, commodity options are discussed supra in section II.B.2(b).

369 See Letter from Roger Cryan, Vice President for Milk Marketing and Economics, National Milk Producers Federation ("NMPF"), dated July 22, 2011 ("NMPF Letter").

370 See ETA Letter. Similarly, COPE comments that a nonfinancial commodity forward contract that, "by its terms," is intended to settle physically should be permitted to contain optionality without being transformed into a swap unless such optionality negates the physical settlement element of the contract. That is, if one party can exercise an option to settle the contract financially based upon the value change in an underlying cash market, then the intent for physical settlement is not contained in "the four corners of the contract" and may render the contract a swap. See COPE Letter. As discussed elsewhere in this release, the CFTC historically has eschewed approaches to the forward exclusion that rely on the "four corners of the contract," which can provide a roadmap to evasion of statutory requirements.

371 Accordingly, this commenter believed that the CFTC should provide in its rules that an embedded option or embedded optionality will not result in a nonfinancial forward being a swap unless: (i) delivery is optional; (ii) financial settlement is allowed; and (iii) transfer and trading of the option separately from the forward is permitted. See ETA Letter.

The CFTC has long applied a facts-and-circumstances approach to the forward exclusion, including with respect to forwards with embedded options, and thus it is an approach with which market participants are familiar. That approach balances the need for legal certainty against the risk of providing opportunities for evasion.[372] The CFTC's additional interpretation noted above, including clarification about the meaning of the phrase "target the delivery term," and forwards with embedded volumetric optionality, provides enhanced legal certainty in response to the commenter's concerns.[373]

Request for Comment

The CFTC's interpretation regarding forwards with volumetric options is an interpretation of the CFTC and may be relied upon by market participants. However, the CFTC believes that it would benefit from public comment about its interpretation, and therefore requests public comment on all aspects of its interpretation regarding forwards with embedded volumetric options,[374] and on the following questions:

1. Are the elements set forth in the interpretation to distinguish forwards with embedded volumetric optionality from commodity options appropriate? Why or why not?

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372 See also NCFC Letter (supporting the CFTC's guidance because it provides legal certainty).

373 See also Commodity Options, 77 FR 25320, 25324 n. 25 (Apr. 27, 2012) (discussing the CFTC's conclusion that an "option[] to redeem" under the USDA Commodity Credit Corporation's marketing loan program constitutes a cotton producer's contractual right to repay its marketing loan and "redeem" the collateral (cotton) to sell in the open market).

374 Separately, it is expected that CFTC staff will be issuing no-action relief with respect to the conditions of the modified trade option exemption (except the enforcement provisions retained in § 32.3(d)) until December 31, 2012. This extension will afford the CFTC an opportunity to review and evaluate the comments received on both the interpretation above regarding embedded volumetric optionality, and the modified trade option exemption, in order to determine whether any changes thereto are appropriate.

2. Are there additional elements that would be appropriate? Please describe and provide support for why such elements would serve to distinguish forwards with embedded volumetric optionality from commodity options.

3. Is the seventh element that, to ensure that an agreement, contract, or transaction with embedded volumetric optionality is a forward and not an option, the volumetric optionality is based primarily on physical factors, or regulatory requirements, that are outside the control of the parties and are influencing demand for, or supply of, the nonfinancial commodity, necessary and appropriate? Why or why not? Is the statement of this element sufficiently clear and unambiguous? If not, what adjustments would be appropriate?

4. Are there circumstances where volumetric optionality is based on other factors? Please describe. Would such factors, if made a part of the interpretation, serve to distinguish forwards with embedded volumetric optionality from commodity options? If so, how?

5. Does the interpretation provide sufficient guidance as to whether agreements, contracts, or transactions with embedded volumetric optionality permitting a nominal amount, or no amount, of a nonfinancial commodity to be delivered are forwards or options, viewing the agreements, contracts, or transactions as a whole, if they satisfy the seven elements of the interpretation? Why or why not? Does this interpretation encourage evasion, or do the seven elements sufficiently distinguish forwards from agreements, contracts, and transactions that may evade commodity options regulation?

6. Is the interpretation sufficiently clear with respect to capacity contracts, transmission (or transportation) services agreements, peaking supply contracts, or tolling agreements? Why or why not? Do capacity contracts, transmission (or transportation) services agreements, peaking supply contracts, or tolling agreements generally have features that satisfy

the forwards with volumetric options interpretation included in this release? If so, which ones? If not, why not? Could these types of agreements, contracts, and transactions qualify for the forward exclusions under other parts of the interpretation set forth above? Are there material differences in the structure, operation, or economic effect of these types of agreements, contracts, and transactions as compared to full requirements contracts that are relevant to whether such agreements, contracts, and transactions are options under the CEA? Please explain. If so, what are the material differences?

7. Do the agreements, contracts, and transactions listed in question no. 6 above have embedded optionality in the first instance? Based on descriptions by commenters, it appears that they may have a binding obligation for delivery, but have no set amount specified for delivery. Instead, delivery (including the possibility of nominal or zero delivery) is determined by the terms and conditions contained within the agreement, contract, or transaction (including, for example, the satisfaction of a condition precedent to delivery, such as a commodity price or temperature reaching a level specified in the agreement, contract, or transaction). That is, the variation in delivery is not driven by the exercise of embedded optionality by the parties. Do the agreements, contracts, and transactions listed in question no. 6 exhibit these kinds of characteristics? If so, should the CFTC consider them in some manner other than its forward interpretation? Why or why not?

iii) Certain Physical Commercial Agreements, Contracts or Transactions

The CFTC is providing an interpretation in response to comments regarding certain physical commercial agreements for the supply and consumption of energy that provide flexibility, such as tolls on power plants, transportation agreements on natural gas pipelines, and natural gas storage agreements.[375] Commenters recognized that these types of agreements, contracts or transactions may have option-like features, but analogized them to leases and concluded that they were forwards rather than swaps. One commenter, for example, characterized taking power produced pursuant to a physical tolling agreement -- which can involve one party thereto providing fuel for a generation plant and having the exclusive right to take the power produced by that plant from the fuel provided -- thus, in effect, "renting" the plant to the extent the plant is used to produce power from the fuel provided -- as more akin to a lease than to an option.[376]

The CFTC will interpret an agreement, contract or transaction not to be an option if the following three elements are satisfied: (1) the subject of the agreement, contract or transaction is usage of a specified facility or part thereof rather than the purchase or sale of the commodity that is to be created, transported, processed or stored using the specified facility; (2) the agreement, contract or transaction grants the buyer the exclusive use of the specified facility or part thereof during its term, and provides for an unconditional obligation on the part of the seller to grant the buyer the exclusive use of the specified facility or part thereof;[377] and (3) the payment for the use of the specified facility or part thereof represents a payment for its use rather than the option to

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375 See BGA Letter and California Utilities Letter. This interpretation also may apply to firm transmission agreements pursuant to which transmission service may not be interrupted for any reason except during an emergency when continued delivery of power is not possible. See http://www.interwest.org/wiki/index.php?title=Firm_transmission_service.

376 See California Utilities Letter.

377 In this regard, the usage rights offered for sale should be limited to the capacity of the specified facility. While overselling such capacity would not per se be inconsistent with satisfying the terms of this interpretation, the CFTC cautions market participants that overselling not based on reasonable commercial expectations of the use of the specified facility could lead the contract to be deemed evasion and lead to an agreement, contract or transaction being considered a swap, as it would undermine the "right" being offered. For example, given physical constraints of the power grid and gas pipelines, overselling transmission or transportation capacity would be per se inconsistent with satisfying the terms of this interpretation.

use it. In such agreements, contracts and transactions, while there is optionality as to whether the person uses the specified facility, the person's right to do so is legally established, does not depend upon any further exercise of an option and merely represents a decision to use that for which the lessor already has paid. In this context, the CFTC would not consider actions such as scheduling electricity transmission, gas transportation or injection of gas into storage to be exercising an option if all three elements of the interpretation above are satisfied. As with the interpretation regarding forwards with embedded options generally, discussed above, in evaluating whether flexible physical commercial agreements that meet the 3-part test qualify for the forward exclusions, the CFTC will look to the specific facts and circumstances of the agreement, contract or transaction as a whole to evaluate whether the agreement, contract or transaction qualifies for the forward exclusions from the definitions of "swap" and "future delivery."

However, in the alternative, if the right to use the specified facility is only obtained via the payment of a demand charge or reservation fee, and the exercise of the right (or use of the specified facility or part thereof) entails the further payment of actual storage fees, usage fees, rents, or other analogous service charges not included in the demand charge or reservation fee, such agreement, contract or transaction is a commodity option subject to the swap definition.

Comments

Two commenters addressed "lease-like" physical agreements, contracts or transactions.[378] One of these commenters asserted that there are many physical commercial agreements for the supply and consumption of energy that effectively provide leases on flexible energy assets, such as tolls on power plants, transportation agreements on natural gas pipelines and natural gas

378 See BGA Letter and California Utilities Letter.

storage agreements.[379] According to this commenter, these assets have the capability to be turned on and off to meet fluctuating demand due to weather and other factors; physical contracts around these assets transfer that delivery flexibility to the contract holder. The commenter believed that these types of commercial arrangements should not be considered commodity options, but rather should be excluded forwards. The other commenter described tolling agreements as having the characteristics of a lease, in that the purchasing entity obtains the exclusive right to the use of the power plant during the term of the agreement.[380] This commenter asserted that such agreements should not be considered commodity options, but rather forwards because the obligations are not contingent. The CFTC is providing the above interpretation that these types of agreements, contracts and transactions are not commodity options if the above conditions are satisfied, but may qualify for the forward exclusions under the facts and circumstances, in response to these commenters' concerns.

iv) Effect of Interpretation on Certain Agreements, Contracts and Transactions

In the Proposing Release,[381] the CFTC requested comment regarding how its proposed interpretation concerning the forward contract exclusion would affect full requirements

[379] See BGA Letter.

[380] See California Utilities Letter.

[381] See Request for Comment 35, which stated: How would the proposed interpretive guidance set forth in this section affect full requirements contracts, capacity contracts, reserve sharing agreements, tolling agreements, energy management agreements, and ancillary services? Do these agreements, contracts, or transactions have optionality as to delivery? If so, should they—or any other agreement, contract, or transaction in a nonfinancial commodity that has optionality as to delivery—be excluded from the swap definition? If so, please provide a detailed analysis of such agreements, contracts, or transactions and how they can be distinguished from options that are to be regulated as swaps pursuant to the Dodd-Frank Act. To what extent are any such agreements, contracts, or transactions in the electric industry regulated by the Federal Energy Regulatory Commission ("FERC"), State regulatory authorities, regional transmission organizations (''RTOs''), independent system operators (''ISOs'') or market monitoring units associated with RTOs or ISOs?

contracts, reserve sharing agreements, tolling agreements, energy management agreements and ancillary services. The CFTC asked whether such agreements, contracts or transactions have optionality as to delivery and, if so, whether they, or any other agreement, contract or transaction in a nonfinancial commodity, should be excluded from the swap definition.[382]

Commenters generally believed that such types of agreements, contracts and transactions, although they may contain delivery optionality, should be considered forwards rather than swaps or commodity options.[383] By contrast, one commenter believed that traded power markets involve many types of contracts that are actually exchanges of cash flows based on referenced values and that have no relevant characteristics of physical delivery.[384]

With the exception of energy management agreements, which are discussed below, the interpretations that the CFTC has already provided above may apply to such types of agreements, contracts and transactions. Specifically, to the extent that such types of agreements,

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See Proposing Release at 29832.

382 Id.

383 See Atmos Letter; BGA Letter; California Utilities Letter; COPE Letter; ETA Letter; Encana Letter; FERC Staff Letter; IECA Letter; NEMA Letter; ONEOK Letter; and Letter from Kenneth R. Carretta, General Regulatory Counsel – Markets, PSEG Services Corp., on behalf of the Public Service Electric and Gas Company, PSEG Power LLC, and PSEG Energy Resources & Trade LLC ("PSEG Companies"), dated July 22, 2011 ("PSEG Letter").

384 See Better Markets Letter. This commenter stated that ancillary services are in substance swaps based on congestion costs between two transmission points, measured by the difference between actual prices assigned at those points by the grid operator. Capacity contracts are often documented using trading agreements for transactions in physicals, but this commenter believed that they constitute swaps that are used to hedge the price risk associated with periodic auctions of the contracts to provide reliable capacity to the grid operator. This commenter asserted that such contracts do not meet the CFTC's appropriate tests to exclude them, which should be made explicit in the guidance. This commenter stated that basic power contracts often do not meet the intent to deliver test because power buyers and sellers each schedule delivery to/from the grid, and such transactions can be settled based on readily available price differentials rather than scheduling capacity and load as a pair. At a minimum, this commenter believed that guidance should be provided to require that, in order to demonstrate intent to deliver, secondary delivery-related costs (e.g., congestion charges and penalties to which those scheduling capacity and load on the grid are subject) must be allocated by contract. Id.

contracts and transactions are forwards with embedded volumetric options, the CFTC has provided an additional interpretation in section II.B.2.b)iii) above. To the extent such types of agreements, contracts or transactions are physical commercial agreements, contracts or transactions discussed in section II.B.2.b)iii), supra, the CFTC has provided an interpretation in that section. To the extent such types of agreements, contracts and transactions are considered commodity options, the CFTC has addressed commodity options under the separate rulemaking establishing a modified trade option exemption.[385] And to the extent that such types of agreements, contracts, and transactions, such as ancillary services, occur in Regional Transmission Organizations or Independent System Operators, or entered into between entities described in section 201(f) of the Federal Power Act,[386] they may be addressed through the public interest waiver process in CEA section 4(c)(6).[387]

With regard to Energy Management Agreements ("EMAs"), in general, commenters expressed the view that EMAs are forwards, and not swaps, although they did not provide analysis to support that conclusion.[388] They also did not provide a working definition of EMAs. The CFTC understands that EMAs can cover a number of services and transactions, which can include spot, forward and swap transactions. EMAs can include services such as: (i) acting as a financial intermediary by substituting one party's credit and liquidity for those of a less credit worthy owner of illiquid energy producing assets (i.e. the other party to the EMA) to facilitate

385 See supra note 317.

386 16 U.S.C. 824(f).

387 7 U.S.C. 6(c)(6).

388 See, e.g., Encana Letter and BGA Letter.

the owner's purchase of fuel and sale of power;[389] (ii) providing market information to assist the owner in developing and refining a risk-management plan for the plant;[390] and (iii) procuring fuel, arranging delivery and storage, selling excess power not needed to serve load for another party.[391] The entity carrying out these activities may receive a portion of the revenue generated from such activities as compensation for its efforts. Because commenters did not provide a working definition of EMAs, the CFTC cannot state categorically that EMAs are or are not swaps. However, if the fuel acquisition, sales of excess generation and any other transactions executed under the auspices of an EMA are not swaps, nothing about the fact that the transactions are executed as a result of or pursuant to an EMA transforms the transactions into swaps. For example, if one party hires another party to enter into spot or forward transactions on its behalf, the fact that their relationship is governed by an EMA does not render those transactions swaps.[392] Conversely, were swaps to be executed by one party on behalf of another party as a result of, or pursuant to, an EMA, the parties thereto would need to consider their respective roles thereunder (e.g. principal versus agent) and whether commodity trading advisor, introducing broker, futures commission merchant, or other registration or other elements of the Dodd-Frank Act regime were implicated. At a minimum, the fact that a swap was executed would implicate reporting and recordkeeping requirements.[393]

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389 See, e.g., The Royal Bank of Scotland Group plc, Order Approving Notice to Engage in Activities Complementary to a Financial Activity, 2008 Federal Reserve Bulletin volume 94.

390 Id.

391 See, e.g., Energy Management Agreement between Long Island Lighting Company and Long Island Power Authority, available at http://www.lipower.org/pdfs/company/papers/contract/energy.pdf.

392 Similarly, using an EMA would not render swaps entered as a result of or pursuant to an EMA spot or forward transactions.

393 This interpretation is limited to the facts and circumstances described herein; the CFTC is not opining on different facts or circumstances, which could change the CFTC's interpretation.

v) Liquidated Damages Provisions

The Commissions also received several comments discussing contractual liquidated damages provisions. The CFTC is clarifying that the presence, in an agreement, contract, or transaction involving physical settlement of a nonfinancial commodity, of a liquidated damages provision (which may be referred to by another name, such as a "cover costs" or "cover damages" provision) does not necessarily render such an agreement, contract, or transaction ineligible for the forward exclusion.[394] Such a provision in an agreement, contract, or transaction is consistent with the use of the forward exclusion, provided that the parties intend the transaction to be physically settled.[395] However, liquidated damages provisions can be used to mask a lack of intent to deliver.[396] In light of the possibility for evasion of the Dodd-Frank Act, the CFTC will continue to utilize its historical facts-and-circumstances approach in determining whether the parties to a particular agreement, contract, or transaction with a liquidated damage provision have the requisite intent to deliver.

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394 With respect to performance guarantees, the fact that a failure to deliver a nonfinancial commodity triggers a payment under a performance guaranty does not excuse the performance, nor render delivery optional. Accordingly, such a payment trigger would not itself preclude an agreement, contract, or transaction from being covered by the forward exclusion from the swap or future delivery definitions. But see supra part II.B.1.g), which provides that the CFTC is interpreting the term "swap" (that is not a security-based swap or mixed swap) to include a guarantee of such swap, to the extent that a counterparty to a swap position would have recourse to the guarantor in connection with the position.

395 See 1985 CFTC OGC Interpretation, supra note 245 (stating generally that while "[s]ome contracts provide for a liquidated damages of penalty clause if the producer fails to deliver, the presence of such clauses in a contract does not change the analysis of the nature of the contract [if] . . . it is intended that delivery of the physical crop occur, absent destruction of all or a portion of the crop by forces which neither party can control"). See generally Corbin on Contracts § 58.1 (characterizing liquidated damages provisions as designed to "[d]etermin[e] the amount of damages that are recoverable for a breach of contract").

396 In that regard, see 1985 CFTC OGC Interpretation, supra note 245 (stating that "a contract provision which permitted a producer to avoid delivery for a reason other than for an intervening condition not in the control of either party could change any conclusion about the nature of the contract").

Comments

One commenter notes that a commercial merchandising arrangement involving a nonfinancial commodity may provide that the remedy for a failure to make or take delivery is the payment of a market-rate replacement price, a payment on a performance guaranty, or "cover damages" to compensate the non-breaching party for the failure of the other party to fulfill its contractual obligations.[397] Such a contractual damages or remedy provision, this commenter contended, is not analogous to a financial settlement option in a trading instrument.[398] This commenter further asserted that one party or the other may be unable to perform, or excused or prevented for commercial reasons from performing, its contractual obligations to make or take delivery of a nonfinancial commodity, and therefore may be liable to the other party for a monetary payment, calculated in accordance with the contract.[399]

Another commenter noted that physically settled gas contracts, including peaking contracts (both for daily and monthly supply), bullet day contracts and weather contracts, use the NAESB Base Contract, which does not provide for financial settlement other than a liquidated damages provision, which would compensate a utility for its cost of obtaining alternative supply

397 See ETA Letter.

398 Id. This commenter cited FERC Order No. 890, which recognizes that "[w]hile any party to any contract can choose to fail to perform, that does not convey a contractual right to fail to perform" and that the Edison Electric Institute Master Power Purchase and Sale Agreement ("EEI MPPSA") clearly obligates the supplier to provide power, except in cases of force majeure. As the ETA explains, "[t]he EEI MPPSA is a master agreement frequently used to document transactions for deferred delivery and receipt of nonfinancial electric energy, and the terms of the ISDA North American Power Annex contain substantially identical master agreement provisions . . . ." Id.

399 According to this commenter, parties typically include liquidated damages provisions in their agreements, contracts and transactions to address situations in which "one party or the other may be unable, excused or prevented for commercial reasons from performing its contractual obligations to deliver or receive [the relevant commodity]," not to serve as "a financial settlement 'option' analogous to a financial settlement option in a trading instrument." Id.

at the prevailing market price if the seller fails to deliver.[400] This commenter stated its view that the seller has no real opportunity to arbitrage its obligation to deliver based on changes in price, and the purchaser has no incentive to fail to take delivery of its specified quantities of gas, because they are needed for the physical operations of its system.[401]

The CFTC generally agrees with these comments regarding liquidated damages provisions, and has provided the final interpretation described above to address them.

c) Security Forwards[402]

As the Commissions stated in the Proposing Release, the Commissions believe it is appropriate to address how the exclusions from the swap and security-based swap definitions apply to security forwards and other purchases and sales of securities.[403] The Commissions are restating the interpretation set out in the Proposing Release without modification.

The Dodd-Frank Act excludes purchases and sales of securities from the swap and security-based swap definitions in a number of different clauses.[404] Under these exclusions, purchases and sales of securities on a fixed or contingent basis[405] and sales of securities for

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400 See AGA Letter.

401 Id. See also Atmos Letter (stating that there is no financial incentive for a seller to fail to deliver natural gas under contracts used in the natural gas industry, as the standard remedy for such a failure to deliver is to pay liquidated damages sufficient to compensate the purchaser for having to obtain its required natural gas).

402 The discussion above regarding the exclusion from the swap definition for forward contracts on nonfinancial commodities does not apply to the exclusion from the swap and security-based swap definitions for security forwards or to the distinction between security forwards and security futures products.

403 See Proposing Release at 29830.

404 See sections 1a(47)(B)(ii), (v), and (vi) of the CEA, 7 U.S.C. 1a(47)(B)(ii), (v), and (vi).

405 See section 1a(47)(B)(v) of the CEA, 7 U.S.C. 1a(47)(B)(v) (excluding from the swap and security-based swap definitions "any agreement, contract, or transaction providing for the purchase or sale of 1 or more securities on a fixed basis that is subject to [the Securities Act and Exchange Act]"); and section 1a(47)(B)(vi) of the CEA, 7 U.S.C. 1a(47)(B)(vi) (excluding from the swap and security-based swap definitions "any agreement, contract, or transaction providing

deferred shipment or delivery that are intended to be physically delivered[406] are explicitly excluded from the swap and security-based swap definitions.[407] The exclusion from the swap and security-based swap definitions of a sale of a security for deferred shipment or delivery involves an agreement to purchase one or more securities, or groups or indexes of securities, at a future date at a certain price.

As with other purchases and sales of securities, security forwards are excluded from the swap and security-based swap definitions. The sale of the security in this case occurs at the time the forward contract is entered into with the performance of the contract deferred or delayed.[408] If such agreement, contract, or transaction is intended to be physically settled, the Commissions believe it would be within the security forward exclusion and therefore outside the swap and security-based swap definitions.[409] Moreover, as a purchase or sale of a security, the Commissions believe it also would be within the exclusions for the purchase or sale of one or more securities on a fixed basis (or, depending on its terms, a contingent basis) and, therefore, outside the swap and security-based swap definitions.[410]

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for the purchase or sale of 1 or more securities on a contingent basis that is subject to [the Securities Act and Exchange Act], unless the agreement, contract, or transaction predicates the purchase or sale on the occurrence of a bona fide contingency that might reasonably be expected to affect or be affected by the creditworthiness of a party other than a party to the agreement, contract, or transaction").

406 See section 1a(47)(B)(ii) of the CEA, 7 U.S.C. 1a(47)(B)(ii).

407 The Commissions note that calling an agreement, contract, or transaction a swap or security-based swap does not determine its status. See supra part II.D.1.

408 A purchase or sale of a security occurs at the time the parties become contractually bound, not at the time of settlement (regardless of whether cash or physically settled). See Securities Offering Reform, 70 FR 44722 (Aug. 3, 2005).

409 See section 1a(47)(B)(ii) of the CEA, 7 U.S.C. 1a(47)(B)(ii).

410 See sections 1a(47)(B)(v) and (vi) of the CEA, 7 U.S.C. 1a(47)(B)(v) and (vi).

In the Proposing Release, the Commissions provided the following specific interpretation in the context of forward sales of mortgage-backed securities ("MBS") guaranteed or sold by the Federal National Mortgage Association ("Fannie Mae"), the Federal Home Loan Mortgage Corporation ("Freddie Mac"), and the Government National Mortgage Association ("Ginnie Mae").[411] The Commissions are restating their interpretation regarding such forward sales.

MBS guaranteed or sold by Fannie Mae, Freddie Mac and Ginnie Mae are eligible to be sold in the "To-Be-Announced" ("TBA") market, which is essentially a forward or delayed delivery market.[412] The TBA market has been described as one that "allows mortgage lenders essentially to sell the loans they intend to fund even before the loans are closed."[413] In the TBA market, the lender enters into a forward contract to sell MBS and agrees to deliver MBS on the settlement date in the future. The specific MBS that will be delivered in the future may not yet be created at the time the forward contract is entered into.[414] In a TBA transaction, the seller and the buyer agree to five terms before entering into the transaction: (i) the type of security, which will usually be a certain type of MBS guaranteed or sold by Fannie Mae, Freddie Mac or Ginnie Mae and the type of mortgage underlying the MBS; (ii) the coupon or interest rate; (iii) the face value (the total dollar amount of MBS the purchaser wishes to purchase); (iv) the price; and (v)

411 The Commissions provided the interpretation in the Proposing Release in response to commenters on the ANPR. See Proposing Release at 29830. These commenters requested clarification that forward sales of MBS guaranteed or sold by Fannie Mae, Freddie Mac and Ginnie Mae would not be included in the swap and security-based swap definitions in order to provide the certainty needed to avoid unnecessary disruption of this market. Id.

412 Task Force on Mortgage-Backed Securities Disclosure, "Staff Report: Enhancing Disclosure in the Mortgage-Backed Securities Markets," part II.E.2 (Jan. 2003), which is available at http://www.sec.gov/news/studies/mortgagebacked.htm ("MBS Staff Report").

413 Id.

414 Id.

the settlement date.[415] The purchaser will contract to acquire a specified dollar amount of MBS, which may be satisfied when the seller delivers one or more MBS pools at settlement.[416]

The Commissions are confirming that such forward sales of MBS in the TBA market would fall within the exclusion for sales of securities on a deferred settlement or delivery basis even though the precise MBS are not in existence at the time the forward MBS sale is entered into.[417] Moreover, as the purchase or sale of a security, the Commissions also are confirming that such forward sales of MBS in the TBA market would fall within the exclusions for the purchase or sale of one or more securities on a fixed basis (or, depending on its terms, a contingent basis) and therefore would fall outside the swap and security-based swap definitions.[418]

Comments

The Commissions received two comments on the interpretation regarding security forwards. One commenter recommended that the Commissions codify in the text of the final rules the interpretation regarding forward sales of MBS in the TBA market.[419] The Commissions

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415 Id.

416 Id. The good delivery guidelines, titled "Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities," which govern the mechanics of trading and settling MBS, contain specific guidelines for trading and settling MBS guaranteed or sold by Fannie Mae, Freddie Mac and Ginnie Mae in the TBA market. The good delivery guidelines outline the basic terms and conditions for trading, confirming, delivering and settling MBS. The good delivery guidelines set forth the basic characteristics that MBS guaranteed or sold by Fannie Mae, Freddie Mac and Ginnie Mae must have to be able to be delivered to settle an open TBA transaction. Id. The Securities Industry and Financial Markets Association ("SIFMA") is the successor to the Bond Market Association and publishes the good delivery guidelines, which are available at http://www.sifma.org/services/standard-forms-and-documentation/securitized-products/.

417 See section 1a(47)(B)(ii) of the CEA, 7 U.S.C. 1a(47)(B)(ii).

418 See sections 1a(47)(B)(v) and (vi) of the CEA, 7 U.S.C. 1a(47)(B)(v) and (vi).

419 See Letter from Lisa M. Ledbetter, Vice President and General Counsel, Legislative & Regulatory Affairs, Freddie Mac, Jul. 21, 2011.

are not codifying the interpretation because codification will create a bright-line test. The Commissions note that the analysis as to whether any product falls within the exclusion for sales of securities on a deferred settlement or delivery basis requires flexibility, including the consideration of applicable facts and circumstances. Because the interpretation regarding forward sales of MBS in the TBA market is based on particular facts and circumstances, the Commissions do not believe that a bright-line test is appropriate.

Another commenter suggested that the Commissions narrow the exclusion for contracts for the purchase and sale of securities for subsequent delivery as applied to security-based swaps because parties can use the formal characterization of a delivery contract for securities to disguise a transaction that is substantively a security-based swap.[420] This commenter was concerned because this commenter believes that the securities subject to such a delivery obligation are often easily convertible into cash, which facilitates cash settlement without actual delivery.[421] As such, this commenter suggested that the Commissions should provide a test for determining whether parties have a bona fide intent to deliver.[422] This commenter recommended that such test should prohibit cash settlement options in contracts for subsequent delivery and should not consider a party that frequently unwinds physical positions with cash settlements using side agreements as having the requisite intent to deliver.[423] The Commissions are not providing a test at this time for determining whether parties have a bona fide intent to deliver because the analysis as to whether sales of securities for deferred shipment or delivery are intended to be physically delivered is a facts and circumstances determination and a bright-line

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420 See Better Markets Letter.

421 Id.

422 Id.

423 Id.

test will not allow for the flexibility needed in such analysis. Further, the Commissions note that the purchase and sale of a security occurs at the time the forward contract is entered into.[424]

3. Consumer and Commercial Agreements, Contracts, and Transactions

The Commissions noted in the Proposing Release that "[c]onsumers enter into various types of agreements, contracts, and transactions as part of their household and personal lives that may have attributes that could be viewed as falling within the swap or security-based swap definition.[425] Similarly, businesses and other entities, whether or not for profit, also enter into agreements, contracts, and transactions as part of their operations relating to, among other things, acquisitions or sales of property (tangible and intangible), provisions of services, employment of individuals, and other matters that could be viewed as falling within the definitions."[426]

Commenters on the ANPR pointed out a number of areas in which a broad reading of the swap and security-based swap definitions could cover certain consumer and commercial arrangements that historically have not been considered swaps or security-based swaps.[427] Examples of such instruments cited by those commenters included evidences of indebtedness with a variable rate of interest; commercial contracts containing acceleration, escalation, or indexation clauses; agreements to acquire personal property or real property, or to obtain mortgages; employment, lease, and service agreements, including those that contain contingent payment arrangements; and consumer mortgage and utility rate caps.[428]

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424 See supra note 408.

425 See Proposing Release at 29832.

426 Id.

427 Id.

428 Id.

The Commissions also stated in the Proposing Release that they "do not believe that Congress intended to include these types of customary consumer and commercial agreements, contracts, or transactions in the swap or security-based swap definition, to limit the types of persons that can enter into or engage in them, or to otherwise to subject these agreements, contracts, or transactions to the regulatory scheme for swaps and security-based swaps."[429]

Accordingly, the Commissions proposed an interpretation in the Proposing Release to assist consumers and commercial and non-profit entities in understanding whether certain agreements, contracts, or transactions that they enter into would be regulated as swaps or security-based swaps.[430] The Commissions are adopting the interpretation set out in the Proposing Release with certain modifications in response to commenters.[431]

With respect to consumers, the Commissions have determined that the types of agreements, contracts, or transactions that will not be considered swaps or security-based swaps

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429 Id. If these types of arrangements were subject to Title VII, the persons that could enter into or engage in them could be restricted because Title VII imposes restrictions on entering into swaps and security-based swaps with persons who are not eligible contract participants ("ECPs"). See sections 723(1), 763(e), and 768(b) of the Dodd-Frank Act. The Dodd-Frank Act amended the Securities Act and the Exchange Act to require that security-based swap transactions involving a person that is not an ECP must be registered under the Securities Act and effected on a national securities exchange, and also amended the CEA to require that swap transactions involving a person that is not an ECP must be entered into on, or subject to the rules of, a board of trade designated as a contract market. Id. The Commissions note that many consumers and commercial and non-profit entities may not be ECPs. See section 1a(18) of the CEA, 7 U.S.C. 1a(18). Further, if these types of arrangements were subject to Title VII, they would be subject to the full regulatory scheme for swaps and security-based swaps created by Title VII. These requirements could increase costs for consumers and commercial and non-profit entities and potentially disrupt their ability to enter into these arrangements.

430 See Proposing Release at 29832-33.

431 See infra note 447 and accompanying text.

when entered into by consumers (natural persons) as principals (or by their agents)[432] primarily for personal, family, or household purposes, include:[433]

- agreements, contracts, or transactions to acquire or lease real or personal property, to obtain a mortgage, to provide personal services, or to sell or assign rights owned by such consumer (such as intellectual property rights);
- agreements, contracts, or transactions to purchase products or services for personal, family or household purposes at a fixed price or a capped or collared price, at a future date or over a certain time period (such as agreements to purchase for personal use or consumption nonfinancial energy commodities, including agreements to purchase home heating fuel or agreements involving residential fuel storage, in either case, where the consumer takes delivery of and uses the fuel, and the counterparty is a merchant that delivers in the service area where the consumer resides);[434]

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432. For example, a mortgage broker may arrange a rate lock on behalf of a consumer borrower.

433 The Commissions are not addressing here the applicability of any other provisions of the CEA, the federal securities laws or the Commissions' regulations to such agreements, contracts or transactions.

434 These agreements, contracts, or transactions require the parties respectively to make and take delivery of the underlying commodity to each other directly; delivery may be deferred for convenience or necessity. But see section 2(c)(2)(D) of the CEA, 7 U.S.C. 2(c)(2)(D), generally prohibiting certain leveraged, margined or financed agreements, contracts and transactions with non-ECPs when actual delivery does not occur within 28 days). The Commissions view consumer agreements, contracts, and transactions involving periodic or future purchases of consumer products and services as transactions that are not swaps. This interpretation does not extend to consumer agreements, contracts or transactions containing embedded optionality or embedded derivatives other than those discussed in the text associated with this footnote. This analysis of consumer contracts is separate from the forward contract analysis for commercial merchandising transactions discussed in supra part II.B.2. The CFTC continues to view the forward contract exclusion for nonfinancial commodities as limited to commercial merchandising transactions.

- agreements, contracts, or transactions that provide for an interest rate cap or lock on a consumer loan or mortgage, where the benefit of the rate cap or lock is realized only if the loan or mortgage is made to the consumer;
- consumer loans or mortgages with variable rates of interest or embedded interest rate options, including such loans with provisions for the rates to change upon certain events related to the consumer, such as a higher rate of interest following a default;[435]
- service agreements, contracts, or transactions that are consumer product warranties, extended service plans, or buyer protection plans, such as those purchased with major appliances and electronics;[436]
- consumer options to acquire, lease, or sell real or personal property, such as options to lease apartments or purchase rugs and paintings, and purchases made through consumer layaway plans;[437]
- consumer agreements, contracts, or transactions where, by law or regulation, the consumer may cancel the transaction without legal cause;[438] and

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435 An example of a consumer loan with a variable rate of interest is credit card debt that includes a "teaser" rate. The teaser rate is a low, adjustable introductory interest rate that is temporary.

436 One commenter indicated that such service agreements, contracts, or transactions may be regulated as insurance in some but not all states. However, the Commissions believe that it is appropriate to address these agreements, contracts, or transactions in the context of their guidance regarding consumer and commercial arrangements. See NAIC Letter.

437 The Commissions believe that options entered into by consumers that result in physical delivery of the commodity, if exercised, are not the type of agreements, contracts or transactions that Congress intended to regulate as swaps or security-based swaps. Conversely, options entered into by consumers that cash settle based on the difference between the market price and the contract price of a commodity are not within the scope of this interpretation.

438 Examples of these types of transactions include consumer transactions that may be cancelled pursuant to the Federal Reserve Board's Regulation Z, 12 CFR Part 226 (i.e. certain consumer credit transactions that involve a lien on the consumer's principal dwelling), consumer

- consumer guarantees of credit card debt, automobile loans, and mortgages of a friend or relative.

The Commissions have included in the interpretation above several additional examples of consumer arrangements that the Commissions do not consider to be swaps or security-based swaps. These additional examples have been included in response to commenters[439] and the Commissions' determination that such additional examples would assist consumers in identifying other agreements, contracts, or transactions that they enter into that would not be regulated as swaps or security-based swaps.[440]

The types of commercial agreements, contracts, or transactions that involve customary business arrangements (whether or not involving a for-profit entity) and will not be considered swaps or security-based swaps under this interpretation include:

- employment contracts and retirement benefit arrangements;
- sales, servicing, or distribution arrangements;
- agreements, contracts, or transactions for the purpose of effecting a business combination transaction;[441]

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mail/telephone orders that may be cancelled when orders have not been filled under 16 CFR Part 435, and other consumer transactions that have cancellations rights conferred by statute or regulation.

439 See supra note 96 and accompanying text. See also infra notes 436, 454 and 455 and accompanying text.

440 The additional example regarding consumer options to acquire, lease, or sell real or personal property was added in response to a commenter on the ANPR. See Letter from White & Case LLP, dated September 20, 2010. The Commissions also are providing as additional examples consumer agreements, contracts, or transactions where, by law or regulation, the consumer may cancel the transaction without legal cause, and consumer guarantees of credit card debt, automobile loans, and mortgages of a friend or relative.

441 These business combination transactions include, for example, a reclassification, merger, consolidation, or transfer of assets as defined under the federal securities laws or any tender offer subject to section 13(e) and/or section 14(d) or (e) of the Exchange Act, 15 U.S.C. 78m(e) and/or

- the purchase, sale, lease, or transfer of real property, intellectual property, equipment, or inventory;
- warehouse lending arrangements in connection with building an inventory of assets in anticipation of a securitization of such assets (such as in a securitization of mortgages, student loans, or receivables);[442]
- mortgage or mortgage purchase commitments, or sales of installment loan agreements or contracts or receivables;
- fixed or variable interest rate commercial loans or mortgages entered into by banks[443] and non-banks, including the following:
  - fixed or variable interest rate commercial loans or mortgages entered into by the Farm Credit System institutions and Federal Home Loan Banks;
  - fixed or variable interest rate commercial loans or mortgages with embedded interest rate locks, caps, or floors, provided that such embedded interest rate locks, caps, or floors are included for the sole purpose of

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78n(d) or (e). These business combination agreements, contracts, or transactions can be contingent on the continued validity of representations and warranties and can contain earn-out provisions and contingent value rights.

442 The Commissions believe that such lending arrangements included in this category are traditional borrower/lender arrangements documented using, for example, a loan agreement or indenture, as opposed to a synthetic lending arrangement documented in the form of, for example, a total return swap. The Commissions also note that securitization transaction agreements also may contain contingent obligations if the representations and warranties about the underlying assets are not satisfied.

443 While the Commissions have included fixed or variable interest rate commercial loans entered into by banks, the Commissions understand that the CEA does not apply to, and the CFTC may not exercise regulatory authority over, identified banking products, and that the definitions of the terms "security-based swap" and "security-based swap agreement" do not include identified banking products. See infra note 488, regarding identified banking products. However, such loans and mortgages provided by certain banks may not qualify as identified banking products because those banks may not satisfy the definition of "bank" for purposes of the "identified banking products" definition. See 7 U.S.C. 27(a).

providing a lock, cap, or floor on the interest rate on such loan or mortgage and do not include additional provisions that would provide exposure to enhanced or inverse performance, or other risks unrelated to the interest rate risk being addressed;

- fixed or variable interest rate commercial loans or mortgages with embedded interest rate options, including such loans or mortgages that contain provisions causing the interest rate to change upon certain events related to the borrower, such as a higher rate of interest following a default, provided that such embedded interest rate options do not include additional provisions that would provide exposure to enhanced or inverse performance, or other risks unrelated to the primary reason the embedded interest rate option is included; and

- commercial agreements, contracts, and transactions (including, but not limited to, leases, service contracts, and employment agreements) containing escalation clauses linked to an underlying commodity such as an interest rate or consumer price index.

In response to commenters,[444] the Commissions have included in the interpretation above several additional examples of commercial arrangements that the Commissions do not consider to be swaps or security-based swaps.

The Commissions intend for this interpretation to enable consumers to engage in transactions relating to their households and personal or family activities without concern that such arrangements would be considered swaps or security-based swaps. Similarly, with respect

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444 See infra notes 456 and 461 and accompanying text.

to commercial business arrangements, this interpretation should allow commercial and non-profit entities to continue to operate their businesses and operations without significant disruption and provide that the swap and security-based swap definitions are not read to include commercial and non-profit operations that historically have not been considered to involve swaps or security-based swaps.

The types of agreements, contracts, and transactions discussed above are not intended to be exhaustive of the customary consumer or commercial arrangements that should not be considered to be swaps or security-based swaps. There may be other, similar types of agreements, contracts, and transactions that also should not be considered to be swaps or security-based swaps. In determining whether similar types of agreements, contracts, and transactions entered into by consumers or commercial entities are swaps or security-based swaps, the Commissions intend to consider the characteristics and factors that are common to the consumer and commercial transactions listed above:

- they do not contain payment obligations, whether or not contingent, that are severable from the agreement, contract, or transaction;
- they are not traded on an organized market or over-the-counter; and
- in the case of consumer arrangements, they:
  - involve an asset of which the consumer is the owner or beneficiary, or that the consumer is purchasing, or they involve a service provided, or to be provided, by or to the consumer, or
- in the case of commercial arrangements, they are entered into:
  - by commercial or non-profit entities as principals (or by their agents) to serve an independent commercial, business, or non-profit purpose, and

– other than for speculative, hedging, or investment purposes.

Two of the key components reflected in these characteristics that distinguish these agreements, contracts, and transactions from swaps and security-based swaps are that: (i) the payment provisions of the agreement, contract, or transaction are not severable; and (ii) the agreement, contract, or transaction is not traded on an organized market or over-the-counter, and therefore such agreement, contract, or transaction does not involve risk-shifting arrangements with financial entities, as would be the case for swaps and security-based swaps.[445] In response to commenters,[446] the Commissions clarify that merely because an agreement, contract, or transaction is assignable does not mean that it is "traded" or that the agreement, contract, or transaction is a swap or security-based swap. An assignment of a contractual obligation must be analyzed to assure that the result is not to sever the payment obligations.

This interpretation is not intended to be the exclusive means for consumers and commercial or non-profit entities to determine whether their agreements, contracts, or transactions fall within the swap or security-based swap definition. If there is a type of agreement, contract, or transaction that is not enumerated above, or does not have all the characteristics and factors that are listed above (including new types of agreements, contracts, or transactions that may be developed in the future), the agreement, contract, or transaction will be

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445 There also are alternative regulatory regimes that have been enacted as part of the Dodd-Frank Act specifically to provide enhanced protections to consumers relating to various consumer transactions. See, e.g., the Consumer Financial Protection Act of 2010, Pub L. 111-203, tit. X, 124 Stat. 1376 (Jul. 21, 2010) (establishing the Bureau of Consumer Financial Protection to regulate a broad category of consumer products and amending certain laws under the jurisdiction of the Federal Trade Commission); the Mortgage Reform and Anti-Predatory Lending Act, Pub L. 111-203, tit. XIV, 124 Stat. 1376 (Jul. 21, 2010) (amending existing laws, and adding new provisions, related to certain mortgages). Some of these agreements, contracts, or transactions are subject to regulation by the Federal Trade Commission and other federal financial regulators and state regulators.

446 See infra note 470.

evaluated based on its particular facts and circumstances. Parties to such an agreement, contract or transaction may also seek an interpretation from the Commissions as to whether the agreement, contract or transaction is a swap or security-based swap.

Comments

Eleven commenters provided comments on the proposed interpretation set forth in the Proposing Release regarding consumer and commercial arrangements.[447] While most commenters supported the proposed interpretation, these commenters suggested certain changes.

Four commenters recommended that the Commissions codify the proposed interpretation regarding consumer and commercial arrangements.[448] The Commissions are not codifying the interpretation. The interpretation is intended to provide guidance to assist consumers and commercial and non-profit entities in evaluating whether certain arrangements that they enter into will be regulated as swaps or security-based swaps. The interpretation is intended to allow the flexibility necessary, including the consideration of the applicable facts and circumstances by the Commissions, in evaluating consumer and commercial arrangements to ascertain whether they may be swaps or security-based swaps. The representative characteristics and factors taken together are indicators that a consumer or commercial arrangement is not a swap or security-based swap and the Commissions have provided specific examples demonstrating how these characteristics and factors apply to some common types of consumer and commercial arrangements. However, as the interpretation is not intended to be a bright-line test for

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447 See BGA Letter; Letter from The Coalition for Derivatives End-Users, Jul. 22, 2011, ("CDEU Letter"); ETA Letter; Letter from Robbie Boone, Vice President, Government Affairs, Farm Credit Council, Jul. 22, 2011 ("FCC Letter"); FERC Staff Letter; Letter from Warren N. Davis, Of Counsel, Sutherland Asbill & Brennan LLP, on behalf of the Federal Home Loan Banks, Jul. 22, 2011 ("FHLB Letter"); IECA Letter; ISDA Letter; Just Energy Letter; PMAA/NEFI Letter; and SEIA Letter.

448 See ETA Letter; FERC Letter; IECA Letter; and Just Energy Letter.

determining whether a particular consumer or commercial arrangement is a swap or security-based swap, if the particular arrangement does not meet all of the identified characteristics and factors, the arrangement will be evaluated based on its particular facts and circumstances.

One commenter was concerned that the interpretation itself implicitly suggests that many types of consumer and commercial arrangements could be swaps, although none of these arrangements historically has been considered a swap.[449] The Commissions do not intend to suggest that many types of consumer and commercial arrangements that historically have not been considered swaps are within the swap or security-based swap definitions. The Commissions provided the interpretation in response to comments received on the ANPR. Commenters on the ANPR identified areas in which a broad reading of the swap and security-based swap definitions could cover certain consumer and commercial arrangements that historically have not been considered swaps or security-based swaps.[450] The Commissions believe it is appropriate to provide the interpretation to allow consumers and commercial and non-profit entities to engage in such transactions without concern that such arrangements would be considered swaps or security-based swaps.

One commenter requested that the Commissions remove the term "customary" from the description of consumer and commercial arrangements in the interpretation.[451] The Commissions note that the use of the term "customary" was not intended to limit the interpretation, but rather was used to describe certain types of arrangements that consumers and businesses may normally or generally enter into. The Commissions also note that the term

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[449] See IECA Letter.

[450] See Proposing Release at 29832.

[451] See ISDA Letter.

"customary" is itself not a separate representative characteristic or factor for purposes of the interpretation.

This commenter also requested that specific examples of consumer and commercial arrangements that are not swaps or security-based swaps include "any other similar agreements, contracts, or transactions."[452] The specific examples are not intended to be an exhaustive list and the Commissions do not believe that it is necessary to include a general catchall provision. The interpretation also includes a list of representative characteristics and factors to be used to analyze other consumer and commercial arrangements.

Several commenters suggested additional examples of consumer and commercial arrangements that the Commissions should not consider to be swaps or security-based swaps.[453] One commenter suggested that the Commissions should expand the example of "consumer agreements, contracts, or transactions to purchase products or services at a fixed price or a capped or collared price, at a future date or over a certain time period (such as agreements to purchase home heating fuel)" to include all nonfinancial energy commodities in the parenthetical example.[454] The Commissions have modified the identified consumer example to include all nonfinancial energy commodities. The parenthetical example was not intended to be limited to agreements to purchase home heating fuel.

One commenter suggested that the Commissions should include as an additional example residential fuel storage contracts.[455] The Commissions agree that these arrangements should not

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452 Id.

453 See CDEU Letter; FCC Letter; FERC Letter; FHLB Letter; ISDA Letter; Just Energy Letter; PMAA/NEFI Letter; and SEIA Letter.

454 See Just Energy Letter.

455 See PMAA/NEFI Letter.

be considered swaps or security-based swaps, provided that they are residential fuel storage contracts where the consumer takes delivery of and consumes the fuel, and the counterparty is a merchant (or agent of a merchant) that delivers in the service area where the consumer's residence is located. Although the consumer may not immediately consume the fuel contracted for, because it will ultimately consume the fuel for personal, family, or household purposes, such a transaction is a type of customary consumer transaction excluded from the swap and security-based swap definitions.

Three commenters requested clarification that commercial loans and mortgages would fall within the interpretation regardless of whether entered into by a bank or non-bank.[456] Two of these commenters were concerned that the specific example was limited to commercial loans and mortgages entered into by non-banks and did not address commercial loans and mortgages entered into by financial institutions that are banks but whose loans and mortgages do not qualify as identified banking products.[457] The Commissions are revising the example to clarify that it includes fixed or variable interest rate commercial loans or mortgages entered into by both banks and non-banks, including such loans and mortgages entered into by the Farm Credit System institutions and Federal Home Loan Banks. The Commissions understand that the CEA does not apply to, and the CFTC may not exercise regulatory authority over, and the definitions of the terms "security-based swap" and "security-based swap agreement" do not include, any fixed or variable interest rate commercial loan or mortgage entered into by a bank that is an identified banking product.[458] However, loans and mortgages provided by certain banks may not qualify as

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456 See CDEU Letter; FCC Letter; and FHLB Letter.

457 See FCC Letter and FHLB Letter.

458 See infra note 488, regarding identified banking products.

identified banking products because those banks do not satisfy the definition of "bank" for purposes of the "identified banking products" definition.[459] According to commenters,[460] while this definition of "bank" includes insured depository institutions, certain foreign banks, credit unions, institutions regulated by the Federal Reserve and trust companies, it does not include certain other financial institutions that provide commercial loans or mortgages, such as government-sponsored enterprises (including the Federal Home Loan Banks) and certain cooperatives (including the Farm Credit System institutions).

Three commenters suggested that the Commissions should include as additional examples commercial rate lock agreements and commercial loans with interest rate caps, floors, or options.[461] The Commissions agree that these arrangements should not be considered swaps or security-based swaps, provided that the interest rate locks, caps, or floors, or interest rate options are embedded in the commercial loans or mortgages and not entered into separately from the commercial loans and mortgages, and are including these arrangements as examples in the interpretation. However, the Commissions are limiting the interpretation to embedded interest rate locks, caps, or floors, and interest rate options because interest rate locks, caps, or floors, or interest rate options that are entered into separately from the commercial loans and mortgages fall within the swap definition.[462] In order to further distinguish these arrangements from swaps

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459 See 7 U.S.C. 27(a). See also FCC Letter and FHLB Letter.

460 See supra note 457.

461 See CDEU Letter; FCC Letter; and FHLB Letter. These commenters indicated that such arrangements are similar to the arrangements included in the list of examples of consumer arrangements that the Commissions would not consider to be swaps or security-based swaps.

462 See section 1a(47)(A)(i) of the CEA, 7 U.S.C. 1a(47)(A)(i). Similarly, with respect to consumer agreements, contracts and transactions providing for an interest rate cap or an interest rate lock on a consumer loan or mortgage, the Commissions are limiting this example to interest rate caps and interest rate locks entered into in connection with the consumer loan or mortgage and prior to closing on the loan or mortgage. For this purpose, both because obtaining a consumer loan or

and security-based swaps, the interpretation provides the following: (i) the embedded interest rate lock, cap, or floor must be included for the sole purpose of providing a lock, cap, or floor on the interest rate on such loan or mortgage and may not include additional provisions that would provide exposure to enhanced or inverse performance, or other risks unrelated to the interest rate risk being addressed, and (ii) the embedded interest rate option may not include additional provisions that would provide exposure to leverage, inverse performance, or other risks unrelated to the primary reason the embedded interest rate option is included in the commercial loan or mortgage.

Four commenters suggested additional examples of commercial arrangements that relate to nonfinancial energy commodities.[463] These arrangements are more appropriately addressed in the context of the forward contract exclusion for nonfinancial commodities[464] or the trade option exemption.[465]

One commenter supported the representative characteristics and factors the Commissions set forth to distinguish consumer and commercial arrangements from swaps and security-based

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mortgage can involve a great deal of documentation, which can be entered into at different times during the process, and because consumers may have some flexibility as to their deadline for deciding when to include or exclude an interest rate cap or lock in their consumer loans or mortgages, the Commissions will consider an interest rate cap or lock to be entered into in connection with a consumer loan or mortgage if it is included in the final terms of the loan at closing.

463 See BGA Letter (commercial physical transactions in the natural gas and electric power markets should also fall under the category of exemptions from the swap definition); FERC Letter (commercial transactions executed or traded on RTOs/ISOs should be included in the interpretation); Just Energy Letter (commercial arrangements to purchase products or services at a fixed price or a capped or collared price, at a future date or over a certain time period); and PMAA/NEFI Letter (petroleum fuel and gas storage contracts between bona fide commercial market participants or entities other than financial entities).

464 See supra part II.B.2. The Commissions note that they provided the interpretation regarding consumer arrangements because the CFTC in the past has not interpreted the forward contract exclusion for nonfinancial commodities to apply to consumer arrangements. See supra note 434.

465 See supra note 317 and accompanying text.

swaps.[466] Two commenters were concerned with certain of these characteristics and factors because these commenters believed that such characteristics and factors are common in a wide variety of consumer and commercial arrangements.[467] Both commenters suggested that the Commissions remove "for other than speculative, hedging or investment purposes" from the interpretation because many of the types of transactions listed as examples may be undertaken for speculative, hedging or investment purposes and because all commercial merchandising transactions are "risk-shifting" of commercial obligations and risks, and "hedge" the enterprise's commercial risks.[468] The Commissions are not revising the interpretation to remove or otherwise modify this representative characteristic and factor. The Commissions believe that commercial arrangements undertaken for speculative, hedging or investment purposes may be a swap or a security-based swap depending on the particular facts and circumstances of the arrangement.

One of these commenters also suggested the Commissions remove "do not contain payment obligations that are severable" from the interpretation because assignment of rights and delegation of obligations are common in a wide variety of consumer and commercial transactions.[469] The Commissions are not revising the interpretation to remove or otherwise modify this representative characteristic and factor. The Commissions believe that the severability of payment obligations could be indicative of a consumer or commercial arrangement that may be a swap or a security-based swap depending on the particular facts and circumstances of the arrangement because the severability of payment obligations could be

466 See FCC Letter.

467 See ETA Letter and ISDA Letter.

468 Id.

469 See ISDA Letter.

indicative of an instrument that is merely an exchange of payments, such as is the case with swaps and security-based swaps.

One of these commenters also suggested that the Commissions remove "not traded on an organized market or over the counter" from the interpretation because many of the types of contracts listed as examples are assignable and frequently assigned or traded.[470] The other commenter did not suggest removing this factor, but requested that the factor be modified to provide that the arrangement is not traded on a "registered entity" in order not to include transactions on organized wholesale electricity markets.[471] The Commissions are not revising the interpretation to remove or otherwise modify this representative characteristic and factor. The Commissions believe that the trading of an instrument on an organized market or over the counter could be indicative of a consumer or commercial arrangement that may be a swap or a security-based swap depending on the particular facts and circumstances of the arrangement. However, as noted above, the Commissions are clarifying that merely because an arrangement is assignable does not mean that it is "traded" or that the arrangement is a swap or security-based swap. An assignment of a contractual obligation must be analyzed to assure that the result is not to sever the payment obligations.

Further, as noted above, the representative characteristics and factors are not intended to be a bright-line test for determining whether a particular consumer or commercial arrangement is a swap or security-based swap. These representative characteristics and factors taken together are indicators that a consumer or commercial arrangement is not a swap or security-based swap. These representative characteristics and factors also do not imply or presume that a consumer or

470 Id.

471 See ETA Letter.

commercial arrangement that does not meet all of these characteristics and factors is a swap or security-based swap. As noted above, if a particular arrangement does not meet all of these characteristics and factors, the parties will need to evaluate the arrangement based on the particular facts and circumstances. Moreover, as noted above, if there is a type of consumer or commercial arrangement that does not meet all of these characteristics and factors, a party to the arrangement can seek an interpretation from the Commissions as to whether the arrangement is outside the scope of the swap and security-based swap definitions.

Residential Exchange Program

One commenter requested that the CFTC further define the term "swap" to exclude consumer benefits under the Pacific Northwest Electric Power Planning and Conservation Act of 1980 ("Northwest Power Act")[472] and transactions under the "Residential Exchange Program" ("REP").[473] According to this commenter, the REP was established by Congress "[t]o extend the benefits of low cost Federal System hydro power to residential and small farm electric power consumers throughout the Pacific Northwest Region."[474] Based on the commenter's description,

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472 16 U.S.C. Chapter 12H.

473 Letter from Virginia K. Schaeffer, Attorney, Office of General Counsel, Bonneville Power Administration, Jul. 22, 2011 ("BPA Letter"). This commenter refers to the implementation of Section 5(c) of the Northwest Power Act, 16 U.S.C. 839c(c), as the "Residential Exchange Program." See Id.

474 See BPA Letter. This commenter explained that, under the REP: "a Pacific Northwest electric utility has a right to . . . sell power to Bonneville at the utility's average system cost (ASC) of providing that power . . . . Bonneville[] is required to purchase that power at the utility's ASC, and then sell an equivalent amount of power back to the utility at Bonneville's rates[,] which are based in substantial part on low cost Federal hydro power. As required by the Residential Exchange Statute, the amount of such power "exchanged" is based on the related utility's residential and small farm customer's power needs (also known as "loads") in the Pacific Northwest Region. Under this "exchange," no actual power is transferred to or from Bonneville. Instead, consistent with Congressional intent, the exchange transaction is implemented as an accounting device that avoids the costs and burdens associated with a physical exchange of power and that results in the payment of funds by Bonneville to the REP exchanging utilities. Reduced

REP transactions do not appear to be among the types of transactions historically considered swaps or security-based swaps. Although the REP transactions described by the commenter share some features with spread options (e.g., they settle in cash based on the difference between two price sources),[475] in both swaps and security-based swaps, each party assumes market risk.[476] By contrast, neither party assumes or hedges risk in an REP transaction.[477] Instead, the Commissions view an REP transaction essentially as a subsidy provided to residential and small farm utility customers.[478] Accordingly, the Commissions do not consider the REP transactions described by the commenter to be swaps or security-based swaps.

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to the essentials, the Residential Exchange Statute as implemented in . . . REP contracts results in Bonneville making cash payments for the positive difference between the utility's ASC and Bonneville's lower rate multiplied by the qualifying residential and small farm loads. And, as required under the Residential Exchange Statute, the entire monetary benefit Bonneville provides to the REP exchanging utilities is in turn passed through to the residential and small farm power consumers of that utility."

Id.

475 A spread option is "an option in which the payout is based on the difference in performance between two assets." Superderivatives, "Spread option in EQ" definition, available at http://www.sdgm.com/Support/Glossary.aspx?letter=S. See also S.J. Denga and S.S. Oren, Electricity derivatives and risk management, Science Direct at 945 (2006), available at http://www.ieor.berkeley.edu/~oren/pubs/Deng%20and%20Oren-86.pdf (defining a spark spread options as "cross-commodity options paying out the difference between the price of electricity sold by generators and the price of the fuels used to generate it"); Chicago Mercantile Exchange, Soybean-Corn Price Ratio Options Fact Card (describing its soybean-corn price ratio option contract as "an option on the ratio between the price of the referencing Soybean futures contract and the price of the referencing Corn futures contract . . . ."), available at http://www.cmegroup.com/trading/agricultural/files/AC-440-Soybean-CornRatioOptionsFC.pdf.

476 Even a hedging party assumes the risk that the market can move against its hedging position, causing the hedge to reduce the profit it otherwise would have made on an unhedged position.

477 The fact that the Commissions are relying in part on this aspect of REP transactions to interpret such transactions to be neither swaps nor security-based swaps does not mean that market participants should conclude, in other contexts, that a lack of market risk removes an agreement, contract, or transaction from the swap and security-based swap definitions. The Commissions' conclusion as to REP transactions is based on the unique facts and circumstances presented by the commenter.

478 See, e.g., Paul M. Murphy, Northwest Public Power Association, Background and Summary of the Residential Exchange Program Settlement Agreement, March 16, 2011, available at http://www.nwppa.org/cwt/external/wcpages/wcmedia/documents/background_and_summary_of

Loan Participations

The Commissions provided an interpretation in the Proposing Release regarding the treatment of loan participations.[479] The Commissions are restating the interpretation set out in the Proposing Release with certain modifications in response to commenters.[480]

Loan participations arise when a lender transfers or offers a participation in the economic risks and benefits of all or a portion of a loan or commitment it has entered into with a borrower to another party as an alternative or precursor to assigning to such person the loan or commitment or an interest in the loan or commitment.[481] The Commissions understand that two types of loan participations exist in the market today,[482] LSTA-style participations[483] and LMA-style participations.[484] LSTA-style participations transfer a beneficial ownership interest in the

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_rep_settlement_agreement.pdf (characterizing the REP as "require[ing] BPA to subsidize the residential and small farm consumers of the higher cost utilities in the Pacific Northwest").

479 See Proposing Release at 29834.

480 See infra note 504 and accompanying text.

481 See Loan Market Association, "Guide to Syndicated Loans," section 6.2.4 ("A [loan] participation…is made between the existing lender and the participant. This creates new contractual rights between the existing lender and the participant which mirror existing contractual rights between the existing lender and the borrower. However this is not an assignment of those existing rights and the existing lender remains in a direct contractual relationship with the borrower."), available at http://www.lma.eu.com/uploads/files/Introductory_Guides/Guide_to_Par_Syndicated_Loans.pdf.

482 See Letter from R. Bram Smith, Executive Director, The Loan Syndications and Trading Association, Jan. 25, 2011 ("January LSTA Letter"); Letter from Elliot Ganz, General Counsel, The Loan Syndications and Trading Association, Mar. 1, 2011 ("March LSTA Letter"); and Letter from Clare Dawson, Managing Director, The Loan Market Association, Feb. 23, 2011. The Commissions understand that neither type of loan participation is a "synthetic" transaction. See March LSTA Letter. Both types of loan participations are merely transfers of cash loan positions and the ratio of underlying loan to participation is always one to one. Id.

483 The LSTA is The Loan Syndications and Trading Association.

484 The LMA is The Loan Market Association.

underlying loan or commitment to the participant.[485] LMA-style participations do not transfer a beneficial ownership interest in the underlying loan or commitment to the participant, but rather create a debtor-creditor relationship between the grantor and the participant under which a future beneficial ownership interest is conveyed.[486]

Depending on the facts and circumstances, a loan participation may be a security under the federal securities laws and, as such, the loan participation would be excluded from the swap definition as the purchase and sale of a security on a fixed or contingent basis.[487] In addition, depending on the facts and circumstances, a loan participation may be an identified banking product and, as such, would be excluded from CFTC jurisdiction and from the security-based swap and security-based swap agreement definitions.[488]

The Commissions believe it is important to provide further guidance as to the other circumstances in which certain loan participations would not fall within the swap and security-based swap definitions. Consistent with the proposal, the Commissions do not interpret the swap and security-based swap definitions to include loan participations that reflect an ownership interest in the underlying loan or commitment. The Commissions believe that for a loan participation to not be considered a swap or security-based swap, the loan participation must

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485 See Letter from Clare Dawson, Managing Director, The LMA, Jul. 22, 2011 ("July LMA Letter").

486 See Id. The participant may exercise an "elevation" right and request that the grantor use commercially reasonable efforts to cause the participant to become the legal owner, by assignment, of the underlying loan or commitment. Id.

487 See sections 1a(47)(B)(v) and (vi) of the CEA, 7 U.S.C. 1a(47)(b)(v) and (vi), as amended by section 721(a)(21) of the Dodd-Frank Act (excluding purchases and sales of a security on a fixed or contingent basis, respectively from the swap definition).

488 See section 403(a) of the Legal Certainty for Bank Products Act of 2000, 7 U.S.C. 27a(a), as amended by section 725(g)(2) of the Dodd-Frank Act (providing that, under certain circumstances, the CEA shall not apply to, and the CFTC shall not exercise regulatory authority over, identified banking products, and the definitions of the terms "security-based swap" and "security-based swap agreement" shall not include identified banking products).

represent a current or future direct or indirect ownership interest in the loan or commitment that is the subject of the loan participation.

In evaluating whether the loan participation represents such an ownership interest, the Commissions believe the following characteristics should be present:

- The grantor of the loan participation is a lender under, or a participant or sub-participant in, the loan or commitment that is the subject of the loan participation.
- The aggregate participation in the loan or commitment that is the subject of the loan participation does not exceed the principal amount of such loan or commitment. Further, the loan participation does not grant, in the aggregate, to the participant in such loan participation a greater interest than the grantor holds in the loan or commitment that is the subject of the loan participation.
- The entire purchase price for the loan participation is paid in full when acquired and not financed. The Commissions believe a purchase price would not be paid in full if the grantor of the loan participation extends financing to the participant or if such participant levers its purchase, including by posting collateral to secure a future payment obligation.
- The loan participation provides the participant all of the economic benefit and risk of the whole or part of the loan or commitment that is the subject of the loan participation.

These characteristics, which were identified by commenters,[489] are intended to distinguish loan participations from swaps and security-based swaps based on loans. The first

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489 See infra note 504 and accompanying text. See also infra notes 490, 491, and 492 and accompanying text.

characteristic above addresses the ownership of the underlying loan or commitment. Swaps and security-based swaps may be created using a synthetic or derivative structure that does not require ownership of the underlying loan.[490] The second characteristic above addresses the ratio of the participation to the underlying loan or commitment. Swaps and security-based swaps based on loans may involve synthetic exposure to a loan that is a multiple of the principal amount.[491] The third characteristic above addresses leverage in the financing of a loan participation. Leverage could be indicative of an instrument that is merely an exchange of payments and not a transfer of the ownership of the underlying loan or commitment, such as may be the case with a swap or security-based swap.[492] The fourth characteristic above addresses the level of participation in the economic benefits and risks of the underlying loan or commitment. This characteristic is indicative of ownership when analyzed with the other characteristics and, as noted above, swaps and security-based swaps may be created using a synthetic or derivative structure that does not require ownership of the underlying loan.

The Commissions agree with commenters that the loan participation does not have to be a "true participation," as the Commissions had stated in their interpretation in the Proposing Release,[493] in order for the loan participation to fall outside the swap and security-based swap definitions.[494] The Commissions note that the "true participation" analysis is used to determine whether a transaction has resulted in the underlying assets being legally isolated from a

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490 See July LMA Letter.

491 Id.

492 Id.

493 Proposing Release at 29834.

494 See infra note 503 and accompanying text.

transferor's creditors for U.S. bankruptcy law purposes.[495] This analysis is unrelated to and does not inform whether a loan participation is a swap or security-based swap. This analysis also may be subject to varying interpretations.[496] Further, the Commissions understand that this analysis could result in certain loan participations that reflect an ownership interest in the underlying loan or commitment being included in the swap and security-based swap definitions, which the Commissions do not intend.[497]

Rather, as noted above, the Commissions believe that the analysis as to whether a loan participation is outside the swap and security-based swap definitions should be based on whether the loan participation reflects an ownership interest in the underlying loan or commitment. The Commissions understand that the characteristics noted above are indicative, based on comments received,[498] of whether a loan participation represents such an ownership interest. Further, in response to commenters,[499] the Commissions are clarifying that the interpretation applies to loan participations that are entered into both with respect to outstanding loans and with respect to a lender's commitments to lend and fund letters of credit (e.g., under a revolving credit facility).

The Commissions believe that the interpretation will prevent disruption in the syndicated loan market for loan participations. Loan participations facilitate a lender's diversification of its portfolio holdings, provide a key component of the efficient settlement process, and enhance

495 Id.

496 Id.

497 Id.

498 See supra note 482. See infra note 501.

499 See infra note 506 and accompanying text.

liquidity in the global syndicated loan market.[500] The interpretation will enable this market to continue operating as it did prior to the enactment of Title VII.

Comments

Commenters supported the interpretation that certain loan participations should not be included in the swap and security-based swaps definitions.[501] Commenters agreed with the proposal that a loan participation should represent a current and future direct or indirect ownership interest in the loan or commitment that is the subject of the loan participation.[502] However, commenters disagreed with the proposal that a loan participation should be required to be a "true participation" in order for the loan participation to fall outside the swap and security-based swap definitions because LMA-style participations do not represent a beneficial ownership in the underlying loan or commitment such that they would be considered a true participation.[503] Commenters requested that the Commissions remove this factor and instead recognize additional

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500 See January LSTA Letter.

501 See FCC Letter; Letter from Richard M. Whiting, Executive Director and General Counsel, Financial Services Roundtable, Jul. 22, 2011 ("FSR Letter"); July LMA Letter; Letter from R. Bram Smith, Executive Director, The LSTA, Jul. 22, 2011 ("July LSTA Letter"); MFA Letter; and Letter from Kenneth E. Bentsen, Jr., Executive Vice President, Public Policy and Advocacy, SIFMA, Jul. 22, 2011 ("SIFMA Letter").

502 See FSR Letter; July LMA Letter; July LSTA Letter; MFA Letter; and SIFMA Letter. Commenters indicated that both LSTA-style participations and LMA-style participations represent a current or future direct or indirect ownership interest in the related loan or commitment. Id.

503 See July LMA Letter; July LSTA Letter; MFA Letter; and SIFMA Letter. These commenters indicated that neither LMA-style participations nor certain LSTA-style participations are true participations. See July LMA Letter; July LSTA Letter; and SIFMA Letter. Further, according to the July LSTA Letter, "[l]oan market participants in the United States will likely interpret the 'true participation' requirement as a requirement that loan participations must qualify for 'true sale' treatment in order to avoid classification as a 'swap.' A 'true sale' or 'true participation' analysis is a test aimed at determining whether a transaction has resulted in the underlying assets being legally isolated from the transferor's creditors for U.S. bankruptcy law purposes. Its underlying purpose is to distinguish between a sale and a financing, not between a sale and a swap." If this is the case, certain LSTA-style participations, which typically are offered in the United States, could be determined under a "true sale" analysis to be a financing and not a true participation. See July LSTA Letter.

factors.[504] The Commissions agree that a loan participation does not have to be a true participation in order for the loan participation to fall outside the swap and security-based swap definitions and are revising the interpretation as noted above.

One commenter also indicated that loan participations are entered into both with respect to outstanding loans and with respect to a lender's commitments to lend and fund letters of credit (e.g., under a revolving credit facility).[505] This commenter requested that the Commissions revise the proposed interpretation to reflect both outstanding loans and a lender's commitments.[506] The Commissions agree and are revising the interpretation to reflect both outstanding loans and loan commitments as noted above.

C. Final Rules and Interpretations Regarding Certain Transactions Within the Scope of the Definitions of the Terms "Swap" and "Security-Based Swap"

1. In General

In light of provisions in the Dodd-Frank Act that specifically address certain foreign exchange products, the Commissions in the Proposing Release proposed rules to clarify the status of products such as foreign exchange forwards, foreign exchange swaps, foreign exchange

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504 See July LMA Letter; July LSTA Letter; MFA Letter; and SIFMA Letter. Commenters recommended that the Commissions revise the interpretation by providing that the Commissions do not interpret the swap and security-based swap definitions to include loan participations in which (1) the participant is acquiring a current or future direct or indirect ownership interest in the related loan or commitment, and (2) the agreement pursuant to which the participant is acquiring such an interest (i) is a participation agreement that is, or any similar agreement of a type that has been, is presently, or in the future becomes, customarily entered into in the primary or secondary loan markets, (ii) requires the grantor to represent that it is a lender under, or a participant or sub-participant in, the loan or commitment, (iii) provides that the participant is entitled to receive from the grantor all of the economic benefit of the whole or part of a loan or commitment to the extent of payments received by the grantor in respect of such loan or commitment, and (iv) requires that 100% of the purchase price calculated with respect to the loan or commitment is paid on the settlement date. See id. The characteristics identified by these commenters are reflected in the Commission's revised interpretation.

505 See July LMA Letter.

506 Id.

options, non-deliverable forwards involving foreign exchange ("NDFs"), and cross-currency swaps. The Commissions also proposed a rule to clarify the status of forward rate agreements and provided interpretations regarding: (i) combinations and permutations of, or options on, swaps or security-based swaps; and (ii) contracts for differences ("CFDs").

The Commissions are adopting the rules as proposed without modification and are restating the interpretations provided in the Proposing Release without modification. In addition, the Commissions are providing additional interpretations regarding foreign exchange spot transactions and retail foreign currency options.

As adopted, rule 1.3(xxx)(2) under the CEA and rule 3a69-2 under the Exchange Act explicitly define the term "swap" to include certain foreign exchange-related products and forward rate agreements unless such products are excluded by the statutory exclusions in subparagraph (B) of the swap definition.[507] In adopting these rules, the Commissions do not mean to suggest that the list of agreements, contracts, and transactions set forth in rule 1.3(xxx)(2) under the CEA and rule 3a69-2(b) under the Exchange Act is an exclusive list.

2. Foreign Exchange Products

a) Foreign Exchange Products Subject to the Secretary's Swap Determination: Foreign Exchange Forwards and Foreign Exchange Swaps

The CEA, as amended by the Dodd-Frank Act, provides that "foreign exchange forwards" and "foreign exchange swaps" shall be considered swaps under the swap definition unless the Secretary of the Treasury ("Secretary") issues a written determination that either foreign exchange swaps, foreign exchange forwards, or both: (i) should not be regulated as swaps; and (ii) are not structured to evade the Dodd-Frank Act in violation of any rule

507 See section 1a(47)(B) of the CEA, 7 U.S.C. 1a(47)(B).

promulgated by the CFTC pursuant to section 721(c) of the Dodd-Frank Act.[508] A foreign exchange forward is defined in the CEA as "a transaction that solely involves the exchange of two different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange."[509] A foreign exchange swap, in turn, is defined as:

> "a transaction that solely involves—
> (A) an exchange of 2 different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange; and
> (B) a reverse exchange of the 2 currencies described in subparagraph (A) at a later date and at a fixed rate that is agreed upon on the inception of the contract covering the exchange."[510]

Under the Dodd-Frank Act, if foreign exchange forwards or foreign exchange swaps are no longer considered swaps due to a determination by the Secretary, nevertheless, certain provisions of the CEA added by the Dodd-Frank Act would continue to apply to such transactions.[511] Specifically, those transactions still would be subject to certain requirements for

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508 See section 1a(47)(E)(i) of the CEA, 7 U.S.C. 1a(47)(E)(i). The Secretary published in the Federal Register a request for comment as to whether an exemption from the swap definition for foreign exchange swaps, foreign exchange forwards, or both, is warranted, and on the application of the statutory factors that the Secretary must consider in making a determination regarding whether to exempt these products. See Determinations of Foreign Exchange Swaps and Forwards, 75 FR 66829 (Oct. 28, 2010). Subsequently, the Secretary published in the Federal Register a proposed determination to exempt both foreign exchange swaps and foreign exchange forwards from the definition of the term "swap" in the CEA. See Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, Notice of Proposed Determination, 76 FR 25774 (May 5, 2011) ("Notice of Proposed Determination"). The comment period on the Secretary's proposed determination closed on June 6, 2011. A final determination has not yet been issued.

509 See section 1a(24) of the CEA, 7 U.S.C. 1a(24).

510 See section 1a(25) of the CEA, 7 U.S.C. 1a(25).

511 The Secretary's determination also does not affect the CFTC's jurisdiction over retail foreign currency agreements, contracts, or transactions pursuant to section 2(c)(2) of the CEA, 7 U.S.C. 2(c)(2). See section 1a(47)(F)(ii) of the CEA, 7 U.S.C. 1a(47)(F)(ii).

reporting swaps, and swap dealers and major swap participants engaging in such transactions still would be subject to certain business conduct standards.[512]

The Commissions are adopting the rules as proposed to explicitly define by rule the term "swap" to include foreign exchange forwards and foreign exchange swaps (as those terms are defined in the CEA),[513] in order to include in one rule the definitions of those terms and the related regulatory authority with respect to foreign exchange forwards and foreign exchange swaps.[514] The final rules incorporate the provision of the Dodd-Frank Act that foreign exchange forwards and foreign exchange swaps will no longer be considered swaps if the Secretary issues the written determination described above to exempt such products from the swap definition.[515] The final rules also reflect the continuing applicability of certain reporting requirements and business conduct standards in the event that the Secretary makes such a determination.[516]

Comments

512 See, e.g., sections 1a(47)(E)(iii) and (iv) of the CEA, 7 U.S.C. 1a(47)(E)(iii) and (iv) (reporting and business conduct standards, respectively). In addition, a determination by the Secretary does not exempt any foreign exchange forward or foreign exchange swap traded on a designated contract market or a swap execution facility, or cleared by a derivatives clearing organization, from any applicable antifraud or anti-manipulation provision under the CEA. See sections 1a(47)(F)(i) and 1b(c) of the CEA, 7 U.S.C. 1a(47)(F)(i) and 1b(c).

513 See rules 1.3(xxx)(3)(iii) and (iv) under the CEA and rule 3a69-2(c)(3) and (4) under the Exchange Act.

514 See rules 1.3(xxx)(2)(i)(C) and (D) under the CEA and rules 3a69-2(b)(1)(iii) and (iv) under the Exchange Act. The rules further provide that foreign exchange forwards and forward exchange swaps are not swaps if they fall within one of the exclusions set forth in subparagraph (B) of the statutory swap definition. See rule 1.3(xxx)(2)(ii) under the CEA and rule 3a69-2(b)(2) under the Exchange Act.

515 See rule 1.3(xxx)(3) under the CEA and rule 3a69-2(c) under the Exchange Act.

516 See rule 1.3(xxx)(3)(ii) under the CEA and rule 3a69-2(c)(2) under the Exchange Act. The exclusion of foreign exchange forwards and foreign exchange swaps would become effective upon the Secretary's submission of the determination to exempt to the appropriate Congressional Committees. See sections 1a(47)(E)(ii) and 1b of the CEA, 7 U.S.C. 1a(46)(E)(ii) and 1b.

Two commenters recommended that the Commissions defer action on defining foreign exchange swaps and foreign exchange forwards in their regulations until the Secretary has made his final determination about whether to exempt them.[517] One commenter believed that finalizing the Commissions' proposal prior to the Secretary's final determination would be "premature."[518] The other commenter believed that the industry will be "better positioned" to assess the need to clarify the scope of the swap definition with respect to foreign exchange derivatives after the Secretary has made his determination.[519] The Commissions understand that, if the final rules are effective before the Secretary issues a written determination, market participants entering into foreign exchange forwards and foreign exchange swaps might incur costs in order to comply with the requirements of the CEA (as amended by the Dodd-Frank Act) that could be rendered unnecessary if the Secretary subsequently were to issue a written determination to exempt.[520] The Commissions, however, believe the final rules are necessary because in the event the Secretary issues a written determination to exempt, certain reporting requirements and business conduct standards will continue to apply to the exempted instruments, and the final rules set forth those requirements that will continue to apply.

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517 See CME Letter and SIFMA Letter.

518 See CME Letter. This commenter also believes that if the Secretary exempts foreign exchange swaps and foreign exchange forwards from the swap definition, it would create an "awkward" situation both for the CFTC and market participants, given that options on such products would be swaps but the products into which they exercise would not be swaps, and would result in a lack of clarity and consistency for market participants. Id.

519 See SIFMA Letter.

520 These costs market participants may incur relate to the upfront and ongoing costs associated with the regulation of Title VII instruments generally. See infra parts X and XI, for a discussion of these costs. The Commissions also note that the final rules will reduce (and may eliminate), the costs of determining whether foreign exchange swaps and foreign exchange forwards are subject to Title VII, as well as the costs associated with determining which provisions of the new Title VII regulatory regime will apply to these instruments. Id.

Further, the Commissions do not believe that adopting the rules is premature, as the Secretary may issue a determination at any time, and the Secretary's authority to do so is independent of the Commissions' authority to issue these rules to further define the term "swap."[521] The Commissions' final rules are consistent with this statutory framework by specifically providing that, in the event a determination to exempt is issued, foreign exchange swaps and foreign exchange forwards will not be considered swaps, and will be subject only to those CEA requirements that are specified in the statute.[522] As such, the final rules accommodate the possibility of (rather than the certainty of) an exemptive determination made by the Secretary.

Moreover, commenters provided no support for the assertion that the situation would be awkward for market participants because options on foreign exchange forwards and foreign exchange swaps will be swaps, regardless of whether the Secretary determines to exempt the underlying transactions from the swap definition. The Commissions note that Congress drew the distinction in the statute between foreign currency options and foreign exchange forwards and foreign exchange swaps. The Commissions conclude that adopting these final rules would not

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521 Compare section 712(d)(1) of the CEA (Commissions' joint rulemaking authority to further define the term "swap"), with section 1a(47)(E) and 1b of the CEA (Secretary's authority to determine to exempt foreign exchange swaps and foreign exchange forwards from the definition of "swap.").

522 See rule 1.3(xxx)(3)(ii) under the CEA and rule 3a69-2(c)(2) under the Exchange Act. The statutory requirements that remain applicable, notwithstanding a written determination by the Secretary to exempt, are that foreign exchange swaps and foreign exchange forwards shall be reported to either a swap data repository, or, if there is no swap data repository that would accept such swaps or forwards, to the CFTC pursuant to section 4r of the CEA, 7 U.S.C. 6r, within such time period as the CFTC may by rule or regulation prescribe, and any party to a foreign exchange swap or forward that is a swap dealer or major swap participant shall conform to the business conduct standards contained in section 4s(h) of the CEA, 7 U.S.C. 6s(h). Section 1a(47)(E)(iii) and (iv) of the CEA, 7 U.S.C. 1a(47)(E)(iii) and (iv).

contribute to a lack of clarity or consistency for market participants, regardless of any determination the Secretary makes.

b) Foreign Exchange Products Not Subject to the Secretary's Swap Determination

The Commissions are adopting rules as proposed stating that a determination by the Secretary that foreign exchange forwards or foreign exchange swaps, or both, should not be regulated as swaps would not affect certain other products involving foreign currency, such as foreign currency options, NDFs, currency swaps and cross-currency swaps.[523] The rules explicitly define the term "swap" to include such products, irrespective of whether the Secretary makes a determination to exempt foreign exchange forwards or foreign exchange swaps from the swap definition.[524]

i) Foreign Currency Options[525]

As discussed above, the statutory swap definition includes options, and it expressly enumerates foreign currency options. It encompasses any agreement, contract, or transaction:

> (i) that is a put, call, cap, floor, collar, or similar option of any kind that is for the purchase or sale, or based on the value, of 1 or more interest or other rates, currencies, commodities, securities, instruments of

523 See rule 1.3(xxx)(3)(v) under the CEA and rule 3a69-2(c)(5) under the Exchange Act.

524 See rule 1.3(xxx)(2)(i) under the CEA and rule 3a69-2(b)(1) under the Exchange Act. The final rules provide, however, that none of these products are swaps if they fall within one of the exclusions set forth in subparagraph (B) of the statutory swap definition. See rule 1.3(xxx)(2)(ii) under the CEA and rule 3a69-2(b)(2) under the Exchange Act. Also, the rules do not define the term "swap" to include currency swaps because they are already included in the statutory definition, but the rules clarify that currency swaps are not subject to the Secretary's determination. See section 1a(47)(A)(iii)(VII) of the CEA, 7 U.S.C. 1a(47)(A)(iii)(VII); rule 1.3(xxx)(3)(v)(A) under the CEA; and rule 3a69-2(c)(5)(i) under the Exchange Act.

525 This discussion is not intended to address, and has no bearing on, the CFTC's jurisdiction over foreign currency options in other contexts. See, e.g., CEA sections 2(c)(2)(A)(iii) and 2(c)(2)(B)-(C), 7 U.S.C. 2(c)(2)(A)(iii) and 2(c)(2)(B)-(C) (off-exchange options in foreign currency offered or entered into with retail customers).

> indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind.[526]

Foreign exchange options traded on a national securities exchange ("NSE"), however, are securities under the federal securities laws and not swaps or security-based swaps.[527]

Any determination by the Secretary, discussed above, that foreign exchange forwards or foreign exchange swaps should not be regulated as swaps would not impact foreign currency options because a foreign currency option is neither a foreign exchange swap nor a foreign exchange forward, as those terms are defined in the CEA. The Commissions did not receive any comments either on the proposed rule further defining the term "swap" to include foreign currency options or the proposed rule clarifying that foreign currency options are not subject to the Secretary's determination to exempt foreign exchange swaps and foreign exchange forwards.[528] Consequently, the Commissions are adopting rules to explicitly define the term "swap" to include foreign currency options (other than foreign currency options traded on an NSE).[529] The rules also state that foreign currency options are not foreign exchange forwards or foreign exchange swaps under the CEA.[530]

ii) Non-Deliverable Forward Contracts Involving Foreign Exchange

[526] See section 1a(47)(A)(i) of the CEA, 7 U.S.C. 1a(47)(A)(i) (emphasis added).

[527] See section 1a(47)(B)(iv) of the CEA, 7 U.S.C. 1a(47)(B)(iv).

[528] A comment regarding the CFTC's jurisdiction over retail foreign currency options is discussed below.

[529] See rule 1.3(xxx)(2)(ii) under the CEA and rule 3a69-2(b)(1) under the Exchange Act. The final rules treat the terms foreign currency options, currency options, foreign exchange options, and foreign exchange rate options as synonymous. Moreover, for purposes of the final rules, foreign currency options include options to enter into or terminate, or that otherwise operate on, a foreign exchange swap or foreign exchange forward, or on the terms thereof. As discussed above, foreign exchange options traded on an NSE are securities and therefore are excluded from the swap definition. See supra note 527 and accompanying text.

[530] See rule 1.3(xxx)(3)(v) under the CEA and rule 3a69-2(c)(5) under the Exchange Act.

As explained by the Commissions in the Proposing Release,[531] an NDF generally is similar to a forward foreign exchange contract,[532] except that at maturity the NDF does not require physical delivery of currencies; rather, the contract typically is settled in a reserve currency, such as U.S. dollars. One of the currencies involved in the transaction, usually an emerging market currency, may be subject to capital controls or similar restrictions, and is therefore said to be "nondeliverable."[533] If the spot market exchange rate on the settlement date is greater (in foreign currency per dollar terms) than the previously agreed forward exchange rate, the party to the contract that is long the nondeliverable (e.g. emerging market) currency must pay its counterparty the difference between the contracted forward price and the spot market rate, multiplied by the notional amount.[534]

NDFs are not expressly enumerated in the swap definition, but as was stated in the Proposing Release,[535] they satisfy clause (A)(iii) of the swap definition because they provide for a future (executory) payment based on an exchange rate, which is an "interest or other rate[]" within the meaning of clause (A)(iii).[536] Each party to an NDF transfers to its counterparty the

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531 See Proposing Release at 29836.

532 A deliverable forward foreign exchange contract is an obligation to buy or sell a specific currency on a future settlement date at a fixed price set on the trade date. See Laura Lipscomb, Federal Reserve Bank of New York, "An Overview of Non-Deliverable Foreign Exchange Forward Markets," 1 (May 2005) (citation omitted) ("Fed NDF Overview").

533 See id. at 1-2 (citation omitted).

534 See id. at 2. Being long the emerging market currency means that the holder of the NDF contract is the "buyer" of the emerging market currency and the "seller" of dollars. Conversely, if the emerging market currency appreciates relative to the previously agreed forward rate, the holder of the contract that is short the emerging market currency must pay its counterparty the difference between the spot market rate and the contracted forward price, multiplied by the notional amount. See id. at 2, n.4.

535 See Proposing Release at 29836.

536 See section 1a(47)(A)(iii) of the CEA, 7 U.S.C. 1a(47)(A)(iii) (providing that a swap is an agreement, contract, or transaction "that provides on an executory basis for the exchange, on a fixed or contingent basis, of 1 or more payments based on the value or level of 1 or more interest

risk of the exchange rate moving against the counterparty, thus satisfying the requirement that there be a transfer of financial risk associated with a future change in rate. This financial risk transfer in the context of an NDF is not accompanied by a transfer of an ownership interest in any asset or liability. Thus, an NDF is a swap under clause (A)(iii) of the swap definition.[537]

Moreover, the Commissions have determined that NDFs do not meet the definitions of "foreign exchange forward" or "foreign exchange swap" set forth in the CEA.[538] NDFs do not involve an "exchange" of two different currencies (an element of the definition of both a foreign exchange forward and a foreign exchange swap); instead, they are settled by payment in one currency (usually U.S. dollars).[539]

Notwithstanding their "forward" label, NDFs also do not fall within the forward contract exclusion of the swap definition because currency is outside the scope of the forward contract

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or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind, or any interest therein or based on the value thereof, and that transfers, as between the parties to the transaction, in whole or in part, the financial risk associated with a future change in any such value or level without also conveying a current or future direct or indirect ownership interest in an asset (including any enterprise or investment pool) or liability that incorporates the financial risk so transferred . . . .").

537 In addition, as was noted in the Proposing Release, at least some market participants view NDFs as swaps today, and thus NDFs also may fall within clause (A)(iv) of the swap definition as "an agreement, contract, or transaction that is, or in the future becomes, commonly known to the trade as a swap." See Proposing Release at 29836. See also section 1a(47)(A)(iv) of the CEA, 7 U.S.C. 1a(47)(A)(iv). Cf. rule 35.1(b)(1)(i) under the CEA, 17 CFR 35.1(b)(1)(i) (providing that the definition of "swap agreement" includes a "forward foreign exchange agreement," without reference to convertibility or delivery).

538 In the Notice of Proposed Determination, the Secretary stated that his authority to issue a determination "is limited to foreign exchange swaps and forwards and does not extend to other foreign exchange derivatives" and noted that "NDFs may not be exempted from the CEA's definition of ''swap'' because they do not satisfy the statutory definitions of a foreign exchange swap or forward." See Notice of Proposed Determination.

539 Likewise, the Commissions have determined that a foreign exchange transaction, which initially is styled as or intended to be a "foreign exchange forward," and which is modified so that the parties settle in a reference currency (rather than settle through the exchange of the 2 specified currencies), does not conform with the definition of "foreign exchange forward" in the CEA. See infra note 626.

exclusion for nonfinancial commodities.[540] Nor have NDFs traditionally been considered commercial merchandising transactions. Rather, as the Commissions observed in the Proposing Release,[541] NDF markets appear to be driven in large part by speculation[542] and hedging,[543] which features are more characteristic of swap markets than forward markets.

Comments

Commenters who addressed the nature of NDFs believed that NDFs should not be considered swaps, but rather should be categorized as foreign exchange forwards. In general, commenters maintained that NDFs are functionally and economically equivalent to foreign exchange forwards, and therefore should be treated in the same manner for regulatory purposes.[544] In support of this view, commenters made several arguments, including that both NDFs and foreign exchange forwards require the same net value to be transferred between

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540 Currency is an excluded commodity under the CEA. See section 1a(19)(i) of the CEA, 7 U.S.C. 1a(19)(i). In accordance with the interpretation regarding nonfinancial commodities, which as discussed above, see supra part II.B.2(a), are exempt and agricultural commodities that can be physically delivered, currency does not qualify as a nonfinancial commodity for purposes of the forward exclusion from the swap definition.

541 See Proposing Release at 29836.

542 See Fed NDF Overview at 5 ("[E]stimates vary but many major market participants estimate as much as 60 to 80 percent of NDF volume is generated by speculative interest, noting growing participation from international hedge funds.") and 4 ("[D]ealers note that much of the volume in Chinese yuan NDFs is generated by speculative positioning based on expectations for an alteration in China's current, basically fixed exchange rate.") (italics in original).

543 See id. at 4 (noting that "[much of the] Korean won NDF volume[,] . . . estimated to be the largest of any currency, . . . is estimated to originate with international investment portfolio managers hedging the currency risk associated with their onshore investments").

544 See CDEU Letter; Letter from The Committee on Investment of Employee Benefit Assets, dated Jul. 22, 2011 ("CIEBA Letter"); Letter from Bruce C. Bennett, Covington & Burling LLP, dated Jul. 22, 2011 ("Covington Letter"); and Letter from Karrie McMillan and Cecelia Calaby, the Investment Company Institute/American Bar Association Securities Association, dated Jul. 22, 2011 ("ICI/ABASA Letter").

counterparties; the purpose for using them is the same – to cover foreign currency exchange risk; both are typically short term transactions; and both may be cleared by CLS Bank.[545]

In addition, commenters believed that not treating NDFs as foreign exchange forwards or foreign exchange swaps would be contrary to both domestic and international market practices. As specific examples, commenters noted that NDFs typically are traded as part of a bank's or broker's foreign exchange desk; the Federal Reserve Bank of New York has described an NDF in a 1998 publication as an instrument "similar to an outright forward," except that there is no physical delivery or transfer of the local currency; the Bank for International Settlements ("BIS") categorizes NDFs in its "outright forward" category; various European regulations do not distinguish between the two transaction types; standard foreign exchange trading documentation includes both net- and physically-settled foreign exchange transactions in general definitions of foreign exchange transactions; and special rules under the U.S. tax code apply equally to physically settled and cash settled foreign exchange forwards.[546]

Commenters also raised potential negative consequences to certain U.S. market participants if NDFs are not considered to be foreign exchange forwards. For example, one commenter argued that treating NDFs as swaps will put U.S. corporations doing business in emerging markets at a disadvantage relative to U.S. corporations doing business solely in developed markets.[547] This commenter stated that NDFs are widely used by U.S. corporations that do business in emerging markets to hedge their exposure to the currencies of those markets,

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545 See Covington Letter and ICI/ABASA Letter. CLS Bank operates the largest multi-currency cash settlement system to eliminate settlement risk in the foreign exchange market.

546 See Covington Letter and ICI/ABASA Letter.

547 See Covington Letter.

and that regulating NDFs as swaps would significantly increase the cost of hedging those exposures.[548]

With respect to the Commissions' legal conclusion that NDFs are not foreign exchange forwards, and thus are not subject to the Secretary's determination, one commenter stated that the Commissions' reading of the definition of the term "foreign exchange forward" as not including NDFs is "too restrictive."[549] In this regard, this commenter believed that the term "exchange" should be read to include "the economic exchange that occurs in net settlement rather than being narrowly read as the physical 'exchange' of two different currencies."

One commenter, in contrast, agreed with the Commissions' interpretation that NDFs are not encompassed within the definition of the term "foreign exchange forward."[550] This commenter requested, though, that the CFTC exempt NDFs from the swap definition, using its exemptive authority under section 4(c) of the CEA.[551]

While commenters raised a number of objections to the Commissions' proposal to define NDFs as swaps, these objections primarily raise policy arguments. No commenter has provided a persuasive, alternative interpretation of the statute's plain language in the definition of the term "foreign exchange forward" to overcome the Commissions' conclusion that, under the CEA, NDFs are swaps, not foreign exchange forwards.

One commenter believed that the Commissions' interpretation of "exchange of 2 different currencies" as used in the foreign exchange forward definition is too restrictive, and that the phrase should be read broadly to mean an economic exchange of value in addition to

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548 See supra note 520.

549 See ICI/ABASA Letter.

550 See CIEBA Letter.

551 7 U.S.C. 6(c).

physical exchange; the Commissions believe that this contention is misplaced.[552] This commenter essentially asks the Commissions to interpret the statutory language to mean an exchange of foreign currencies themselves, as well as an exchange based on the value of such currencies. However, only the word "exchange" appears in the relevant definitions, reinforcing the conclusion that Congress intended the definition of "foreign exchange forward" to be distinct from other types of transactions covered by the definition of "swap" in the CEA. Moreover, the language of each definition emphasizes that these transactions may "solely" involve an exchange. The ordinary meaning of the verb "exchange" is to "barter"[553] or "part with, give or transfer for an equivalent,"[554] i.e., each party is both giving to and receiving from the other party. This does not occur under an NDF, in which only a single party makes a payment.

Elsewhere in the CEA, Congress used explicit language that potentially could provide support for a broader interpretation of the type advocated by this commenter, but such language is absent from the definition of the term "foreign exchange forward." For example, section 2(a)(1)(C)(ii) confers exclusive jurisdiction on the CFTC over "contracts of sale for future delivery of a group or index of securities (or any interest therein or based upon the value thereof) [that meet certain requirements]" (emphasis added). If the phrase "exchange of 2 different currencies" had been intended to include economic exchanges of value, as suggested by this commenter, that phrase would have included language similar to "based on the value thereof" to indicate that other mechanisms of transferring value may occur in these particular types of transactions. Instead, as noted above, Congress limited the scope of each of these particular

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552 See ICI/ABASA Letter.

553 See Webster's New World Dictionary (3d College Ed. 1988).

554 See Black's Law Dictionary.

transactions by using the words "solely involves the exchange of 2 different currencies" (emphasis added). The Commissions conclude that the use of the word "solely" provides further support for the Commissions' interpretation that exchange means an actual interchange of the 2 different currencies involved in the transaction.[555]

iii) Currency Swaps and Cross-Currency Swaps

A currency swap[556] and a cross-currency swap[557] each generally can be described as a swap in which the fixed legs or floating legs based on various interest rates are exchanged in different currencies. Such swaps can be used to reduce borrowing costs, to hedge currency

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555 This commenter's request that the CFTC exempt NDFs from the swap definition using its exemptive authority under section 4(c) of the CEA, 7 U.S.C. 6(c), and that the SEC exercise its exemptive authority under section 36 of the Exchange Act, 78 U.S.C. 78mm, with respect to NDFs, is beyond the scope of this rulemaking.

556 A swap that exchanges a fixed rate against a fixed rate is known as a currency swap. See Federal Reserve System, "Trading and Capital-Markets Activities Manual," section 4335.1 (Jan. 2009).

557 Cross-currency swaps with a fixed leg based on one rate and a floating leg based on another rate, where the two rates are denominated in different currencies, are generally referred to as cross-currency coupon swaps, while those with a floating leg based on one rate and another floating leg based on a different rate are known as cross-currency basis swaps. Id. Cross-currency swaps also include annuity swaps and amortizing swaps. In cross-currency annuity swaps, level cash flows in different currencies are exchanged with no exchange of principal; annuity swaps are priced such that the level payment cash flows in each currency have the same net present value at the inception of the transaction. An amortizing cross-currency swap is structured with a declining principal schedule, usually designed to match that of an amortizing asset or liability. Id.

See also Derivatives ONE, "Cross Currency Swap Valuation" ("A cross currency swap is swap of an interest rate in one currency for an interest rate payment in another currency . . . . This could be considered an interest rate swap with a currency component."), available at http://www.derivativesone.com/cross-currency-swap-valuation/; Financial Accounting Standards Board, "Examples Illustrating Application of FASB Statement No. 138," Accounting for Certain Derivative Instruments and Certain Hedging Activities, section 2, Example 1, at 3 ("The company designates the cross-currency swap as a fair value hedge of the changes in the fair value of the loan due to both interest and exchange rates."), available at http://www.fasb.org/derivatives/examples.pdf.

exposure, and to create synthetic assets[558] and are viewed as an important tool, given that they can be used to hedge currency and interest rate risk in a single transaction.

Currency swaps and cross-currency swaps are not foreign exchange swaps as defined in the CEA because, although they may involve an exchange of foreign currencies, they also require contingent or variable payments in different currencies. Because the CEA defines a foreign exchange swap as a swap that "solely" involves an initial exchange of currencies and a reversal thereof at a later date, subject to certain parameters, currency swaps and cross-currency swaps would not be foreign exchange swaps. Similarly, currency swaps and cross-currency swaps are not foreign exchange forwards because foreign exchange forwards "solely" involve an initial exchange of currencies, subject to certain parameters, while currency swaps and cross-currency swaps contain additional elements, as discussed above.

Currency swaps are expressly enumerated in the statutory definition of the term "swap."[559] Cross-currency swaps, however, are not.[560] Accordingly, based on the foregoing considerations, the Commissions are adopting rules explicitly defining the term "swap" to include cross-currency swaps.[561] The rules also state that neither currency swaps nor cross-currency swaps are foreign exchange forwards or foreign exchange swaps as those terms are defined in the CEA. The Commissions did not receive any comments either on the rule further defining the term "swap" to include cross-currency swaps or the rule clarifying that cross-

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558 BMO Capital Markets, "Cross Currency Swaps," available at http://www.bmocm.com/products/marketrisk/intrderiv/cross/default.aspx.

559 See section 1a(47)(A)(iii)(VII) of the CEA, 7 U.S.C. 1a(47)(A)(iii)(VII).

560 Clause (A)(iii) of the swap definition expressly refers to a cross-currency rate swap. See section 1a(47)(A)(iii)(V) of the CEA, 7 U.S.C. 1a(47)(A)(iii)(V). Although the swap industry appears to use the term "cross-currency swap," rather than "cross-currency rate swap" (the term used in section 1a(47)(A)(iii)(V) of the CEA), the Commissions interpret these terms as synonymous.

561 See rule 1.3(xxx)(2)(i)(A) under the CEA and rule 3a69-2(b)(1)(i) under the Exchange Act.

currency swaps and currency swaps are not subject to the Secretary's determination to exempt foreign exchange swaps and foreign exchange forwards.

c) Interpretation Regarding Foreign Exchange Spot Transactions

The CEA generally does not confer regulatory jurisdiction on the CFTC with respect to spot transactions.[562] In the context of foreign currency, spot transactions typically settle within two business days after the trade date ("T+2").[563] The accepted market practice of a two-day settlement for spot foreign currency transactions has been recognized by the CFTC[564] and the courts.[565]

The Commissions recognize that the new foreign exchange forward definition in the CEA, which was added by the Dodd-Frank Act and which applies to an exchange of two different currencies "on a specific future date," could be read to apply to any foreign exchange transaction that does not settle on the same day. Such a reading could render most foreign exchange spot transactions foreign exchange forwards under the CEA; as a result, such transactions would be subject to the CEA reporting and business conduct standards requirements applicable to foreign exchange forwards even if the Secretary determines to exempt foreign

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562 But see supra note 227.

563 Bank for International Settlements, Triennial Central Bank Survey, Report on Global Foreign Exchange Market Activity in 2010 at 32 (Dec. 2010) (defining a foreign exchange spot transaction to provide for cash settlement within 2 business days); Sam Y. Cross, Federal Reserve Bank of New York, "All About . . . The Foreign Exchange Market in the United States" at 31-32 (1998).

564 See CFTC Division of Trading and Markets, Report on Exchange of Futures for Physicals at 124-127 (1987) (noting that foreign currency spot transactions settle in 2 days).

565 See CFTC v. Frankwell Bullion, Ltd., 99 F.3d 299, 300 (9th Cir. 1996) ("Spot transactions in foreign currencies call for settlement within two days."); CFTC v. Int'l Fin. Servs. (NewYork), Inc., 323 F. Supp. 2d 482, 495 (S.D.N.Y.2004) (noting that spot transactions ordinarily call for settlement within two days); Bank Brussels Lambert, S.A. v. Intermetals Corp., 779 F.Supp. 741, 742 (S.D.N.Y. 1991) (same). But the Commissions understand that the settlement cycle for spot transactions exchanging Canadian dollars for U.S. dollars (or vice versa) is T+1. See Cross, supra 563, at 31.

exchange forwards from the definition of "swap." The Commissions do not believe that Congress intended, solely with respect to foreign exchange transactions, to extend the reach of the CEA to transactions that historically have been considered spot transactions. At the same time, however, the Commissions do not want to enable market participants simply to label as "spot" foreign exchange transactions that regularly settle after the relevant foreign exchange spot market settlement deadline, or with respect to which the parties intentionally delay settlement, both of which would be properly categorized as foreign exchange forwards, or CEA section 2(c)(2) transactions (discussed separately below), in order to avoid applicable foreign exchange regulatory requirements.

Accordingly, the Commissions are providing an interpretation that a bona fide foreign exchange spot transaction, i.e., a foreign exchange transaction that is settled on the customary timeline of the relevant spot market, is not within the definition of the term "swap." In general, a foreign exchange transaction will be considered a bona fide spot transaction if it settles via an actual delivery of the relevant currencies within two business days. In certain circumstances, however, a foreign exchange transaction with a longer settlement period concluding with the actual delivery of the relevant currencies may be considered a bona fide spot transaction depending on the customary timeline of the relevant market.[566] In particular, as discussed below, the Commissions will consider a foreign exchange transaction that is entered into solely to effect the purchase or sale of a foreign security to be a bona fide spot transaction where certain conditions are met.

566 In this regard, while the Commissions will look at the relevant facts and circumstances, they will not expect that an unintentional settlement failure or delay for operational reasons or due to a market disruption will undermine the character of a bona fide spot foreign exchange transaction as such.

The CFTC will consider the following to be a bona fide spot foreign exchange transaction: an agreement, contract or transaction for the purchase or sale of an amount of foreign currency equal to the price of a foreign security with respect to which (i) the security and related foreign currency transactions are executed contemporaneously in order to effect delivery by the relevant securities settlement deadline and (ii) actual delivery of the foreign security and foreign currency occurs by such deadline (such transaction, a "Securities Conversion Transaction").[567] For Securities Conversion Transactions, the CFTC will consider the relevant foreign exchange spot market settlement deadline to be the same as the securities settlement deadline. As noted above, while the CFTC will look at the relevant facts and circumstances, it does not expect that an unintentional settlement failure or delay for operational reasons or due to a market disruption will undermine the character of a bona fide spot foreign exchange transaction as such.

The CFTC also will interpret a Securities Conversion Transaction as not leveraged, margined or financed within the meaning of section 2(c)(2)(C) of the CEA.[568] While it is possible to view the fact that the buyer of a currency in a such a transaction does not pay for the currency until it is delivered as leverage (in that the buyer puts nothing down until taking delivery, thus achieving 100% leverage) or a financing arrangement, the CFTC does not interpret

567 The interpretation herein with respect to Security Conversion Transactions is limited to such transactions.

568 7 U.S.C. 2(c)(2)(C). Similarly, a Securities Conversion Transaction is not an option, option on a futures contract or futures contract and thus would not be subject to CEA section 2(c)(2)(B), 7 U.S.C. 2(c)(2)(B). Of course, optionality as to settlement would render the transaction an option and is inconsistent with a "spot" characterization.

it as such for purposes of CEA section 2(c)(2)(C).[569] Congress recognized that settlement of bona fide spot foreign exchange transactions typically takes two days.[570] The fact that Congress expressly excluded these types of bona fide spot foreign exchange transactions does not mean that Congress intended to subject Security Conversion Transactions to regulation under the retail foreign exchange regime.[571] For the foregoing reasons, the CFTC will interpret a Securities Conversion Transaction as not leveraged, margined or financed within the meaning of section 2(c)(2)(C) of the CEA.[572]

Comments

One commenter requested clarification regarding the status of foreign exchange spot transactions.[573] This commenter recommended that the Commissions clarify that foreign exchange spot transactions, which this commenter defined as "transactions of one currency into another that settle within a customary settlement cycle," are neither foreign exchange forwards

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569 Cf. 12 C.F.R. § 220.8(b)(1) under Regulation T (12 C.F.R. Part 220) (generally permits a customer to purchase a security (including a foreign security) in a cash account, rather than a margin account, even if the customer has no collateral in the account, if payment for the security is made within the appropriate payment period). Similarly, if a foreign exchange buyer in a Securities Conversion Transaction posts no margin or collateral on the trade date, the CFTC does not consider that transaction to be "margined" within the meaning of 7 U.S.C. 2(c)(2)(C)(i)(I)(bb).

570 See section 2(c)(2)(C)(i)(II) of the CEA, 7 U.S.C. 2(c)(2)(C) ("[s]ubclause (I) of this clause shall not apply to . . . a contract of sale that . . . results in delivery within 2 days").

571 The CFTC notes, for example, that Congress recognized that settlement in various spot markets in commodities other than foreign exchange can be longer than two days. See CEA section 2(c)(2)(D)(ii)(III)(aa) (disapplying the DCM-trading requirement for certain commodity transactions with non-ECPs when the contract "results in actual delivery within 28 days or such other longer period as the [CFTC] may determine by rule or regulation based on the typical commercial practice in cash or spot markets for the commodity involved").

572 This interpretation is not intended to address, and has no bearing on, the CFTC's interpretation of the term "actual delivery" as set forth in section 2(c)(2)(D)(ii)(III)(aa), 7 C.F.R. 2(c)(2)(D)(ii)(III)(aa). See Retail Commodity Transactions under the Commodity Exchange Act, 76 FR 77670, Dec. 14, 2011.

573 See SIFMA Letter.

nor swaps.[574] Another commenter indicated that the customary settlement cycle for purchases of most non-U.S. denominated securities is "T+3" (in some securities markets, such as South Africa, the settlement cycle can take up to seven days), and requires the buyer to pay for the foreign securities in the relevant foreign currency.[575] Typically, according to this commenter, a broker-dealer or bank custodian acting on behalf of the buyer or seller will enter into a foreign currency transaction to settle on a T+3 basis (or the relevant settlement period) as well. Timing the foreign exchange transaction to settle at the same time as the securities transaction benefits the customer by reducing his or her exposure to currency risk on the securities transaction between trade date and settlement date. The Commissions have provided the interpretation described above regarding the interplay between the foreign exchange forward definition, the meaning of "leveraged, margined or financed" under section 2(c)(2)(C) of the CEA, and bona fide foreign exchange spot transactions to address these commenters' concerns.

d) Retail Foreign Currency Options

The CFTC is providing an interpretation regarding the status of retail foreign currency options that are described in section 2(c)(2)(B) of the CEA.[576] As noted above, the Commissions

574 Id. In this commenter's view, such clarification is necessary to avoid the statutory foreign exchange forward definition "unwittingly captur[ing] many typical foreign exchange spot transactions . . . settl[ing] within a customary settlement cycle," which this commenter stated is generally "T+2" in the United States, but can be "T+3" in some other countries.

575 See Letter from Phoebe A. Papageorgiou, Senior Counsel, American Bankers Ass'n and James Kemp, Managing Director, Global Foreign Exchange Division, dated April 18, 2012 ("ABA/Global FX Letter"). This commenter requested clarification that the purchase, sale or exchange of a foreign currency by a bank on behalf of a retail customer for the sole purpose of effecting a purchase or sale of a foreign security or in order to clear or settle such purchase or sale, when the settlement period for such FX transaction is within the settlement cycle for such foreign security, is excluded from the retail foreign exchange under the CEA. The CFTC has provided the clarification regarding the meaning of "leveraged, margined or financed" under section 2(c)(2)(C) of the CEA to address this commenter's concern.

576 7 U.S.C. 2(c)(2)(B).

proposed to include foreign currency options generally within the definition of the term "swap," subject to the statutory exclusions in subparagraph (B) of the definition. The statutory exclusions from the swap definition encompass transactions described in sections 2(c)(2)(C) and (D) of the CEA, but not those in section 2(c)(2)(B) of the CEA.[577] Section 2(c)(2)(B) of the CEA applies to futures, options on futures and options on foreign currency (other than foreign currency options executed or traded on a national securities exchange), and permits such transactions to be entered into with counterparties who are not ECPs[578] on an off-exchange basis by certain enumerated regulated entities.[579] No issue arises with respect to futures or options on futures in foreign currency that are covered by section 2(c)(2)(B) of the CEA, because they are

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577 See section 1a(47)(B)(i) of the CEA, 7 U.S.C. 1a(47)(B)(i). Sections 2(c)(2)(B), (C), and (D) of the CEA, 7 U.S.C. 2(c)(2)(B), (C), and (D), govern certain types of off-exchange transactions in commodities, including foreign currency, in which one of the parties to the transaction is not an ECP.

578 ECPs are defined in section 1a(18) of the CEA, 7 U.S.C. 1a(18).

579 Section 2(c)(2)(B)(i) of the CEA provides: (i) This Act applies to, and the Commission shall have jurisdiction over, an agreement, contract, or transaction in foreign currency that— (I) is a contract of sale of a commodity for future delivery (or an option on such a contract) or an option (other than an option executed or traded on a national securities exchange registered pursuant to section 6(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78f(a)); and (II) is offered to, or entered into with, a person that is not an eligible contract participant, unless the counterparty, or the person offering to be the counterparty, of the person is [certain regulated counterparties enumerated in the statute.] 7 U.S.C. 2(c)(2)(B)(i). Thus, under section 2(c)(2)(B)(i) of the CEA, the CEA's exchange-trading requirement generally applies with respect to futures, options on futures, and options on foreign currency. See section 4(a) of the CEA, 7 U.S.C. 6(a) (generally requiring futures contracts to be traded on or subject to the rules of a DCM); section 4c(b) of the CEA, 7 U.S.C. 6c(b) (prohibiting trading options subject to the CEA contrary to CFTC rules, regulations or orders permitting such trading); Part 32 of the CFTC's rules, 17 CFR Part 32 (generally prohibiting entering into options subject to the CEA (other than options on futures) other than on or subject to the rules of a DCM); and CFTC Rule 33.3(a), 17 CFR 33.3(a) (prohibiting entering into options on futures other than on or subject to the rules of a DCM). However, if the counterparty to the non-ECP is an enumerated regulated entity identified in section 2(c)(2)(B)(i)(II) of the CEA, 7 U.S.C. 2(c)(2)(B)(i)(II), the CEA's exchange-trading requirement does not apply. Accordingly, an enumerated regulated entity – including a banking institution regulated by the OCC – can, pursuant to section 2(c)(2)(B) of the CEA, lawfully enter into a future, an option on a future, or an option on foreign currency with a non-ECP counterparty on an off-exchange basis.

expressly excluded from the statutory swap definition.[580] Commodity options, including options on foreign currency, however, are not excluded from the swap definition (other than foreign currency options executed or traded on a national securities exchange).

The CFTC notes that, in further defining the term "swap" to include foreign currency options, the Proposing Release stated that the proposal was not intended to address, and had no bearing on, the CFTC's jurisdiction over foreign currency options in other contexts, specifically citing section 2(c)(2)(B) of the CEA.[581] Nonetheless, the CFTC acknowledges the ambiguity in the statute regarding the status of off-exchange foreign currency options with non-ECPs that are subject to section 2(c)(2)(B) of the CEA. While foreign currency options are swaps, they also are subject to section 2(c)(2)(B) of the CEA when entered into off-exchange with non-ECPs, and there is no statutory exclusion from the swap definition for section 2(c)(2)(B) transactions. If foreign currency options were deemed to be swaps, then, pursuant to section 2(e) of the CEA, as added by the Dodd-Frank Act,[582] they could not be entered into by non-ECP counterparties, except on a DCM. This would render the provisions of section 2(c)(2)(B) of the CEA, permitting off-exchange foreign currency options with non-ECPs by enumerated regulated entities, a nullity.

The CFTC believes that Congress did not intend the swap definition to overrule and effectively repeal another provision of the CEA in such an oblique fashion.[583] Nor is there

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580 See section 1a(47)(B)(i) of the CEA, 7 U.S.C. 1a(47)(B)(i).

581 See Proposing Release at 29835 n.125.

582 7 U.S.C. 2(e).

583 The CFTC notes in this regard that repeals by implication are strongly disfavored by the courts. See, e.g., Village of Barrington, Ill. v. Surface Transp. Bd., 636 F.3d 650, 662 (D.C. Cir. 2011) ("Repeals by implication, however, are strongly disfavored 'absent a clearly expressed congressional intention'") (quoting Branch v. Smith, 538 U.S. 254, 273, 123 S.Ct. 1429 (2003)); Agri Processor Co., Inc. v. N.L.R.B., 514 F.3d 1, 4 (D.C. Cir. 2008) ("[a]mendments by

anything in the legislative history of the Dodd-Frank Act to suggest a congressional intent to prohibit only one type of off-exchange foreign currency transaction with non-ECPs (out of the three types of off-exchange foreign currency transactions with non-ECPs that are addressed in CEA section 2(c)(2)(B)). The omission of section 2(c)(2)(B) of the CEA from the exclusions set forth in the statutory swap definition appears to be a scrivener's error.[584] Accordingly, the CFTC is applying the exclusion from the swap definition to foreign currency options described in CEA section 2(c)(2)(B).

3. Forward Rate Agreements

The Commissions are adopting rules as proposed to explicitly define the term "swap" to include forward rate agreements ("FRAs").[585] The Commissions did not receive any comments on the proposed rules regarding the inclusion of FRAs in the swap definition.

In general, an FRA is an over-the-counter contract for a single cash payment, due on the settlement date of a trade, based on a spot rate (determined pursuant to a method agreed upon by the parties) and a pre-specified forward rate. The single cash payment is equal to the product of the present value (discounted from a specified future date to the settlement date of the trade) of the difference between the forward rate and the spot rate on the settlement date multiplied by the notional amount. The notional amount itself is not exchanged.[586]

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implication, like repeals by implication, are not favored" and "will not be found unless an intent to repeal [or amend] is 'clear and manifest.'") (quoting United States v. Welden, 377 U.S. 95, 102 n. 12, 84 S.Ct. 1082 (1964) and Rodriguez v. United States, 480 U.S. 522, 524, 107 S.Ct. 1391 (1987)).

584 See, e.g., Singer and Singer, Sutherland Statutes and Statutory Construction §47:38 (7th ed. 2011) ("Words may be supplied in a statute . . . where omission is due to inadvertence, mistake, accident, or clerical error").

585 See rules 1.3(xxx)(2)(i)(E) under the CEA and rule 3a69-2(b)(1)(v) under the Exchange Act.

586 See generally "Trading and Capital-Markets Activities Manual," supra note 556, section 4315.1 ("For example, in a six-against-nine-month (6x9) FRA, the parties agree to a three-month rate

An FRA provides for the future (executory) payment based on the transfer of interest rate risk between the parties as opposed to transferring an ownership interest in any asset or liability.[587] Thus, the Commissions believe that an FRA satisfies clause (A)(iii) of the swap definition.[588]

Notwithstanding their "forward" label, FRAs do not fall within the forward contract exclusion from the swap definition. FRAs do not involve nonfinancial commodities and thus are outside the scope of the forward contract exclusion. Nor is an FRA a commercial merchandising transaction, as there is no physical product to be delivered in an FRA.[589] Accordingly, the

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that is to be netted in six months' time against the prevailing three-month reference rate, typically LIBOR. At settlement (after six months), the present value of the net interest rate (the difference between the spot and the contracted rate) is multiplied by the notional principal amount to determine the amount of the cash exchanged between the parties . . . . If the spot rate is higher than the contracted rate, the seller agrees to pay the buyer the differences between the prespecified forward rate and the spot rate prevailing at maturity, multiplied by a notional principal amount. If the spot rate is lower than the forward rate, the buyer pays the seller.").

587 It appears that at least some in the trade view FRAs as swaps today. See, e.g., The Globecon Group, Ltd., "Derivatives Engineering: A Guide to Structuring, Pricing and Marketing Derivatives," 45 (McGraw-Hill 1995) ("An FRA is simply a one-period interest-rate swap."); DerivActiv, Glossary of Financial Derivatives Terms ("A swap is . . . a strip of FRAs."), available at http://www.derivactiv.com/definitions.aspx?search=forward+rate+agreements. Cf. Don M. Chance, et. al, "Derivatives in Portfolio Management," 29 (AIMR 1998) ("[An FRA] involves one specific payment and is basically a one-date swap (in the sense that a swap is a combination of FRAs[,] with some variations)."). Thus, FRAs also may fall within clause (A)(iv) of the swap definition, as "an agreement, contract, or transaction that is, or in the future becomes, commonly known to the trade as a swap." See section 1a(47)(a)(iv) of the CEA, 7 U.S.C. 1a(47)(a)(iv).

588 See section 1a(47)(A)(iii) of the CEA, 7 U.S.C. 1a(47)(A)(iii). CFTC regulations have defined FRAs as swap agreements. See rule 35.1(b)(1)(i) under the CEA, 17 CFR 35.1(b)(1)(i); Exemption for Certain Swap Agreements, 58 FR 5587 (Jan. 22, 1993). The CFTC recently repealed that rule and amended Part 35 of its rules in light of the enactment of Title VII of the Dodd-Frank Act. See Agricultural Swaps, 76 FR 49291 (Aug. 10, 2011).

589 See Regulation of Hybrid and Related Instruments, 52 FR 47022, 47028 (Dec. 11, 1987) (stating "[FRAs] do not possess all of the characteristics of forward contracts heretofore delineated by the [CFTC]").

Commissions believe that the forward contract exclusion from the swap definition for nonfinancial commodities does not apply to FRAs.[590]

Based on the foregoing considerations, the Commissions are adopting rules to provide greater clarity by explicitly defining the term "swap" to include FRAs. As with the foreign exchange-related products discussed above, the final rules provide that FRAs are not swaps if they fall within one of the exclusions set forth in subparagraph (B) of the swap definition.

4. Combinations and Permutations of, or Options on, Swaps and Security-Based Swaps

Clause (A)(vi) of the swap definition provides that "any combination or permutation of, or option on, any agreement, contract, or transaction described in any of clauses (i) through (v)" of the definition is a swap.[591] The Commissions provided an interpretation regarding clause (A)(vi) in the Proposing Release.[592] The Commissions received no comments on the interpretation provided in the Proposing Release regarding combinations and permutations of, or options on, swaps and security-based swaps and are restating their interpretation of clause (A)(vi) of the swap definition with one technical correction and one clarification.

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590 The Commissions note that Current European Union law includes FRAs in the definition of "financial instruments." See Markets in Financial Instruments Directive (MiFID), "Directive 2004/39/EC of the European Parliament and of the Council," Annex I(C), 4, 5, 10 (Apr. 21, 2004), available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2004L0039:20070921:EN:PDF. European Commission legislation on derivatives, central clearing, and trade repositories applies to FRAs that are traded over-the-counter and, thus, would subject such transactions to mandatory clearing, reporting and other regulatory requirements. See Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories, tit. I, art. 2 (1(3b)), 7509/1/12 REV 1 (Mar. 19, 2012).

591 See section 1a(47)(vi) of the CEA, 7 U.S.C. 1a(47)(vi). Clause (A)(vi) of the swap definition refers specifically to other types of swaps in the swap definition. However, because section 3(a)(68) of the Exchange Act defines a security-based swap as a swap [with some connection to a security], clause (A)(vi) of the swap definition is relevant to determining whether any combination or permutation of, or option on, a security-based swap is a security-based swap.

592 See Proposing Release at 29838.

Clause (A)(vi) means, for example, that an option on a swap or security-based swap (commonly known as a "swaption") would itself be a swap or security-based swap, respectively. The Commissions also interpret clause (A)(vi) to mean that a "forward swap" would itself be a swap or security-based swap, respectively.[593] By listing examples here, the Commissions do not intend to limit the broad language of clause (A)(vi) of the swap definition, which is designed to capture those agreements, contracts and transactions that are not expressly enumerated in the CEA swap definition but that nevertheless are swaps.[594]

5. Contracts for Differences

As the Proposing Release notes, the Commissions have received inquiries over the years regarding the treatment of CFDs under the CEA and the federal securities laws.[595] A CFD generally is an agreement to exchange the difference in value of an underlying asset between the time at which a CFD position is established and the time at which it is terminated.[596] If the value

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593 Forward swaps are also commonly known as forward start swaps, or deferred or delayed start swaps. A forward swap can involve two offsetting swaps that both start immediately, but one of which ends on the deferred start date of the forward swap itself. For example, if a counterparty wants to hedge its risk for four years, starting one year from today, it could enter into a one-year swap and a five-year swap, which would partially offset to create a four-year swap, starting one year forward. A forward swap also can involve a contract to enter into a swap or security-based swap at a future date or with a deferred start date. A forward swap is not a nonfinancial commodity forward contract or security forward, both of which are excluded from the swap definition and discussed elsewhere in this release.

594 This category could include categories of agreements, contracts or transactions that do not yet exist as well as more esoteric swaps that exist but that Congress did not refer to by name in the statutory swap definition.

595 See Proposing Release at 29838.

596 See Ontario Securities Commission, Staff Notice 91-702, "Offerings of Contracts for Difference and Foreign Exchange Contracts to Investors in Ontario," at part IV.1 (defining a CFD as "a derivative product that allows an investor to obtain economic exposure (for speculative, investment or hedging purposes) to an underlying asset . . . such as a share, index, market sector, currency or commodity, without acquiring ownership of the underlying asset"), available at http://www.osc.gov.on.ca/documents/en/Securities-Category9/sn_20091030_91-702_cdf.pdf (Oct. 30, 2009); Financial Services Authority, Consultation Paper 7/20, "Disclosure of Contracts for Difference - Consultation and draft Handbook text," at part 2.2 (defining a CFD on a share as

increases, the seller pays the buyer the difference; if the value decreases, the buyer pays the seller the difference. CFDs can be traded on a number of products, including treasuries, foreign exchange rates, commodities, equities, and stock indexes. Equity CFDs closely mimic the purchase of actual shares. The buyer of an equity CFD receives cash dividends and participates in stock splits.[597] In the case of a long position, a dividend adjustment is credited to the client's account. In the case of a short position, a dividend adjustment is debited from the client's account. CFDs generally are traded over-the-counter (though they also are traded on the Australian Securities Exchange) in a number of countries outside the United States.

The Commissions provided an interpretation in the Proposing Release regarding the treatment of CFDs. The Commissions are restating the interpretation set out in the Proposing Release without modification.

CFDs, unless otherwise excluded, fall within the scope of the swap or security-based swap definition, as applicable.[598] Whether a CFD is a swap or security-based swap will depend on the underlying product of that particular CFD transaction. Because CFDs are highly variable and a CFD can contain a variety of elements that would affect its characterization, the Commissions believe that market participants will need to analyze the features of the underlying product of any particular CFD in order to determine whether it is a swap or a security-based

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"a derivative product that gives the holder an economic exposure, which can be long or short, to the change in price of a specific share over the life of the contract"), available at http://www.fsa.gov.uk/pubs/cp/cp07_20.pdf (Nov. 2007).

597 See, e.g., Int'l Swaps and Derivatives Ass'n, "2002 ISDA Equity Derivatives Definitions," art. 10 (Dividends) and 11 (Adjustments and Modifications Affecting Indices, Shares and Transactions).

598 In some cases, depending on the facts and circumstances, the SEC may determine that a particular CFD on an equity security, for example, should be characterized as constituting a purchase or sale of the underlying equity security and, therefore, be subject to the requirements of the federal securities laws applicable to such purchases or sales.

swap. The Commissions are not adopting rules or additional interpretations at this time regarding CFDs.

Comments

Two commenters requested that the Commissions clarify that non-deliverable forward contracts are not CFDs.[599] These commenters requested that the Commissions determine that NDFs involving foreign exchange are not swaps. Given that the Commissions are defining NDFs as swaps and that CFDs involving foreign currency also would be swaps, there is no need to distinguish NDFs involving foreign exchange from CFDs involving foreign exchange.

D. Certain Interpretive Issues

1. Agreements, Contracts, or Transactions That May Be Called, or Documented Using Form Contracts Typically Used for, Swaps or Security-Based Swaps

The Commissions are restating the interpretation provided in the Proposing Release regarding agreements, contracts, or transactions that may be called, or documented using form contracts typically used for, swaps or security-based swaps with one modification in response to a commenter.[600]

As was noted in the Proposing Release,[601] individuals and companies may generally use the term "swap" to refer to certain of their agreements, contracts, or transactions. For example, they may use the term "swap" to refer to an agreement to exchange real or personal property between the parties or to refer to an agreement for two companies that produce fungible products and with delivery obligations in different locations to perform each other's delivery obligations

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599 See Covington Letter and ICI/ABASA Letter.

600 See infra note 606.

601 See Proposing Release at 29839.

instead of their own.[602] However, the name or label that the parties use to refer to a particular agreement, contract, or transaction is not determinative of whether it is a swap or security-based swap.[603]

It is not dispositive that the agreement, contract, or transaction is documented using an industry standard form agreement that is typically used for swaps and security-based swaps,[604] but it may be a relevant factor.[605] The key question is whether the agreement, contract, or transaction falls within the statutory definitions of the term "swap" or "security-based swap" (as further defined and interpreted pursuant to the final rules and interpretations herein) based on its

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602 For example, a company obligated to deliver its product to a customer in Los Angeles would instead deliver the product in Albany to a different company's customer on behalf of that other company. In return, the company with the obligation to deliver a product to its customer in Albany would deliver the product instead in Los Angeles to the customer of the company obligated to deliver its product to that customer in Los Angeles.

603 See, e.g., Haekel v. Refco, 2000 WL 1460078, at *4 (CFTC Sept. 29, 2000) ("[T]he labels that parties apply to their transactions are not necessarily controlling"); Reves v. Ernst & Young, 494 U.S. 56, 61 (1990) (stating that the purpose of the securities laws is "to regulate investments, in whatever form they are made and by whatever name they are called") (emphasis in original).

604 As noted in the Proposing Release, the CFTC consistently has found that the form of a transaction is not dispositive in determining its nature, citing Grain Land, supra note 213, at *16 (CFTC Nov. 25, 2003) (holding that contract substance is entitled to at least as much weight as form); In the Matter of First Nat'l Monetary Corp., [1984–1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,698 at 30,974 (CFTC Aug. 7, 1985) ("When instruments have been determined to constitute the functional equivalent of futures contracts neither we nor the courts have hesitated to look behind whatever self-serving labels the instruments might bear."); Stovall, supra note 63 (holding that the CFTC "will not hesitate to look behind whatever label the parties may give to the instrument"). As also noted in the Proposing Release, the form of a transaction is not dispositive in determining whether an agreement, contract, or transaction falls within the regulatory regime for securities. See SEC v. Merch. Capital, LLC, 483 F.3d 747, 755 (11th Cir. 2007) ("The Supreme Court has repeatedly emphasized that economic reality is to govern over form and that the definitions of the various types of securities should not hinge on exact and literal tests.") (quoting Williamson v. Tucker, 645 F.2d 404, 418 (5th Cir. 1981)); Robinson v. Glynn, 349 F.3d 166, 170 (4th Cir. 2003) ("What matters more than the form of an investment scheme is the 'economic reality' that it represents . . . .") (internal citation omitted); Caiola v. Citibank, N.A., New York, 295 F.3d 312, 325 (2d Cir. 2002) (quoting United Housing Foundation v. Foreman, 421 U.S. 837, 848 (1975) ("In searching for the meaning and scope of the word 'security' . . . the emphasis should be on economic reality")). See Proposing Release at 29839 n. 152.

605 The Commissions note, though, that documentation is not controlling in evaluating whether an agreement, contract or transaction is a swap, security-based swap, or neither.

terms and other characteristics. Even if one effect of an agreement is to reduce the risk faced by the parties (for example, the "swap" of physical delivery obligations described above may reduce the risk of non-delivery), the agreement would not be a swap or security-based swap unless it otherwise meets one of those statutory definitions, as further defined by the Commissions. If the agreement, contract, or transaction satisfies the swap or security-based swap definitions, the fact that the parties refer to it by another name would not take it outside the Dodd-Frank Act regulatory regime. Conversely, if an agreement, contract, or transaction is not a swap or security-based swap, as those terms are defined in the CEA and the Exchange Act and the rules and regulations thereunder, the fact that the parties refer to it, or document it, as a swap or security-based swap will not subject that agreement, contract, or transaction to regulation as a swap or a security-based swap.

Comments

The Commissions requested comment regarding what agreements, contracts, or transactions that are not swaps or security-based swaps are documented using industry standard form agreements that are typically used for swaps and security-based swaps, and asked for examples thereof and details regarding their documentation, including why industry standard form agreements typically used for swaps and security-based swaps are used. One commenter stated its view that documentation can be a relevant factor in determining whether an agreement, contract or transaction is a swap or security-based swap.[606] The Commissions are persuaded by the commenter and are modifying the interpretation to clarify that in determining whether an

[606] See IECA Letter. This commenter noted that "[e]ven though swaps are commonly documented on the ISDA Master Agreements without annexes, physical transactions under such agreements with power or natural gas annexes are not swaps because they are physically settled forward contracts that are exempt under 1a47(B)"). Id.

agreement, contract or transaction is a swap or security-based swap, documentation may be a relevant (but not dispositive) factor.

2. Transactions in Regional Transmission Organizations and Independent System Operators

The CFTC declines to address the status of transactions in Regional Transmission Organizations ("RTOs") and Independent System Operators ("ISOs"), including financial transmission rights ("FTRs") and ancillary services, within this joint definitional rulemaking. As was noted in the Proposing Release, section 722 of the Dodd-Frank Act specifically addresses certain instruments and transactions regulated by FERC that also may be subject to CFTC jurisdiction. Section 722(f) added CEA section 4(c)(6),[607] which provides that, if the CFTC determines that an exemption for FERC-regulated instruments or other specified electricity transactions would be in accordance with the public interest, then the CFTC shall exempt such instruments or transactions from the requirements of the CEA. Given that specific statutory directive, the treatment of these FERC-regulated instruments and transactions should be considered under the standards and procedures specified in section 722 of the Dodd-Frank Act for a public interest waiver, rather than through this joint rulemaking to further define the terms "swap" and "security-based swap."[608]

The CFTC notes that it has been engaged in discussions with a number of RTOs and ISOs regarding the possibility of a petition seeking an exemption pursuant to CEA section 4(c)(6) for certain RTO and ISO transactions. The CFTC also notes that the status of some RTO and ISO transactions may have been addressed in the interpretation above regarding embedded

607 7 U.S.C. 6(c)(6).

608 The Commissions note that this approach should not be taken to suggest any finding by the Commissions as to whether or not FTRs or any other FERC-regulated instruments or transactions are swaps (or futures contracts).

options and the forward exclusion from the swap definition,[609] and/or indirectly through the CFTC's recent interim final rulemaking relating to trade options.[610]

Comments

The CFTC received a number of comments discussing transactions in RTOs and ISOs.[611] These commenters argued that the CFTC should further define the term "swap" to exclude transactions executed or traded on RTOs and ISOs.[612] One commenter argued that the CEA section 4(c)(6) exemptive approach will leave regulatory ambiguity for market participants, since the CFTC might not grant an exemption, later revoke an existing exemption, grant a partial or conditional exemption, or limit an exemption to existing products.[613] This commenter also noted that FERC has complete regulatory authority over RTOs and ISOs and their transactions, and that Congress expected the CFTC and FERC to avoid duplicative, unnecessary regulation.[614] Another commenter argued that the CFTC should exclude RTO and ISO transactions in the same manner as insurance has been excluded.[615] A third commenter stated that RTO and ISO transactions are commercial merchandising transactions and thus forwards or, alternatively, that defining them as swaps is inconsistent with the text, goals, and purpose of the Dodd-Frank Act.[616]

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609 See supra part II.B.2(a).

610 See supra note 317.

611 See COPE Letter; ETA Letter; and FERC Staff Letter.

612 Id.

613 See COPE Letter.

614 Id.

615 See ETA Letter.

616 See FERC Staff Letter.

By contrast, one commenter asserted that FTRs are in substance swaps and should be regulated as such.[617]

Two commenters supported the CFTC's use of its section 722(f) authority to exempt FERC-regulated transactions and other transactions in RTOs or ISOs.[618] As discussed above, section 722(f) of the Dodd-Frank Act added new section 4(c)(6) to the CEA specifically addressing how the CFTC should approach certain instruments and transactions regulated by FERC that also may be subject to CFTC jurisdiction. The CFTC continues to believe, as was stated in the Proposing Release, that such an approach is the more appropriate means of considering issues relating to the instruments and transactions specified in CEA section 4(c)(6). One commenter's argument that the CEA section 4(c)(6) exemptive approach will cause regulatory ambiguity is not a convincing basis on which to forego a process specifically designated by Congress for the issue at hand.[619] The CFTC also believes that the ability to tailor exemptive relief, after notice and public comment, to the complex issues presented by transactions on RTOs and ISOs, is further reason to favor such an approach over the more general directive to further define the terms "swap" and "security-based swap" that is the subject of this rulemaking.

In response to one commenter's contentions that FERC has complete regulatory authority over RTOs and ISOs and their transactions, and that Congress expected the CFTC and FERC to avoid duplicative, unnecessary regulation, the CFTC notes that Congress addressed this issue not

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617 See Better Markets Letter.

618 See NEMA Letter and WGCEF Letter.

619 See COPE Letter.

by excluding RTO and ISO transactions from the comprehensive regime for swap regulation, but rather by enacting the exemptive process in CEA section 4(c)(6).

And in response to another commenter's contention that the CFTC should exclude RTO and ISO transactions in the same manner as insurance has been excluded, the CFTC notes that Congress provided neither an exemptive process equivalent to CEA section 4(c)(6) for insurance, nor an energy market-equivalent to the McCarran-Ferguson Act.[620]

As noted above, FERC staff opines that defining RTO and ISO transactions as swaps would be inconsistent with the text, goals, and purpose of the Dodd-Frank Act. The CFTC can consider concerns of the sort expressed by FERC staff in connection with any petition for a CEA section 4(c)(6) exemption that may be submitted to the CFTC.[621] Interested parties on all sides of the issue would receive an opportunity to comment on the scope and other aspects of any proposed exemptive relief at that time.

III. The Relationship between the Swap Definition and the Security-Based Swap Definition

A. Introduction

Title VII of the Dodd-Frank Act defines the term "swap" under the CEA,[622] and also defines the term "security-based swap" under the Exchange Act.[623] Pursuant to the regulatory framework established in Title VII, the CFTC has regulatory authority over swaps and the SEC has regulatory authority over security-based swaps. The Commissions are further defining the terms "swap" and "security-based swap" to clarify whether particular agreements, contracts, or

620 15 U.S.C. §§ 1011-1015.

621 CEA section 4(c)(6) requires the CFTC to determine that an exemption pursuant to such section "is consistent with the public interest and the purposes of th[e CEA]." 7 U.S.C. 6(c)(6).

622 See section 1a(47) of the CEA, 7 U.S.C. 1a(47).

623 See section 3(a)(68) of the Exchange Act, 15 U.S.C. 78c(a)(68).

transactions are swaps or security-based swaps based on characteristics including the specific terms and conditions of the instrument and the nature of, among other things, the prices, rates, securities, indexes, or commodities upon which the instrument is based.

Because the discussion below is focused on whether particular agreements, contracts, or transactions are swaps or security-based swaps, the Commissions use the term "Title VII instrument" in this release to refer to any agreement, contract, or transaction that is included in either the definition of the term "swap" or the definition of the term "security-based swap." Thus, the term "Title VII instrument" is synonymous with "swap or security-based swap."[624]

The determination of whether a Title VII instrument is either a swap or a security-based swap should be made based on the facts and circumstances relating to the Title VII instrument prior to execution, but no later than when the parties offer to enter into the Title VII instrument.[625] If the Title VII instrument itself is not amended, modified, or otherwise adjusted during its term by the parties, its characterization as a swap or security-based swap will not change during its duration because of any changes that may occur to the factors affecting its character as a swap or security-based swap.[626]

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[624] In some cases, the Title VII instrument may be a mixed swap. Mixed swaps are discussed further in section IV below.

[625] The determination must be made no later than when the parties offer to enter into the Title VII instrument because persons are prohibited from offering to sell, offering to buy or purchase, or selling a security-based swap to any person who is not an ECP unless a registration statement is in effect as to the security-based swap. See section 5(e) of the Securities Act. This analysis also would apply with respect to mixed swaps and security-based swap agreements. With respect to swaps, the determination also would need to be made no later than the time that provisions of the CEA and the regulations thereunder become applicable to a Title VII Instrument. For instance, certain duties apply to swaps prior to execution. See Daily Trading Records under Rule 23.202 under the CEA, 17 CFR 23.202, and Subpart H of Part 23 of the CFTC's regulations, 17 CFR Part 23, Subpart H (Business Conduct Standards for Swap Dealers and Major Swap Participants Dealing with Counterparties, Including Special Entities).

[626] See infra part III.G.5(a), for a discussion regarding the evaluation of Title VII Instruments on security indexes that move from broad-based to narrow-based or narrow-based to broad-based.

Classifying a Title VII instrument as a swap or security-based swap is straightforward for most instruments. However, the Commissions provided an interpretation in the Proposing Release to clarify the classification of swaps and security-based swaps in certain areas and to provide an interpretation regarding the use of certain terms and conditions in Title VII instruments. The Commissions are restating the interpretation set out in the Proposing Release with certain modifications to the interpretation regarding TRS.

B. Title VII Instruments Based on Interest Rates, Other Monetary Rates, and Yields

Parties frequently use Title VII instruments to manage risks related to, or to speculate on, changes in interest rates, other monetary rates or amounts, or the return on various types of assets. Broadly speaking, Title VII instruments based on interest or other monetary rates would be swaps, whereas Title VII instruments based on the yield or value of a single security, loan, or narrow-based security index would be security-based swaps. However, market participants and financial professionals sometimes use the terms "rate" and "yield" in different ways. The Commissions proposed an interpretation in the Proposing Release regarding whether Title VII instruments that are based on interest rates, other monetary rates, or yields would be swaps or security-based swaps and are restating the interpretation, but with a modification to the list of examples of reference rates to include certain secured lending rates under money market rates.[627] The Commissions find that this interpretation is an appropriate way to address Title VII instruments based on interest rates, other monetary rates, or yields and is designed to reduce

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627 These secured lending rates are the Eurepo, The Depository Trust & Clearing Corporation's General Collateral Finance Repo Index, the Repurchase Overnight Index Average Rate and the Tokyo Repo Rate.

costs associated with determining whether such instruments are swaps or security-based swaps.[628]

1. Title VII Instruments Based on Interest Rates or Other Monetary Rates that are Swaps

The Commissions believe that when payments exchanged under a Title VII instrument are based solely on the levels of certain interest rates or other monetary rates that are not themselves based on one or more securities, the instrument would be a swap and not a security-based swap.[629] Often swaps on interest rates or other monetary rates require the parties to make payments based on the comparison of a specified floating rate (such as the London Interbank Offered Rate ("LIBOR")) to a fixed rate of interest agreed upon by the parties. A rate swap also may require payments based on the differences between two floating rates, or it may require that the parties make such payments when any agreed-upon events with respect to interest rates or other monetary rates occur (such as when a specified interest rate crosses a threshold, or when the spread between two such rates reaches a certain point). The rates referenced for the parties' obligations are varied, and examples of such rates include the following:

Interbank Offered Rates: an average of rates charged by a group of banks for lending money to each other or other banks over various periods of time, and other similar interbank rates,[630] including, but not limited to, LIBOR (regardless of currency);[631] the Euro Interbank

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628 See supra part I, under "Overall Economic Considerations".

629 See infra part III.F, regarding the use of certain terms and conditions.

630 Interbank lending rates are measured by surveys of the loan rates that banks offer other banks, or by other mechanisms. The periods of time for such loans may range from overnight to 12 months or longer.

The interbank offered rates listed here are frequently called either a "reference rate," the rate of "reference banks," or by a designation that is specific to the service that quotes the rate. For some of the interbank offered rates listed here, there is a similar rate that is stated as an interbank bid

Offered Rate ("Euribor"); the Canadian Dealer Offered Rate ("CDOR"); and the Tokyo Interbank Offered Rate ("TIBOR");[632]

Money Market Rates: a rate established or determined based on actual lending or money market transactions, including, but not limited to, the Federal Funds Effective Rate; the Euro Overnight Index Average ("EONIA" or "EURONIA") (which is the weighted average of overnight unsecured lending transactions in the Euro-area interbank market); the EONIA Swap Index; the Eurepo (the rate at which, at 11.00 a.m. Brussels time, one bank offers, in the euro-zone and worldwide, funds in euro to another bank if in exchange the former receives from the latter the best collateral within the most actively-traded European repo market); the Australian dollar RBA 30 Interbank Overnight Cash Rate; the Canadian Overnight Repo Rate Average ("CORRA"); The Depository Trust & Clearing Corporation's General Collateral Finance ("GCF") Repo Index (an average of repo rates collateralized by U.S. Treasury and certain other securities); the Mexican interbank equilibrium interest rate ("TIIE"); the NZD Official Cash Rate; the Sterling Overnight Interbank Average Rate ("SONIA") (which is the weighted average

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rate, which is the average rate at which a group of banks bid to borrow money from other banks. For example, the bid rate similar to LIBOR is called LIBID.

631 Today, LIBOR is used as a rate of reference for the following currencies: Australian Dollar, Canadian Dollar, Danish Krone, Euro, Japanese Yen, New Zealand Dollar, Pound Sterling, Swedish Krona, Swiss Franc, and U.S. Dollar.

632 Other interbank offered rates include the following (with the country or city component of the acronym listed in parentheses): AIDIBOR (Abu Dhabi); BAIBOR (Buenos Aires); BKIBOR (Bangkok); BRAZIBOR (Brazil); BRIBOR/BRIBID (Btatislava); BUBOR (Budapest); CHIBOR (China); CHILIBOR (Chile); CIBOR (Copenhagen); COLIBOR (Columbia); HIBOR (Hong Kong); JIBAR (Johannesburg); JIBOR (Jakarta); KAIBOR (Kazakhstan); KIBOR (Karachi); KLIBOR (Kuala Lumpur); KORIBOR ((South) Korea); MEXIBOR (Mexico); MIBOR (Mumbai); MOSIBOR (Moscow); NIBOR (Norway); PHIBOR (Philippines); PRIBOR (Prague); REIBOR/REIBID (Reykjavik); RIGIBOR/RIGIBID (Riga); SHIBOR (Shanghai); SIBOR (Singapore); SOFIBOR (Sofia); STIBOR (Stockholm); TAIBOR (Taiwan); TELBOR (Tel Aviv); TRLIBOR and TURKIBOR (Turkey); VILIBOR (Vilnius); VNIBOR (Vietnam); and WIBOR (Warsaw).

of unsecured overnight cash transactions brokered in London by the Wholesale Markets Brokers' Association ("WMBA")); the Repurchase Overnight Index Average Rate ("RONIA") (which is the weighted average rate of all secured overnight cash transactions brokered in London by WMBA); the Swiss Average Rate Overnight ("SARON"); the Tokyo Overnight Average Rate ("TONAR") (which is based on uncollateralized overnight average call rates for interbank lending); and the Tokyo Repo Rate (average repo rate of active Japanese repo market participants).

Government Target Rates: a rate established or determined based on guidance established by a central bank including, but not limited to, the Federal Reserve discount rate, the Bank of England base rate and policy rate, the Canada Bank rate, and the Bank of Japan policy rate (also known as the Mutan rate);

General Lending Rates: a general rate used for lending money, including, but not limited to, a prime rate, rate in the commercial paper market, or any similar rate provided that it is not based on any security, loan, or group or index of securities;

Indexes: a rate derived from an index of any of the foregoing or following rates, averages, or indexes, including but not limited to a constant maturity rate (U.S. Treasury and certain other rates),[633] the interest rate swap rates published by the Federal Reserve in its "H.15 Selected Interest Rates" publication, the ISDAFIX rates, the ICAP Fixings, a constant maturity swap, or a rate generated as an average (geometric, arithmetic, or otherwise) of any of the

[633] A Title VII instrument based solely on the level of a constant maturity U.S. Treasury rate would be a swap because U.S. Treasuries are exempted securities that are excluded from the security-based swap definition. Conversely, a Title VII instrument based solely on the level of a constant maturity rate on a narrow-based index of non-exempted securities under the security-based swap definition would be a security-based swap.

foregoing, such as overnight index swaps ("OIS") – provided that such rates are not based on a specific security, loan, or narrow-based group or index of securities;

Other Monetary Rates: a monetary rate including, but not limited to, the Consumer Price Index ("CPI"), the rate of change in the money supply, or an economic rate such as a payroll index; and

Other: the volatility, variance, rate of change of (or the spread, correlation or difference between), or index based on any of the foregoing rates or averages of such rates, such as forward spread agreements, references used to calculate the variable payments in index amortizing swaps (whereby the notional principal amount of the agreement is amortized according to the movement of an underlying rate), or correlation swaps and basis swaps, including but not limited to, the "TED spread"[634] and the spread or correlation between LIBOR and an OIS.

As discussed above, the Commissions believe that when payments under a Title VII instrument are based solely on any of the foregoing, such Title VII instrument would be a swap.

Comments

Two commenters believed that constant maturity swaps always should be treated as swaps, rather than mixed swaps, because they generally are viewed by market participants as rates trades instead of trades on securities.[635] According to the commenters, the "bulk" of constant maturity swaps are based on exempted securities, but the commenters noted that the constant maturity leg may be based on a number of different rates or yields, including, among

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634 The TED spread is the difference between the interest rates on interbank loans and short-term U.S. government debt (Treasury bills or "T-bills"). The latter are exempted securities that are excluded from the statutory definition of the term "security-based swap." Thus, neither any aspect of U.S. Treasuries nor interest rates on interbank loans can form the basis of a security-based swap. For this reason, a Title VII instrument on a spread between interbank loan rates and T-bill rates also would be a swap, not a security-based swap.

635 See CME Letter and SIFMA Letter.

other things, U.S. Treasury yields, Treasury auction rates, yields on debt of foreign governments, and debt related to indices of mortgage-backed securities.[636] As discussed above, the Commissions are adopting the interpretation as proposed. The statutory language of the swap and security-based swap definitions explicitly states that a Title VII instrument that is based on a non-exempted security should be a security-based swap and not a swap.[637]

2. Title VII Instruments Based on Yields

The Commissions proposed an interpretation in the Proposing Release clarifying the status of Title VII instruments in which one of the underlying references of the instrument is a "yield." The Commissions received no comments on the interpretation set out in the Proposing Release regarding Title VII instruments based on yields and are restating the interpretation without modification. In cases when a "yield" is calculated based on the price or changes in price of a debt security, loan, or narrow-based security index, it is another way of expressing the price or value of a debt security, loan, or narrow-based security index. For example, debt securities often are quoted and traded on a yield basis rather than on a dollar price, where the yield relates to a specific date, such as the date of maturity of the debt security (i.e., yield to maturity) or the date upon which the debt security may be redeemed or called by the issuer (e.g., yield to first whole issue call).[638]

Except in the case of certain exempted securities, when one of the underlying references of the Title VII instrument is the "yield" of a debt security, loan, or narrow-based security index in the sense where the term "yield" is used as a proxy for the price or value of the debt security loan, or narrow-based security index, the Title VII instrument would be a security-based swap.

636 Id.

637 See supra note 633.

638 See, e.g., Securities Confirmations, 47 FR 37920 (Aug. 27, 1982).

And, as a result, in cases where the underlying reference is a point on a "yield curve" generated from the different "yields" on debt securities in a narrow-based security index (e.g., a constant maturity yield or rate), the Title VII instrument would be a security-based swap. However, where certain exempted securities, such as U.S. Treasury securities, are the only underlying reference of a Title VII instrument involving securities, the Title VII instrument would be a swap. Title VII instruments based on exempted securities are discussed further below.

The above interpretation would not apply in cases where the "yield" referenced in a Title VII instrument is not based on a debt security, loan, or narrow-based security index of debt securities but rather is being used to reference an interest rate or monetary rate as outlined above in subsection one of this section. In these cases, this "yield" reference would be considered equivalent to a reference to an interest rate or monetary rate and the Title VII instrument would be, under the interpretation in this section, a swap (or mixed swap depending on other references in the instrument).

3. Title VII Instruments Based on Government Debt Obligations

The Commissions provided an interpretation in the Proposing Release regarding instances in which the underlying reference of the Title VII instrument is a government debt obligation. The Commissions received no comments on the interpretation provided regarding instances in which the underlying reference of the Title VII instrument is a government debt obligation and are restating such interpretation without modification.

The security-based swap definition specifically excludes any agreement, contract, or transaction that meets the definition of a security-based swap only because it "references, is based upon, or settles through the transfer, delivery, or receipt of an exempted security under [section 3(a)(12) of the Exchange Act], as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in [section 3(a)(29) of the

Exchange Act] . . .), unless such agreement, contract, or transaction is of the character of, or is commonly known in the trade as, a put, call, or other option."[639]

As a result of this exclusion in the security-based swap definition for "exempted securities,"[640] if the only underlying reference of a Title VII instrument involving securities is, for example, the price of a U.S. Treasury security and the instrument does not have any other underlying reference involving securities, then the instrument would be a swap. Similarly, if the Title VII instrument is based on the "yield" of a U.S. Treasury security and does not have any other underlying reference involving securities, then the instrument also would be a swap, regardless of whether the term "yield" is a proxy for the price of the security.

Foreign government securities, by contrast, were not "exempted securities" as of the date of enactment of the Futures Trading Act of 1982[641] and thus do not explicitly fall within this exclusion from the security-based swap definition. Therefore, if the underlying reference of the Title VII instrument is the price, value, or "yield" (where "yield" is a proxy for price or value) of a foreign government security, or a point on a yield curve derived from a narrow-based security index composed of foreign government securities, then the instrument is a security-based swap.

C. Total Return Swaps

The Commissions are restating the interpretation regarding TRS set out in the Proposing Release with certain changes with respect to quanto and compo equity TRS and loan TRS based

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639 Section 3(a)(68)(C) of the Exchange Act, 15 U.S.C. 76c(a)(68)(C).

640 As of January 11, 1983, the date of enactment of the Futures Trading Act of 1982, Pub. L. 97-444, 96 Stat. 2294, section 3(a)(12) of the Exchange Act, 15 U.S.C. 78c(a)(12), provided that, among other securities, "exempted securities" include: i) securities which are direct obligations of, or obligations guaranteed as to principal or interest by, the United States; ii) certain securities issued or guaranteed by corporations in which the United States has a direct or indirect interest as designated by the Secretary of the Treasury; and iii) certain other securities as designated by the SEC in rules and regulations.

641 Pub. L. 97-444, 96 Stat. 2294 (1983).

on two or more loans, and to reflect that TRS can overlie reference items other than securities, loans, and indexes of securities or loans.[642] The Commissions find that this interpretation is an appropriate way to address TRS and is designed to reduce the cost associated with determining whether a TRS is a swap or a security-based swap.[643]

As was described in the Proposing Release,[644] a TRS is a Title VII instrument in which one counterparty, the seller of the TRS, makes a payment that is based on the price appreciation and income from an underlying security or security index.[645] A TRS also can overlie a single loan, two or more loans and other underliers. The other counterparty, the buyer of the TRS, makes a financing payment that is often based on a variable interest rate, such as LIBOR (or other interbank offered rate or money market rate, as described above), as well as a payment based on the price depreciation of the underlying reference. The "total return" consists of the price appreciation or depreciation, plus any interest or income payments.[646] Accordingly, where a TRS is based on a single security or loan, or a narrow-based security index, the TRS would be a security-based swap.[647]

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642 While this guidance focuses on TRS overlying securities and loans, TRS also may overlie other commodities. Such TRS may be structured differently due to the nature of the underlying.

643 See supra part I, under "Overall Economic Considerations."

644 See Proposing Release at 29842.

645 Where the underlying security is an equity security, a TRS is also known as an "equity swap." A bond may also be the underlying security of a TRS.

646 If the total return is negative, the seller receives this amount from the buyer. TRS can be used to synthetically reproduce the payoffs of a position. For example, two counterparties may enter into a 3-year TRS where the buyer of the TRS receives the positive total return on XYZ security, if any, and the seller of the TRS receives LIBOR plus 30 basis points and the absolute value of the negative total return on XYZ security, if any.

647 However, if the underlying reference of the TRS is a broad-based security index, it is a swap (and an SBSA) and not a security-based swap. In addition, a TRS on an exempted security, such as a U.S. Treasury, under section 3(a)(12) of the Exchange Act, 15 U.S.C. 78c(a)(12), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Exchange Act, 15 U.S.C. 78c(a)(29), as in effect on the date of

In addition, the Commissions are providing a final interpretation providing that, generally, the use of a variable interest rate in the TRS buyer's payment obligations to the seller is incidental to the purpose of, and the risk that the counterparties assume in, entering into the TRS, because such payments are a form of financing reflecting the seller's (typically a security-based swap dealer) cost of financing the position or a related hedge, allowing the TRS buyer to receive payments based on the price appreciation and income of a security or security index without purchasing the security or security index. As stated in the Proposing Release, the Commissions believe that when such interest rate payments act merely as a financing component in a TRS, or in any other security-based swap, the inclusion of such interest rate terms would not cause the TRS to be characterized as a mixed swap.[648] Financing terms may also involve adding or subtracting a spread to or from the financing rate,[649] or calculating the financing rate in a currency other than that of the underlying reference security or security index.[650]

However, where such payments incorporate additional elements that create additional interest rate or currency exposures that are unrelated to the financing of the security-based swap, or otherwise shift or limit risks that are related to the financing of the security-based swap, those

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enactment of the Futures Trading Act of 1982), is a swap (and an SBSA), and not a security-based swap. Similarly, and as discussed in more detail below, an LTRS based on two or more loans that are not securities ("non-security loans") are swaps, and not security-based swaps.

648 See infra part IV.

649 See, e.g., Moorad Chowdry, "Total Return Swaps: Credit Derivatives and Synthetic Funding Instruments," at 3–4 (noting that the spread to the TRS financing rate is a function of: the credit rating of the counterparty paying the financing rate; the amount, value, and credit quality of the reference asset; the dealer's funding costs; a profit margin; and the capital charge associated with the TRS), available at http://www.yieldcurve.com/Mktresearch/LearningCurve/TRS.pdf.

650 For example, a security-based swap on an equity security priced in U.S. dollars in which payments are made in Euros based on the U.S. dollar/Euro spot rate at the time the payment is made would not be a mixed swap. As the Commissions stated in the Proposing Release, under these circumstances, the currency is merely referenced in connection with the method of payment, and the counterparties are not hedging the risk of changes in currency exchange rates during the term of the security-based swap See Proposing Release at 29842, n. 176.

additional elements may cause the security-based swap to be a mixed swap. For example, where the counterparties embed interest-rate optionality (e.g., a cap, collar, call, or put) into the terms of a security-based swap in a manner designed to shift or limit interest rate exposure, the inclusion of these terms would cause the TRS to be both a swap and a security-based swap (i.e., a mixed swap). Similarly, if a TRS is also based on non-security-based components (such as the price of oil, or a currency), the TRS would also be a mixed swap.[651]

The Commissions also are providing an additional interpretation regarding a quanto equity swap, in response to comments raised by one commenter,[652] and for illustrative purposes, a similar but contrasting product, a compo equity swap. A quanto equity swap, which "can provide a U.S. investor with currency-protected exposure to a non-U.S. equity index by translating the percentage equity return in the currency of such non-U.S. equity index into U.S. dollars,"[653] can be described as:

> an equity swap in which [(1)] the underlying is denominated in a currency (the foreign currency) other than that in which the equity swap is denominated (the domestic currency) . . . [and (2) t]he final value of the underlying is denominated in the foreign currency and is converted into the domestic currency using the exchange rate prevailing at inception[,] result[ing in] the investor . . . . not [being] exposed to currency risk.[654]

While a quanto equity swap, therefore, effectively "exposes the dealer on the foreign leg of the correlation product to a variable notional principal amount that changes whenever the

651 See Mixed Swaps, infra part IV.

652 See SIFMA Letter.

653 Id.

654 Handbook of Corporate Equity Derivatives and Equity Capital Markets ("Corporate Equity Derivatives Handbook"), § 1.2.10, at 23, available at, http://media.wiley.com/product_data/excerpt/05/11199759/1119975905-83.pdf <last visited May 4, 2012>.

exchange rate or the foreign index fluctuates,"[655] such exposure results from the choice of hedges for the quanto equity swap, not from the cash flows of the quanto equity swap itself.[656] Thus, that exposure could be viewed as created in the seller by the act of entering into the quanto equity swap, rather than as a transfer between the parties, as is required by the third prong of the statutory swap definition. Consequently, the dealer's exchange rate exposure could be seen as incidental to the securities exposure desired by the party initiating the quanto equity swap.

The Commissions view a quanto equity swap as a security-based swap, and not a mixed swap, where (i) the purpose of the quanto equity swap is to transfer exposure to the return of a security or security index without transferring exposure to any currency or exchange rate risk; and (ii) any exchange rate or currency risk exposure incurred by the dealer due to a difference in the currency denomination of the quanto equity swap and of the underlying security or security index is incidental to the quanto equity swap and arises from the instrument(s) the dealer chooses to use to hedge the quanto equity swap and is not a direct result of any expected payment obligations by either party under the quanto equity swap.[657]

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655 James M. Mahoney, Correlation Products and Risk Management Issues, FRBNY ECONOMIC POLICY REVIEW / OCTOBER 1995 at 2, available at, http://www.ny.frb.org/research/epr/95v01n3/9510maho.pdf <last visited May 4, 2012>.

656 While applicable in general, this logic, which merely expands upon the principle that the character of a Title VII instrument as either a swap or a security-based swap should follow the underlying factors which are incorporated into the cash flows of the instrument – a security, yield, loan, or other trigger for SEC jurisdiction or as a commodity triggering CFTC jurisdiction (or both for joint jurisdiction), should not be extrapolated to other Title VII instruments, for which other principles may override.

657 Although the SIFMA Letter describes quanto equity swaps in terms of equity indexes, if the underlying reference of a quanto equity swap is a single security, the result would be the same. The Commissions also note that if a security index underlying a quanto equity swap is not narrow-based, the quanto equity swap is a swap. In that event, it is not a mixed swap because no element of the quanto equity swap is a security-based swap and, to be a mixed swap, a Title VII instrument must have both swap and security-based swap components.

By contrast, in a compo equity swap, the parties assume exposure to, and the total return is calculated based on, both the performance of specified foreign stocks and the change in the relevant exchange rate.[658] Because the counterparty initiating a transaction can choose to avoid currency exposure by entering into a quanto equity swap, the currency exposure obtained via a compo equity swap is not incidental to the equity exposure for purposes of determining mixed swap status. In fact, investors seeking synthetic exposure to foreign securities via a TRS may also be seeking exposure to the exchange rate between the currencies, as evidenced by the fact that a number of mutual funds exist in both hedged and unhedged versions to provide investors exposure to the same foreign securities with or without the attendant currency exposure.[659] Consequently, a compo equity swap is a mixed swap.[660]

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658 See generally Corporate Equity Derivatives Handbook, supra note 654, § 1.2.9, at 21-23.

659 See, e.g., Descriptive Brochure: The Tweedy, Browne Global Value Fund II - Currency Unhedged at 1, available at http://www.tweedy.com/resources/gvf2/TBGVF-II_verJuly2011.pdf <last visited May 4, 2012> (comparing the Tweedy, Browne Global Value Fund II - Currency Unhedged and the Tweedy, Browne Global Value Fund (which hedges its currency exposure) and stating that "[t]he only material difference [between the funds] is that the Unhedged Global Value Fund generally does not hedge currency risk [and] is designed for long-term value investors who wish to focus their investment exposure on foreign stock markets, and their associated non-U.S. currencies" and "[b]y establishing the Tweedy, Browne Global Value Fund II – Currency Unhedged, we were acknowledging that many investors may view exposure to foreign currency as another form of diversification when investing outside the U.S., and/or may have strong opinions regarding the future direction of the U.S. dollar."). See also the PIMCO Foreign Bond Fund (Unhedged) Fact Sheet at 1 (stating that "[t]he fund seeks to capture the returns of non-U.S. bonds including potential returns due to changes in exchange rates. In a declining dollar environment foreign currency appreciation may augment the returns generated by investments in foreign bonds."), available at http://investments.pimco.com/ShareholderCommunications/External%20Documents/Foreign%20Bond%20Fund%20(Unhedged)%20Institutional.pdf <last visited May 4, 2012> and the PIMCO Foreign Bond Fund (U.S. Dollar-Hedged) INSTL Fact Sheet at 1 (stating that "[t]he fund seeks to capture the returns of non-U.S. bonds but generally hedges out most currency exposure in order to limit the volatility of returns."), available at http://investments.pimco.com/ShareholderCommunications/External%20Documents/Foreign%20Bond%20Fund%20(U.S.%20Dollar-Hedged)%20Institutional.pdf <last visited May 4, 2012>.

660 Such swaps are examples of swaps with payments that "incorporate additional elements that create additional . . . currency exposures . . . unrelated to the financing of the security-based swap

In response to comments,[661] the Commissions also are providing an interpretation with respect to the treatment of loan TRS ("LTRS") on two or more loans. As noted above, the second prong of the security-based swap definition includes a swap that is based on "a single security or loan, including any interest therein or on the value thereof." Thus, an LTRS based on a single loan, as mentioned above, is a security-based swap. The Commissions believe, however, that an LTRS based on two or more non-security loans are swaps, and not security-based swaps.[662] An LTRS on a group or index of such non-security loans is not covered by the first prong of the security-based swap definition--swaps based on a narrow-based security index--because the definition of the term "narrow-based security index" in both the CEA and the Exchange Act only applies to securities, and not to non-security loans.[663] An LTRS, moreover, is not covered by the third prong of the security-based swap definition because it is based on the total return of such loans, and not events related thereto. Accordingly, an LTRS on two or more loans that are non-security loans is a swap and not a security-based swap.[664]

Comments

. . . that may cause the security-based swap to be a mixed swap." See Proposing Release at 29842.

661 See infra note 667 and accompanying text.

662 Depending on the facts and circumstances loans may be notes or evidences of indebtedness that are securities. See section 3(a)(10) of the Exchange Act. In this section, the Commissions address only groups or indexes of loans that are not securities.

663 See CEA section 1a(35), 7 U.S.C. 1a(35), and section 3(a)(55) of the Exchange Act, 15 U.S.C. 78c(a)(55).

664 The same would be true with respect to swaps (e.g., options, CFDs, NDFs), other than LTRS or loan index credit default swaps, on two or more loans that are not securities.

The Commissions received three comments with respect to the interpretation provided on TRS in the Proposing Release.[665] One of these commenters addressed the Commissions' interpretation on security-based TRS.[666] The other two commenters requested that the Commissions clarify the treatment of LTRS on two or more loans.[667]

One commenter asserted that the terms of a TRS that create interest rate or currency exposures incidental to the primary purpose of the TRS should not cause a transaction that otherwise would be deemed to be a security-based swap to be characterized as a mixed swap.[668] This commenter agreed with the Commissions that the scope of the mixed swap category of Title VII instruments is intended to be narrow and that, when variable interest rates are used for financing purposes incidental to counterparties' purposes, and risks assumed, in entering into a TRS, the TRS is a security-based swap and not a mixed swap.[669]

This commenter also opined that the Commissions' interpretation that "where such payments incorporate additional elements that create additional interest rate or currency exposures . . . unrelated to the financing of the [TRS], or otherwise shift or limit risks that are related to the financing of the [TRS], those additional elements may cause the [TRS] to be a mixed swap" could be seen as requiring a quantitative analysis to determine whether a reference

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665 See July LSTA Letter; Letter from David Lucking, Allen & Overy LLP, dated May 26, 2011 ("Allen & Overy Letter"); and SIFMA Letter.

666 See SIFMA Letter.

667 See Allen & Overy Letter and July LSTA Letter.

668 See SIFMA Letter.

669 Id.

to interest rates or currencies in a TRS is solely for financing purposes or creates additional exposure that might be construed as extending beyond those purposes.[670]

The Commissions are clarifying that a quantitative analysis is not necessarily required in order to determine whether a TRS is a mixed swap. Any analysis, quantitative or qualitative, clearly demonstrating the nature of a payment (solely financing-related, unrelated to financing or a combination of the two) can suffice.[671]

The Commissions also are clarifying that market participants are not necessarily required to compare their financing rates to market financing rates in order to determine whether the financing leg of a TRS is merely a financing leg or is sufficient to render the TRS a mixed swap. Because a number of factors can influence how a particular TRS is structured,[672] the Commissions cannot provide an interpretation applicable to all situations. If the financing leg of a TRS reflects the dealer's financing costs on a one-to-one basis, the Commissions would view such leg as a financing leg. Adding a spread would not alter that conclusion if the spread is consistent with the dealer's course of dealing generally, with respect to a particular type of TRS or with respect to a particular counterparty. The Commissions believe that this would be the

670 Id. SIFMA added that such a determination could require market participants to determine whether a specific interest rate or spread referenced in the TRS is sufficiently in line with market rates to constitute a financing leg of a transaction under the proposed test. SIFMA continues by noting that there are a number of examples where a TRS can provide for some interest rate or currency exposure incidental to the primary purpose of the TRS, describing a quanto equity swap as an example.

671 To the extent a market participant is uncertain as to the results of such an analysis, it may seek informal guidance from the Commissions' staffs or use the process established in this release, see infra part VI, for seeking formal guidance from the Commissions as to the nature of a Title VII instrument as a swap, security-based swap or mixed swap.

672 For example, the Commissions would expect a dealer perceived by the market to constitute a higher counterparty risk to have higher funding costs generally, which might affect its TRS financing costs. To the extent such a dealer passed through its higher TRS financing costs to its TRS counterparty, such a pass-through simply would reflect the dealer's specific circumstances, and would not transform the TRS from a security-based swap into a mixed swap.

case even if the spread is "off-market," if the deviance from a market spread is explained by factors unique to the dealer (e.g., the dealer has high financing costs), to the TRS (e.g., the underlying securities are highly illiquid, so financing them is more costly than would be reflected in a "typical" market spread for other TRS) or to then-current market conditions (e.g., a share repurchase might make shares harder for a dealer to procure in order to hedge its obligations under a TRS to pay its counterparty the capital appreciation of a security, resulting in higher financing costs due to the decrease in shares outstanding, assuming demand for the shares does not change). If the spread is designed to provide exposure to an underlying reference other than securities, however, rather than to reflect financing costs, such a TRS is a mixed swap.

Market participants are better positioned than are the Commissions to determine what analysis, and what supporting information and materials, best establish whether the nature of a particular payment reflects financing costs alone, or something more. Moreover, the Commissions expect that a dealer would know if the purpose of the payment(s) in question is to cover its cost of financing a position or a related hedge.[673] In such cases, a detailed analysis should not be necessary.

One commenter noted the nature of quanto equity swaps as TRS and maintained that such a transaction "is equivalent to a financing of a long position in the underlying non-U.S. equity index[]" and that the currency protection is incidental to the financing element, which is the primary purpose of the TRS.[674] As discussed above, the Commissions have provided a final

673 The Commissions expect that dealers know their financing costs and can readily explain the components of the financing leg paid by their TRS counterparties.

674 Id. SIFMA distinguished quanto equity swaps from the examples of mixed swaps that the Commissions provided in the Proposing Release, characterizing them as "very different."

interpretation regarding the appropriate classification of Title VII instruments that are quanto equity swaps and compo equity swaps.

Two commenters requested that the Commissions clarify the status of LTRS on two or more loans.[675] Both commenters stated that while the statutory definition of the term "security-based swap" provides that swaps based on a single loan are security-based swaps, it does not explicitly provide whether swaps on indexes of loans are security-based swaps.[676] They requested clarification regarding the treatment of loan based swaps, including both LTRS and loan index credit default swaps.[677]

The Commissions have provided the final interpretation discussed above regarding LTRS based on two or more loans that are not securities. The Commissions acknowledge that this interpretation results in different treatment for an LTRS on two non-security loans (a swap), as opposed to a Title VII instrument based on two securities (a security-based swap). This result, however, is dictated by the statute.

D. Security-Based Swaps Based on a Single Security or Loan and Single-Name Credit Default Swaps

The Commissions provided an interpretation in the Proposing Release regarding security-based swaps based on a single security or loan and single-name CDS[678] and are restating such interpretation with certain modifications in response to commenters.[679] The second prong of the

675 See Allen & Overy Letter and July LSTA Letter.

676 See Allen & Overy Letter. Allen & Overy notes that a Title VII Instrument that references two securities is a security-based swap. It believes that treating an LTRS on two or more loans as a swap would result in functionally and potentially economically similar products being treated in an arbitrarily different way, contrary to the spirit of the Dodd-Frank Act.

677 The Commissions address the comments regarding loan index credit default swaps below. See infra note 768 and accompanying text.

678 See Proposing Release at 29843.

679 See infra note 689 and accompanying text.

statutory security-based swap definition includes a swap that is based on "a single security or loan, including any interest therein or on the value thereof."[680] The Commissions believe that under this prong of the security-based swap definition, a single-name CDS that is based on a single reference obligation would be a security-based swap because it would be based on a single security or loan (or any interest therein or on the value thereof).

In addition, the third prong of the security-based swap definition includes a swap that is based on the occurrence of an event relating to a "single issuer of a security," provided that such event "directly affects the financial statements, financial condition, or financial obligations of the issuer."[681] This provision applies generally to event-triggered swap contracts. With respect to a CDS, such events could include, for example, the bankruptcy of an issuer, a default on one of an issuer's debt securities, or the default on a non-security loan of an issuer.[682]

The Commissions believe that if the payout on a CDS on a single issuer of a security is triggered by the occurrence of an event relating to that issuer, the CDS is a security-based swap under the third prong of the statutory security-based swap definition.[683]

In relation to aggregations of transactions under a single ISDA Master Agreement,[684] the Commissions are revising the example that was included in the Proposing Release referring to

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680 Section 3(a)(68)(A)(ii)(II) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(ii)(II). The first prong of the security-based swap definition is discussed below. See infra part III.G.

681 Section 3(a)(68)(A)(ii)(III) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(ii)(III).

682 The Commissions understand that in the context of credit derivatives on asset-backed securities or MBS, the events include principal writedowns, failure to pay principal and interest shortfalls.

683 The Commissions understand that some single-name CDS now trade with fixed coupon payments expressed as a percentage of the notional amount of the transaction and payable on a periodic basis during the term of the transaction. See Markit, "The CDS Big Bang: Understanding the Changes to the Global CDS Contract and North American Conventions," 3, available at http://www.markit.com/cds/announcements/resource/cds_big_bang.pdf. The Commissions are restating their view that the existence of such single-name CDS does not change their interpretation.

single-name CDS to clarify that the interpretation regarding aggregations of transactions is non-exclusive and thus not limited to either CDS or single-reference instruments.[685]

The Commissions believe that each transaction under an ISDA Master Agreement would need to be analyzed to determine whether it is a swap or security-based swap. For example, the Commissions believe that a number of Title VII instruments that are executed at the same time and that are documented under one ISDA Master Agreement, but in which a separate confirmation is sent for each instrument, should be treated as an aggregation of such Title VII instruments, each of which must be analyzed separately under the swap and security-based swap definitions.[686] The Commissions believe that, as a practical and economic matter, each such Title VII instrument would be a separate and independent transaction. Thus, such an aggregation of Title VII instruments would not constitute a Title VII instrument based on one "index or group"[687] under the security-based swap definition but instead would constitute multiple Title VII instruments. The Commissions find that this interpretation is an appropriate way to address CDS, TRS or other Title VII instruments referencing a single security or loan or entity that is documented under a Master Agreement or Master Confirmation and is designed to reduce the cost associated with determining whether such instruments are swaps or security-based swaps.[688]

Comments

The Commissions received two comments regarding the interpretation regarding aggregation of Title VII instruments under a single ISDA Master Agreement. One commenter

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684 See Proposing Release at 29843.

685 See infra note 689 and accompanying text.

686 See infra note 691.

687 The security-based swap definition further defines "index to include an "index or group of securities." See section 3(a)(68)(E) of the Exchange Act, 15 U.S.C. 78c(a)(68)(E).

688 See supra part I, under "Overall Economic Considerations".

requested that the Commissions clarify that the interpretation applies to other types of instruments, such as TRS, in addition to CDS.[689] The commenter also stated that the interpretation should be helpful with respect to use of a "Master Confirmation" structure, which the commenter described as use of general terms in a "Master Confirmation" that apply to a number of instruments with separate underlying references but for which a separate "Supplemental Confirmation" is sent for each separate component.[690]

A second commenter agreed with the Commissions' interpretation that a number of single-name CDS that are executed at the same time and that are documented under one ISDA Master Agreement, but in which a separate confirmation is sent for each CDS, should not be treated as a single index CDS and stated that this approach is consistent with market practice.[691]

As discussed above, in response to comments the Commissions are expanding the example so it is clear that it applies beyond just CDS.[692]

E. Title VII Instruments Based on Futures Contracts

The Commissions proposed an interpretation in the Proposing Release regarding the treatment, generally, of swaps based on futures contracts.[693] The Commissions are restating the

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689 See July LSTA Letter.

690 Id.

691 See Letter from Richard M. McVey, Chairman and Chief Executive Officer, MarketAxess Holdings, Inc. ("MarketAxess"), July 22, 2011 ("MarketAxess Letter").

692 The Commissions believe, based on the July LSTA Letter, that the "Master Confirmation" structure the commenter described is the same general structure as the aggregation of single-name CDS the Commissions provided as an example in the Proposing Release, but that a "Master Confirmation" structure may not be limited to single-reference instruments or to CDS and instead may be used for a broader range of instruments. See July LSTA Letter. The Commissions note that the following are examples of "Master Confirmation" structure to which the interpretive guidance would apply: 2009 Americas Master Equity Derivatives Confirmation Agreement, Stand-alone 2007 Americas Master Variance Swap Confirmation Agreement, and 2004 Americas Interdealer Master Equity Derivatives Confirmation Agreement and March 2004 Canadian Supplement to the Master Confirmation. The Commissions believe the broader example in this release provides the clarification the commenter requested.

interpretation they provided in the Proposing Release without modification. The Commissions also discussed in the Proposing Release the unique circumstance involving certain futures contracts on foreign government debt securities and requested comment as to how Title VII instruments on these futures contracts should be treated.[694] In response to commenters,[695] the Commissions are adopting a rule regarding the treatment of Title VII instruments on certain futures contracts on foreign government debt securities.[696]

A Title VII instrument that is based on a futures contract will either be a swap or a security-based swap, or both (i.e., a mixed swap), depending on the nature of the futures contract, including the underlying reference of the futures contract. Thus, a Title VII instrument where the underlying reference is a security future is a security-based swap.[697] In general, a Title VII instrument where the underlying reference is a futures contract that is not a security future is a swap.[698] As the Commissions noted in the Proposing Release,[699] Title VII instruments

693 See Proposing Release at 29843-44.

694 Id.

695 See infra note 718 and accompanying text.

696 See rule 1.3(bbbb) under the CEA and rule 3a68-5 under the Exchange Act.

697 A security future is defined in both the CEA and the Exchange Act as a futures contract on a single security or a narrow-based security index, including any interest therein or based on the value thereof, except an exempted security under section 3(a)(12) of the Exchange Act, 15 U.S.C. 78c(a)(12), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Exchange Act, 15 U.S.C. 78c(a)(29), as in effect on the date of enactment of the Futures Trading Act of 1982).

The term security future does not include any agreement, contract, or transaction excluded from the CEA under sections 2(c), 2(d), 2(f), or 2(g) of the CEA, 7 U.S.C. 2(c), 2(d), 2(f), or 2(g), as in effect on the date of enactment of the Commodity Futures Modernization Act of 2000 ("CFMA") or Title IV of the CFMA. See section 1a(44) of the CEA, 7 U.S.C. 1a(44), and section 3(a)(55) of the Exchange Act, 15 U.S.C. 78c(a)(55).

698 Depending on the underlying reference of the futures contract, though, such swaps could be SBSAs. For example, a swap on a future on the S&P 500 index would be an SBSA.

699 See Proposing Release at 29843.

involving certain futures contracts on foreign government debt securities present a unique circumstance, which is discussed below.

Rule 3a12-8 under the Exchange Act exempts certain foreign government debt securities, for purposes only of the offer, sale, or confirmation of sale of futures contracts on such foreign government debt securities, from all provisions of the Exchange Act which by their terms do not apply to an "exempted security," subject to certain conditions.[700] To date, the SEC has enumerated within rule 3a12-8 the debt securities of 21 foreign governments solely for purposes of futures trading ("21 enumerated foreign governments").[701]

The Commissions recognize that as a result of rule 3a12-8, futures contracts on the debt securities of the 21 enumerated foreign governments that satisfy the conditions of rule 3a12-8 are subject to the CFTC's exclusive jurisdiction and are not considered security futures. As a result, applying the interpretation above to a Title VII instrument that is based on a futures contract on the debt securities of these 21 enumerated foreign governments would mean that the Title VII instrument would be a swap.[702] The Commissions note, however, that the conditions in rule

700 Specifically, rule 3a12-8 under the Exchange Act requires as a condition to the exemption that the foreign government debt securities not be registered under the Securities Act (or be the subject of any American depositary receipt registered under the Securities Act) and that futures contracts on such foreign government debt securities "require delivery outside the United States, [and] any of its possessions or territories, and are traded on or through a board of trade, as defined in [section 2 of the CEA, 7 U.S.C. 2]." See rules 3a12-8(a)(2) and 3a12-8(b) under the Exchange Act, 17 CFR 240.3a12-8(a)(2) and 240.3a12-8(b). These conditions were "designed to minimize the impact of the exemption on securities distribution and trading in the United States . . . ." See Exemption for Certain Foreign Government Securities for Purposes of Futures Trading, 49 FR 8595 (Mar. 8, 1984) at 8596-97 (citing Futures Trading Act of 1982).

701 See rule 3a12-8(a)(1) under the Exchange Act (designating the debt securities of the governments of the United Kingdom, Canada, Japan, Australia, France, New Zealand, Austria, Denmark, Finland, the Netherlands, Switzerland, Germany, Ireland, Italy, Spain, Mexico, Brazil, Argentina, Venezuela, Belgium, and Sweden).

702 The Commissions note, by contrast, that a Title VII instrument that is based on the price or value of, or settlement into, a futures contract on the debt securities of one of the 21 enumerated foreign governments and that also has the potential to settle directly into such debt securities would be a

3a12-8 were established specifically for purposes of the offer and sale of "qualifying foreign futures contracts" (as defined in rule 3a12-8)[703] on the debt securities of the 21 enumerated foreign governments,[704] not Title VII instruments based on futures contracts on the debt securities of the 21 enumerated governments. Further, the Commissions note that the Dodd-Frank Act did not exclude swaps on foreign government debt securities generally from the definition of the term "security-based swap." Accordingly, a Title VII instrument that is based directly on foreign government debt securities, including those of the 21 enumerated governments, is a security-based swap or a swap under the same analysis as any other Title VII instruments based on securities.

The Commissions indicated in the Proposing Release that they would evaluate whether Title VII instruments based on futures contracts on the debt securities of the 21 enumerated foreign governments that satisfy the conditions of rule 3a12-8 should be characterized as swaps, security-based swaps, or mixed swaps.[705] In response to commenters,[706] the Commissions are adopting rule 1.3(bbbb) under the CEA and rule 3a68-5 under the Exchange Act, which address the treatment of these Title VII instruments.

The final rules provide that a Title VII instrument that is based on or references a qualifying foreign futures contract on the debt securities of one or more of the 21 enumerated

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security-based swap and, depending on other features of the Title VII instrument, possibly a mixed swap.

703 Rule 3a12-8(b) under the Exchange Act defines "qualifying foreign futures contracts" as "contracts for the purchase or sale of a designated foreign government security for future delivery, as 'future delivery' is defined in 7 U.S.C. 2, provided such contracts require delivery outside the United States, any of its possessions or territories, and are traded on or through a board of trade, as defined at 7 U.S.C. 2." 17 CFR 240.3a12-8(b).

704 See supra note 700.

705 See Proposing Release at 29844.

706 See infra note 718 and accompanying text.

foreign governments is a swap and not a security-based swap, provided that the Title VII instrument satisfies the following conditions:

- The futures contract on which the Title VII instrument is based or that is referenced is a qualifying foreign futures contract (as defined in rule 3a12-8)[707] on the debt securities of any one or more of the 21 enumerated foreign governments that satisfies the conditions of rule 3a12-8;
- The Title VII instrument is traded on or through a board of trade (as defined in section 1a(6) of the CEA);
- The debt securities on which the qualifying foreign futures contract is based or referenced and any security used to determine the cash settlement amount pursuant to the fourth condition below are not covered by an effective registration statement under the Securities Act or the subject of any American depositary receipt covered by an effective registration statement under the Securities Act;
- The Title VII instrument may only be cash settled; and
- The Title VII instrument is not entered into by the issuer of the securities upon which the qualifying foreign futures contract is based or referenced (including any security used to determine the cash payment due on settlement of such Title VII instrument), an affiliate (as defined in the Securities Act and the rules and regulations thereunder)[708] of the issuer, or an underwriter with respect to such securities.

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707 See supra note 703.

708 See, e.g., rule 405 under the Securities Act, 17 CFR 230.405.

Under the first condition, the final rules provide that the futures contract on which the Title VII instrument is based or referenced must be a qualifying foreign futures contract that satisfies the conditions of rule 3a12-8 and may only be based on the debt of any one or more of the enumerated 21 foreign governments. If the conditions of rule 3a12-8 are not satisfied, then there cannot be a qualifying foreign futures contract, the futures contract is a security future, and a swap on such a security future is a security-based swap.

The second condition of the final rules provides that the Title VII instrument on the qualifying foreign futures contract must itself be traded on or through a board of trade because a qualifying foreign futures contract on the debt securities of one or more of the 21 enumerated foreign governments itself is required to be traded on a board of trade. The Commissions believe that swaps on such futures contracts should be traded subject to rules applicable to such futures contracts themselves.

The third condition of the final rules provides that the debt securities on which the qualifying foreign futures contract is based or referenced and any security used to determine the cash settlement amount pursuant to the fourth condition cannot be registered under the Securities Act or be the subject of any American depositary receipt registered under the Securities Act. This condition is intended to prevent circumvention of registration and disclosure requirements of the Securities Act applicable to foreign government issuances of their securities. This condition is similar to a condition included in rule 3a12-8.[709]

The fourth condition of the final rules provides that the Title VII instrument must be cash settled. Although, as the Commissions recognize, rule 3a12-8 permits a qualifying foreign futures contract to be physically settled so long as delivery is outside the United States, any of its

[709] See supra note 700.

possessions or territories,[710] in the context of Title VII instruments, only cash settled Title VII instruments based on qualifying foreign futures contracts on the debt securities of the 21 enumerated foreign governments will be considered swaps. The Commissions believe that this condition is appropriate in order to provide consistent treatment of Title VII instruments based on qualifying foreign futures contracts on the debt securities of the 21 enumerated foreign governments with the Commissions' treatment of swaps and security-based swaps generally.[711]

The fifth condition of the final rules provides that for a Title VII instrument to be a swap under such rules, it cannot be entered into by the issuer of the securities upon which the qualifying foreign futures contract is based or referenced (including any security used to determine the cash payment due on settlement of such Title VII instrument), an affiliate of the issuer, or an underwriter of the issuer's securities. The Commissions have included this condition to address the concerns raised by the SEC in the Proposing Release that the characterization of a Title VII instrument that is based on a futures contract on the debt securities of one of the 21 enumerated foreign governments may affect federal securities law provisions relating to the distribution of the securities upon which the Title VII instrument is based or referenced.[712]

The Dodd-Frank Act included provisions that would not permit issuers, affiliates of issuers, or underwriters to use security-based swaps to offer or sell the issuers' securities underlying a security-based swap without complying with the requirements of the Securities

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710 Id.

711 See infra part III.H.

712 See Proposing Release at 29844.

Act.[713] This provision applies regardless of whether the Title VII instrument allows the parties to physically settle any such security-based swap. In addition, the Dodd-Frank Act provided that any offer or sale of security-based swaps to non-ECPs would have to be registered under the Securities Act.[714] For example, if a Title VII instrument that is based on a futures contract on the debt securities of one of the 21 enumerated foreign governments is characterized as a swap, and not a security-based swap, then the provisions of the Dodd-Frank Act enacted to ensure that there could not be offers and sales of securities made without compliance with the Securities Act, either by issuers, their affiliates, or underwriters or to non-ECPs, would not apply to such swap transactions.

Only those Title VII instruments that are based on qualifying foreign futures contracts on the debt securities of the 21 enumerated foreign governments and that satisfy these five conditions will be swaps, not security-based swaps. The Commissions note that the final rules are intended to provide consistent treatment (other than with respect to method of settlement) of qualifying foreign futures contracts and Title VII instruments based on qualifying foreign futures contracts on the debt securities of the 21 enumerated foreign governments.[715] The Commissions understand that many of the qualifying foreign futures contracts on the debt securities of the 21 enumerated foreign governments trade with substantial volume through foreign trading venues

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[713] See section 2(a)(3) of the Securities Act, 15 U.S.C. 77b(a)(3), as amended by the Dodd-Frank Act.

[714] See section 5 of the Securities Act, 15 U.S.C. 77e, as amended by the Dodd-Frank Act.

[715] The Commissions note that the final rules provide consistent treatment of qualifying foreign futures contracts on the debt securities of the 21 enumerated foreign governments and Title VII instruments based on qualifying foreign futures contracts on the debt securities of the 21 enumerated foreign governments unless the Title VII instrument is entered into by the issuer of the securities upon which the qualifying foreign futures contract is based or referenced (including any security used to determine the cash payment due on settlement of such Title VII instrument), an affiliate of the issuer, or an underwriter with respect to such securities.

under the conditions set forth in rule 3a12-8[716] and permitting swaps on such futures contracts subject to similar conditions would not raise concerns that such swaps could be used to circumvent the conditions of rule 3a12-8 and the federal securities laws concerns that such conditions are intended to protect.[717] Further, providing consistent treatment for qualifying foreign futures contracts on the debt securities of the 21 enumerated foreign governments and Title VII instruments based on futures contracts on the debt securities of the 21 enumerated foreign governments will allow trading of these instruments through designated contract markets on which such futures are listed.

The Commissions recognize that the rules may result in a different characterization of a Title VII instrument that is based directly on a foreign government debt security and one that is based on a qualifying foreign futures contract on a debt security of one of the 21 enumerated foreign governments. However, the Commissions note that this is the case today (i.e., different treatments) with respect to other instruments subject to CFTC regulation and/or SEC regulation, such as futures on broad-based security indexes and futures on a single security or narrow-based security index.

<u>Comments</u>

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716 For the quarter that ended December 31, 2011, the trading volume reported to the CFTC of qualifying foreign futures contracts on the debt securities of the 21 enumerated foreign governments made available for trading by direct access from the U.S. on foreign trading venues granted direct access no-action relief by the CFTC that exceeded 100,000 contracts per quarter from the U.S. were as follows: (i) 7,985,959 contracts for 3 Year Treasury Bond Futures on the Australian Securities Exchange's ASX Trade24 platform; (ii) 1,872,592 contracts for 10-Year Government of Canada Bond Futures on the Bourse de Montreal; (iii) 47,874,911 contracts for Euro Bund Futures on Eurex Deutschland ("Eurex"); (iv) 26,434,713 contracts for Euro Bobl Futures on Eurex; (v) 30,489,427 contracts for Euro Schatz Futures on Eurex; and (vi) 8,292,222 contracts for Long Gilt Futures on the NYSE LIFFE.

717 <u>See</u> <u>supra</u> note 712 and accompanying text.

Commenters did not address the interpretation as it applied to Title VII instruments based on futures contracts generally. Two commenters addressed Title VII instruments based on futures contracts on debt securities of the 21 enumerated foreign governments.[718] Both commenters requested that the Commissions treat these Title VII instruments as swaps.[719] The Commissions agree that these instruments should be treated as swaps under certain conditions and, therefore, are adopting rule 1.3(bbbb) under the CEA and rule 3a68-5 under the Exchange Act as discussed above to treat Title VII instruments based on qualifying foreign futures contracts on the debt securities of the 21 enumerated foreign governments as swaps, provided such Title VII instruments satisfy certain conditions.

F. Use of Certain Terms and Conditions in Title VII Instruments

The Commissions provided an interpretation in the Proposing Release regarding the use of certain fixed terms in Title VII instruments and are restating that interpretation without modification.[720] The Commissions are aware that market participants' setting of certain fixed terms or conditions of Title VII instruments may be informed by the value or level of a security, rate, or other commodity at the time of the execution of the instrument. The Commissions believe that, in evaluating whether a Title VII instrument with such a fixed term or condition is a swap or security-based swap, the nature of the security, rate, or other commodity that informed the setting of such fixed term or condition should not itself impact the determination of whether

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718 See CME Letter and SIFMA Letter.

719 Id. Both commenters stated their belief that the range of factors considered by the SEC in designating the debt securities of the 21 enumerated foreign governments as exempted securities indicated that there is sufficient disclosure about the 21 enumerated foreign governments and their securities such that the further disclosure should not be necessary. Both commenters also indicated that subjecting futures contracts on the debt securities of the 21 enumerated foreign governments to CFTC regulation, while subjecting Title VII instruments based on these futures contracts to SEC regulation, would be problematic. Id.

720 See Proposing Release at 29845.

the Title VII instrument is a swap or a security-based swap, provided that the fixed term or condition is set at the time of execution and the value or level of that fixed term or condition may not vary over the life of the Title VII instrument.[721]

For example, a Title VII instrument, such as an interest rate swap, in which floating payments based on three-month LIBOR are exchanged for fixed rate payments of five percent would be a swap, and not a security-based swap, even if the five percent fixed rate was informed by, or quoted based on, the yield of a security, provided that the five percent fixed rate was set at the time of execution and may not vary over the life of the Title VII instrument.[722] Another example would be where a private sector or government borrower that issues a five-year, amortizing $100 million debt security with a semi-annual coupon of LIBOR plus 250 basis points also, at the same time, chooses to enter into a five-year interest rate swap on $100 million notional in which this same borrower, using the same amortization schedule as the debt security, receives semi-annual payments of LIBOR plus 250 basis points in exchange for five percent fixed rate payments. The fact that the specific terms of the interest rate swap (e.g., five-year, LIBOR plus 250 basis points, $100 million notional, fixed amortization schedule) were set at the time of execution to match related terms of a debt security does not cause the interest rate swap to become a security-based swap. However, if the interest rate swap contained additional terms that were in fact contingent on a characteristic of the debt security that may change in the future,

721 This interpretation relates solely to the determination regarding whether a Title VII instrument is a swap or security-based swap. The Commissions are not expressing a view regarding whether such Title VII instrument would be a security-based swap agreement.

722 However, to the extent the fixed term or condition is set at a future date or at a future value or level of a security, rate, or other commodity rather than the value or level of such security, rate, or other commodity at the time of execution of the Title VII instrument, the discussion above would not apply, and the nature of the security, rate, or other commodity used in determining the terms or conditions would be considered in evaluating whether the Title VII instrument is a swap or security-based swap.

such as an adjustment to future interest rate swap payments based on the future price or yield of the debt security, then this Title VII instrument would be a security-based swap that would be a mixed swap.

Comments

One commenter agreed with the Commissions' interpretation generally, but believed that the Commissions should broaden the interpretation to allow a swap to reflect "resets," or changes in the referenced characteristic of a security, where those "resets" or changes are "intended to effect a purpose other than transmitting the risk of changes in the characteristic itself," without causing a Title VII instrument that is not a security-based swap to become a security-based swap.[723]

The Commissions are not expanding the interpretation to allow "resets" of a fixed rate derived from a security. The interpretation is consistent with the statutory swap and security-based swap definitions. The Commissions believe that a Title VII instrument based on a rate that follows a security, and that may "reset" or change in the future based on changes in that security, is a security-based swap. Further, any amendment or modification of a material term of a Title VII instrument would result in a new Title VII instrument and a corresponding reassessment of the instrument's status as either a swap or a security-based swap.[724]

G. The Term "Narrow-Based Security Index" in the Security-Based Swap Definition

1. Introduction

As noted above, a Title VII instrument in which the underlying reference of the instrument is a "narrow-based security index" is a security-based swap subject to regulation by

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723 See ISDA Letter.

724 See infra part III.G.5(a).

the SEC, whereas a Title VII instrument in which the underlying reference of the instrument is a security index that is not a narrow-based security index (i.e., the index is broad-based) is a swap subject to regulation by the CFTC. The Commissions proposed an interpretation and rules regarding usage of the term "narrow-based security index" in the security-based swap definition, including:

- the existing criteria for determining whether a security index is a narrow-based security index and the applicability of past guidance of the Commissions regarding those criteria to Title VII instruments;
- new criteria for determining whether a CDS where the underlying reference is a group or index of entities or obligations of entities (typically referred to as an "index CDS") is based on an index that is a narrow-based security index;
- the meaning of the term "index";
- rules governing the tolerance period for Title VII instruments on security indexes traded on DCMs, SEFs, foreign boards of trade ("FBOTs"), security-based SEFs, or NSEs, where the security index temporarily moves from broad-based to narrow-based or from narrow-based to broad-based; and
- rules governing the grace period for Title VII instruments on security indexes traded on DCMs, SEFs, FBOTs, security-based SEFs, or NSEs, where the security index moves from broad-based to narrow-based or from narrow-based to broad-based and the move is not temporary.[725]

[725] See Proposing Release at 29845-58.

As discussed below, the Commissions are restating the interpretation set forth in the Proposing Release with certain further clarifications and adopting the rules as proposed with certain modifications.

2. Applicability of the Statutory Narrow-Based Security Index Definition and Past Guidance of the Commissions to Title VII Instruments

The Commissions provided an interpretation in the Proposing Release regarding the applicability of the statutory definition of the term "narrow-based security index" and past guidance of the Commissions relating to such term to Title VII instruments.[726] The Commissions are restating the interpretation set out in the Proposing Release without modification.

As defined in the CEA and Exchange Act,[727] an index is a narrow-based security index if, among other things, it meets any one of the following four criteria:

- it has nine or fewer component securities;
- a component security comprises more than 30 percent of the index's weighting;
- the five highest weighted component securities in the aggregate comprise more than 60 percent of the index's weighting; or
- the lowest weighted component securities comprising, in the aggregate, 25 percent of the index's weighting have an aggregate dollar value of average daily trading volume of less than $50,000,000 (or in the case of an index with more than 15 component

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[726] See Proposing Release at 29845-48.

[727] Sections 3(a)(55)(B) and (C) of the Exchange Act, 15 U.S.C. 78c(a)(55)(B) and (C), include a definition of "narrow-based security index" in the same paragraph as the definition of security future. See also sections 1a(35)(A) and (B) of the CEA, 7 U.S.C. 1a(35)(A) and (B). A security future is a contract for future delivery on a single security or narrow-based security index (including any interest therein or based on the value thereof). See section 3(a)(55) of the Exchange Act, 15 U.S.C. 78c(a)(55), and section 1a(44) of the CEA, 7 U.S.C. 1a(44).

securities, $30,000,000), except that if there are two or more securities with equal weighting that could be included in the calculation of the lowest weighted component securities comprising, in the aggregate, 25 percent of the index's weighting, such securities shall be ranked from lowest to highest dollar value of average daily trading volume and shall be included in the calculation based on their ranking starting with the lowest ranked security.[728]

The first three criteria apply to the number and concentration of the "component securities" in the index. The fourth criterion applies to the average daily trading volume of an index's "component securities."[729]

This statutory narrow-based security index definition focuses on indexes composed of equity securities and certain aspects of the definition, in particular the evaluation of average daily trading volume, are designed to take into account the trading patterns of individual stocks.[730] However, the Commissions, pursuant to authority granted in the CEA and the Exchange Act,[731] previously have extended the definition to other categories of indexes but modified the definition to take into account the characteristics of those other categories. Specifically, the Commissions have previously provided guidance regarding the application of the narrow-based security index

728 See section 3(a)(55)(B) of the Exchange Act, 15 U.S.C. 78c(a)(55)(B). See also sections 1a(35)(A) and (B) of the CEA, 7 U.S.C. 1a(35)(A) and (B).

729 The narrow-based security index definition in the CEA and Exchange Act also excludes from its scope security indexes that satisfy certain specified criteria. See sections 3(a)(55)(C)(i) – (vi) of the Exchange Act, 15 U.S.C. 78c(a)(55)(C)(i) – (vi), and sections 1a(35)(B)(i) – (vi) of the CEA, 7 U.S.C. 1a(35)(B)(i) – (vi).

730 See Joint Order Excluding Indexes Comprised of Certain Index Options From the Definition of Narrow-Based Security Index, 69 FR 16900 (Mar. 31, 2004) ("March 2004 Index Options Joint Order").

731 See section 1a(35)(B)(vi) of the CEA, 7 U.S.C. 1a(35)(B)(vi), and section 3(a)(55)(C)(vi) of the Exchange Act, 15 U.S.C. 78c(a)(55)(C)(vi).

definition to futures contracts on volatility indexes[732] and debt security indexes.[733] Today, then, there exists guidance for determining what constitutes a narrow-based security index.

Volatility indexes are indexes composed of index options. The Commissions issued a joint order in 2004 to define when a volatility index is not a narrow-based security index. Under this joint order, a volatility index is not a narrow-based security index if the index meets all of the following criteria:

- the index measures the magnitude of changes (as calculated in accordance with the order) in the level of an underlying index that is not a narrow-based security index pursuant to the statutory criteria for equity indexes discussed above;
- the index has more than nine component securities, all of which are options on the underlying index;
- no component security of the index comprises more than 30 percent of the index's weighting;
- the five highest weighted component securities of the index in the aggregate do not comprise more than 60 percent of the index's weighting;
- the average daily trading volume of the lowest weighted component securities in the underlying index (those comprising, in the aggregate, 25 percent of the underlying index's weighting) have a dollar value of more than $50,000,000 (or $30,000,000 in the case of an underlying index with 15 or more component securities), except if there are 2 or more securities with equal weighting that could be included in the calculation

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732 See March 2004 Index Options Joint Order.

733 See Joint Final Rules: Application of the Definition of Narrow-Based Security Index to Debt Securities Indexes and Security Futures on Debt Securities, 71 FR 39434 (Jul. 13, 2006) ("July 2006 Debt Index Release").

of the lowest weighted component securities comprising, in the aggregate, 25 percent of the underlying index's weighting, such securities shall be ranked from lowest to highest dollar value of average daily trading volume and shall be included in the calculation based on their ranking starting with the lowest ranked security;

- options on the underlying index are listed and traded on an NSE registered under section 6(a) of the Exchange Act;[734] and
- the aggregate average daily trading volume in options on the underlying index is at least 10,000 contracts calculated as of the preceding 6 full calendar months.[735]

With regard to debt security indexes, the Commissions issued joint rules in 2006 ("July 2006 Debt Index Rules") to define when an index of debt securities[736] is not a narrow-based security index. The first three criteria of that definition are similar to the statutory definition for equities and the order regarding volatility indexes in that a debt security index would not be narrow-based if:

- it is comprised of more than nine debt securities that are issued by more than nine non-affiliated issuers;

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734 15 U.S.C. 78f(a).

735 See March 2004 Index Options Joint Order. In 2009, the Commissions issued a joint order that provided that, instead of the index options having to be listed on an NSE, the index options must be listed on an exchange and pricing information for the index options, and the underlying index, must be computed and disseminated in real time through major market data vendors. See Joint Order To Exclude Indexes Composed of Certain Index Options From the Definition of Narrow-Based Security Index, 74 FR 61116 (Nov. 23, 2009) (expanding the criteria necessary for exclusion under the March 2004 Index Options Joint Order to apply to volatility indexes for which pricing information for the underlying broad-based security index, and the options that compose such index, is current, accurate, and publicly available).

736 Under the rules, debt securities include notes, bonds, debentures or evidence of indebtedness. See rule 41.15(a)(1)(i) under the CEA, 17 CFR 41.15(a)(1)(i) and rule 3a55-4(a)(1)(i) under the Exchange Act, 17 CFR 240.3a55-4(a)(1)(i). See also July 2006 Debt Index Release.

- the securities of any issuer included in the index do not comprise more than 30 percent of the index's weighting; and
- the securities of any five non-affiliated issuers in the index do not comprise more than 60 percent of the index's weighting.

In the July 2006 Debt Index Rules, instead of the statutory average daily trading volume test, however, the Commissions adopted a public information availability requirement. Under this requirement, assuming the aforementioned number and concentration criteria were satisfied, a debt security index would not be a narrow-based security index if the debt securities or the issuers of debt securities in the index met any one of the following criteria:

- the issuer of the debt security is required to file reports pursuant to section 13 or section 15(d) of the Securities Exchange Act of 1934;[737]
- the issuer of the debt security has a worldwide market value of its outstanding common equity held by non-affiliates of $700 million or more;
- the issuer of the debt security has outstanding securities that are notes, bonds, debentures, or evidence of indebtedness having a total remaining principal amount of at least $1 billion;
- the security is an exempted security as defined in section 3(a)(12) of the Securities Exchange Act of 1934[738] and the rules promulgated thereunder; or
- the issuer of the security is a government of a foreign country or a political subdivision of a foreign country.[739]

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[737] 15 U.S.C. 78m or 78o(d).

[738] 15 U.S.C. 78c(a)(12).

In the Dodd-Frank Act, Congress included the term "narrow-based security index" in the security-based swap definition, and thus the statutory definition of the term "narrow-based security index"[740] also applies in distinguishing swaps (on security indexes that are not narrow-based, also known as "broad-based") and security-based swaps (on narrow-based security indexes).[741] The Commissions have determined that their prior guidance with respect to what constitutes a narrow-based security index in the context of volatility indexes[742] and debt security indexes[743] applies in determining whether a Title VII instrument is a swap or a security-based swap, except as the rules the Commissions are adopting provide for other treatment with respect to index CDS as discussed below.[744]

To make clear that the Commissions are applying the prior guidance and rules to Title VII instruments, the Commissions are adopting rules to further define the term "narrow-based security index" in the security-based swap definition. Under paragraph (1) of rule 1.3(yyy) under the CEA and paragraph (a) of rule 3a68-3 under the Exchange Act, for purposes of the security-based swap definition, the term "narrow-based security index" has the same meaning as the statutory definition set forth in section 1a(35) of the CEA and section 3(a)(55) of the

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739 See July 2006 Debt Index Rules. The July 2006 Debt Index Rules also provided that debt securities in the index must satisfy certain minimum outstanding principal balance criteria, established certain exceptions to these criteria and the public information availability requirement, and provided for the treatment of indexes that include exempted securities (other than municipal securities).

740 See sections 3(a)(55)(B) and (C) of the Exchange Act, 15 U.S.C. 78c(a)(55)(B) and (C). See also sections 1a(35)(A) and (B) of the CEA, 7 U.S.C. 1a(35)(A) and (B).

741 The statutory definition of the term "narrow-based security index" for equities, and the Commissions' subsequent guidance as to what constitutes a narrow-based security index with respect to volatility and debt indexes, is applicable in the context of distinguishing between futures contracts and security futures products.

742 See March 2004 Index Options Joint Order.

743 See July 2006 Debt Index Rules.

744 See infra part III.G.3.

Exchange Act,[745] and the rules, regulations, and orders issued by the Commissions relating to such definition. As a result, except as the rules the Commissions are adopting provide for other treatment with respect to index CDS as discussed below,[746] market participants generally may use the Commissions' past guidance in determining whether certain Title VII instruments based on a security index are swaps or security-based swaps.

The Commissions also are providing an interpretation and adopting additional rules establishing criteria for indexes composed of securities, loans, or issuers of securities referenced by an index CDS.[747] The interpretation and rules also address the definition of an "index"[748] and the treatment of broad-based security indexes that become narrow-based and narrow-based indexes that become broad-based, including rule provisions regarding tolerance and grace periods for swaps on security indexes that are traded on CFTC-regulated trading platforms and security-based swaps on security indexes that are traded on SEC-regulated trading platforms.[749] These rules and interpretation are discussed below.

3. Narrow-Based Security Index Criteria for Index Credit Default Swaps

a) In General

The Commissions provided an interpretation in the Proposing Release regarding the narrow-based security index criteria for index CDS and are restating it without modification.[750] While the Commissions understand that the underlying reference for most cleared CDS is a single entity or an index of entities rather than a single security or an index of securities, the

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745 7 U.S.C. 1a(35) and 15 U.S.C. 78c(a)(55).

746 See infra part III.G.3.

747 Id.

748 See infra part III.G.4.

749 See infra part III.G.5.

750 See Proposing Release at 29847-48.

underlying reference for CDS also could be a single security or an index of securities.[751] A CDS where the underlying reference is a single entity (i.e., a single-name CDS), a single obligation of a single entity (e.g., a CDS on a specific bond, loan, or asset-backed security, or any tranche or series of any bond, loan, or asset-backed security), or an index CDS where the underlying reference is a narrow-based security index or the issuers of securities in a narrow-based security index is a security-based swap. An index CDS where the underlying reference is not a narrow-based security index or the issuers of securities in a narrow-based security index (i.e., a broad-based index) is a swap.[752]

The statutory definition of the term "narrow-based security index," as explained above, was designed with the U.S. equity markets in mind.[753] Thus, the statutory definition is not necessarily appropriate for determining whether an index underlying an index CDS is broad or narrow-based. Nor is the guidance that the Commissions have previously issued with respect to the narrow-based security index definition discussed above necessarily appropriate, because that

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751 See, e.g., Markit, "Markit CDX" (describing the Markit CDX indexes and the number of "names" included in each index), available at http://www.markit.com/en/products/data/indices/credit-and-loan-indices/cdx/cdx.page; Markit, "Markit iTraxx Indices," (stating that the "Markit iTraxx indices are comprised of the most liquid names in the European and Asian markets") (emphasis added), available at http://www.markit.com/en/products/data/indices/credit-and-loan-indices/itraxx/itraxx.page . Examples of indexes based on securities include the Markit ABX.HE and CMBX indexes. See Markit, "Markit ABX.HE," (describing the Markit ABX.HE index as "a synthetic tradeable index referencing a basket of 20 subprime mortgage-backed securities"), available at http://www.markit.com/en/products/data/indices/structured-finance-indices/abx/abx.page; and Markit, "Markit CMBX," (describing the Markit CMBX index as "a synthetic tradeable index referencing a basket of 25 commercial mortgage-backed securities"), available at http://www.markit.com/en/products/data/indices/structured-finance-indices/cmbx/cmbx.page.

752 Similarly, an option to enter into a single-name CDS or a CDS referencing a narrow-based security index as described above would be a security-based swap, while an option to enter into a CDS on a broad-based security index or the issuers of securities in a broad-based security index would be a swap. Index CDS where the underlying reference is a broad-based security index would be SBSAs. The SEC has enforcement authority with respect to swaps that are SBSAs, as discussed further in section V., infra.

753 See July 2006 Debt Index Rules.

guidance was designed to address and was uniquely tailored to the characteristics of volatility indexes and debt security indexes in the context of futures. Accordingly, the Commissions are clarifying that the guidance that the Commissions have previously issued with respect to the narrow-based security index definition discussed above does not apply to index CDS. Instead, the Commissions are adopting rules as discussed below that include separate criteria for determining whether an index underlying an index CDS is a narrow-based security index.

The Commissions are further defining the term "security-based swap," and the use of the term "narrow-based security index" within that definition, to modify the criteria applied in the context of index CDS in assessing whether the index is a narrow-based security index. The third prong of the security-based swap definition includes a Title VII instrument based on the occurrence of an event relating to the "issuers of securities in a narrow-based security index," provided that such event directly affects the "financial statements, financial condition, or financial obligations of the issuer."[754] The first prong of the security-based swap definition includes a Title VII instrument that is based on a narrow-based security-index.[755] Because the third prong of the security-based swap definition relates to issuers of securities, while the first prong of such definition relates to securities, the Commissions are further defining both the term "narrow-based security index" and the term "issuers of securities in a narrow-based security index" in the context of the security-based swap definition as applied to index CDS. The Commissions believe it is important to further define both terms in order to assure consistent

754 Section 3(a)(68)(A)(ii)(III) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(ii)(III).

755 Section 3(a)(68)(A)(ii)(I) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(ii)(I).

analysis of index CDS.[756] While the wording of the two definitions as adopted differs slightly, the Commissions expect that they will yield the same substantive results in distinguishing narrow-based and broad-based index CDS.[757]

b) Rules Regarding the Definitions of "Issuers of Securities in a Narrow-Based Security Index" and "Narrow-Based Security Index" for Index Credit Default Swaps

The Commissions proposed rules to further define the terms "issuers of securities in a narrow-based security index" and "narrow-based security index" in order to provide appropriate criteria for determining whether an index composed of issuers of securities referenced by an index CDS and an index composed of securities referenced by an index CDS are narrow-based security indexes.[758] The Commissions are adopting rules 1.3(zzz) and 1.3(aaaa) under the CEA and rules 3a68-1a and 3a68-1b under the Exchange Act as proposed with certain modifications.[759]

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756 Because they apply only with respect to index CDS, the definitions of "issuers of securities in a narrow-based security index" and "narrow-based security index" as adopted do not apply with respect to other types of event contracts, whether analyzed under the first or third prong.

757 For example, if the reference entities included in one index are the same as the issuers of securities included in another index, application of the two definitions should result in both indexes being either broad-based or narrow-based.

758 See Proposing Release at 29848.

759 The discussion throughout this section refers to "reference entities" and "issuers" in discussing the final rules. The term "reference entity" is defined in paragraph (c)(3) of rule 1.3(zzz) under the CEA and rule 3a68-1a under the Exchange Act and the term "issuer" is defined in paragraph (c)(3) of rule 1.3(aaaa) under the CEA and rule 3a68-1b under the Exchange Act. The final rules provide that the term "reference entity" includes: (i) an issuer of securities; (ii) an issuer of securities that is an issuing entity of asset-backed securities is a reference entity or issuer, as applicable; and (iii) an issuer of securities that is a borrower with respect to any loan identified in an index of borrowers or loans is a reference entity. The final rules provide that the term "issuer" includes: (i) an issuer of securities; and (ii) an issuer of securities that is an issuing entity of asset-backed securities is a reference entity or issuer, as applicable. See paragraph (c)(3) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

In formulating the criteria in the final rules, and consistent with the guidance and rules the Commissions have previously issued and adopted regarding narrow-based security indexes in the context of security futures, the Commissions believe that there should be public information available about a predominant percentage of the reference entities included in the index, or, in the case of an index CDS on an index of securities, about the issuers of the securities or the securities underlying the index, in order to reduce the likelihood that non-narrow-based indexes referenced in index CDS or the component securities or issuers of securities in that index would be readily susceptible to manipulation, as well as to help prevent the misuse of material non-public information through the use of CDS based on such indexes.

To satisfy these objectives, the Commissions are adopting rules that are based on the criteria developed for debt indexes discussed above[760] but that tailor these criteria to address index CDS.[761] These criteria are included solely for the purpose of defining the terms "narrow-based security index" and "issuers of securities in a narrow-based security index" in the first and third prongs of the security-based swap definition with respect to index CDS and will not affect

760 See discussion of July 2006 Debt Index Rules.

761 The Commissions note that the language of the rules is intended, in general, to be consistent with the criteria developed for debt indexes discussed above. Certain changes from the criteria developed for debt indexes are necessary to address differences between futures on debt indexes and index CDS. Certain other changes are necessary because the rules for debt indexes define under what conditions an index is not a narrow-based security index, whereas the rules for index CDS define what is a narrow-based security index. For example, an index is not a narrow-based security index under the rule for debt indexes if it is not a narrow-based security index under either subparagraph (a)(1) or paragraph (a)(2) of the rule. See July 2006 Debt Index Rules. Under the rules for index CDS, however, an index is a narrow-based security index if it meets the requirements of both of the counterpart paragraphs in the rules regarding index CDS (paragraphs (1)(i) and (1)(ii) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and paragraphs (a)(1) and paragraph (a)(2) of rules 3a68-1a and 3a68-1b under the Exchange Act), even though the criteria in the debt index rules and the rules for index CDS include generally the same criteria and structure.

any other interpretation or use of the term "narrow-based security index" or any other provision of the Dodd-Frank Act, the CEA, or the Exchange Act.

Further, in response to commenters,[762] the Commissions are clarifying that if an index CDS is based on an index of loans that are not securities,[763] an event relating to a loan in the index, such as a default on a loan, is an event "relating to" the borrower.[764] To the extent that the borrower is an issuer of securities, the index CDS based on such index of loans will be analyzed under the third prong of the security-based swap definition in the same manner as any other index CDS.

Comments

The Commissions received two general comments requesting that the proposed rules further defining the terms "issuers of securities in a narrow-based security index" and "narrow-based security index" be simplified.[765] One commenter believed that the rules were exceedingly complicated.[766] Another commenter thought that the criteria should allow transactions to be readily and transparently classifiable as a swap or security-based swap.[767] The commenters did not provide analysis supporting their comments or recommend language changes.

The Commissions are adopting the rules regarding index CDS essentially as proposed with certain modifications to address commenters' concerns. While the final rules contain a

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762 See infra note 768 and accompanying text.

763 If the loans underlying the index of loans are securities, the index CDS would be analyzed in the same manner as any other index CDS based on an index of securities.

764 An index CDS referencing loans also may be based on events relating to the borrower, such as bankruptcy, and to defaults on any obligation of the borrower.

765 See ISDA Letter and MarketAxess Letter.

766 See MarketAxess Letter. This commenter stated that "The Proposed Rules layout an exceedingly complex process for determining whether an index CDS is broad-based or narrow-based." Id.

767 See ISDA Letter.

number of elements that are similar or identical to elements contained in the statutory narrow-based security index definition, in order to enable the narrow-based security index definition to apply appropriately to index CDS, the final rules contain some alternative tests to those set forth in the statutory definition.

The Commissions also recognize the diversity of Title VII instruments. While the final rules for index CDS are based on the July 2006 Debt Index Rules, the substantive differences between the final rules in the index CDS and the equity or debt security contexts are intended to reflect the particular characteristics of the CDS marketplace, in which, for example, index components may be entities (issuers of securities) as well as specific equity and debt securities.

The Commissions also received three comments requesting clarification regarding the applicability of the index CDS rules to CDS based on indexes of loans.[768] One commenter noted that the Commissions did not address in the Proposing Release the question of whether an index composed exclusively of loans should be treated as a narrow-based security index.[769] This commenter noted that because the first and third prongs of the statutory security-based swap definition do not explicitly reference loans, the statutory definition does not expressly categorize Title VII instruments based on more than one loan, or contingent on events that occur with respect to more than one loan borrower, unless such borrowers are also "issuers of securities."[770] Based on this commenter's view of the statutory definition, this commenter requested that the Commissions clarify the treatment of indexes composed exclusively of loans.[771] Another commenter provided similar comments and also requested clarification regarding the treatment

768 See Allen & Overy Letter; July LSTA Letter; and SIFMA Letter.

769 See Allen & Overy Letter.

770 Id.

771 Id.

of CDS based on indexes of loans.[772] A third commenter stated its view that the third prong of the statutory security-based swap definition implies that Title VII instruments on a basket of loans are security-based swaps if the lenders would satisfy the criteria for issuers of a "narrow-based security index" and encouraged the Commissions to clarify this issue.[773] The Commissions agree with commenters that an index CDS based on an index of loans that are not securities is analyzed under the third prong of the statutory security-based swap definition and, therefore, are clarifying the treatment of these Title VII instruments above.[774]

i) Number and Concentration Percentages of Reference Entities or Securities

The Commissions believe that the first three criteria of the debt security index test (which are based on the statutory narrow-based security index definition) discussed above (i.e., the number and concentration weighting requirements) are appropriate to apply to index CDS, whether CDS on indexes of securities or indexes of issuers of securities.[775] Accordingly, the Commissions are adopting the first three criteria of rule 1.3(zzz) under the CEA and rule 3a68-1a under the Exchange Act as proposed with certain modifications in response to commenters' concerns.[776] These rules contain the same number and concentration criteria as proposed, but

772 See July LSTA Letter. This commenter noted that prong (III) of the statutory security-based swap definition does not clearly reference borrowers of loans or indexes of borrowers. However, this commenter noted that because most borrowers that are named as reference entities in loan CDS transactions are corporate entities that issue equity interests to one or more shareholders (although they may not issue public securities or become subject to public reporting requirements), this commenter believes that prong (III) can be interpreted to include swaps that reference a single borrower or borrowers of loans in an index. Id.

773 See SIFMA Letter.

774 The Commissions also are providing guidance with respect to TRS based on two or more loans that are not securities. See supra part III.C.

775 See infra notes 792 and 793 and accompanying text.

776 See paragraphs (a)(1)(i)-(iii) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rules 3a68-1a and 3a68-1b under the Exchange Act.

modify the method of calculating affiliation among issuers and reference entities in response to commenters.[777] Further, in response to commenters,[778] the Commissions are providing an additional interpretation with respect to the application of these criteria to two particular types of CDS, commonly known as "nth-to-default CDS" and "tranched CDS."

The first three criteria provide that, for purposes of determining whether an index CDS is a security-based swap under section 3(a)(68)(A)(ii)(III) of the Exchange Act,[779] the term "issuers of securities in a narrow-based security index" includes issuers of securities identified in an index (including an index referencing loan borrowers) in which:

- Number: There are nine or fewer non-affiliated issuers of securities that are reference entities included in the index, provided that an issuer of securities shall not be deemed a reference entity included in the index unless (i) a credit event with respect to such reference entity would result in a payment by the credit protection seller to the credit protection buyer under the index CDS based on the related notional amount allocated to such reference entity; or (ii) the fact of such credit event or the calculation in accordance with clause (i) above of the amount owed with respect to such credit event is taken into account in determining whether to make any future payments under the index CDS with respect to any future credit events;
- Single Component Concentration: The effective notional amount allocated to any reference entity included in the index comprises more than 30 percent of the index's weighting; or

777 See infra note 804 and accompanying text.

778 See infra notes 795 and 796 and accompanying text.

779 15 U.S.C. 78c(a)(68)(A)(ii)(III).

- Largest Five Component Concentration: The effective notional amount allocated to any five non-affiliated reference entities included in the index comprises more than 60 percent of the index's weighting.[780]

Similarly, the Commissions are adopting as proposed the first three criteria of rule 1.3(aaaa) under the CEA and rule 3a68-1b under the Exchange Act. These three criteria provide that, for purposes of determining whether an index CDS is a security-based swap under section 3(a)(68)(A)(ii)(I) of the Exchange Act,[781] the term "narrow-based security index" includes an index in which essentially the same criteria apply, substituting securities for issuers. Under these criteria, the term "narrow-based security index" would mean an index in which:

- Number: There are nine or fewer securities, or securities that are issued by nine or fewer non-affiliated issuers, included in the index, provided that a security shall not be deemed a component of the index unless (i) a credit event with respect to the issuer of such security or a credit event with respect to such security would result in a payment by the credit protection seller to the credit protection buyer under the index CDS based on the related notional amount allocated to such security, or (ii) the fact of such credit event or the calculation in accordance with clause (i) above of the amount owed with respect to such credit event is taken into account in determining whether to

780 These rules refer to the "effective notional amount" allocated to reference entities or securities in order to address potential situations in which the means of calculating payout across the reference entities or securities is not uniform. Thus, if one or more payouts is leveraged or enhanced by the structure of the transaction (i.e., 2x recovery rate), that amount would be the "effective notional amount" for purposes of the 30 percent and 60 percent tests in paragraphs (1)(i)(B) and (1)(i)(C) of rules 1.3(zzz) and 1.3(aaaa) and paragraphs (a)(1)(ii) and (a)(1)(iii) of rules 3a68-1a and 3a68-1b. Similarly, if the aggregate notional amount under a CDS is not uniformly allocated to each reference entity or security, then the portion of the notional amount allocated to each reference entity or security (which may be by reference to the product of the aggregate notional amount and an applicable percentage) would be the "effective notional amount."

781 15 U.S.C. 78c(a)(68)(A)(ii)(I).

make any future payments under the index CDS with respect to any future credit events;

- Single Component Concentration: The effective notional amount allocated to the securities of any issuer included in the index comprises more than 30 percent of the index's weighting; or
- Largest Five Component Concentration: The effective notional amount allocated to the securities of any five non-affiliated issuers included in the index comprises more than 60 percent of the index's weighting.

Thus, the applicability of the final rules depends on conditions relating to the number of non-affiliated reference entities or issuers of securities, or securities issued by non-affiliated issuers, as applicable, included in an index and the weighting of notional amounts allocated to the reference entities or securities included in the index, as applicable. These first three criteria of the final rules evaluate the number and concentration of the reference entities or securities included in the index, as applicable, and ensure that an index with a small number of reference entities, issuers, or securities or concentrated in only a few reference entities, issuers, or securities is narrow-based, and thus where such index is the underlying reference of an index CDS, the index CDS is a security-based swap. Further, as more fully described below,[782] the final rules provide that a reference entity or issuer of securities included in an index and any of that reference entity's or issuer's affiliated entities (as defined in the final rules) that also are included in the index are aggregated for purposes of determining whether the number and concentration criteria are met.

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782 See infra part III.G.3(b)(ii), for a discussion of the affiliation definition applicable to calculating the number and concentration criteria. As noted above, the Commissions are modifying the method of calculating affiliation for purposes of these criteria.

Specifically, the final rules provide that an index meeting any one of certain identified conditions would be a narrow-based security index. The first condition in paragraph (1)(i)(A) of rule 1.3(zzz) under the CEA and paragraph (a)(1)(i) of rule 3a68-1a under the Exchange Act is that there are nine or fewer non-affiliated issuers of securities that are reference entities in the index. An issuer of securities counts toward this total only if a credit event with respect to such entity would result in a payment by the credit protection seller to the credit protection buyer under the index CDS based on the notional amount allocated to such entity, or if the fact of such a credit event or the calculation of the payment with respect to such credit event is taken into account when determining whether to make any future payments under the index CDS with respect to any future credit events.

Similarly, the first condition in paragraph (1)(i)(A) of rule 1.3(aaaa) under the CEA and paragraph (a)(1)(i) of rule 3a68-1b under the Exchange Act provides that a security counts toward the total number of securities in the index only if a credit event with respect to such security, or the issuer of such security, would result in a payment by the credit protection seller to the credit protection buyer under the index CDS based on the notional amount allocated to such security, or if the fact of such a credit event or the calculation of the payment with respect to such credit event is taken into account when determining whether to make any future payments under the index CDS with respect to any future credit events.

These provisions are intended to ensure that an index concentrated in a few reference entities or securities, or a few reference entities that are affiliated (as defined in the final rules) or a few securities issued by issuers that are affiliated, are within the narrow-based security index definition.[783] These provisions also are intended to ensure that an entity is not counted as a reference entity included in the index, and a security is not counted as a security included in the index, unless a credit event with respect to the entity, issuer, or security affects payout under a CDS on the index.[784]

Further, as this condition is in the alternative (i.e., *either* there must be a credit event resulting in a payment under the index CDS *or* a credit event is considered in determining future CDS payments), the tests encompass all index CDS. For example, and in response to a commenter,[785] the test would cover an nth-to-default CDS,[786] in which default with respect to a specified component of an index (such as the first default or fifth default) triggers the CDS payment, even if the CDS payment is not made with respect to such particular credit event. As another example, and in response to another commenter,[787] the test applies to a tranched CDS[788] if the payments are made on only a tranche, or portion, of the potential aggregate notional amount of the CDS (often expressed as a percentage range of the total notional amount of the

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783 This requirement is generally consistent with the definition of "narrow-based security index" in section 1a(35)(A) of the CEA, 7 U.S.C. 1a(35)(A), and section 3(a)(55)(B) of the Exchange Act, 15 U.S.C. 78c(a)(55)(B), and the July 2006 Debt Index Rules.

784 Id.

785 See infra note 795 and accompanying text.

786 An "nth-to-default CDS" is a CDS in which the payout is linked to one in a series of defaults (such as first-, second- or third-to-default), with the contract terminating at that point. See SIFMA Letter.

787 See infra note 796 and accompanying text.

788 A "tranched CDS" is a CDS in which the counterparties agree to buy and sell credit protection on only a portion of the potential losses that could occur on an underlying portfolio of reference entities. The portion is typically denoted as a specified percentage range of aggregate losses (e.g., 2 percent to 5 percent, meaning the credit protection seller would not make payments until aggregate losses exceed 2 percent of the notional of the transaction, and would no longer be obligated to make payments after aggregate losses reach 5 percent). See SIFMA Letter.

CDS) because the CDS payment takes into account a credit event with respect to an index component, even if the credit event itself does not result in such a payment.

The second condition, in paragraphs (1)(i)(B) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and paragraphs (a)(1)(ii) of rules 3a68-1a and 3a68-1b under the Exchange Act, is that the effective notional amount allocated to any reference entity or security of any issuer included in the index comprises more than 30 percent of the index's weighting.

The third condition, in paragraphs (1)(i)(C) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and paragraphs (a)(1)(iii) of rules 3a68-1a and 3a68-1b under the Exchange Act, is that the effective notional amount allocated to any five non-affiliated reference entities, or to the securities of any five non-affiliated issuers, included in the index comprises more than 60 percent of the index's weighting.

Given that Congress determined that these concentration percentages are appropriate to characterize an index as a narrow-based security index, and the Commissions have determined they are appropriate for debt security indexes in the security futures context,[789] the Commissions believe that these concentration percentages are appropriate to apply to the notional amount allocated to reference entities and securities in order to apply similar standards to indexes that are the underlying references of index CDS. Moreover, with respect to both the number and concentration criteria, the markets have had experience with these criteria with respect to futures on equity indexes, volatility indexes, and debt security indexes.[790]

Comments

789 See July 2006 Debt Index Rules.

790 As noted above, the Commissions are modifying the method of calculating affiliation for purposes of the number and concentration criteria. See infra part III.G.3(b)(ii).

One commenter expressed its view that the Commissions should increase the percentage test in the largest five component concentration.[791] The Commissions are adopting the number and concentration criteria as proposed. The statutory definition of the term "security-based swap" references the definition of the term "narrow-based security index" contained in the Exchange Act and the CEA,[792] which includes the same number and concentration percentages as the Commissions are adopting in this release. The Commissions are not modifying the statutory definition to change the percentages. The statutory definition included the concentration percentages, which the Commissions understand are intended to assure that a security index could not be used as a surrogate for the underlying securities in order to avoid application of the federal securities laws. The Commissions also previously determined to retain these statutory percentages in connection with rules relating to debt security indexes in the security futures context.[793] The Commissions believe that these percentages are similarly appropriate to apply to indexes on which index CDS are based. Moreover, with respect to the number and concentration criteria, as these are in the statutory definition of the term "narrow-based security index" applicable to security futures, market participants have experience in analyzing indexes, including equity, volatility and debt security indexes, to determine compliance with these criteria. As discussed below,[794] though, the Commissions are modifying the affiliation definition used in analyzing the number and concentration criteria for an index.

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791 See ISDA Letter. According to this commenter, the "operational complexity" of the number and concentration criteria will increase costs and compliance risks. Id.

792 See 15 U.S.C. 78c(a)(55)(B) and 7 U.S.C. 1a(35).

793 See July 2006 Debt Index Rules.

794 See infra part III.G.3(b)(ii).

Two commenters requested clarification regarding nth-to-default CDS, stating their view that such CDS should be treated as security-based swaps to reflect their single-entity triggers.[795] Two commenters requested clarification regarding tranched index CDS, including whether the CDS would be classified based on the underlying index.[796] As discussed above, the Commissions are providing an interpretation on the applicability of the first three criteria of the rules to nth-to-default CDS and tranched CDS. As noted above, the Commissions believe the rules encompass all index CDS, regardless of the type or payment structure, such as whether there is a single-entity payment based on credit events of other index components or whether the payment is based on a specific entity.

ii) Affiliation of Reference Entities and Issuers of Securities With Respect to Number and Concentration Criteria

The Commissions are adopting the affiliation definition that applies when calculating the number and concentration criteria with certain modifications from the proposal to address commenters' concerns.[797] The final rules provide that the terms "reference entity included in the index" and "issuer of the security included in the index" include a single reference entity or issuer of securities included in an index, respectively, or a group of affiliated reference entities or issuers included in an index, respectively.[798] For purposes of the rules, affiliated reference

795 See ISDA Letter and SIFMA Letter. One of these commenters noted that such an approach also made sense for nth-to-default CDS because they are typically based on baskets of less than 10 securities. See ISDA Letter.

796 See Markit Letter and SIFMA Letter. One of these commenters stated that classifying tranches underlying index CDS according to attachment or detachment points is not appropriate because it is impossible to know for certain at inception of the CDS the number of credit events that will ultimately affect actual payments, which typically depend on the severity of loss associated with each credit event. See SIFMA Letter.

797 See infra note 804 and accompanying text.

798 See paragraph (c)(4) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

entities or issuers of securities included in an index or securities included in an index issued by affiliated issuers will be counted together for determining whether the number and concentration criteria are met. However, with respect to asset-backed securities, the final rules provide that each reference entity or issuer of securities included in an index that is an issuing entity of an asset-backed security is considered a separate reference entity or issuer, as applicable, and will not be considered affiliated with other reference entities or issuers of securities included in the index.

The final rules provide that a reference entity or issuer of securities included in an index is affiliated with another reference entity or issuer of securities included in the index if it controls, is controlled by, or is under common control with, that other reference entity or issuer.[799] The final rules define control, solely for purposes of this affiliation definition, to mean ownership of more than 50 percent of a reference entity's or issuer's equity or the ability to direct the voting of more than 50 percent of a reference entity's or issuer's voting equity.[800] The affiliation definition in the final rules differs from the definition included in the proposal, which provided for a control threshold of 20 percent ownership.[801] This change is based on the Commissions' consideration of comments received.[802] By using a more than 50 percent (i.e.,

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799 See paragraph (c)(1) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

800 See paragraph (c)(2) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

801 See Proposing Release at 29849.

802 See infra note 804 and accompanying text. The Commissions note that another alternative would have been to include a requirement that the entities satisfy the 20 percent control threshold and also be consolidated with each other in financial statements. The Commissions did not include a requirement that the entities be consolidated with each other in financial statements because they do not believe that the scope of the affiliation definition should be exposed to the risk of future changes in accounting standards. Further, the use of a majority ownership control threshold (more than 50 percent) is generally consistent with consolidation under generally accepted

majority ownership) test rather than a 20 percent ownership test for the control threshold, there is a greater likelihood that there will be an alignment of economic interests of the affiliated entities that is sufficient to aggregate reference entities or issuers of securities included in an index for purposes of the number and concentration criteria.[803]

As the affiliation definition is applied to the number criterion, affiliated reference entities or issuers of securities included in an index will be viewed as a single reference entity or issuer of securities to determine whether there are nine or fewer non-affiliated reference entities included in the index or securities that are issued by nine or fewer non-affiliated issuers. Similarly, as the affiliation definition is applied to the concentration criteria, the notional amounts allocated to affiliated reference entities included in an index or the securities issued by a group of affiliated issuers of securities included in an index must be aggregated to determine the level of concentration of the components of the index for purposes of the 30-percent and 60-percent concentration criteria.

Comments

Three commenters requested that the Commissions revise the affiliation definition that applies when calculating the number and concentration criteria to increase the control threshold from 20 percent ownership to majority ownership.[804] These commenters noted that majority

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accounting principles. See FASB ASC section 810-10-25, Consolidation – Overall – Recognition (stating that consolidation is appropriate if a reporting entity has a controlling financial interest in another entity and a specific scope exception does not apply).

803 In such a case, as noted by commenters, the affiliated entities are viewed as part of group for which aggregation of these entities is appropriate. See infra note 806 and accompanying text.

804 See ISDA Letter (requesting a threshold of at least 50 percent); Markit Letter (requesting a threshold of at least 50 percent); and SIFMA Letter (requesting a threshold of majority ownership, or 51 percent). One commenter also requested that the Commissions clarify the application of the affiliation definition.. See Markit Letter. The Commissions have provided above and in infra part III.G.3(b)(ii), several examples illustrating the application of the affiliation definition in response to this commenter.

ownership is consistent with current market practice, including the definition of affiliate included in the 2003 ISDA Credit Derivatives Definitions.[805] One commenter also stated its belief that affiliated entities should only be aggregated where the reference entities' credit risks are substantially similar and credit decisions are made by the same group of individuals.[806] This commenter stated its view that 20 percent ownership is too low and that majority ownership is necessary for credit risk and credit decisions to be aligned enough as to warrant collapsing two issuers into one for purposes of the number and concentration criteria.[807]

As stated above, the Commissions are modifying the affiliation definition that applies when calculating the number and concentration criteria in response to commenters to use an affiliation test based on majority ownership. Based on commenters' letters, the Commissions understand that the current standard CDS documentation and the current approach used by certain index providers for index CDS with respect to the inclusion of affiliated entities in the same index use majority ownership rather than 20 percent ownership to determine affiliation. The Commissions are persuaded by commenters that, in the case of index CDS only it is more appropriate to use majority ownership because majority-owned entities are more likely to have their economic interests aligned and be viewed by the market as part of a group. The Commissions believe that revising the affiliation definition in this manner for purposes of calculating the number and concentration criteria responds to commenters' concerns that the

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805 Id.

806 See SIFMA Letter. The ISDA Letter provide a similar rationale that "the control threshold was too low and potentially disruptive when viewed against entities that the swap markets now trade as separate entities. In the CDS market, for example, entities that share ownership ties of substantially more than 20 percent trade quite independently. These entities may have completely disparate characteristics for the purpose of an index grouping of one sort or another." See ISDA Letter.

807 See SIFMA Letter.

percentage control threshold may inadvertently include entities that are not viewed as part of a group. Thus, as revised, the affiliation definition will include only those reference entities or issuers included in an index that satisfy the more than 50 percent (i.e., majority ownership) control threshold. The Commissions believe that determining affiliation in this manner for purposes of calculating the number and concentration criteria responds to the commenters' concerns.

The Commissions also believe that the modified affiliation definition addresses commenters' concerns noted above[808] that the rules further defining the terms "issuers of securities in a narrow-based security index" and "narrow-based security index" should be simplified. The modified affiliation definition enables market participants to make an affiliation determination for purposes of calculating the number and concentration criteria by measuring the more than 50 percent (i.e., majority ownership) control threshold.

iii) Public Information Availability Regarding Reference Entities and Securities

In addition to the number and concentration criteria, the debt security index test also includes, as discussed above, a public information availability test. The public information availability test is intended as the substitute for the average daily trading volume ("ADTV") provision in the statutory narrow-based security index definition. An ADTV test is designed to take into account the trading of individual stocks and, because Exchange Act registration of the security being traded is a listing standard for equity securities, the issuer of the security being traded must be subject to the reporting requirements under the Exchange Act. Based on the provisions of the statutory ADTV test, the Commissions have determined that the ADTV test is

808 See supra note 765 and accompanying text.

not useful for purposes of determining the status of the index on which the index CDS is based because index CDS most commonly reference entities, which do not "trade," or debt instruments, which commonly are not listed, and, therefore, do not have a significant trading volume. However, the underlying rationale of such provision, that there is sufficient trading in the securities and therefore public information and market following of the issuer of the securities, applies to index CDS.

In general, if an index is not narrow-based under the number and concentration criteria, it will be narrow-based if one of the reference entities or securities included in the index fails to meet at least one of the criteria in the public information availability test. This test was designed to reduce the likelihood that broad-based debt security indexes or the component securities or issuers of securities in that index would be readily susceptible to manipulation. The fourth condition in the index CDS rules sets out a similar public information availability test that is intended solely for purposes of determining whether an index underlying a CDS is narrow-based.[809] The Commissions are adopting the public information availability test essentially as proposed with certain modifications to address commenters' concerns, including modifications to the definition of affiliation for purposes of satisfying certain criteria of the public information availability test.[810]

The Commissions are adopting final rules under which an index CDS will be considered narrow-based (except as discussed below) if a reference entity or security included in the index does not meet any of the following criteria:[811]

809 See Proposing Release at 29850.

810 See infra notes 845, 847, 849 and 867 and accompanying text.

811 See paragraphs (a)(1)(iv)(A)-(G) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

- the reference entity or the issuer of the security included in the index is required to file reports pursuant to the Exchange Act or the regulations thereunder;
- the reference entity or the issuer of the security included in the index is eligible to rely on the exemption provided in rule 12g3-2(b) under the Exchange Act;[812]
- the reference entity or the issuer of the security included in the index has a worldwide market value of its outstanding common equity held by non-affiliates of $700 million or more;[813]
- the reference entity or the issuer of the security included in the index (other than a reference entity or an issuer of the security included in the index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Exchange Act[814]) has outstanding notes, bonds, debentures, loans, or evidences of indebtedness (other than revolving credit facilities) having a total remaining principal amount of at least $1 billion;[815]
- the reference entity included in the index is an issuer of an exempted security, or the security included in the index is an exempted security, each as defined in section 3(a)(12) of the Exchange Act[816] and the rules promulgated thereunder (except a municipal security);

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812 17 CFR 240.12g3-2(b).

813 See July 2006 Debt Index Rules (noting that issuers having worldwide equity market capitalization of $700 million or more are likely to have public information available about them).

814 15 U.S.C. 78c(a)(77).

815 See July 2006 Debt Index Rules (noting that issuers having at least $1 billion in outstanding debt are likely to have public information available about them).

816 15 U.S.C. 78c(a)12.

- the reference entity or the issuer of the security included in the index is a government of a foreign country or a political subdivision of a foreign country; or
- if the reference entity or the issuer of the security included in the index is an issuing entity of asset-backed securities as defined in section 3(a)(77) of the Exchange Act,[817] such asset-backed security was issued in a transaction registered under the Securities Act and has publicly available distribution reports.

However, so long as the effective notional amounts allocated to reference entities or securities included in the index that satisfy the public information availability test comprise at least 80 percent of the index's weighting, failure by a reference entity or security included in the index to satisfy the public information availability test will be disregarded if the effective notional amounts allocated to that reference entity or security comprise less than five percent of the index's weighting.[818] In this situation, the public information availability test for purposes of the index would be satisfied.

The determination as to whether an index CDS is narrow-based is conditioned on the likelihood that information about a predominant percentage of the reference entities or securities included in the index is publicly available.[819] For example, a reference entity or an issuer of

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817 15 U.S.C. 78c(a)(77).

818 See paragraph (b) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

819 Most of the thresholds in the public information availability test are similar to those the Commissions adopted in their joint rules regarding the application of the definition of the term "narrow-based security index" to debt security indexes and security futures on debt securities. See July 2006 Debt Index Rules. The July 2006 Debt Index Rules also included an additional requirement regarding the minimum principal amount outstanding for each security in the index. The Commissions have not included this requirement in rule 1.3(zzz) under the CEA and rule 3a68-1a under the Exchange Act. That requirement was intended as a substitute criterion for trading volume because the trading volume of debt securities with a principal amount outstanding above that minimum amount was found to be generally larger than debt securities with a principal amount outstanding below that minimum amount. See July 2006 Debt Index Release. There is

securities included in the index that is required to file reports pursuant to the Exchange Act or the regulations thereunder makes regular and public disclosure through those filings. Moreover, a reference entity or an issuer of securities included in the index that does not file reports with the SEC but that is eligible to rely on the exemption in rule 12g3-2(b) under the Exchange Act (i.e., foreign private issuers) is required to make certain types of financial information publicly available in English on its website or through an electronic information delivery system generally available to the public in its primary trading markets.[820]

The Commissions believe that other reference entities or issuers of securities included in the index that do not file reports with the SEC, but that have worldwide equity market capitalization of $700 million or more, have at least $1 billion in outstanding debt obligations (other than in the case of issuing entities of asset-backed securities), issue exempted securities (other than municipal securities), or are foreign sovereign entities either are required to or are otherwise sufficiently likely, solely for purposes of the "narrow-based security-index" and "issuers of securities in a narrow-based security index" definitions, to have public information available about them.[821]

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no similar criterion that would be applicable in the context of index CDS. The numerical thresholds also are similar to those the SEC adopted in other contexts, including in the existing definitions of "well-known seasoned issuer" and "large accelerated filer." See rule 405 under the Securities Act, 17 CFR 230.405, and rule 12b-2 under the Exchange Act, 17 CFR 240.12b-2.

820 17 CFR 240.12g3-2(b).

821 It is important to note that the public information availability test is designed solely for purposes of distinguishing between index CDS that are swaps and index CDS that are security-based swaps. The proposed criteria are not intended to provide any assurance that there is any particular level of information actually available regarding a particular reference entity or issuer of securities. Meeting one or more of the criteria for the limited purpose here – defining the terms "narrow-based security index" and "issuers of securities in a narrow-based security index" in the first and third prongs of the security-based swap definition with respect to index CDS – would not substitute for or satisfy any other requirement for public disclosure of information or public availability of information for purposes of the federal securities laws.

In response to commenters,[822] the Commissions are modifying the outstanding debt threshold criterion in the public information availability test to include any indebtedness, including loans, so long as such indebtedness is not a revolving credit facility. The Commissions believe that expanding the definition of indebtedness to include loans (other than revolving credit) for purposes of the debt threshold determination is consistent with the view that entities that have significant outstanding indebtedness likely will have public information available about them.[823]

As more fully described below,[824] for purposes of satisfying one of these issuer eligibility criteria, the final rules provide that a reference entity or an issuer of securities included in an index may rely upon the status of an affiliated entity as an Exchange Act reporting company or foreign private issuer or may aggregate the worldwide equity market capitalization or outstanding indebtedness of an affiliated entity, regardless of whether such affiliated entity itself or its securities are included in the index.

In the case of indexes including asset-backed securities, or reference entities that are issuing entities of asset-backed securities, information about the reference entity or issuing entity of the asset-backed security will not alone be sufficient and, consequently, the rules provide that the public information availability test will be satisfied only if certain information also is available about the asset-backed securities. An issuing entity (whether or not a reference entity) of asset-backed securities will meet the public information availability test if such asset-backed securities were issued in a transaction for which the asset-backed securities issued (which

822 See infra note 845 and accompanying text.

823 See July 2006 Debt Index Release.

824 See infra part III.G.3(b)(iv), for a discussion regarding the affiliation definition applicable to the public information availability test. As noted above, the Commissions are modifying the method of calculating affiliation for purposes of this test.

includes all tranches)[825] were registered under the Securities Act and distribution reports about such asset-backed securities are publicly available. In response to commenters,[826] the Commissions note that distribution reports, which sometimes are referred to as servicer reports, delivered to the trustee or security holders, as the case may be, are filed with the SEC on Form 10-D. In addition, because of the lack of public information regarding many asset-backed securities, despite the size of the outstanding amount of securities,[827] the rules do not permit such reference entities and issuers to satisfy the public information availability test by having at least $1 billion in outstanding indebtedness. Characterizing an index with reference entities or securities for which public information is not likely to be available as narrow-based, and thus index CDS where the underlying references or securities are such indexes as security-based swaps, should help to ensure that the index cannot be used to circumvent the federal securities laws, including those relating to Securities Act compliance and the antifraud, antimanipulation and insider trading prohibitions with respect to the index components or the securities of the reference entities.

As noted above, if an index is not narrow-based under the number and concentration criteria, it will be narrow-based if one of the reference entities or securities included in the index fails to meet at least one of the criteria in the public information availability test. However, even if one or more of the reference entities or securities included in the index fail the public information availability test, the final rules provide that the index will not be considered "issuers

825 Under this part of the public information availability test, all offerings of the asset-backed securities will have to be covered by a registration statement under the Securities Act, including all tranches, so that public information would exist for any tranche included in an index. However, as noted below, CDS that are offered to ECPs only may rely on alternatives to satisfy the public information test for asset-backed securities.

826 See infra note 849 and accompanying text.

827 See generally Asset-Backed Securities, 75 FR 23328 (May 3, 2010).

of securities in a narrow-based security index" or a "narrow-based security index," so long as the applicable reference entity or security that fails the test represents less than five percent of the index's weighting, and so long as reference entities or securities comprising at least 80 percent of the index's weighting satisfy the public information availability test.

An index that includes a very small proportion of reference entities or securities that do not satisfy the public information availability test will be treated as a broad-based security index if the other elements of the definition, including the five percent and 80 percent thresholds, are satisfied prior to execution, but no later than when the parties offer to enter into the index CDS.[828] The five-percent weighting threshold is designed to provide that reference entities or securities not satisfying the public information availability test comprise only a very small portion of the index, and the 80-percent weighting threshold is designed to provide that a predominant percentage of the reference entities or securities in the index satisfy the public information availability test. As a result, these thresholds provide market participants with flexibility in constructing an index. The Commissions believe that these thresholds are appropriate and that providing such flexibility is not likely to increase the likelihood that an index that satisfies these provisions or the component securities or issuers of securities in that index would be readily susceptible to manipulation or that there would be misuse of material non-public information about the component securities or issuers of securities in that index through the use of CDS based on such indexes.

The final rules also provide that, for index CDS entered into solely between ECPs, there are alternative means to satisfy the public information availability test. Under the final rules, solely for index CDS entered into between ECPs, an index will be considered narrow-based if a

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828 See supra note 625 and accompanying text.

reference entity or security included in the index does not meet (i) any of the criteria enumerated above or (ii) any of the following criteria:[829]

- the reference entity or the issuer of the security included in the index (other than a reference entity or issuer included in the index that is an issuing entity of an asset-backed security) makes available to the public or otherwise makes available to such ECP information about such reference entity or issuer pursuant to rule 144A(d)(4) under the Securities Act;[830]
- financial information about the reference entity or the issuer of the security included in the index (other than a reference entity or issuer included in the index that is an issuing entity of an asset-backed security) is otherwise publicly available; or
- in the case of an asset-backed security included in the index, or a reference entity included in the index that is an issuing entity of an asset-backed security, information of the type and level included in public distribution reports for similar asset-backed securities is publicly available about both the reference entity or issuing entity and the asset-backed security.

As more fully described below, for purposes of satisfying either the rule 144A information criterion or the financial information otherwise publicly available criterion, the final rules provide that a reference entity or an issuer of securities included in an index may look to an

829 See paragraph (a)(1)(iv)(H) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

830 17 CFR 230.144A(d)(4).

affiliated entity to determine whether it satisfies one of these criterion, regardless of whether such affiliated entity itself or its securities are included in the index.[831]

In response to commenters,[832] the Commissions are revising the rule 144A information criterion of the public information availability test applicable to index CDS entered into solely between ECPs to clarify that the rule 144A information must either be made publicly available or otherwise made available to the ECP. In addition, the Commissions are clarifying that financial information about the reference entity or the issuer of the security may otherwise be publicly available through an issuer's website, through public filings with other regulators or exchanges, or through other electronic means. This method of satisfying the public information availability test does not specify the precise method by which financial information must be available.

As with other index CDS, with respect to index CDS entered into solely with ECPs, if the percentage of the effective notional amounts allocated to reference entities or securities satisfying this expanded public information availability test comprise at least 80 percent of the index's weighting, then a reference entity or security included in the index that fails to satisfy the alternative public information test criteria will be disregarded so long as the effective notional amount allocated to that reference entity or security comprises less than five percent of the index's weighting.

Comments

The Commissions received a number of general and specific comments regarding the public information availability test.

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831 See infra part III.G.3(b)(iv), for a discussion regarding the affiliation definition applicable to the public information availability test applicable to index CDS entered into solely between ECPs. As noted above, the Commissions are modifying the method of calculating affiliation for purposes of this test.

832 See infra note 847 and accompanying text.

A number of commenters believed that the public information availability test should not be included in the final rules for various reasons, including the potential disparate treatment between products based on indexes due to changes in index components,[833] the impact of the migration of indexes from narrow-based to broad-based and vice-versa,[834] and assertions that the test was not needed due to the types of participants engaged in swap and security-based swap transactions.[835] One commenter suggested replacing the public information availability test with a volume trading test.[836]

The Commissions are adopting the public information availability test as proposed with certain modifications described above. As discussed above, the public information availability test is intended as the substitute for the ADTV provision in the statutory narrow-based security

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833 See SIFMA Letter. This commenter expressed its concern that transactions on the same or similar indexes may result in differing regulatory treatment due to changes in index components as a result of component adjustments or as the availability of information relating to a component issuer changes over time. Id.

834 See Markit Letter. According to this commenter, determining whether an index of loans or borrowers meets the public information availability test would be more difficult and more costly than making the same determination for an index of securities, which "are generally subject to national or exchange-based reporting and disclosure regimes" and could create regulatory uncertainty. Id. This commenter also expressed its belief that the public information availability test would cause indexes to switch between a narrow-based and broad-based classification, which could result in unnecessary cost, confusion, and market disruption. Id.

835 See ISDA Letter. This commenter expressed its belief that the public information availability test is not needed given the largely institutional nature of the existing over-the-counter market. Id. See also July LSTA Letter.

836 See Markit Letter. This commenter expressed its belief that a volume-based classification process would be preferable to the public information availability test for several reasons. First, the statutory definition of "narrow-based security index" includes a volume-based factor. Second, a volume-based factor could be applied easily and transparently because the outstanding notional volume of CDS referencing each index constituent is captured by the Trade Information Warehouse. Third, an index classification based on outstanding notional amount as opposed to the public information availability test would result in less indices migrating from broad- to narrow-based classifications, and vice versa. This commenter also expressed its belief that a volume-based test would ensure that broad-based indices are not readily susceptible to manipulation because indexes based on constituents with high volumes are likely to have significant public information available. Id.

index definition, which the Dodd-Frank Act included as the method for determining whether index CDS are swaps or security-based swaps. Based on the reasons discussed above, the Commissions have retained the public information availability test as the underlying rationale of such provision, that there is sufficient trading in the securities and therefore public information and market following of the issuer of the securities, applies to index CDS. Accordingly, the Commissions believe that there should be public information available about a predominant percentage of the reference entities or issuers of securities underlying the index in order to prevent circumvention of other provisions of the federal securities laws through the use of CDS based on such indexes, to reduce the likelihood that the index, the component securities, or the named issuers of securities in the index could be readily susceptible to manipulation, and to prevent the misuse of material non-public information about such an index, the component securities, or the reference entities.

The Commissions understand that the characterization of an index underlying a CDS as broad-based or narrow-based may change because of changes to the index, such as addition or removal of components, or changes regarding the specific components of the index, such as a decrease in the amount of outstanding common equity for a component. However, these types of changes are contemplated by the statutory narrow-based security index definition, which the Dodd-Frank Act used to establish whether index CDS are swaps or security-based swaps.[837] Moreover, the Commissions have provided that the determination of whether a Title VII instrument is a swap, security-based swap or mixed swap is made prior to execution, but no later

[837] The index migration issue exists for all products in which the "narrow-based security index" definition is used. Thus, as is true for security futures, the migration issue exists for debt security indexes and the statutory definition of the term "narrow-based security index," under which an index's characterization may be affected by a change to the index itself or to the components of the index.

than when the parties offer to enter into the Title VII instrument,[838] and does not change if a security index underlying such instrument subsequently migrates from broad to narrow (or vice versa) during its life. Accordingly, even if the public information availability test would cause indexes underlying index CDS to migrate as suggested by a commenter, that will not affect the classification of outstanding index CDS entered into prior to such migration. However, if an amendment or change is made to such outstanding index CDS that would cause it to be a new purchase or sale of such index CDS, that could affect the classification of such outstanding index CDS. Further, as is true for other products using the narrow-based security index definition, the Commissions also believe that the effects of changes to an index underlying a CDS traded on an organized platform are addressed through the tolerance period and grace period rules the Commissions are adopting, which rules are based on tolerance period and grace period rules for security futures to which the statutory narrow-based security index definition applies.[839]

The Commissions are not adopting a volume-based test based on the trading of the CDS or the trading of the index, either as a replacement for the public information availability test or as an alternative means of satisfying it, as one commenter suggested.[840] The Commissions believe that using a volume-based test based on the trading of the CDS or the trading of the index would not work in the index CDS context because the character of the index CDS would have to be determined before any trading volume could exist and, therefore, the index CDS would fail a volume-based test. The Commissions also believe that a volume-based test based either on the CDS components of the index or the index itself would not be an appropriate substitute for or an

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838 See supra note 625 and accompanying text.

839 See infra part III.G.6.

840 See supra note 836 and accompanying text.

alternative to a public information availability test with respect to the referenced entity, issuer of securities, or underlying security because such a volume-based test would not provide transparency on such underlying entities, issuers of securities or securities.[841]

The Commissions believe that the public information availability test in the index CDS rules allows more flexibility with respect to the types of components included in indexes underlying index CDS. For many indexes, such as bespoke indexes, trading volume for CDS on individual components may not be significant even though the index component would otherwise have no trouble satisfying one of the criteria of the public information availability test. The public information availability test in the index CDS rules also is very similar to the test in the rules for debt security indexes, which, as noted above, apply in the context of Title VII instruments, thus providing a consistent set of rules under which index compilers and market participants can analyze the characterization of CDS.

One commenter also had concerns regarding specific types of indexes and specific types of index components, including the applicability of the public information availability test to indexes of loans or borrowers.[842] As discussed above, however, the Commissions believe that index CDS based on indexes of loans or borrowers should be analyzed under the third prong of the statutory security-based swap definition in the same manner as any other index CDS. Although this commenter noted such indexes may include a higher proportion of "private"

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841 In the context of equity securities indexes to which the ADTV test applies, there likely is information regarding the underlying entities, issuers of securities or securities because, as noted above, Exchange Act registration of the security being traded is a listing standard for equity securities and, therefore, the issuer of the security being traded must be subject to the reporting requirements under the Exchange Act. However, in the context of index CDS, there are no comparable listing standards that would be applicable to provide transparency on the underlying entities, issuers of securities or securities.

842 See July LSTA Letter.

borrowers (those borrowers who are not public reporting companies or that do not register offerings of their securities) and thus may themselves not satisfy any of the criteria for the public information availability test,[843] the Commissions believe that the information tests of the rule as modified will address these concerns. The modified rule will add loans to the categories of instruments to be aggregated for purposes of the outstanding indebtedness criterion and, as discussed below, will aggregate outstanding indebtedness of affiliates.[844] As a result of these modifications, the Commissions believe that the indexes the commenter was concerned about may be more likely to satisfy the public information availability test.

One commenter agreed with including an outstanding debt threshold as a criterion in the public information availability test, but requested that the Commissions change this criterion to include loans that are not within the definition of security, as well as affiliate debt guaranteed by the issuer of securities or reference entity, and to reduce the required outstanding debt threshold from $1 billion to $100 million.[845] As discussed above, the Commissions are revising the rules to expand the types of debt that are counted toward the $1 billion debt threshold to include any indebtedness, including loans, so long as such indebtedness is not a revolving credit facility. The Commissions have made no other changes to the $1 billion debt threshold.

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843 Id.

844 As noted above, the Commissions are modifying the method of calculating affiliation for purposes of certain criteria of the public information availability test. See infra part III.G.3(b)(iv).

845 See Markit Letter. This commenter suggested that the debt threshold should be reduced to $100 million because debt issuances in some debt markets, such as the high yield markets, tend to be relatively small. This commenter also suggested that the debt threshold should include debt guaranteed by the issuer of the securities or reference entity because in many cases the issuer of the securities or reference entity is merely guaranteeing debt of its affiliates and not issuing the debt. Finally, this commenter requested clarification as to whether the debt threshold included loans and leveraged loans.

The Commissions believe that the fact that an entity has guaranteed the obligations of another entity will not affect the likelihood that public information is available about either the borrower on the guaranteed obligation or on the guarantor entity. However, the Commissions note that they are providing an additional interpretation on the affiliation definition of the index CDS rules, including modifying the method of calculating affiliation, that should address this commenter's concerns regarding guaranteed affiliate debt.[846] The Commissions also believe that the $1 billion debt threshold, which is the same amount as the outstanding debt threshold in the rules for debt security indexes, is set at the appropriate level to achieve the objective that such entities are likely to have public information available about them.

One commenter suggested that the proposed rule 144A information criterion of the public information availability test applicable to index CDS entered into solely between ECPs should be satisfied if the issuer made the rule 144A information available upon request to the public or to the ECP in question, rather than being required to provide the information.[847] In response to this commenter, the Commissions are revising the rule 144A information criterion of the public information availability test applicable to index CDS entered into solely between ECPs to clarify that the rule 144A information must be made publicly available or otherwise made available to the ECP.

The Commissions received one comment regarding the criteria of the public information availability test that relate specifically to asset-backed securities.[848] The commenter was concerned that the test for asset-backed securities underlying an index may be difficult to apply

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846 See infra part III.G.3(b)(iv).

847 See SIFMA Letter.

848 See Markit Letter.

because all asset-backed securities underlying an index are not always registered under the Securities Act.[849] This commenter also was concerned that the term "distribution reports" may not be the same as monthly service reports, which this commenter indicated are available through the deal trustee and/or the SEC website.[850] This commenter also believed that it was unclear whether these monthly service reports would qualify as "distribution reports" for purposes of the public information availability test and whether information regarding Agency MBS pools, which are available on Agency websites, would be sufficient to satisfy the public information availability test.[851] In addition, this commenter requested that the Commissions clarify that not all tranches of a transaction need to be registered under the Securities Act to satisfy the publicly available distribution report requirement.[852]

The Commissions are adopting as proposed the provisions of the public information availability test applicable to indexes based on asset-backed securities. The Commissions note that there are two possible ways to satisfy the public information availability test for index CDS based on asset-backed securities or asset-backed issuers. For index CDS available to non-ECPs, all asset-backed securities in the index or of the issuer in the index must have been sold in registered offerings under the Securities Act and have publicly available distribution reports. The Commissions are clarifying that monthly service reports filed with the SEC will satisfy the requirement for publicly available distribution reports.[853] However, for index CDS being sold only to ECPs, the public information availability test with respect to the index components is

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849 Id.

850 Id.

851 Id.

852 Id.

853 Distribution reports, which sometimes are referred to as servicer reports, delivered to the trustee or security holders, as the case may be, are filed with the SEC on Form 10-D.

satisfied, regardless of whether the asset-backed securities have been sold in registered offerings under the Securities Act, if information of the type and level included in public distribution reports for similar asset-backed securities is publicly available about both the issuing entity and such asset-backed securities. The Commissions believe that requiring such information about the asset-backed securities and the assets in the pools underlying such asset-backed securities is consistent with existing disclosure requirements for asset-backed securities and existing practices of ABS issuers.

iv) Affiliation of Reference Entities and Issuers of Securities With Respect to Certain Criteria of the Public Information Availability Test

The Commissions are adopting the affiliation definition that applies to certain criteria of the public information availability test with certain modifications from the proposals to address commenters' concerns.[854] The Commissions are making modifications to this affiliation definition that are the same as the modifications the Commissions are making to the affiliation definition that applies when calculating the number and concentration criteria.[855]

This affiliation definition applies for purposes of determining whether a reference entity or issuer of securities included in an index satisfies one of the following four criteria of the public information availability test: (i) the reference entity or issuer of the security included in the index is required to file reports pursuant to the Exchange Act or the regulations thereunder;[856] (ii) the reference entity or issuer of the security included in the index is eligible to rely on the

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854 See infra note 867 and accompanying text.

855 See supra part III.G.3(b)(ii).

856 See paragraph (a)(1)(iv)(A) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

exemption provided in rule 12g3-2(b) under the Exchange Act for foreign private issuers;[857] (iii) the reference entity or issuer of the security included in the index has a worldwide market value of its outstanding common equity held by non-affiliates of $700 million or more;[858] and (iv) the reference entity or issuer of the security included in the index has outstanding notes, bonds, debentures, loans, or evidences of indebtedness (other than revolving credit facilities) having a total remaining principal amount of at least $1 billion.[859] This affiliation definition also applies for purposes of determining whether a reference entity or issuer of securities included in an index satisfies one of the following two criteria of the alternative public information availability test applicable to index CDS entered into solely between ECPs: (i) the reference entity or issuer of the security included in the index makes available rule 144A information;[860] and (ii) financial information about the reference entity or issuer of the security included in the index is otherwise publicly available.[861]

The final rules provide that the terms "reference entity included in the index" and "issuer of the security included in the index" include a single reference entity or issuer of securities included in an index, respectively, or a group of affiliated entities.[862] For purposes of the rules, a reference entity or issuer of securities included in an index may rely upon an affiliated entity to

857 See paragraph (a)(1)(iv)(B) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

858 See paragraph (a)(1)(iv)(C) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

859 See paragraph (a)(1)(iv)(D) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

860 See paragraph (a)(1)(iv)(H)(1) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

861 See paragraph (a)(1)(iv)(H)(2) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

862 See paragraph (c)(4) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

satisfy certain criteria of the public information availability test. However, with respect to asset-backed securities, the final rules provide that each reference entity or issuer of securities included in an index that is an issuing entity of an asset-backed security is considered a separate reference entity or issuer, as applicable, and will not be considered affiliated with any other entities.

The final rules provide that a reference entity or issuer of securities included in an index is affiliated with another entity if it controls, is controlled by, or is under common control with, that other entity.[863] The final rules define control, solely for purposes of this affiliation definition, to mean ownership of more than 50 percent of a reference entity's or issuer's equity or the ability to direct the voting of more than 50 percent of a reference entity's or issuer's voting equity.[864] This revision is the same as the modification the Commissions are making to the affiliation definition that applies when calculating the number and concentration criteria, which is discussed above.[865]

As the Commissions noted above, this change is based on the Commissions' consideration of comments received. By using a more than 50 percent (i.e., majority ownership) test rather than a 20 percent ownership test for the control threshold, there is a greater likelihood that there will be information available about the reference entity or issuer of securities included in the index because the market likely will view the affiliated entity and the reference entity or issuer of securities included in the index as a single company or economic entity.[866]

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863 See paragraph (c)(1) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

864 See paragraph (c)(2) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

865 See supra part III.G.3(b)(ii).

866 The more than 50 percent (i.e., majority ownership) test is generally consistent with consolidation under U.S. generally accepted accounting principles. See FASB ASC section 810-10-25, Consolidation – Overall – Recognition (stating that consolidation is appropriate if a reporting

Accordingly, to the extent information regarding the affiliated entity is publicly available, there may be information regarding the reference entity or issuer of securities included in the index that also is publicly available. This modified control threshold will permit such reference entity or issuer of securities to rely upon an affiliated entity to satisfy one of the criteria of the public information availability test. Further, unlike the affiliation definition that applies when calculating the number and concentration criteria, the affiliation definition that applies to certain criteria of the public information availability test does not require that the affiliated entity or its securities be included in the index.

As the affiliation definition applies to the Exchange Act reporting company and foreign private issuer criteria of the public information availability test, a reference entity or an issuer of securities included in an index that itself is not required to file reports pursuant to the Exchange Act or the regulations thereunder or is not eligible to rely on the exemption provided in rule 12g3-2(b) under the Exchange Act for foreign private issuers may rely upon the status of an affiliated entity as an Exchange Act reporting company or foreign private issuer, regardless of whether that affiliated entity itself or its securities are included in the index, to satisfy one of these criteria. For example, a majority-owned subsidiary included in an index may rely upon the status of its parent, which may or may not be included in the index, to satisfy the issuer eligibility criteria if the parent is required to file reports under the Exchange Act or is a foreign private issuer.

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entity has a controlling financial interest in another entity and a specific scope exception does not apply). Accordingly, using a more than 50 percent (i.e., majority ownership) test will make it more likely that the reference entity or issuer of securities included in the index and the affiliated entity will be consolidated with each other in financial statements. Consolidated financial statements present the financial position and results of operations for a parent (controlling entity) and one or more subsidiaries (controlled entities) as if the individual entities actually were a single company or economic entity.

Similarly, as the affiliation definition applies to the worldwide equity market capitalization and outstanding indebtedness criteria of the public information availability test, a reference entity or an issuer of securities included in an index that itself does not have a worldwide market value of its outstanding common equity held by non-affiliates of $700 million or more or outstanding notes, bonds, debentures, loans, or evidences of indebtedness (other than revolving credit facilities) having a total remaining principal amount of at least $1 billion, may aggregate the worldwide equity market capitalization or outstanding indebtedness of an affiliated entity, regardless of whether that affiliated entity itself or its securities are included in the index, to satisfy one of these criteria. For example, a majority-owned subsidiary included in an index may aggregate the worldwide equity market capitalization or outstanding indebtedness of its parent and/or other affiliated entities, such as other majority-owned subsidiaries of the parent, to satisfy one of these criteria.

Finally, as the affiliation definition applies to the rule 144A information and financial information otherwise publicly available criteria of the alternative public information availability test applicable to index CDS entered into solely between ECPs, a reference entity or an issuer of securities included in an index that itself does not make available rule 144A information or does not have financial information otherwise publicly available may rely upon an affiliated entity, regardless of whether that affiliated entity itself or its securities are included in the index, to satisfy one of these criteria.

Comments

One commenter requested that the Commissions revise the affiliation definition that applies for purposes of the public information availability test to increase the threshold from 20 percent ownership to majority ownership.[867] This commenter noted that majority ownership is consistent with current market practice, including the definition of affiliate included in the 2003 ISDA Credit Derivatives Definitions.[868] This commenter also noted that the current approach with respect to the inclusion of affiliated entities in the same index uses majority ownership rather than 20 percent ownership to determine affiliation.[869] This commenter also requested that the Commissions clarify the application of the affiliation definition to the public information availability test.[870] Further, this commenter requested that the worldwide equity market capitalization criterion should include all affiliated entities because the reference entity included in the index may not be the member of a corporate group that issues public equity.[871] Finally, this commenter was concerned that the outstanding indebtedness criterion would not include affiliate debt guaranteed by the reference entity or issuer of securities included in the index.[872] Further, as noted above,[873] another commenter was concerned that index CDS may include a higher proportion of "private" borrowers (those borrowers that are not public reporting companies or that do not register offerings of their securities) and thus may themselves not satisfy each of the criteria for the public information availability test.[874]

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867 See Markit Letter (requesting a threshold of at least 50 percent).

868 Id.

869 Id.

870 Id.

871 Id. This commenter provided Kinder Morgan Kansas Inc. (CDS) and Kinder Morgan Inc. (equity) as an example of where the reference entity and issuer of equity among a corporate group are not the same. Id.

872 Id.

873 See supra note 842 and accompanying text.

874 See July LSTA Letter.

The Commissions note the commenters' concerns. The Commissions are modifying the method of determining affiliation that applies for purposes of satisfying certain criteria of the public information availability test. The final rules provide that a reference entity or issuer of securities included in an index may rely upon an affiliated entity (meeting the more than 50 percent control threshold) to satisfy one of the criterion of the public information availability test. This modification is similar to the one the Commissions are making to the affiliation definition that applies for purposes of calculating the number and concentration criteria. As noted above, based on commenters' letters, the Commissions understand that the current standard CDS documentation and the current approach with respect to the inclusion of affiliated entities in the same index use majority ownership rather than 20 percent ownership to determine affiliation. The Commissions agree with commenters that in the case of index CDS only it is more appropriate to use a more than 50 percent (i.e., majority ownership) test rather than a 20 percent ownership test. The Commissions believe that because reference entities or issuers of securities included in an index may rely on an affiliated entity to help satisfy the public information availability test a threshold of majority ownership rather than 20 percent ownership will increase the likelihood that there is information available about the reference entity or issuer of securities included in the index. The Commissions believe that determining affiliation in this manner for purposes of the public availability of information test responds to the commenter's concerns.

Further, the Commissions are providing several illustrative examples of the way in which the affiliation definition works in the context of the public availability of information criteria to address the commenter's concerns regarding the application of the affiliation definition in that context. The Commissions also note that the final rules respond to the commenter's concerns regarding the applicability of the affiliation definition to the worldwide equity market capitalization criterion by providing that the worldwide market capitalization of an affiliate can be counted in determining whether the reference entity or issuer of securities included in the index meets the worldwide equity market capitalization criterion. Moreover, the Commissions note that the final rules respond to the commenter's concerns regarding affiliate debt by providing that indebtedness of an affiliate can be counted in determining whether the reference entity or issuer of securities included in the index meets the outstanding indebtedness criterion. Finally, the Commissions note that the affiliation definition as modified responds to the commenter's concerns regarding "private" borrowers because the modified affiliation definition will allow a reference entity or issuer of securities included in an index to consider the indebtedness, the outstanding equity, and the reporting status of an affiliate in determining whether the public information availability test is satisfied.

As noted above, the Commissions also believe that the modified affiliation definition responds to commenters' concerns noted above that the rules further defining the terms "issuers of securities in a narrow-based security index" and "narrow-based security index" should be simplified. The modified affiliation definition enables market participants to make an affiliation determination for purposes of the public information availability test criteria by measuring the more than 50 percent (i.e., majority ownership) control threshold.

v) Application of the Public Information Availability Requirements to Indexes Compiled by a Third-Party Index Provider

The Commissions requested comment in the Proposing Release as to whether the public information availability test should apply to an index compiled by an index provider that is not a party to an index CDS ("third-party index provider") that makes publicly available general information about the construction of the index, index rules, identity of components, and predetermined adjustments, and which index is referenced by an index CDS that is offered on or subject to the rules of a DCM or SEF, or by direct access in the U.S. from an FBOT that is registered with the CFTC.[875] Two commenters stated that the presence of a third-party index provider would assure that sufficient information is available regarding the index CDS itself.[876] Neither commenter provided any analysis to explain how or whether a third-party index provider would be able to provide information about the underlying securities or issuers of securities in the index. The Commissions are not revising the rules to exclude from the public information availability test any index compiled by a third-party index provider.

vi) Treatment of Indexes Including Reference Entities That Are Issuers of Exempted Securities or Including Exempted Securities

The Commissions are adopting the rules regarding the treatment of indexes that include exempted securities or reference entities that are issuers of exempted securities as proposed without modification.[877] The Commissions believe such treatment is consistent with the objective and intent of the statutory definition of the term "security-based swap," as well as the approach taken in the context of security futures.[878] Accordingly, paragraph (1)(ii) of rules

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875 See Proposing Release at 29851-52.

876 See ISDA Letter and SIFMA Letter.

877 See rules 1.3(zzz)(1)(i) and 1.3(aaaa)(1)(i) under the CEA and rules 3a68-1a(a)(2) and 3a68-1b(a)(2) under the Exchange Act; and July 2006 Debt Index Rules. The Commissions did not receive any comments on the proposed rules regarding the treatment of indexes that include exempted securities or reference entities that are issuers of exempted securities.

878 See section 3(a)(68)(C) of the Exchange Act, 15 U.S.C. 78c(a)(68)(C) (providing that "[t]he term 'security-based swap' does not include any agreement, contract, or transaction that meets the definition of a security-based swap only because such agreement, contract, or transaction references, is based upon, or settles through the transfer, delivery, or receipt of an exempted security under paragraph (12) [of the Exchange Act], as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in paragraph (29) [of the Exchange Act] as in effect on the date of enactment of the Futures Trading Act of 1982), unless such agreement, contract, or transaction is of the character of, or is commonly known in the trade as, a put, call, or other option").

1.3(zzz) and 1.3(aaaa) under the CEA and paragraph (a)(2) of rules 3a68-1a and 3a68-1b under the Exchange Act provide that, in the case of an index that includes exempted securities, or reference entities that are issuers of exempted securities, in each case as defined as of the date of enactment of the Futures Trading Act of 1982 (other than municipal securities), such securities or reference entities are excluded from the index when determining whether the securities or reference entities in the index constitute a "narrow-based security index" or "issuers of securities in a narrow-based security index" under the rules.

Under paragraph (1)(ii) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and paragraph (a)(2) of rules 3a68-1a and 3a68-1b) under the Exchange Act, an index composed solely of securities that are, or reference entities that are issuers of, exempted securities (other than municipal securities) will not be a "narrow-based security index" or an index composed of "issuers of securities in a narrow-based security index." In the case of an index where some, but not all, of the securities or reference entities are exempted securities (other than municipal securities) or issuers of exempted securities (other than municipal securities), the index will be a "narrow-based security index" or an index composed of "issuers of securities in a narrow-based security index" only if the index is narrow-based when the securities that are, or reference entities that are issuers of, exempted securities (other than municipal securities) are disregarded. The Commissions believe this approach should result in consistent treatment for indexes regardless of whether they include securities that are, or issuers of securities that are, exempted securities (other than municipal securities) while helping to ensure that exempted securities (other than municipal securities) and issuers of exempted securities (other than municipal securities) are not included in an index merely to make the index either broad-based or narrow-based under the rules.

4. Security Indexes

The Dodd-Frank Act defines the term "index" as "an index or group of securities, including any interest therein or based on the value thereof."[879] The Commissions provided an interpretation in the Proposing Release regarding how to determine when a portfolio of securities is a narrow-based or broad-based security index, and the circumstances in which changes to the composition of a security index (including a portfolio of securities)[880] underlying a Title VII instrument would affect the characterization of such Title VII instrument.[881] The Commissions are restating the interpretation set forth in the Proposing Release with one clarification in response to a commenter.[882] Specifically, the Commissions are clarifying what is meant by "predetermined" for purposes of whether criteria or a self-executing formula for adjusting the security index underlying a Title VII instrument qualify under the interpretation. The Commissions find that this interpretation is an appropriate way to address how to determine when a portfolio of securities is a narrow-based or broad-based security index, and the circumstances in which changes to the composition of a security index (including a portfolio of securities) underlying a Title VII instrument would affect the characterization of such Title VII instrument, and is designed to reduce costs associated with making such a determination.[883]

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879 See section 3(a)(68)(E) of the Exchange Act, 15 U.S.C. 78c(a)(68)(E).

880 The Commissions noted in the Proposing Release that a "portfolio" of securities could be a group of securities and therefore an "index" for purposes of the Dodd-Frank Act. See Proposing Release at 29854. To the extent that changes are made to the securities underlying the Title VII instrument and each such change is individually confirmed, then those substituted securities are not part of a security index as defined in the Dodd-Frank Act, and therefore a Title VII instrument on each of those substituted securities is a security-based swap.

881 Solely for purposes of the discussion in this section, the terms "security index" and "security portfolio" are intended to include either securities or the issuers of securities.

882 See infra note 891 and accompanying text.

883 See supra part I, under "Overall Economic Considerations".

A security index in most cases is designed to reflect the performance of a market or sector by reference to representative securities or interests in securities. There are several well-known security indexes established and maintained by recognized index providers currently in the market.[884] However, instead of using these established indexes, market participants may enter into a Title VII instrument where the underlying reference of the Title VII instrument is a portfolio of securities selected by the counterparties or created by a third-party index provider at the behest of one or both counterparties. In some cases, the Title VII instrument may give one or both of the counterparties, either directly or indirectly (e.g., through an investment adviser or through the third-party index provider), discretionary authority to change the composition of the security portfolio, including, for example, by adding or removing securities in the security portfolio on an "at-will" basis during the term of the Title VII instrument.[885] Where the counterparties, either directly or indirectly (e.g., through an investment adviser or through the third-party index provider), have this discretionary authority to change the composition or weighting of securities in a security portfolio, that security portfolio will be treated as a narrow-based security index, and therefore a Title VII instrument on that security portfolio is a security-based swap.[886]

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884 One example is the S&P 500® Index, an index that gauges the large cap U.S. equities market.

885 Alternatively, counterparties may enter into Title VII instruments where a third-party investment manager selects an initial portfolio of securities and has discretionary authority to change the composition of the security portfolio in accordance with guidelines agreed upon with the counterparties. Under the final guidance the Commissions are issuing today, such security portfolios are treated as narrow-based security indexes, and Title VII instruments on those security portfolios are security-based swaps.

886 The Commissions understand that a security portfolio could be labeled as such or could just be an aggregate of individual Title VII instruments documented, for example, under a master agreement or by amending an annex of securities attached to a master trade confirmation. If the security portfolio were created by aggregating individual Title VII instruments, each Title VII instrument must be evaluated in accordance with the guidance to determine whether it is a swap or a security-based swap. For the avoidance of doubt, if the counterparties to a Title VII instrument

However, not all changes that occur to the composition or weighting of a security index underlying a Title VII instrument will always result in that security index being treated as a narrow-based security index. Many security indexes are constructed and maintained by an index provider pursuant to a published methodology.[887] For instance, the various Standard & Poor's security indexes are reconstituted and rebalanced as needed and on a periodic basis pursuant to published index criteria.[888] Such indexes underlying a Title VII instrument would be broad-based or narrow-based depending on the composition and weighting of the underlying security index.

In addition, counterparties to a Title VII instrument frequently agree to use as the underlying reference of a Title VII instrument a security index based on predetermined criteria where the security index composition or weighting may change as a result of the occurrence of certain events specified in the Title VII instrument at execution, such as "succession events." Counterparties to a Title VII instrument also may use a predetermined self-executing formula to make other changes to the composition or weighting of a security index underlying a Title VII instrument. In either of these situations, the composition of a security index may change

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exchanged payments under that Title VII instrument based on a security index that was itself created by aggregating individual security-based swaps, such Title VII instrument would be a security-based swap. See supra part III.D.

887 See, e.g., NASDAQ, "NASDAQ-100 Index" ("The NASDAQ-100 Index is calculated under a modified capitalization-weighted methodology. The methodology generally is expected to retain the economic attributes of capitalization-weighting while providing enhanced diversification. To accomplish this, NASDAQ will review the composition of the NASDAQ-100 Index on a quarterly basis and adjust the weightings of Index components using a proprietary algorithm, if certain pre-established weight distribution requirements are not met."), available at http://dynamic.nasdaq.com/dynamic/nasdaq100_activity.stm.

888 Information regarding security indexes and their related methodologies may be widely available to the general public or restricted to licensees in the case of proprietary or "private label" security indexes. Both public and private label security indexes frequently are subject to intellectual property protection.

pursuant to predetermined criteria or predetermined self-executing formulas without the Title VII instrument counterparties, their agents, or third-party index providers having any direct or indirect discretionary authority to change the security index.

In general, and by contrast to Title VII instruments in which the counterparties, either directly or indirectly (e.g., through an investment adviser or through the third-party index provider), have the discretion to change the composition or weighting of the referenced security index, where there is an underlying security index for which there are predetermined criteria or a predetermined self-executing formula for adjusting the security index that are not subject to change or modification through the life of the Title VII instrument and that are set forth in the Title VII instrument at execution (regardless of who establishes the criteria or formula), a Title VII instrument on such underlying security index is based on a broad-based or narrow-based security index, depending on the composition and weighting of the underlying security index. Subject to the interpretation discussed below regarding security indexes that may shift from being a narrow-based security index or broad-based security index during the life of an existing Title VII instrument, the characterization of a Title VII instrument based on a security index as either a swap or a security-based swap will depend on the characterization of the security index using the above interpretation.[889]

The Commissions are clarifying in response to a commenter that, for purposes of this interpretation, criteria or a self-executing formula regarding composition of a security index underlying a Title VII instrument shall be considered "predetermined" if it is bilaterally agreed upon pre-trade by the parties to a transaction.[890] In order to qualify under this interpretation,

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889 See supra note 886, regarding the aggregation of separate trades.

890 See infra note 891 and accompanying text.

however, the Commissions reiterate that the "predetermined" criteria or self-executing formula, as described above, must not be subject to change or modification through the life of the Title VII instrument and must be set forth in the Title VII instrument at execution (regardless of who establishes the criteria or formula).

Comments

The Commissions requested comment on a number of issues regarding the interpretation contained in this section as it was proposed, including whether the terms "predetermined criteria" and "predetermined self-executing formula" are clear, and whether additional interpretations should be provided with respect to these terms. The Commissions received one comment on the interpretation provided in the Proposing Release, in which the commenter requested clarification that criteria affecting the composition of an index, when such criteria are agreed bilaterally, pre-trade, by the counterparties to a bespoke index trade, are "predetermined" for purposes of determining whether the index is treated as narrow-based or broad-based.[891]

The Commissions are restating the interpretation set forth in the Proposing Release with one clarification in response to the commenter's concerns. As discussed above, the Commissions are providing that not all changes that occur to the composition or weighting of a security index underlying a Title VII instrument will result in that security index being treated as

[891] See ISDA Letter. While this commenter agrees with the guidance that the predetermined changes described in this section should not alter the character of an index (or the classification of a Title VII instrument based thereon), this commenter disagrees that the ability to make discretionary changes should cause an otherwise broad-based security index to be a narrow-based security index. This commenter requested that the Commissions classify transactions "at inception and upon actual change in respect of any classification-related characteristic, be that change the product of a renegotiation or a unilateral exercise of discretion." Id. The Commissions note that if material terms of a Title VII instrument are amended or modified during its life based on an exercise of discretion and not through predetermined criteria or a predetermined self-executing formula, the Commissions view the amended or modified Title VII instrument as a new Title VII instrument. See infra part III.G.5.

a narrow-based security index. Foremost among these examples is a security index that is constructed and maintained by an index provider pursuant to a published methodology.[892] Changes to such an index pursuant to such a methodology are not the type of discretionary changes that will render an otherwise broad-based security index a narrow-based security index. The Commissions believe this clarification addresses the commenter's concerns.

5. Evaluation of Title VII Instruments on Security Indexes That Move from Broad-Based to Narrow-Based or Narrow-Based to Broad-Based

a) In General

The determination of whether a Title VII instrument is a swap, a security-based swap, or both (i.e., a mixed swap), is made prior to execution, but no later than when the parties offer to enter into the Title VII instrument.[893] If the security index underlying a Title VII instrument migrates from being broad-based to being narrow-based, or vice versa, during the life of a Title VII instrument, the characterization of that Title VII instrument will not change from its initial characterization regardless of whether the Title VII instrument was entered into bilaterally or was executed through a trade on or subject to the rules of a DCM, SEF, FBOT, security-based SEF, or NSE. For example, if two counterparties enter into a swap based on a broad-based security index, and three months into the life of the swap the security index underlying that Title VII instrument migrates from being broad-based to being narrow-based, the Title VII instrument will remain a swap for the duration of its life and will not be recharacterized as a security-based swap.

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892 Indeed, the Commissions specifically mentioned in this regard, and have included in the final guidance above, the various Standard & Poor's security indexes--some of which may be described as "common equity indices" as alluded to in ISDA's comment--that are reconstituted and rebalanced as needed and on a periodic basis pursuant to published index criteria.

893 See supra note 625 and accompanying text.

If the material terms of a Title VII instrument are amended or modified during its life based on an exercise of discretion and not through predetermined criteria or a predetermined self-executing formula, the Commissions view the amended or modified Title VII instrument as a new Title VII instrument.[894] As a result, the characteristics of the underlying security index must be reassessed at the time of such an amendment or modification to determine whether the security index has migrated from broad-based to narrow-based, or vice versa. If the security index has migrated, then the characterization of the amended or modified Title VII instrument will be determined by evaluating the underlying security index at the time the Title VII instrument is amended or modified. Similarly, if a security index has migrated from broad-based to narrow-based, or vice versa, any new Title VII instrument based on that security index will be characterized pursuant to an evaluation of the underlying security index at the execution of that new Title VII instrument.

The Commissions provided an interpretation in the Proposing Release regarding circumstances in which the character of a security index on which a Title VII instrument is based changes according to predetermined criteria or a predetermined self-executing formula set forth in the Title VII instrument (or in a related or other agreement entered into by the counterparties

[894] For example, if, on its effective date, a Title VII instrument tracks the performance of an index of 12 securities but is amended during its term to track the performance of only 8 of those 12 securities, the Commissions would view the amended or modified Title VII instrument as a new Title VII instrument. Because it is a new Title VII instrument, any regulatory requirements regarding new Title VII instruments apply. Conversely, if, on its effective date, a Title VII instrument tracks the performance of an index of 12 securities but is amended during its term to reflect the replacement of a departing "key person" of a hedge fund that is a counterparty to the Title VII instrument with a new "key person," the Commissions would not view the amended or modified Title VII instrument as a new Title VII instrument because the amendment or modification is not to a material term of the Title VII instrument.

or a third-party index provider to the Title VII instrument) at execution. The Commissions are restating this interpretation with one clarification in response to a commenter.[895]

Where at the time of execution such criteria or such formula would cause the underlying broad-based security index to become or assume the characteristics of a narrow-based security index or vice versa during the duration of the instrument,[896] then the Title VII instrument based on such security index is a mixed swap during the entire life of the Title VII instrument.[897] Although at certain points during the life of the Title VII instrument, the underlying security index would be broad-based and at other points the underlying security index would be narrow-based, regulating such a Title VII instrument as a mixed swap from the execution of the Title VII instrument and throughout its life reflects the appropriate characterization of a Title VII instrument based on a security index that migrates pursuant to predetermined criteria or a predetermined self-executing formula.

The Commissions are clarifying what is meant by whether the pre-determined criteria or pre-determined self-executing formula "would cause" the underlying broad-based security index to become or assume the characteristics of a narrow-based security index, or vice versa, as noted above in the interpretation. The Commissions believe that, unless the criteria or formula were

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895 See infra note 898 and accompanying text.

896 Thus, for example, if a predetermined self-executing formula agreed to by the counterparties of a Title VII instrument at or prior to the execution of the Title VII instrument provided that the security index underlying the Title VII instrument would decrease from 20 to 5 securities after six months, such that the security index would become narrow-based as a result of the reduced number of securities, then the Title VII instrument is a mixed swap at its execution. The characterization of the Title VII instrument as a mixed swap will not change during the life of the Title VII instrument.

897 As discussed in section III.G.4., supra, to the extent a Title VII instrument permits "at-will" substitution of an underlying security index, however, as opposed to the use of predetermined criteria or a predetermined self-executing formula, the Title VII instrument is a security-based swap at its execution and throughout its life regardless of whether the underlying security index was narrow-based at the execution of the Title VII instrument.

intentionally designed to change the index from narrow to broad, or vice versa, Title VII instruments based on indexes that may, but will not necessarily, change from broad to narrow (or vice versa) under such criteria or formula should be considered swaps or security-based swaps, as appropriate, at execution and for the term thereof, and not mixed swaps. In such circumstances, it is not the case that the criteria or formula "would cause" the change within the meaning of the Commission's interpretation.

The Commissions believe that this interpretation regarding the use of predetermined criteria or a predetermined self-executing formula will prevent potential gaming of the Commissions' interpretation regarding security indexes, and prevent potential regulatory arbitrage based on the migration of a security index from broad-based to narrow-based, or vice versa. In particular, predetermined criteria and predetermined self-executing formulas can be constructed in ways that take into account the characteristics of a narrow-based security index and prevent a narrow-based security index from becoming broad-based, and vice versa.

Comments

The Commissions received two comments on the proposed interpretation in this section regarding the classification of Title VII Instruments based on security indexes that change from narrow-based to broad-based, or vice versa, under predetermined criteria or a predetermined self-executing formula, as mixed swaps. One commenter requested that the Commissions clarify that a Title VII instrument based on a security index that may, but will not necessarily, change from narrow-based to broad-based, or vice versa, under predetermined criteria or a predetermined self-executing formula should be characterized at execution as a swap or security-based swap, as applicable, and not as a mixed swap.[898] This commenter believed that the Commissions'

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898 See SIFMA Letter.

interpretation should capture as mixed swaps only those Title VII instruments on indexes that will change with certainty, and not those that might change given specific market circumstances.[899] Moreover, this commenter believed that the Commissions' statement that a Title VII instrument on a security index governed by a pre-determined self-executing formula that "would cause" a change from broad to narrow, or narrow to broad, means that the change in character must be a certainty for the instrument to be classified as a mixed swap.[900] The Commissions have clarified their interpretation in response to this commenter's concerns as discussed above.

Another commenter disagreed with the Commissions' proposed interpretation that transactions on indexes under predetermined criteria or a predetermined self-executing formula that would change from broad to narrow, or narrow to broad, should be classified as mixed swaps at inception.[901] This commenter does not believe that regulatory arbitrage is such a significant concern in this context that would justify the challenges to market participants if these transactions were treated as mixed swaps subject to the dual regulatory authority of the Commissions.[902]

The Commissions believe that regulatory arbitrage is a sufficient concern to justify mixed swap status and dual regulatory oversight for Title VII instruments where the index would change from broad to narrow, or narrow to broad, under the pre-determined criteria or predetermined self-executing formula. Counterparties that are concerned about regulatory burdens associated with mixed swap status can redesign their formula to avoid the result, or enter

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899 Id.

900 Id.

901 See ISDA Letter.

902 Id.

into another swap or security-based swap that is structured to achieve the same economic result without mixed swap status.

b) Title VII Instruments on Security Indexes Traded on Designated Contract Markets, Swap Execution Facilities, Foreign Boards of Trade, Security-Based Swap Execution Facilities, and National Securities Exchanges

As was recognized in the Proposing Release, security indexes underlying Title VII instruments that are traded on DCMs, SEFs, FBOTs, security-based SEFs, or NSEs raise particular issues if an underlying security index migrates from broad-based to narrow-based, or vice versa.[903] The Commissions are adopting as proposed their interpretation clarifying that the characterization of an exchange-traded Title VII instrument based on a security index at its execution will not change through the life of the Title VII instrument, regardless of whether the underlying security index migrates from broad-based to narrow-based, or vice versa. Accordingly, a market participant who enters into a swap on a broad-based security index traded on or subject to the rules of a DCM, SEF or FBOT that migrates from broad-based to narrow-based may hold that position until the swap's expiration without any change in regulatory responsibilities, requirements, or obligations; similarly, a market participant who enters into a security-based swap on a narrow-based security index traded on a security-based SEF or NSE that migrates from narrow-based to broad-based may hold that position until the security-based swap's expiration without any change in regulatory responsibilities, requirements, or obligations.

In addition, the Commissions are adopting, as proposed, final rules providing for tolerance and grace periods for Title VII instruments on security indexes that are traded on

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903 See Proposing Release at 29856.

DCMs, SEFs, FBOTs, security-based SEFs and NSEs.[904] As was noted in the Proposing Release,[905] in the absence of any action by the Commissions, if a market participant wants to offset a swap or enter into a new swap on a DCM, SEF or FBOT where the underlying security index has migrated from broad-based to narrow-based, or to offset a security-based swap or enter into a new security-based swap on a security-based SEF or NSE where the underlying security index has migrated from narrow-based to broad-based, the participant would be prohibited from doing so. That is because swaps may trade only on DCMs, SEFs, and FBOTs, and security-based swaps may trade only on registered NSEs and security-based SEFs.[906] The rules being adopted by the Commissions address how to treat Title VII instruments traded on trading platforms where the underlying security index migrates from broad-based to narrow-based or narrow-based to broad-based, so that market participants will know where such Title VII instruments may be traded and can avoid potential disruption of their ability to offset or enter into new Title VII instruments on trading platforms when such migration occurs.[907]

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904 See paragraphs (2), (3) and (4) of rule 1.3(yyy) under the CEA and paragraphs (b), (c) and (d) of rule 3a68-3 under the Exchange Act.

905 See Proposing Release at 29857.

906 If a swap were based on a security index that migrated from broad-based to narrow-based, a DCM, SEF, or FBOT could no longer offer the Title VII instrument because it is now a security-based swap. Similarly, if a security-based swap were based on a security index that migrated from narrow-based to broad-based, a security-based SEF or NSE could no longer offer the Title VII instrument because it is now a swap.

907 The rules apply only to the particular Title VII instrument that is traded on or subject to the rules of a DCM, SEF, FBOT, security-based SEF, or NSE. As the Commissions noted in the Proposing Release, to the extent that a particular Title VII instrument is not traded on such a trading platform (even if another Title VII instrument of the same class or type is traded on such a trading platform), the rules do not apply to that particular Title VII instrument. See Proposing Release at 29857 n. 259.

As was noted in the Proposing Release,[908] Congress and the Commissions addressed a similar issue in the context of security futures, where the security index on which a future is based may migrate from broad-based to narrow-based or vice versa. Congress provided in the definition of the term "narrow-based security index" in both the CEA and the Exchange Act[909] for a tolerance period ensuring that, under certain conditions, a futures contract on a broad-based security index traded on a DCM may continue to trade, even when the index temporarily assumes characteristics that would render it a narrow-based security index under the statutory definition.[910] In general, an index is subject to this tolerance period, and therefore is not a narrow-based security index, if: (i) a futures contract on the index traded on a DCM for at least 30 days as a futures contract on a broad-based security index before the index assumed the characteristics of a narrow-based security index; and (ii) the index does not retain the characteristics of a narrow-based security index for more than 45 business days over 3 consecutive calendar months. Pursuant to these statutory provisions, if the index becomes narrow-based for more than 45 business days over 3 consecutive calendar months, the index is excluded from the definition of the term "narrow-based security index" for the following 3 calendar months as a grace period.

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908 See Proposing Release at 29857.

909 CEA section 1a(35)(B)(iii), 7 U.S.C. 1a(35)(B)(iii); section 3(a)(55)(C)(iii) of the Exchange Act, 15 U.S.C. 78c(a)(55)(C)(iii).

910 By joint rules, the Commissions have provided that "[w]hen a contract of sale for future delivery on a security index is traded on or subject to the rules of a foreign board of trade, such index shall not be a narrow-based security index if it would not be a narrow-based security index if a futures contract on such index were traded on a designated contract market . . . ." See rule 41.13 under the CEA, 17 CFR 41.13, and rule 3a55-3 under the Exchange Act, 17 CFR 240.3a55-3. Accordingly, the statutory tolerance period applicable to futures on security indexes traded on DCMs applies to futures traded on FBOTs as well.

The Commissions believe that a similar tolerance period should apply to swaps traded on DCMs, SEFs, and FBOTs and security-based swaps traded on security-based SEFs and NSEs. Accordingly, the Commissions are adopting the rules, as proposed, providing for tolerance periods for swaps that are traded on DCMs, SEFs, or FBOTs[911] and for security-based swaps traded on security-based SEFs and NSEs.[912]

The final rules provide that to be subject to the tolerance period, a security index underlying a swap executed on or subject to the rules of a DCM, SEF, or FBOT must not have been a narrow-based security index[913] during the first 30 days of trading.[914] If the index becomes narrow-based during the first 30 days of trading, the index must not have been a narrow-based security index during every trading day of the 6 full calendar months preceding a date no earlier than 30 days prior to the commencement of trading of a swap on such index.[915] If either of these alternatives is met, the index will not be a narrow-based security index if it has been a narrow-based security index for no more than 45 business days over 3 consecutive calendar months.[916]

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911 See paragraph (2) of rule 1.3(yyy) under the CEA and paragraph (b) of rule 3a68-3 under the Exchange Act.

912 See paragraph (3) of rule 1.3(yyy) under the CEA and paragraph (c) of rule 3a68-3 under the Exchange Act.

913 For purposes of these rules, the term "narrow-based security index" shall also mean "issuers of securities in a narrow-based security index." See supra part III.G.3(b), (discussing the rules defining "issuers of securities in a narrow-based security index").

914 This provision is consistent with the provisions of the CEA and the Exchange Act applicable to futures contracts on security indexes. CEA section 1a(35)(B)(iii)(I), 7 U.S.C. 1a(35)(B)(iii)(I); section 3(a)(55)(C)(iii)(I) of the Exchange Act, 15 U.S.C. 78c(a)(55)(C)(iii)(I).

915 This alternative test is the same as the alternative test applicable to futures contracts in CEA rule 41.12, 17 CFR 41.12, and rule 3a55-2 under the Exchange Act, 17 CFR 240.3a55-2.

916 These provisions are consistent with the parallel provisions in the CEA and Exchange Act applicable to futures contracts on security indexes traded on DCMs. See CEA section 1a(35)(B)(iii)(II), 7 U.S.C. 1a(35)(B)(iii)(II), and section 3(a)(55)(C)(iii)(II) of the Exchange Act, 15 U.S.C. 78c(a)(55)(C)(iii)(II).

These provisions apply solely for purposes of swaps traded on or subject to the rules of a DCM, SEF, or FBOT.

Similarly, the rules provide a tolerance period for security-based swaps traded on security-based SEFs or NSEs. To be subject to the tolerance period, a security index underlying a security-based swap executed on a security-based SEF or NSE must have been a narrow-based security index during the first 30 days of trading. If the index becomes broad-based during the first 30 days of trading, paragraph (3)(i)(B) of rule 1.3(yyy) under the CEA and paragraph (c)(1)(ii) of rule 3a68-3 under the Exchange Act provide that the index must have been a non-narrow-based (i.e., a broad-based) security index during every trading day of the 6 full calendar months preceding a date no earlier than 30 days prior to the commencement of trading of a security-based swap on such index. If either of these alternatives is met, the index will be a narrow-based security index if it has been a security index that is not narrow-based for no more than 45 business days over 3 consecutive calendar months.[917] These provisions apply solely for purposes of security-based swaps traded on security-based SEFs or NSEs.

In addition, the Commissions are adopting rules as proposed that, once the tolerance period under the rules has ended, there will be a grace period during which a Title VII instrument based on a security index that has migrated from broad-based to narrow-based, or vice versa, will be able to trade on the platform on which Title VII instruments based on such security index were trading before the security index migrated and can also, during such period, be cleared.[918]

917 These provisions are consistent with the parallel provisions in the CEA and the Exchange Act applicable to futures contracts on security indexes traded on DCMs. See CEA section 1a(35)(B)(iii), 7 U.S.C. 1a(35)(B)(iii); section 3(a)(55)(C)(iii) of the Exchange Act, 15 U.S.C. 78c(a)(55)(C)(iii).

918 See paragraph (4) of rule 1.3(yyy) under the CEA and paragraph (d) of rule 3a68-3 under the Exchange Act.

The final rules provide for an additional three-month grace period applicable to a security index that becomes narrow-based for more than 45 business days over three consecutive calendar months, solely with respect to swaps that are traded on or subject to the rules of DCMs, SEFs, or FBOTs. During the grace period, such an index will not be considered a narrow-based security index. The rules apply the same grace period to a security-based swap on a security index that becomes broad-based for more than 45 business days over 3 consecutive calendar months, solely with respect to security-based swaps that are traded on a security-based SEF or NSE. During the grace period, such an index will not be considered a broad-based security index.[919] As a result, this rule provides sufficient time for a Title VII instrument based on a migrated security index to satisfy listing and clearing requirements applicable to swaps or security-based swaps, as appropriate.

As was noted in the Proposing Release,[920] there will be no overlap between the tolerance and the grace periods under the rules and no "re-triggering" of the tolerance period. For example, if a security index becomes narrow-based for more than 45 business days over 3 consecutive calendar months, solely with respect to swaps that are traded on or subject to the rules of DCMs, SEFs, or FBOTs, but as a result of the rules is not considered a narrow-based security index during the grace period, the tolerance period provisions will not apply, even if the security-index migrated temporarily during the grace period. After the grace period has ended, a security index will need to satisfy anew the requirements under the rules regarding the tolerance period in order to trigger a new tolerance period.

919 These provisions are consistent with the parallel provisions in the CEA and the Exchange Act applicable to futures contracts on security indexes traded on DCMs. See CEA section 1a(35)(D), 7 U.S.C. 1a(35)(D); section 3(a)(55)(E) of the Exchange Act, 15 U.S.C. 78c(a)(55)(E).

920 See Proposing Release at 29858.

The rules will not result in the re-characterization of any outstanding Title VII instruments. In addition, the tolerance and grace periods as adopted will apply only to Title VII instruments that are traded on or subject to the rules of DCMs, SEFs, FBOTs, security-based SEFs, and NSEs.

Comments

The Commissions received one comment on the proposed rules described in this section.[921] This commenter stated its view that extending the "grace period" from three months to six months would ease any disruption or dislocation associated with the delisting process with respect to an index that has migrated from broad to narrow, or narrow to broad, and that has failed the tolerance period.[922] This commenter also stated its view that where an index CDS migrates, for entities operating both a SEF and a security-based SEF, such entities should be permitted to move the index from one platform to the other simply by providing a notice to the SEC and CFTC.[923]

As discussed above, the Commissions are adopting the proposed rules without modification. The Commissions note that the three-month grace period applicable to security futures was mandated by Congress in that context,[924] and the commenter has provided no data or evidence for its request that the Commissions diverge from that grace period and provide for a longer grace period with respect to swaps and security-based swaps. The Commissions believe that the three-month grace period is similarly appropriate to apply in the context of a Title VII

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921 See MarketAxess Letter.

922 Id.

923 Id.

924 See July 2006 Debt Index Rules. The Commissions are not aware of any disruptions caused by the three-month grace period in the context of security futures.

instrument based on an index that has migrated to provide sufficient time to execute off-setting positions. With respect to the commenter's other suggestion that entities operating both a SEF and a security-based SEF should be able to move the index from one platform to another where an index CDS migrates simply by filing a notice with the SEC and CFTC, the Commissions do not believe that this proposal is within the scope of this rulemaking.

H. Method of Settlement of Index CDS

The method that the parties have chosen or use to settle an index CDS following the occurrence of a credit event under such index CDS also can affect whether such index CDS would be a swap, a security-based swap, or both (i.e., a mixed swap). The Commissions provided an interpretation in the Proposing Release regarding the method of settlement of index CDS and are restating the interpretation without modification. The Commissions find that this interpretation is an appropriate way to address index CDS with different settlement methods and is designed to reduce the cost associated with determining whether such an index CDS is a swap or a security-based swap.[925]

If an index CDS that is not based on a narrow-based security index under the Commissions' rules includes a mandatory physical settlement provision that would require the delivery of, and therefore the purchase and sale of, a non-exempted security[926] or a loan in the

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[925] See supra part I, under "Overall Economic Considerations".

[926] The Commissions note that section 3(a)(68)(C) of the Exchange Act, 15 U.S.C. 78c(a)(68)(C), provides that "[t]he term "security-based swap" does not include any agreement, contract, or transaction that meets the definition of a security-based swap only because such agreement, contract, or transaction references, is based upon, or settles through the transfer, delivery, or receipt of an exempted security under paragraph (12) [of the Exchange Act], as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in paragraph (29) [of the Exchange Act] as in effect on the date of enactment of the Futures Trading Act of 1982), unless such agreement, contract, or transaction is of the character of, or is commonly known in the trade as, a put, call, or other option."

event of a credit event, such an index CDS is a mixed swap.[927] Conversely, if an index CDS that is not based on a narrow-based security index under the Commissions' rules includes a mandatory cash settlement[928] provision, such index CDS is a swap, and not a security-based swap or a mixed swap, even if the cash settlement were based on the value of a non-exempted security or a loan.

An index CDS that is not based on a narrow-based security index under the Commissions' rules and that provides for cash settlement in accordance with the 2009 ISDA Credit Derivatives Determinations Committees and Auction Settlement Supplement to the 2003 Definitions (the "Auction Supplement") or with the 2009 ISDA Credit Derivatives Determinations Committees and Auction Settlement CDS Protocol ("Big Bang Protocol")[929] is a swap, and will not be considered a security-based swap or a mixed swap solely because the determination of the cash price to be paid is established through a securities or loan auction.[930] In 2009, auction settlement, rather than physical settlement, became the default method of

927 The SEC also notes that there must either be an effective registration statement covering the transaction or an exemption under the Securities Act would need to be available for such physical delivery of securities and compliance issues under the Exchange Act would also need to be considered.

928 The Commissions are aware that the 2003 Definitions include "Cash Settlement" as a defined term and that such "Settlement Method" (also a defined term in the 2003 Definitions) works differently than auction settlement pursuant to the "Big Bang Protocol" or "Auction Supplement" (each as defined below). The Commissions' use of the term "cash settlement" in this section includes "Cash Settlement," as defined in the 2003 Definitions, and auction settlement, as described in the "Big Bang Protocol" or "Auction Supplement." See infra note 929 and accompanying text.

929 See ISDA, "2009 ISDA Credit Derivatives Determinations Committees and Auction Settlement CDS Protocol," available at http://www.isda.org/bigbangprot/docs/Big-Bang-Protocol.pdf.

930 The possibility that such index CDS may, in fact, be physically settled if an auction is not held or if the auction fails would not affect the characterization of the index CDS.

settlement for, among other types of CDS, index CDS on corporate issuers of securities.[931] The amount of the cash settlement is determined through an auction triggered by the occurrence of a credit event.[932] The Auction Supplement "hard wired" the mechanics of credit event auctions into the 2003 Definitions.[933] The Commissions understand that the credit event auction process that is part of the ISDA terms works as follows.

Following the occurrence of a credit event under a CDS, a determinations committee ("DC") established by ISDA, following a request by any party to a credit derivatives transaction that is subject to the Big Bang Protocol or Auction Supplement, will determine, among other matters: (i) whether and when a credit event occurred; (ii) whether or not to hold an auction to enable market participants to settle those of their credit derivatives transactions covered by the auction; (iii) the list of deliverable obligations of the relevant reference entity; and (iv) the necessary auction specific terms. The credit event auction takes place in two parts. In the first part of the auction, dealers submit physical settlement requests, which are requests to buy or sell any of the deliverable obligations (based on the dealer's needs and those of its counterparties), and an initial market midpoint price is created based on dealers' initial bids and offers. Following the establishment of the initial market midpoint, the physical settlement requests are then calculated to determine the amount of open interest.

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931 The Commissions understand that the Big Bang Protocol is followed for index CDS involving corporate debt obligations but is not followed for index CDS based on asset-backed securities, loan-only CDS, and certain other types of CDS contracts. To the extent that such other index CDS contain auction procedures similar to the auction procedures for corporate debt to establish the cash price to be paid, the Commissions also would not consider such other index CDS that are not based on narrow-based security indexes under the Commissions' rules to be mixed swaps.

932 The Commissions understand that other conditions may need to be satisfied as well for an auction to be held.

933 See supra note 48.

The aggregate amount of open interest is the basis for the second part of the auction. In the second part of the auction, dealers and investors can determine whether to submit limit orders and the levels of such limit orders. The limit orders, which are irrevocable, have a firm price in addition to size and whether it is a buy or sell order. The auction is conducted as a "dutch" auction, in which the open buy interests and open sell interests are matched.[934] The final price of the auction is the last limit order used to match against the open interest. The final price in the auction is the cash price used for purposes of calculating the settlement payments in respect of the orders to buy and sell the deliverable obligations and it is also used to determine the cash settlement payment under the CDS.

Comments

One commenter believed that a mandatory physical settlement provision in an index CDS based on a broad-based security index should not transform a swap into a mixed swap because (i) the SEC would retain jurisdiction over a transfer of securities as part of such settlement and (ii) application of the interpretation would be difficult since many instruments contemplate physical settlement but have a cash settlement option, or vice versa.[935]

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934 The second part of the credit event auction process involves offers and sales of securities that must be made in compliance with the provisions of the Securities Act and the Exchange Act. First, the submission of a physical settlement request constitutes an offer by the counterparty to either buy or sell any one of the deliverable obligations in the auction. Second, the submission of the irrevocable limit orders by dealers or investors are sales or purchases by such persons at the time of submission of the irrevocable limit order. Through the auction mechanism, where the open interest (which represents physical settlement requests) is matched with limit orders, buyers and sellers are matched. Finally, following the auction and determination of the final price, the counterparty who has submitted the physical delivery request decides which of the deliverable obligations will be delivered to satisfy the limit order in exchange for the final price. The sale of the securities in the auction occurs at the time the limit order is submitted, even though the identification of the specific deliverable obligation does not occur until the auction is completed.

935 See ISDA Letter.

As discussed above, the Commissions are restating the interpretation regarding mandatory physical settlement as provided in the Proposing Release. The Commissions' interpretation assures that the federal securities laws apply to the offer and sale of the underlying securities at the time the index CDS is sold.[936] The Commissions note the commenter's concerns but believe that as a result of the Commissions' understanding of the auction settlement process for index CDS, which is the primary method by which index CDS are settled and which addresses circumstances in which securities may be tendered in the auction process separate from the CDS settlement payment, it is not clear that there is in fact any significant number of circumstances in which such index CDS may be optionally physically settled. The Commissions note that this commenter did not elaborate on the circumstances in which the auction process would not apply.

I. Security-Based Swaps as Securities under the Exchange Act and Securities Act

Pursuant to the Dodd-Frank Act, a security-based swap is defined as a "security" under the Exchange Act[937] and Securities Act.[938] As a result, security-based swaps are subject to the Exchange Act and the Securities Act and the rules and regulations promulgated thereunder.[939]

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936 With respect to the applicability of the federal securities laws, the Commissions are concerned about the use of index CDS to effect distributions of securities without compliance with the requirements of the Securities Act. The Commissions recognize that with respect to transactions in security-based swaps by an issuer of an underlying security, an affiliate of the issuer, or an underwriter the offer and sale of the underlying security (in this case the security to be delivered) occur at the time that the security-based swap is offered and sold, not at the time of settlement. Further, the Commissions note the restrictions on offers and sales of security-based swaps to non-ECPs without compliance with the registration requirements of the Securities Act. See section 5(e) of the Securities Act, 15 U.S.C. 77e(d).

937 See section 761(a)(2) of the Dodd-Frank Act (inserting the term "security-based swap" into the definition of "security" in section 3a(10) of the Exchange Act, 15 U.S.C. 78c(a)(10)).

938 See section 768(a)(1) of the Dodd-Frank Act (inserting the term "security-based swap" into the definition of "security" in section 2(a)(1) of the Securities Act, 15 U.S.C. 77b(a)(1)).

The SEC did not provide interpretations in the Proposing Release on the application of the Exchange Act and the Securities Act, and the rules and regulations thereunder, to security-based swaps. However, the SEC solicited comment on whether additional interpretations may be necessary regarding the application of certain provisions of the Exchange Act and the Securities Act, and the rules and regulations promulgated thereunder, to security-based swaps. The SEC did not receive any comments with respect to this issue in the context of this rulemaking and is not providing any interpretations in this release.

IV. Mixed Swaps

A. Scope of the Category of Mixed Swap

The category of mixed swap is described, in both the definition of the term "security-based swap" in the Exchange Act and the definition of the term "swap" in the CEA, as a security-based swap that is also:

> based on the value of 1 or more interest or other rates, currencies, commodities, instruments of indebtedness, indices, quantitative measures, other financial or economic interest or property of any kind (other than a single security or a narrow-based security index), or the occurrence, non-occurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence (other than an event described in subparagraph (A)(ii)(III) [of section 3(a)(68) of the Exchange Act]).[940]

[939] Sections 761(a)(3) and (4) of the Dodd-Frank Act amend sections 3(a)(13) and (14) of the Exchange Act, 15 U.S.C. 78c(a)(13) and (14), and section 768(a)(3) of the Dodd-Frank Act adds section 2(a)(18) to the Securities Act, 15 U.S.C. 77b(a)(18), to provide that the terms "purchase" and "sale" of a security-based swap shall mean the "the execution, termination (prior to its scheduled maturity date), assignment, exchange, or similar transfer or conveyance of, or extinguishing of rights or obligations under, a security-based swap, as the context may require."

[940] Section 3(a)(68)(D) of the Exchange Act, 15 U.S.C. 78c(a)(68)(D); section 1a(47)(D) of the CEA, 7 U.S.C. 1a(47)(D).

A mixed swap, therefore, is both a security-based swap and a swap.[941] As stated in the Proposing Release, the Commissions believe that the scope of mixed swaps is, and is intended to be, narrow.[942] Title VII establishes robust and largely parallel regulatory regimes for both swaps and security-based swaps and directs the Commissions to jointly prescribe such regulations regarding mixed swaps as may be necessary to carry out the purposes of the Dodd-Frank Act.[943] More generally, the Commissions believe the category of mixed swap was designed so that there would be no gaps in the regulation of swaps and security-based swaps. Therefore, in light of the statutory scheme created by the Dodd-Frank Act for swaps and security-based swaps, the Commissions believe the category of mixed swap covers only a small subset of Title VII instruments.

For example, a Title VII instrument in which the underlying references are the value of an oil corporation stock and the price of oil would be a mixed swap. Similarly, a Title VII instrument in which the underlying reference is a portfolio of both securities (assuming the portfolio is not an index or, if it is an index, that the index is narrow-based) and commodities would be a mixed swap. Mixed swaps also would include certain Title VII instruments called "best of" or "out performance" swaps that require a payment based on the higher of the performance of a security and a commodity (other than a security). As discussed elsewhere in this release, the Commissions also believe that certain Title VII instruments may be mixed swaps if they meet specified conditions.

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941 Id. The exclusion from the definition of the term "swap" for security-based swaps does not include security-based swaps that are mixed swaps. See section 1a(47)(B)(x) of the CEA, 7 U.S.C. 1a(47)(B)(x).

942 See Proposing Release at 29860.

943 See section 712(a)(8) of the Dodd-Frank Act.

The Commissions also believe that the use of certain market standard agreements in the documentation of Title VII instruments should not in and of itself transform a Title VII instrument into a mixed swap. For example, many instruments are documented by incorporating by reference market standard agreements. Such agreements typically set out the basis of establishing a trading relationship with another party but are not, taken separately, a swap or security-based swap. These agreements also include termination and default events relating to one or both of the counterparties; such counterparties may or may not be entities that issue securities.[944] The Commissions believe that the term "any agreement . . . based on . . . the occurrence of an event relating to a single issuer of a security," as provided in the definition of the term "security-based swap," was not intended to include such termination and default events relating to counterparties included in standard agreements that are incorporated by reference into a Title VII instrument.[945] Therefore, an instrument would not be simultaneously a swap and a security-based swap (and thus not a mixed swap) simply by virtue of having incorporated by reference a standard agreement, including default and termination events relating to counterparties to the Title VII instrument.

Comments

While the Commissions did not receive any comments on the interpretation regarding the scope of the category of mixed swaps, one commenter recommended that the Commissions require that market participants disaggregate mixed swaps and enter into separate simultaneous transactions so that they cannot employ mixed swaps to obscure the underlying substance of

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944 Those standard events include inter alia bankruptcy, breach of agreement, cross default to other indebtedness, and misrepresentations.

945 See section 3(a)(68)(A)(ii)(III) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(ii)(III).

transactions.[946] The Commissions are not adopting any rules or interpretations to require disaggregation of mixed swaps into their separate components, as the Dodd-Frank Act specifically contemplated that there would be mixed swaps comprised of both swaps and security-based swaps.

B. Regulation of Mixed Swaps

1. Introduction

The Commissions are adopting as proposed paragraph (a) of rule 1.9 under the CEA and rule 3a68-4 under the Exchange Act to define a "mixed swap" in the same manner as the term is defined in both the CEA and the Exchange Act. The Commissions also are adopting as proposed two rules to address the regulation of mixed swaps. First, paragraph (b) of rule 1.9 under the CEA and rule 3a68-4 under the Exchange Act will provide a regulatory framework with which parties to bilateral uncleared mixed swaps (i.e., mixed swaps that are neither executed on or subject to the rules of a DCM, NSE, SEF, security-based SEF, or FBOT nor cleared through a DCO or clearing agency), as to which at least one of the parties is dually registered with both Commissions, will need to comply. Second, paragraph (c) of rule 1.9 under the CEA and rule 3a68-4 under the Exchange Act establishes a process for persons to request that the Commissions issue a joint order permitting such persons (and any other person or persons that subsequently lists, trades, or clears that class of mixed swap)[947] to comply, as to parallel provisions[948] only,

[946] See Better Markets Letter.

[947] All references to Title VII instruments in parts IV and VI shall include a class of such Title VII instruments as well. For example, a "class" of Title VII instrument would include instruments that are of similar character and provide substantially similar rights and privileges.

[948] As stated in paragraph (c) of proposed rule 1.9 under the CEA and rule 3a68-4 under the Exchange Act, "parallel provisions" means comparable provisions of the CEA and the Exchange Act that were added or amended by Title VII with respect to security-based swaps and swaps, and the rules and regulations thereunder.

with specified parallel provisions of either the CEA or the Exchange Act, and related rules and regulations (collectively "specified parallel provisions"), instead of being required to comply with parallel provisions of both the CEA and the Exchange Act.

2. Bilateral Uncleared Mixed Swaps Entered Into by Dually-Registered Dealers or Major Participants

Swap dealers and major swap participants will be comprehensively regulated by the CFTC, and security-based swap dealers and major security-based swap participants will be comprehensively regulated by the SEC.[949] The Commissions recognize that there may be differences in the requirements applicable to swap dealers and security-based swap dealers, or major swap participants and major security-based swap participants, such that dually-registered market participants may be subject to potentially conflicting or duplicative regulatory requirements when they engage in mixed swap transactions. In order to assist market participants in addressing such potentially conflicting or duplicative requirements, the Commissions are adopting, as proposed with one modification explained below, rules that will permit dually-registered swap dealers and security-based swap dealers and dually-registered major swap participants and major security-based swap participants to comply with an alternative regulatory regime when they enter into certain mixed swaps under specified circumstances. The Commissions received no comments on the proposed rules.

Accordingly, as adopted, paragraph (b) of rule 1.9 under the CEA and rule 3a68-4 under the Exchange Act provide that a bilateral uncleared mixed swap,[950] where at least one party is

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949 Section 712(a)(7)(A) of the Dodd-Frank Act requires the Commissions to treat functionally or economically similar entities in a similar manner.

950 Under paragraph (b) of rule 1.9 under the CEA and rule 3a68-4 under the Exchange Act, a "bilateral uncleared mixed swap" will be a mixed swap that: i) is neither executed on nor subject to the rules of a DCM, NSE, SEF, security-based SEF, or FBOT; and ii) will not be submitted to a DCO or registered or exempt clearing agency to be cleared. To the extent that a mixed swap is

dually-registered with the CFTC as a swap dealer or major swap participant and with the SEC as a security-based swap dealer or major security-based swap participant, will be subject to all applicable provisions of the federal securities laws (and SEC rules and regulations promulgated thereunder). The rules as adopted also provide that such mixed swaps will be subject to only the following provisions of the CEA (and CFTC rules and regulations promulgated thereunder):

- Examinations and information sharing: CEA sections 4s(f) and 8;[951]
- Enforcement: CEA sections 2(a)(1)(B), 4(b), 4b, 4c, 4s(h)(1)(A), 4s(h)(4)(A), 6(c), 6(d), 6c, 6d, 9, 13(a), 13(b) and 23;[952]
- Reporting to an SDR: CEA section 4r;[953]
- Real-time reporting: CEA section 2(a)(13);[954]
- Capital: CEA section 4s(e);[955] and
- Position Limits: CEA section 4a.[956]

The Commissions are modifying proposed rule 1.9(b)(3)(i) under the CEA and Rule 3a68-4(b)(3)(i) to include additional "enforcement" authority. Specifically, as adopted, the rules provide that such swaps will be subject to the anti-fraud, anti-manipulation, and other provisions

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subject to the mandatory clearing requirement (see section 2(h)(1)(A) of the CEA, 7 U.S.C. 2(h)(1)(A), and section 3C(a)(1) of the Exchange Act) (and where a counterparty is not eligible to rely on the end-user exclusion from the mandatory clearing requirement (see section 2(h)(7) of the CEA, 7 U.S.C. 2(h)(7), and section 3C(g) of the Exchange Act)), this alternative regulatory treatment will not be available.

951 7 U.S.C. 6s(f) and 12, respectively.

952 7 U.S.C. 2(a)(1)(B), 6(b), 6b, 6c, 6s(h)(1)(A), 6s(h)(4)(A), 9 and 15, 13b, 13a-1, 13a-2, 13, 13c(a), 13c(b), and 26, respectively.

953 7 U.S.C. 6r.

954 7 U.S.C. 2(a)(13).

955 7 U.S.C. 6s(e).

956 7 U.S.C. 6a.

of the business conduct standards in CEA sections 4s(h)(1)(A) and 4s(h)(4)(A) and the rules promulgated thereunder for mixed swaps.[957] Rule 23.410 under the CEA,[958] adopted under CEA section 4s(h)(1)(A), applies to swap dealers and major swap participants and prohibits fraud, manipulation, and other abusive practices and also imposes requirements regarding the confidential treatment of counterparty information, which will apply to mixed swaps.[959]

As discussed in the Proposing Release, the Commissions believe that paragraph (b) of rule 1.9 under the CEA and rule 3a68-4 under the Exchange Act will address potentially conflicting or duplicative regulatory requirements for dually-registered dealers and major participants that are subject to regulation by both the CFTC and the SEC, while requiring dual registrants to comply with the regulatory requirements the Commissions believe are necessary to provide sufficient regulatory oversight for mixed swap transactions entered into by such dual registrants. The CFTC also believe that paragraph (b) of rule 1.9 under the CEA and rule 3a68-4 under the Exchange Act will provide clarity to dually-registered dealers and major participants, who are subject to regulation by both the CFTC and the SEC, as to the requirements of each Commission that will apply to their bilateral uncleared mixed swaps.

3. Regulatory Treatment for Other Mixed Swaps

957 7 U.S.C. 6s(h)(1)(A) and 6s(h)(4)(A).

958 17 CFR 23.410.

959 Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 FR 9734, 9751-9755 (Feb. 17, 2012). The Commissions note that, while the introductory text of rule 1.9(b)(3)(i)(A) through (F) under the CEA and rule 3a68-4(b)(3)(i)(A) through (F) under the Exchange Act characterizes the cited CEA sections (e.g., "enforcement", "capital," etc.), such characterization is meant as guidance only. For example, final rule 1.9(b)(3)(i)(B) uses the word "enforcement" to characterize certain of the cited CEA sections and the rules and regulations promulgated thereunder that prohibit fraud, manipulation, or abusive practices. Other cited provisions, such as the Whistleblower protections under CEA section 23, or the related rules and regulations, such as requirements to keep counterparty information confidential under rule 23.410(c) under the CEA, 17 CFR 23.410(c), are similarly enforcement provisions in that they protect market participants from fraudulent or other abusive practices.

Because mixed swaps are both security-based swaps and swaps,[960] absent a joint rule or order by the Commissions permitting an alternative regulatory approach, persons who desire or intend to list, trade, or clear a mixed swap (or class thereof) will be required to comply with all the statutory provisions in the CEA and the Exchange Act (including all the rules and regulations thereunder) that were added or amended by Title VII with respect to swaps or security-based swaps.[961] Such dual regulation may not be appropriate in every instance and may result in potentially conflicting or duplicative regulatory requirements. However, before the Commissions can determine the appropriate regulatory treatment for mixed swaps (other than the treatment discussed above), the Commissions will need to understand better the nature of the mixed swaps that parties want to trade. As a result, the Commissions proposed paragraph (c) of rule 1.9 under the CEA and rule 3a68-4 under the Exchange Act to establish a process pursuant to which any person who desires or intends to list, trade, or clear a mixed swap (or class thereof) that is not subject to the provisions of paragraph (b) of the rules (i.e., bilateral uncleared mixed swaps entered into by at least one dual registrant) may request the Commissions to publicly issue a joint order permitting such person (and any other person or persons that subsequently lists, trades, or clears that class of mixed swap) to comply, as to parallel provisions only, with the specified parallel provisions, instead of being required to comply with parallel provisions of both

960 See supra note 10.

961 Because security-based swaps are also securities, compliance with the federal securities laws and rules and regulations thereunder (in addition to the provisions of the Dodd-Frank Act and the rules and regulations thereunder) will also be required. To the extent one of the Commissions has exemptive authority with respect to other provisions of the CEA or the federal securities laws and the rules and regulations thereunder, persons may submit separate exemptive requests or rulemaking petitions regarding those provisions to the relevant Commission.

the CEA and the Exchange Act.[962] The Commissions received no comments on the proposed rules and are adopting the rules as proposed.

As adopted, paragraph (c) of rule 1.9 under the CEA and rule 3a68-4 under the Exchange Act further provide that a person submitting such a request to the Commissions must provide the Commissions with:

i) all material information regarding the terms of the specified, or specified class of, mixed swap;

ii) the economic characteristics and purpose of the specified, or specified class of, mixed swap;

iii) the specified parallel provisions, and the reasons the person believes such specified parallel provisions would be appropriate for the mixed swap (or class thereof);

iv) an analysis of (1) the nature and purposes of the parallel provisions that are the subject of the request; (2) the comparability of such parallel provisions; and (3) the extent of any conflicts or differences between such parallel provisions; and

v) such other information as may be requested by either of the Commissions.

This provision is intended to provide the Commissions with sufficient information regarding the mixed swap (or class thereof) and the proposed regulatory approach to make an informed determination regarding the appropriate regulatory treatment of the mixed swap (or class thereof).

962 Other than with respect to the specified parallel provisions with which such persons may be permitted to comply instead of complying with parallel provisions of both the CEA and the Exchange Act, any other provision of either the CEA or the federal securities laws that applies to swaps or security-based swaps will continue to apply.

As adopted, paragraph (c) of rule 1.9 under the CEA and rule 3a68-4 under the Exchange Act also will allow a person to withdraw a request regarding the regulation of a mixed swap at any time prior to the issuance of a joint order by the Commissions. This provision is intended to permit persons to withdraw requests that they no longer need. This, in turn, will save the Commissions time and staff resources.

As adopted, paragraph (c) of rule 1.9 under the CEA and rule 3a68-4 under the Exchange Act further provide that in response to a request pursuant to the rules, the Commissions may jointly issue an order, after public notice and opportunity for comment, permitting the requesting person (and any other person or persons that subsequently lists, trades, or clears that class of mixed swap) to comply, as to parallel provisions only, with the specified parallel provisions (or another subset of the parallel provisions that are the subject of the request, as the Commissions determine is appropriate), instead of being required to comply with parallel provisions of both the CEA and the Exchange Act. In determining the contents of such a joint order, the Commissions can consider, among other things:

i) the nature and purposes of the parallel provisions that are the subject of the request;

ii) the comparability of such parallel provisions; and

iii) the extent of any conflicts or differences between such parallel provisions.

Finally, as adopted, paragraph (c) of rule 1.9 under the CEA and rule 3a68-4 under the Exchange Act require the Commissions, if they determine to issue a joint order pursuant to these rules, to do so within 120 days of receipt of a complete request (with such 120-day period being tolled during the pendency of a request for public comment on the proposed interpretation). If the Commissions do not issue a joint order within the prescribed time period, the rules require that each Commission publicly provide the reasons for not having done so. Paragraph (c) of rule

1.9 under the CEA and rule 3a68-4 under the Exchange Act makes clear that nothing in the rules requires either Commission to issue a requested joint order regarding the regulation of a particular mixed swap (or class thereof).

These provisions are intended to provide market participants with a prompt review of requests for a joint order regarding the regulation of a particular mixed swap (or class thereof). The rules also will provide transparency and accountability by requiring that at the end of the review period, the Commissions issue the requested order or publicly state the reasons for not doing so.

V. Security-Based Swap Agreements

A. Introduction

SBSAs are swaps over which the CFTC has regulatory and enforcement authority but for which the SEC also has antifraud and certain other authority.[963] The term "security-based swap agreement" is defined as a "swap agreement" (as defined in section 206A of the GLBA[964]) of which "a material term is based on the price, yield, value, or volatility of any security or any

963 See section 3(a)(78) of the Exchange Act, 15 U.S.C. 78c(a)(78); CEA section 1a(47)(A)(v), 7 U.S.C. 1a(47)(A)(v). The Dodd-Frank Act provides that certain CFTC registrants, such as DCOs and SEFs, will keep records regarding SBSAs open to inspection and examination by the SEC upon request. See, e.g., sections 725(e) and 733 of the Dodd-Frank Act. The Commissions are committed to working cooperatively together regarding their dual enforcement authority over SBSAs.

964 15 U.S.C. 78c note. The Dodd-Frank Act amended the definition of "swap agreement" in section 206A of the GLBA to eliminate the requirements that a swap agreement be between ECPs, as defined in section 1a(18)(C) of the CEA, 7 U.S.C. 1a(18)(C), and subject to individual negotiation. See section 762(b) of the Dodd-Frank Act. Sections 762(c) and (d) of the Dodd-Frank Act also made conforming amendments to the Exchange Act and the Securities Act to reflect the changes to the regulation of "swap agreements" that are either "security-based swaps" or "security-based swap agreements" under the Dodd-Frank Act.

group or index of securities, including any interest therein" but does not include a security-based swap.[965]

B. Swaps that are Security-Based Swap Agreements

Although the Commissions believe it is not possible to provide a bright line test to define an SBSA, the Commissions believe that it is possible to clarify that certain types of swaps clearly fall within the definition of SBSA. For example, as the Commissions noted in the Proposing Release, a swap based on an index of securities that is not a narrow-based security index (i.e., a broad-based security index) would fall within the definition of an SBSA under the Dodd-Frank Act.[966] Similarly, an index CDS that is not based on a narrow-based security index or on the "issuers of securities in a narrow-based security index," as defined in rule 1.3(zzz) under the CEA and rule 3a68-1a under the Exchange Act, would be an SBSA. In addition, a swap based

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965 See section 3(a)(78) of the Exchange Act, 15 U.S.C. 78c(a)(78). The CFMA amended the Exchange Act and the Securities Act to exclude swap agreements from the definitions of security in those statutes but subjected "security-based swap agreements," as defined in section 206B of the GLBA, 15 U.S.C. 78c note, to the antifraud, anti-manipulation, and anti-insider trading provisions of the Exchange Act and Securities Act. See CFMA, supra note 697, title III.

The CEA does not contain a stand-alone definition of "security-based swap agreement," but includes the definition instead in subparagraph (A)(v) of the swap definition in CEA section 1a(47), 7 U.S.C. 1a(47). The only difference between these definitions is that the definition of SBSA in the Exchange Act specifically excludes security-based swaps (see section 3(a)(78)(B) of the Exchange Act, 15 U.S.C. 78c(a)(78)(B)), while the definition of SBSA in the CEA does not contain a similar exclusion. Instead, the exclusion for security-based swaps is placed in the general exclusions from the swap definition in the CEA (see CEA section 1a(47)(B)(x), 7 U.S.C. 1a(47)(B)(x)).

966 See Proposing Release at 29863. Swaps based on indexes that are not narrow-based security indexes are not included within the definition of the term security-based swap under the Dodd-Frank Act. See section 3(a)(68)(A)(ii)(I) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(ii)(I), and discussion supra part III.G. However, such swaps have a material term that is "based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein," and therefore such swaps fall within the SBSA definition.

on a U.S. Treasury security or on certain other exempted securities other than municipal securities would fall within the definition of an SBSA under the Dodd-Frank Act.[967]

The Commissions received no comments on the examples provided in the Proposing Release regarding SBSAs. Accordingly, the Commissions are not further defining SBSA beyond restating the examples above.[968]

C. Books and Records Requirements for Security-Based Swap Agreements

The Commissions are adopting rule 1.7 under the CEA and rule 3a68-3 under the Exchange Act, as proposed, to clarify that there will not be additional books and records requirements regarding SBSAs other than those that are required for swaps. The Dodd-Frank Act provides that the Commissions shall adopt rules regarding the books and records required to be kept for SBSAs.[969] As discussed above, SBSAs are swaps over which the CFTC has

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967 Swaps on U.S. Treasury securities that do not have any other underlying references involving securities are expressly excluded from the definition of the term "security-based swap" under the Dodd-Frank Act. See section 3(a)(68)(C) of the Exchange Act, 15 U.S.C. 78c(a)(68)(C) (providing that an agreement, contract, or transaction that would be a security-based swap solely because it references, is based on, or settles through the delivery of one or more U.S. Treasury securities (or certain other exempted securities) is excluded from the security-based swap definition). However, swaps on U.S. Treasury securities or on other exempted securities covered by subparagraph (C) of the security-based swap definition have a material term that is "based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein," and therefore fall within the SBSA definition.

968 The Commissions noted that certain transactions that were not "security-based swap agreements" under the CFMA are nevertheless included in the definition of security-based swap under the Dodd-Frank Act – including, for example, a CDS on a single loan. Accordingly, although such transactions were not subject to insider trading restrictions under the CFMA, under the Dodd-Frank Act they are subject to the federal securities laws, including insider trading restrictions.

969 Specifically, section 712(d)(2)(B) of the Dodd-Frank Act requires the Commissions, in consultation with the Board, to jointly adopt rules governing books and records requirements for SBSAs by persons registered as SDRs under the CEA, including uniform rules that specify the data elements that shall be collected and maintained by each SDR. Similarly, section 712(d)(2)(C) of the Dodd-Frank Act requires the Commissions, in consultation with the Board, to jointly adopt rules governing books and records for SBSAs, including daily trading records, for swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants.

regulatory authority, but for which the SEC has antifraud, anti-manipulation, and certain other authority. In the Proposing Release, the Commissions noted that the CFTC had proposed rules governing books and records for swaps, which would apply to swaps that also are SBSAs.[970] The Commissions further stated their belief that those proposed rules would provide sufficient books and records regarding SBSAs, and that additional books and records requirements were not necessary for SBSAs.[971] The Commissions received no comments on the proposed rules.

Accordingly, rule 1.7 under the CEA and rule 3a68-3 under the Exchange Act provide that persons registered as SDRs under the CEA and the rules and regulations thereunder are not required to i) keep and maintain additional books and records regarding SBSAs other than the books and records regarding swaps that SDRs would be required to keep and maintain pursuant to the CEA and rules and regulations thereunder; and ii) collect and maintain additional data regarding SBSAs other than the data regarding swaps that SDRs are required to collect and maintain pursuant to the CEA and rules and regulations thereunder. In addition, rule 1.7 under the CEA and rule 3a68-3 under the Exchange Act provide that persons registered as swap dealers

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970 See Swap Data Recordkeeping and Reporting Requirements, 75 FR 76573 (Dec. 8, 2010) (proposed rules regarding swap data recordkeeping and reporting requirements for SDRs, DCOs, DCMs, SEFs, swap dealers, major swap participants, and swap counterparties who are neither swap dealers nor major swap participants); See Reporting, Recordkeeping, and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants, 75 FR 76666 (Dec. 9, 2010) (proposed rules regarding reporting and recordkeeping requirements and daily trading records requirements for swap dealers and major swap participants). These rules have been adopted by the CFTC. See Swap Data Recordkeeping and Reporting Requirements, 77 FR 2136 (Jan. 13, 2012) (final rules regarding swap data recordkeeping and reporting requirements for SDRs, DCOs, DCMs, SEFs, swap dealers, major swap participants, and swap counterparties who are neither swap dealers or major swap participants); See Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants, 77 FR 20128 (Apr. 3, 2012) (final rules regarding reporting and recordkeeping requirements and daily trading records requirements for swap dealers and major swap participants).

971 See Proposing Release at 29863.

or major swap participants under the CEA and the rules and regulations thereunder, or registered as security-based swap dealers or major security-based swap participants under the Exchange Act and the rules and regulations thereunder, are not required to keep and maintain additional books and records, including daily trading records, regarding SBSAs other than the books and records regarding swaps that those persons are required to keep and maintain pursuant to the CEA and the rules and regulations thereunder.[972]

VI. Process for Requesting Interpretations of the Characterization of a Title VII Instrument

The Commissions recognize that there may be Title VII instruments (or classes of Title VII instruments) that may be difficult to categorize definitively as swaps or security-based swaps. Further, because mixed swaps are both swaps and security-based swaps, identifying a mixed swap may not always be straightforward.

Section 712(d)(4) of the Dodd-Frank Act provides that any interpretation of, or guidance by, either the CFTC or SEC regarding a provision of Title VII shall be effective only if issued jointly by the Commissions (after consultation with the Board) on issues where Title VII requires the CFTC and SEC to issue joint regulations to implement the provision. The Commissions believe that any interpretation or guidance regarding whether a Title VII instrument is a swap, a security-based swap, or both (i.e., a mixed swap), must be issued jointly pursuant to this requirement.

The Commissions proposed rules in the Proposing Release to establish a process for interested persons to request a joint interpretation by the Commissions regarding whether a

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972 Rule 1.7 under the CEA and Rule 3a69-3 under the Exchange Act provide that the term "security-based swap agreement" has the meaning set forth in CEA section 1a(47)(A)(v), 7 U.S.C. 1a(47)(A)(v), and section 3(a)(78) of the Exchange Act, 15 U.S.C. 78c(a)(78), respectively.

particular Title VII instrument (or class of Title VII instruments) is a swap, a security-based swap, or both (i.e., a mixed swap).[973] The Commissions are adopting the rules as proposed.

Section 718 of the Dodd-Frank Act establishes a process for determining the status of "novel derivative products" that may have elements of both securities and futures contracts. Section 718 of the Dodd-Frank Act provides a useful model for a joint Commission review process to appropriately categorize Title VII instruments. As a result, the final rules include various attributes of the process established in section 718 of the Dodd-Frank Act. In particular, to permit an appropriate review period that provides sufficient time to ensure federal regulatory interests are satisfied that also does not unduly delay the introduction of new financial products, the adopted process, like the process established in section 718, includes a deadline for responding to a request for a joint interpretation.[974]

The Commissions are adopting rule 1.8 under the CEA and rule 3a68-2 under the Exchange Act that establish a process for parties to request a joint interpretation regarding the characterization of a particular Title VII instrument (or class thereof). Specifically, the final rules provide that any person may submit a request to the Commissions to provide a public joint interpretation of whether a particular Title VII instrument is a swap, a security-based swap, or both (i.e., a mixed swap).[975]

The final rules afford market participants with the opportunity to obtain greater certainty from the Commissions regarding the regulatory status of particular Title VII instruments under

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973 See Proposing Release at 29864-65.

974 The Commissions note that section 718 of the Dodd-Frank Act is a separate process from the process the Commissions are adopting, and that any future interpretation involving the process under section 718 would not affect the process being adopted here, nor will any future interpretation involving the process adopted here affect the process under section 718.

975 See paragraph (a) of rule 1.8 under the CEA and rule 3a68-2 under the Exchange Act.

the Dodd-Frank Act. This provision should decrease the possibility that market participants inadvertently might fail to meet the regulatory requirements applicable to a particular Title VII instrument.

The final rules provide that a person requesting an interpretation as to the characterization of a Title VII instrument as a swap, a security-based swap, or both (i.e., a mixed swap), must provide the Commissions with the person's determination of the characterization of the instrument and supporting analysis, along with certain other documentation.[976] Specifically, the person must provide the Commissions with the following information:

- All material information regarding the terms of the Title VII instrument;
- A statement of the economic characteristics and purpose of the Title VII instrument;
- The requesting person's determination as to whether the Title VII instrument should be characterized as a swap, a security-based swap, or both (i.e., a mixed swap), including the basis for such determination; and
- Such other information as may be requested by either Commission.

This provision should provide the Commissions with sufficient information regarding the Title VII instrument at issue so that the Commissions can appropriately evaluate whether it is a swap, a security-based swap, or both (i.e., a mixed swap).[977] By requiring that requesting persons furnish a determination regarding whether they believe the Title VII instrument is a swap, a security-based swap, or both (i.e., a mixed swap), including the basis for such

[976] See paragraph (b) of rule 1.8 under the CEA and rule 3a68-2 under the Exchange Act.

[977] The Commissions also may use this information to issue (within the timeframe for issuing a joint interpretation) a joint notice of proposed rulemaking to further define one or more of the terms "swap," "security-based swap," or "mixed swap." See paragraph (f) of rule 1.8 under the CEA and rule 3a68-2 under the Exchange Act, which are discussed below.

determination, this provision also will assist the Commissions in more quickly identifying and addressing the relevant issues involved in arriving at a joint interpretation of the characterization of the instrument.

The final rules provide that a person may withdraw a request at any time prior to the issuance of a joint interpretation or joint notice of proposed rulemaking by the Commissions.[978] Notwithstanding any such withdrawal, the Commissions may provide an interpretation regarding the characterization of the Title VII instrument that was the subject of a withdrawn request.

This provision will permit parties to withdraw requests for which the party no longer needs an interpretation. This, in turn, should save the Commissions time and staff resources. If the Commissions believe such an interpretation is necessary regardless of a particular request for interpretation, however, the Commissions may provide such a joint interpretation of their own accord.

The final rules provide that if either Commission receives a proposal to list, trade, or clear an agreement, contract, or transaction (or class thereof) that raises questions as to the appropriate characterization of such agreement, contract, or transaction (or class thereof) as a swap, security-based swap, or both (i.e., a mixed swap), the receiving Commission promptly shall notify the other.[979] This provision of the final rules further provides that either Commission, or their Chairmen jointly, may submit a request for a joint interpretation to the Commissions as to the characterization of the Title VII instrument where no external request has been received.

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978 See paragraph (c) of rule 1.8 under the CEA and rule 3a68-2 under the Exchange Act.

979 See paragraph (d) of rule 1.8 under the CEA and rule 3a68-2 under the Exchange Act.

This provision is intended to ensure that Title VII instruments do not fall into regulatory gaps and will help the Commissions to fulfill their responsibility to oversee the regulatory regime established by Title VII of the Dodd-Frank Act by making sure that Title VII instruments are appropriately characterized, and thus appropriately regulated. An agency, or their Chairmen jointly, submitting a request for an interpretation as to the characterization of a Title VII instrument under this paragraph will be required to submit the same information as, and could withdraw a request in the same manner as, a person submitting a request to the Commissions. The bases for these provisions are set forth above with respect to paragraphs (b) and (c) of the final rules.

The final rules require that the Commissions, if they determine to issue a joint interpretation as to the characterization of a Title VII instrument, do so within 120 days of receipt of the complete external or agency submission (unless such 120-day period is tolled during the pendency of a request for public comment on the proposed interpretation).[980] If the Commissions do not issue a joint interpretation within the prescribed time period, the final rules require that each Commission publicly provide the reasons for not having done so within such prescribed time period. This provision of the final rules also incorporates the mandate of the Dodd-Frank Act that any joint interpretation by the Commissions be issued only after consultation with the Board of Governors of the Federal Reserve System.[981] Finally, the rules make clear that nothing requires either Commission to issue a requested joint interpretation regarding the characterization of a particular instrument.

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980 See paragraph (e) of rule 1.8 under the CEA and rule 3a68-2 under the Exchange Act. This 120-day period is based on the timeframe set forth in section 718(a)(3) of the Dodd-Frank Act.

981 See section 712(d)(4) of the Dodd-Frank Act.

These provisions are intended to assure market participants a prompt review of submissions requesting a joint interpretation of whether a Title VII instrument is a swap, a security-based swap, or both (i.e., a mixed swap). The final rules also provide transparency and accountability by requiring that at the end of the review period, the Commissions issue the requested interpretation or publicly state the reasons for not doing so.

The final rules permit the Commissions, in lieu of issuing a requested interpretation, to issue (within the timeframe for issuing a joint interpretation) a joint notice of proposed rulemaking to further define one or more of the terms "swap," "security-based swap," or "mixed swap."[982] Under the final rules, the 120-day period to provide a response will be tolled during the pendency of a request for public comment on any such proposed interpretation. Such a rulemaking, as required by Title VII, would be required to be done in consultation with the Board of Governors of the Federal Reserve System. This provision is intended to provide the Commissions with needed flexibility to address issues that may be of broader applicability than the particular Title VII instrument that is the subject of a request for a joint interpretation.

Comments

Three commenters discussed the proposed process for requesting interpretations of the characterization of a Title VII instrument,[983] and while supporting such joint interpretive process, suggested certain changes, including extending it to SBSAs,[984] mandating that the Commissions

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982 See paragraph (f) of rule 1.8 under the CEA and rule 3a68-2 under the Exchange Act.

983 See Better Markets Letter; CME Letter; and SIFMA Letter.

984 See Better Markets Letter.

issue a response to a request,[985] and suggesting that the Commissions should seek expedited judicial review in the event the Commissions do not agree on the interpretation.[986]

The Commissions are adopting the final rules as proposed and are not including SBSAs in the process. The joint interpretive process is intended to decrease the possibility that market participants inadvertently might fail to meet regulatory requirements that are applicable to swaps, security-based swaps, or mixed swaps and, as such, provides a mechanism for market participants to request whether an instrument will be regulated by the CFTC, the SEC, or both. However, the Commissions do not believe it is appropriate to predetermine whether particular swaps also are SBSAs as SBSAs are already swaps over which the CFTC has regulatory and enforcement authority and as to which the SEC has antifraud and certain other related authorities.[987] Predetermining whether particular swaps may be SBSAs under this process is not needed to provide certainty as to the applicable regulatory treatment of these instruments.

The Commissions also are retaining in the final rules the framework for providing or not providing joint interpretations. As noted above, section 718 of the Dodd-Frank Act contains a framework for evaluating novel derivative products that may have elements of both securities and futures contracts (other than swaps, security-based swaps or mixed swaps). The Commissions believe that establishing a joint interpretive process for swaps, security-based

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985 See CME Letter and SIFMA Letter. These commenters suggested that the Commissions should be required to issue a joint interpretation for all joint interpretive requests that are not withdrawn. Id.

986 See CME Letter. This commenter suggested that the Commissions should seek expedited judicial review to determine the characterization of a Title VII instrument if the Commissions cannot agree on a joint interpretation. Id.

987 See section 3(a)(78) of the Exchange Act, 15 U.S.C. 78c(a)(78), and section 1a(47)(A)(v) of the CEA, 7 U.S.C. 1a(47)(A)(v). The Dodd-Frank Act provides that certain CFTC registrants, such as DCOs and SEFs, will keep records regarding security-based swap agreements open to inspection and examination by the SEC upon request. See, e.g., sections 725(e) and 733 of the Dodd-Frank Act.

swaps and mixed swaps that is modeled in part on this statutory framework should facilitate providing interpretations to market participants in a timely manner, if the Commissions determine to do so. Establishing a process by rule will provide market participants with an understandable method by which they can request an interpretation from the Commissions. As the Commissions have the authority, but not the obligation, under the Dodd-Frank Act to further define the terms "swap," "security-based swap," and "mixed swap," the Commissions are retaining the flexibility in the interpretive process rules to decide whether or not to issue joint interpretations. The Commissions believe, however, that it is appropriate to advise market participants of the reasons why such interpretation is not being issued and the final rules retain the requirement that the Commissions publicly explain the reasons for not issuing a joint interpretation.

Further, the Commissions are not revising the final rules to provide for expedited judicial review. The Dodd-Frank Act does not contain any provision that provides for expedited judicial review if the Commissions do not issue a joint interpretation with respect to a Title VII instrument. Although the Commissions note that section 718 of the Dodd-Frank Act contains a statutorily mandated expedited judicial review of one of the Commission's actions (if sought by the other Commission) regarding novel derivative products that may have elements of both securities and futures contracts, such statutory provision does not apply to Title VII instruments.[988] Further, Title VII provides flexibility to the Commissions to determine the

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988 The Commissions note that judicial review provisions in section 718 relating to the status of novel derivative products only provide that either Commission (either the SEC or the CFTC) has the right to petition for review of a final order of the other Commission with respect to novel derivative products that may have elements of both securities and futures that affects jurisdictional issues. Nothing in section 718 requires that the Commissions issue exemptions or interpretations pursuant to such section or provides any person other than the Commissions the right to petition for Court review of a Commission order issued pursuant to section 718.

methods by which joint interpretations are provided. Title VII does not contain any required expedited judicial review of Commission actions, and the Commissions do not have the authority to require expedited judicial review under Title VII, with respect to a Title VII instrument. Accordingly, the Commissions do not believe that including such a provision is appropriate in the context of providing interpretations to market participants regarding the definitions of swap, security-based swap, or mixed swap.

Two commenters were concerned about the length of the review period and believed that the Commissions should shorten such time period.[989] The Commissions are not modifying the final rules from those proposed with respect to the length of the review period. The 120-day review period is based on a timeframe established by Congress with respect to determining the status of novel derivative products.[990] The Commissions believe that this length of the review period also is appropriate for other derivative products such as swaps, security-based swaps, and mixed swaps. Further, the Commissions believe the 120-day review period is necessary to enable the Commissions to obtain the necessary information regarding a Title VII instrument,

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989 See CME Letter and Markit Letter. One of these commenters suggested that the Commissions should reduce the 120-day review period to 30 days because the value of receiving a joint interpretation would be negated if a market participant had to wait 120 days. This commenter also suggested that foreign competitors will gain a competitive advantage to U.S. market participants because they will not need to wait for a joint interpretation before trading similar or identical products. See CME Letter. The Commissions note that to the extent foreign competitors are engaging in swap and security-based swap transactions subject to either Commission's jurisdiction, they will be subject to the same process for requesting interpretations of the characterization of Title VII instruments as U.S. market participants. The other commenter requested that the Commissions issue a joint interpretation for each "widely-utilized index," at the time of the index series' launch, within a two-week period rather than the proposed 120-day period for novel derivative products under section 718 of the Dodd-Frank Act. This commenter did not recognize that the joint interpretive process would be available in this case, and that it may be initiated by an index provider. See paragraph (a) of rule 1.8 under the CEA and rule 3a68-2 under the Exchange Act (providing that "[a]ny person" may submit a request for a joint interpretation). See Markit Letter.

990 See section 718(a)(3) of the Dodd-Frank Act.

thoroughly analyze the instrument, and formulate any joint interpretation regarding the instrument. In a related comment, one commenter suggested that the Commissions allow a requesting party, while awaiting a joint interpretation, to make a good faith characterization of a particular Title VII instrument and engage in transactions based on such characterization.[991] The Commissions believe that it is essential that the characterization of an instrument be established prior to any party engaging in the transactions so that the appropriate regulatory schemes apply. The Commissions do not believe that allowing market participants to make such a determination as to the status of a product is either appropriate or consistent with the statutory provisions providing for the Commissions to further define the terms "swap," "security-based swap" and "mixed swap." Further, allowing market participants to determine the status of a product could give rise to regulatory arbitrage and inconsistent treatment of similar products.

Finally, some commenters expressed concern about the public availability of information regarding the joint interpretive process and asked that the parties be able to seek confidential treatment of their submissions.[992] The Commissions note that under existing rules of both Commissions, requesting parties may seek confidential treatment for joint interpretive requests from the SEC and the CFTC in accordance with the applicable existing rules relating to

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991 See SIFMA Letter. This commenter also suggested that while the requesting party, and all other market participants, would be bound by the joint interpretation when issued, they should not face retroactive re-characterization of a transaction executed during the review period and prior to the issuance of the joint interpretation. Id.

992 One commenter suggested that the Commissions should permit the parties seeking a joint interpretation to request confidential treatment from the Commissions during the course of the review period in order to protect proprietary information and deal structures. See SIFMA Letter. Another commenter suggested that the Commissions should make public all requests for joint interpretations, any guidance actually provided in response to such requests, and any decisions not to provide guidance in response to such requests (along with an explanation of the grounds for any such decision). See Better Markets Letter.

confidential treatment of information.[993] The Commissions also note that even if confidential treatment has been requested, all joint interpretive requests, as well all joint interpretations and any decisions not to issue a joint interpretation (along with the explanation of the grounds for such decision), will be made publicly available at the conclusion of the review period.[994]

VII. Anti-Evasion

A. CFTC Anti-Evasion Rules

1. CFTC's Anti-Evasion Authority

a) Statutory Basis for the Anti-Evasion Rules

Pursuant to the authority in sections 721(c) and 725(g)(2) of the Dodd-Frank Act and CEA sections 1a(47)(E) and 2(i),[995] the CFTC is promulgating the anti-evasion rules as they were proposed and restating the accompanying interpretation with modifications in response to

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993 See 17 CFR 200.81 and 17 CFR 140.98. The Commissions note that the joint interpretive process is intended to provide, among other things, notification to all market participants as to the regulatory classification of a particular Title VII instrument. In this regard, the Commissions do not believe it is appropriate to provide a joint interpretation only to the market participants requesting the interpretation, while delaying publication of the same joint interpretation to market participants generally. Therefore, CFTC staff will not exercise its discretion under 17 CFR 140.98(b) to delay publication of a joint interpretation. SEC staff does not have discretion under 17 CFR 200.81(b) to delay publication of a joint interpretation.

994 The CFTC's publication of any joint interpretative request and the joint interpretation itself will be subject to the restrictions of section 8 of the CEA. See 7 U.S.C. 12. Subject to limited exceptions, CEA section 8 generally restricts the CFTC from publishing "data and information that would separately disclose the business transactions or market positions of any person and trade secrets or names of customers..." Id. The CFTC and its staff have a long history of providing interpretive guidance with respect to the regulatory status of specific proposed transactions in compliance with CEA section 8. However, market participants making a joint interpretive request should be aware that the SEC is not subject to CEA section 8 and, therefore, is not subject to the restrictions of CEA section 8. The CFTC anticipates that most joint interpretive requests will not contain CEA Section 8 information. However, given that the SEC is not subject to the restrictions of CEA section 8, the CFTC intends to work with requesting parties to assure that joint interpretive requests do not include CEA section 8 information. Nevertheless, given the foregoing, market participants should not submit CEA section 8 information in their joint interpretive requests.

995 7 U.S.C. 1a(47)(E) and 2(i).

commenters. The CFTC also is providing an additional interpretation regarding rules 1.3(xxx)(6) and 1.6 under the CEA.

Section 721(c) of the Dodd-Frank Act requires the CFTC to further define the terms "swap," "swap dealer," "major swap participant," and "eligible contract participant," in order "[t]o include transactions and entities that have been structured to evade" subtitle A of Title VII (or an amendment made by subtitle A of the CEA). Moreover, as the CFTC noted in the Proposing Release,[996] several other provisions of Title VII reference the promulgation of anti-evasion rules, including:

- Subparagraph (E) of the definition of "swap" provides that foreign exchange swaps and foreign exchange forwards shall be considered swaps unless the Secretary of the Treasury makes a written determination that either foreign exchange swaps or foreign exchange forwards, or both, among other things, "are not structured to evade the [Dodd-Frank Act] in violation of any rule promulgated by the [CFTC] pursuant to section 721(c) of that Act;"[997]
- Section 722(d) of the Dodd-Frank Act provides that the provisions of the CEA relating to swaps shall not apply to activities outside the United States unless those activities, among other things, "contravene such rules or regulations as the [CFTC] may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of [the CEA] that was enacted by the [Title VII];"[998] and

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996 Proposing Release at 29866.

997 CEA section 1a(47)(E), 7 U.S.C. 1a(47)(E).

998 CEA section 2(i), 7 U.S.C. 2(i). New CEA section 2(i), as added by section 722(d) of the Dodd-Frank Act, also provides that the provisions of Title VII relating to swaps shall not apply to activities outside the United States unless those activities "have a direct and significant connection with activities in, or effect on, commerce of the United States."

- Section 725(g) of the Dodd-Frank Act amends the Legal Certainty for Bank Products Act of 2000 to provide that, although identified banking products generally are excluded from the CEA, that exclusion shall not apply to an identified banking product that is a product of a bank that is not under the regulatory jurisdiction of an appropriate Federal banking agency,[999] meets the definition of the terms "swap" or "security-based swap," and "has been structured as an identified banking product for the purpose of evading the provisions of the [CEA], the [Securities Act], or the [Exchange Act]."[1000]

Comments

One commenter asserted the CFTC has no statutory basis to promulgate the anti-evasion rules, as proposed.[1001] Specifically, this commenter stated that neither CEA sections 2(h)(4)(A) nor 6(e) grant the CFTC authority to prescribe an anti-evasion rule and interpretation as described in the Proposing Release.[1002] Moreover, this commenter argued that CEA section 2(i) limits the CFTC to prescribing anti-evasion rules related only to activities occurring outside of the United States.[1003] The CFTC finds these comments misplaced because CEA sections

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999 The term "identified banking product" is defined in section 402 of the Legal Certainty for Bank Products Act of 2000, 7 U.S.C. 27. The term "appropriate Federal banking agency" is defined in CEA section 1a(2), 7 U.S.C. 1a(2), and section 3(a)(72) of the Exchange Act, 15 U.S.C. 78c(a)(72), which were added by sections 721(a) and 761(a) of the Dodd-Frank Act, respectively.

1000 Section 741(b) of the Dodd-Frank Act amends section 6(e) of the CEA, 7 U.S.C. 9a, to provide that any DCO, swap dealer, or major swap participant "that knowingly or recklessly evades or participates in or facilitates an evasion of the requirements of section 2(h) [of the CEA] shall be liable for a civil monetary penalty in twice the amount otherwise available for a violation of section 2(h) [of the CEA]." This anti-evasion provision is not dependent upon the promulgation of a rule under section 721(c) of the Dodd Frank Act, and hence the proposed rule and interpretive guidance is not meant to apply to CEA section 6(e).

1001 See IECA Letter.

1002 Id.; 7 U.S.C. 2(h)(4)(A) and 9a.

1003 See IECA Letter; 7 U.S.C. 2(i).

2(h)(4)(A) and 6(e) provide the CFTC with additional authority to prescribe anti-evasion rules for specific purposes above and beyond the authority provided by sections 721(c) and 725(g) of the Dodd-Frank Act and CEA sections 1a(47)(E) and 2(i), upon which the CFTC is relying in this rulemaking.[1004] In addition, section 2(i) of the CEA provides that activities conducted outside the United States, including entering into agreements, contracts and transactions or structuring entities, which willfully evade or attempt to evade any provision of the CEA, shall be subject to the provisions of Subtitle A of Title VII of the Dodd-Frank Act; it does not limit the CFTC's other authorities cited above. Accordingly, nothing in CEA sections 2(h)(4)(A), 2(i) or 6(e) prevent the CFTC from prescribing rules 1.3(xxx)(6) and 1.6.

Two commenters supported the proposal's "principles-based" approach to anti-evasion,[1005] while several others suggested modifications.[1006] Two commenters believed that the Proposing Release is overly broad and that, if the CFTC does finalize anti-evasion rules, such rules should be narrower in scope.[1007] Similarly, one other commenter asserted that the CFTC erred in the Proposing Release by placing too great an emphasis on the flexibility of the rules as

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1004 CEA section 2(h)(4)(A), 7 U.S.C. 2(h)(4)(A), provides: The Commission shall prescribe rules under this subsection (and issue interpretations of rules prescribed under this subsection) as determined by the Commission to be necessary to prevent evasions of the mandatory clearing requirements under this Act.

CEA section 6(e), 7 U.S.C. 9a, in relevant part, provides: (4) Any designated clearing organization that knowingly or recklessly evades or participates in or facilitates an evasion of the requirements of section 2(h) shall be liable for a civil money penalty in twice the amount otherwise available for a violation of section 2(h). (5) Any swap dealer or major swap participant that knowingly or recklessly evades or participates in or facilitates an evasion of the requirements of section 2(h) shall be liable for a civil money penalty in twice the amount otherwise available for a violation of section 2(h).

1005 See Barnard Letter and Better Markets Letter.

1006 See CME Letter; ISDA Letter; and SIFMA Letter.

1007 See ISDA Letter and SIFMA Letter.

opposed to providing clarity for market participants.[1008] The CFTC continues to believe a "principles-based" approach to its anti-evasion rules is appropriate. The CFTC is not adopting an alternative approach, whereby it provides a bright-line test of non-evasive conduct, because such an approach may provide potential wrongdoers with a roadmap for structuring evasive transactions. Notwithstanding this concern, as described below, the CFTC is providing an additional interpretation and examples of evasion in order to provide clarity to market participants.[1009]

One commenter suggested an alternative standard for a finding of evasion should be "whether the transaction is lawful or not" under the CEA, CFTC rules and regulations, orders, or other applicable federal, state or other laws.[1010] The CFTC is not adopting this suggested alternative standard for evasion because to adopt this standard would blur the distinction between whether a transaction (or entity) is lawful and whether it is structured in a way to evade the Dodd-Frank Act and the CEA. The anti-evasion rules provided herein are concerned with the latter conduct, not the former.[1011] Thus, the CFTC does not believe it is appropriate to limit the enforcement of its anti-evasion authority to only unlawful transactions.

2. Final Rules

a) Rule 1.3(xxx)(6)

1008 See CME Letter.

1009 Examples described in the guidance are illustrative and not exhaustive of the transactions, instruments or entities that could be considered evasive. In considering whether a transaction, instrument or entity is evasive, the CFTC will consider the facts and circumstances of each situation.

1010 See WGCEF Letter.

1011 If a transaction is unlawful, the CFTC (or another authority) may be able to bring an action alleging a violation of the applicable rule, regulation, order or law.

The CFTC is adopting the Rule 1.3(xxx)(6) as proposed. As adopted, Rule 1.3(xxx)(6)(i) under the CEA generally defines as swaps those transactions that are willfully structured to evade the provisions of Title VII governing the regulation of swaps. Furthermore, rules 1.3(xxx)(6)(ii) and (iii) effectuate CEA section 1a(47)(E)(i) and section 725(g) of the Dodd-Frank Act, respectively, and will be applied in a similar fashion as rule 1.3(xxx)(6)(i). Rule 1.3(xxx)(6)(ii) applies to currency and interest rate swaps that are willfully structured as foreign exchange forwards or foreign exchange swaps to evade the new regulatory regime for swaps enacted in Title VII. Rule 1.3(xxx)(6)(iii) applies to transactions of a bank that are not under the regulatory jurisdiction of an appropriate Federal banking agency and where the transaction is willfully structured as an identified banking product to evade the new regulatory regime for swaps enacted in Title VII.

Rule 1.3(xxx)(6)(iv) provides that in determining whether a transaction has been willfully structured to evade rules 1.3(xxx)(6)(i) through (iii), the CFTC will not consider the form, label, or written documentation dispositive.[1012] This approach is intended to prevent evasion through clever draftsmanship of a form, label, or other written documentation.

Rule 1.3(xxx)(6)(v) further provides that transactions, other than transactions structured as securities, willfully structured to evade (as provided in rules 1.3(xxx)(6)(i) through (iii)) will be considered in determining whether a person is a swap dealer or major swap participant.

Lastly, rule 1.3(xxx)(6)(vi) provides that rule 1.3(xxx)(6) will not apply to any agreement, contract or transaction structured as a security (including a security-based swap) under the securities laws as defined in section 3(a)(47) of the Exchange Act.[1013]

1012 See supra part II.D.1.

1013 15 U.S.C. 78c(a)(47).

b) Rule 1.6

The CFTC is adopting rule 1.6 as proposed. Section 2(i) of the CEA states that the provisions of the CEA relating to swaps that were enacted by Title VII (including any rule prescribed or regulation promulgated thereunder) shall not apply to activities outside the United States unless, among other things, those activities "contravene such rules or regulations as the [CFTC] may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of [the CEA] that was enacted by [Title VII]."

Pursuant to this authority, rule 1.6(a), as adopted, makes it unlawful to conduct activities outside the United States, including entering into transactions and structuring entities, to willfully evade or attempt to evade any provision of the CEA as enacted under Title VII or the rules and regulations promulgated thereunder.

In addition, rule 1.6(b) provides that in determining whether a transaction or entity has been entered into or structured willfully to evade, as provided in rule 1.6(a), the CFTC will not consider the form, label, or written documentation as dispositive.

Rule 1.6(c) provides that an activity conducted outside the United States to evade, as described in proposed rule 1.6(a), shall be subject to the provisions of Subtitle A of Title VII of the Dodd-Frank Act. As the CFTC explained in the Proposing Release,[1014] such provisions are necessary to fully prevent those who seek to willfully evade the regulatory requirements established by Congress in Title VII relating to swaps from enjoying any benefits from their efforts to evade.

1014 Proposing Release at 29866.

Lastly, rule 1.6(d) provides that no agreement, contract or transaction structured as a security (including a security-based swap) under the securities laws shall be deemed a swap pursuant to rule 1.6.

c) Interpretation of the Final Rules

The CFTC is providing an interpretation of the final rules in response to commenters, addressing (i) the applicability of the anti-evasion rules to transactions that qualify for the forward exclusion, (ii) the applicability of the anti-evasion rules to transactions executed on a SEF, (iii) the treatment of evasive transactions after they are discovered, and (iv) documentation considerations.[1015]

With regard to the forward exclusion, the CFTC is clarifying, in response to a commenter,[1016] that entering into transactions that qualify for the forward exclusion from the swap definition shall not be considered evasive. However, in circumstances where a transaction does not, in fact, qualify for the forward exclusion, the transaction may or may not be evasive depending on an analysis of all relevant facts and circumstances.[1017]

1015 The CFTC also is adopting the interpretive guidance from the Proposing Release, as proposed, but with certain clarifications. See infra part VII.A.3.

1016 See COPE Letter (requesting clarification that transacting in the physical markets (e.g., entering into nonfinancial commodity forward contracts), as opposed to executing a swap, would not be considered evasion).

1017 The CFTC is aware that there are circumstances where a forward contract can perform the same or a substantially similar economic function as a swap through alternative delivery procedures. Further, there are circumstances where a person who deals in both forwards and swaps may make decisions regarding financial risk assessment that will involve the consideration of regulatory obligations. The CFTC will carefully scrutinize the facts and circumstances associated with forward contracts.

Concerning the applicability of the anti-evasion rules to transactions executed on a SEF, the CFTC is clarifying, in response to comments,[1018] that a transaction that has been self-certified by a SEF (or a DCM), or that has received prior approval from the CFTC, will not be considered evasive.[1019]

With respect to the treatment of evasive transactions after they are discovered, the CFTC is clarifying, in response to comments,[1020] that in instances where one party willfully structures a transaction to evade but the counterparty does not, the transaction, which meets the swap definition under rule 1.3(xxx)(6), or is subject to the provisions of Subtitle A of Title VII pursuant to rule 1.6, will be subject to all CEA provisions and the regulations thereunder (as applied to the party who willfully structures a transaction to evade). In rare situations where there is a true "innocent party,"[1021] it will likely be due to fraud or misrepresentation by the evading party and the business consequences and remedies will be the same as for any such victim.[1022] The CFTC will impose appropriate sanctions only on the willful evader for violations

1018 See MarketAxess Letter (commenting that the anti-evasion rules should not apply to transactions executed on, or subject to the rules of, a SEF, because before a SEF may list a swap, it must self-certify or voluntarily obtain CFTC approval to list the product).

1019 Pursuant to part 40 of the CFTC's regulations, 17 CFR Part 40, registered SEFs and DCMs must self-certify with the CFTC that any products that they list "[comply] with the [CEA] and regulations thereunder" and are liable for any false self-certifications. Therefore, market participants that have entered into such transactions will not be considered to be engaging in evasion, while a SEF or DCM could be found to have falsely self-certified.

1020 See WGCEF Letter (generally expressing concern that the penalty for anti-evasion is "draconian") and IECA Letter (commenting that the non-evading party should not become a party to an evasive "swap" transaction, and thus subject to the regulatory requirements of the Dodd-Frank Act.) .

1021 The analysis of whether a party is "innocent" is based on the facts and circumstances of a particular transaction as well as a course of dealing by each of the parties.

1022 This is not dissimilar to an enforcement action for trading illegal off-exchange futures contracts in violation of CEA section 4(a), 7 U.S.C. 6(a). The CFTC regularly seeks restitution for victims in enforcement actions where applicable. Additionally, victims retain their private rights of action for breach of contract and any related equitable remedies.

of the relevant provisions of the CEA and CFTC regulations since the individual agreement, contract or transaction was (and always should have been) subject to them.[1023] Further, on a prospective basis for future transactions or instruments similar to those of the particular evasive swap, the CFTC will consider these transactions or instruments to be swaps within the meaning of the Dodd-Frank Act (as applied to both the party who willfully structures a transaction to evade and the "innocent party").

Moreover, evasive transactions will count toward determining whether each evading party with the requisite intent is a swap dealer or major swap participant.[1024] In response to a commenter's suggestion that, as proposed, rule 1.3(xxx)(6)(v) should require a pattern of transactions,[1025] the CFTC is not requiring a pattern of evasive transactions as a prerequisite to prove evasion, although such a pattern may be one factor in analyzing whether evasion has occurred under rules 1.3(xxx)(6) or 1.6. Further, in determining whether such a transaction is a swap, the CFTC will consider whether the transaction meets the definition of the term "swap" as defined by statute and as it is further defined in this rulemaking.[1026]

1023 In considering which provisions of the CEA and CFTC regulations are relevant, the CFTC will evaluate which CEA provisions and CFTC regulations the evasive swap would have had to comply with had it not evaded the definition of swap (e.g., reporting, recordkeeping, clearing, etc.). However, where both parties have willfully structured to evade or attempted to evade the requirements of the Dodd-Frank Act, the CFTC may subject the agreement, contract, instrument, or transaction itself to the full regulatory regime and the willful evaders to applicable sanctions.

1024 In other words, the evasive transaction would count toward the relevant thresholds (e.g., de minimis (with respect to determining swap dealer status, if the evasive transaction constituted dealing activity) and substantial position (with respect to determining major swap participant status)).

1025 See IECA Letter. This same commenter suggested that rule 1.3(xxx)(6)(v) should be applied only to the authorities regarding evasion provided by Congress and refer to the entity structuring the evading transaction have been addressed above.

1026 Thus, for example, if a person, in seeking to evade Title VII, structures a product that is a privilege on a certificate of deposit, the CFTC's anti-evasion rules would not be implicated because CEA section 1a(47)(B)(iii), 7 U.S.C. 1a(47)(B)(iii), excludes such a product from the swap definition.

As an illustration of some of the foregoing concepts, if the market for foreign exchange forwards on a particular currency settles on a T+ 4 basis, but two counterparties agree to expedite the settlement of an foreign exchange forward on such currency to characterize the transaction falsely as a spot transaction in order to avoid reporting the transaction, rule 1.3(xxx)(6)(i) would define the transaction as a swap. In this example, both parties may be subject to sanctions if they both have the requisite intent (i.e., willfully evaded). However, had the counterparty with the reporting obligation in this example convinced the other counterparty, by using a false rationale unrelated to avoiding reporting, to expedite the foreign exchange forward settlement in order to avoid reporting, then the only party that would be at risk for sanctions (i.e., the only party with the requisite intent) would be the counterparty with the reporting obligation who deceived the other counterparty.

With regard to documentation considerations, as discussed above, the CFTC is adopting rules 1.3(xxx)(6)(iv) and 1.6(b), as proposed,[1027] but is providing the following interpretation. As stated in the Proposing Release,[1028] the structuring of instruments, transactions, or entities to evade the requirements of the Dodd- Frank Act may be "limited only by the ingenuity of man."[1029] Therefore, the CFTC will look beyond manner in which an instrument, transaction, or entity is documented to examine its actual substance and purpose to prevent any evasion through clever draftsmanship--an approach consistent with the CFTC's case law in the context of determining whether a contract is a futures contract and the CFTC's interpretations in this

1027 Rules 1.3(xxx)(6)(iv) and 1.6(b) provide that "in determining whether a transaction has been willfully structured to evade, neither the form, label, nor written documentation of the transaction shall be dispositive."

1028 Proposing Release at 29866.

1029 Cargill v. Hardin, 452 F.2d 1154, 1163 (8th Cir. 1971).

release regarding swaps.[1030] The documentation of an instrument, transaction, or entity (like its form or label) is a relevant, but not dispositive, factor in determining whether evasion has occurred.

Comments

The CFTC received a number of comments on various aspects of proposed rules 1.3(xxx)(6) and 1.6.

Several commenters requested clarity as to what types of transactions might be considered evasive under proposed rule 1.3(xxx)(6) and 1.6.[1031] One commenter requested that the CFTC clarify that transacting in the physical markets (e.g., entering into nonfinancial commodity forward contracts), as opposed to executing a swap, would not be considered evasion.[1032] As discussed above, the CFTC has provided an interpretation regarding the applicability of the anti-evasion rules to transactions that qualify for the forward exclusion. Another commenter requested that the CFTC clarify that the anti-evasion rules would not apply to transactions executed on a SEF because, before a SEF may list a swap, it must self-certify or voluntarily obtain CFTC permission to list that product.[1033] The CFTC has provided an interpretation discussed above to address this comment.

Two commenters expressed concern regarding the penalty to the counterparties to a transaction that is deemed to violate the CFTC's anti-evasion provisions.[1034] Pursuant to the final rule, when a transaction violates the anti-evasion rules, the CFTC will consider the

1030 See supra part II.D.1.

1031 See CME Letter; COPE Letter; IECA Letter; MarketAxess Letter; and WGCEF Letter.

1032 See COPE Letter.

1033 See MarketAxess Letter.

1034 See IECA Letter and WGCEF Letter.

transaction a swap. One of these commenters said that the non-evading party should not unilaterally become a party to a swap, and thus be subject to the regulatory requirements of the Dodd-Frank Act.[1035] This commenter believed the rule should be clear that only the "evading" party would become a party to a swap, but the "non-evading" party would not.[1036] The other comments believed that a transaction that is determined to have violated the CFTC's anti-evasion rules should be considered a swap only if it meets all other aspects of the statutory definition of the term "swap."[1037] The CFTC agrees that the anti-evasion rules are not meant to "punish the innocent," but rather to appropriately address the evading counterparty's or counterparties' failure to meet the requirements of the Dodd-Frank Act. Therefore, the CFTC has provided an interpretation described above about how a transaction, discovered to have evaded the CEA or the Dodd-Frank Act (and therefore, a swap under rule 1.3(xxx)(6) or subject to the provisions of Subtitle A under rule 1.6) will be treated after the evasion is discovered.

Furthermore, the CFTC agrees that a transaction that is determined to have violated the CFTC's anti-evasion rules will be considered a swap only if it meets the definition of the term "swap," and has provided an interpretation to address this comment. In response to both comments, the CFTC also has provided an example to illustrate the concepts in the interpretation.

The CFTC received one comment regarding rules 1.3(xxx)(6)(iv) and 1.6(b). This commenter believed that a difference exists between "documentation," which contains terms,

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1035 See IECA Letter.

1036 Id.

1037 See WGCEF Letter.

conditions, etc. of an agreement, and the "form or label."[1038] Thus, because a form or label may be duplicitously assigned to a transaction, this commenter agreed that neither the form nor the label should be dispositive.[1039] However, because documentation contains the substance of an agreement, this commenter believed that documentation should be dispositive in determining whether a given contract has been entered to willfully evade because the substance of a contract is derived from its documentation.[1040] Alternatively, this commenter requested that if the CFTC does not amend its proposal, the CFTC clarify what evidence or subject matter would be dispositive of willful evasion.[1041] The CFTC disagrees with these comments and has provided an interpretation discussed above that the documentation of an instrument, transaction, or entity is a relevant, but not dispositive, factor. This view not only is consistent with CFTC case law, and the CFTC's interpretations herein, but reduces the possibility of providing a potential roadmap for evasion.

Two commenters raised issues applicable to proposed rule 1.6 alone. One commenter believed that proposed rule 1.6 should not be adopted until the cross-border application of the swap provisions of Title VII is addressed.[1042] The CFTC disagrees and believes that the rule provides sufficient clarity to market participants even though the CFTC has not yet finalized guidance regarding the cross-border application of the swap provisions of the Dodd-Frank Act. The other commenters believed that the proposed rule text and interpretation does not fully explain how the CFTC would apply proposed rule 1.6 in determining whether a swap subject to

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1038 See CME Letter.

1039 Id.

1040 Id.

1041 Id.

1042 See ISDA Letter.

foreign jurisdiction and regulated by a foreign regulator is evasive.[1043] As stated above, an agreement, contract, instrument or transaction that is found to have been willfully structured to evade will be subject to CEA provisions and the regulations thereunder pursuant to rule 1.6(c).

3. Interpretation Contained in the Proposing Release

The CFTC is restating the interpretation contained in the Proposing Release,[1044] but is providing additional clarification regarding certain types of circumstances that may (or may not) constitute an evasion of the requirements of Title VII. However, the CFTC notes that each activity will be evaluated on a case-by-case basis with consideration given to all relevant facts and circumstances.

In developing its interpretation, the CFTC considered legislative, administrative, and judicial precedent with respect to the anti-evasion provisions in other Federal statutes. For example, the CFTC examined the anti-evasion provisions in the Truth in Lending Act,[1045] the Bank Secrecy Act,[1046] and the Internal Revenue Code.[1047]

1043 See CME Letter.

1044 See Proposing Release at 29865.

1045 15 U.S.C. 1604(a) provides, in relevant part, that the Federal Reserve Board: shall prescribe regulations to carry out the purposes of this subchapter . . . . [T]hese regulations may contain such classifications, differentiations, or other provisions, and may provide for such adjustments and exceptions for any class of transactions, as in the judgment of the Board are necessary or proper to effectuate the purposes of this subchapter, to prevent circumvention or evasion thereof, or to facilitate compliance therewith.

In affirming the Board's promulgation of Regulation Z, the Supreme Court noted that anti-evasion provisions such as section 1604(a) evince Congress's intent to "stress[] the agency's power to counteract attempts to evade the purposes of a statute." Mourning v. Family Publ'ns Serv., Inc., 411 U.S. 356, 370 (1973) (citing Gemsco v. Walling, 324 U.S. 244 (1945) (giving great deference to a regulation promulgated under similar prevention-of-evasion rulemaking authority in the Fair Labor Standards Act)).

1046 31 U.S.C. 5324 (stating, in pertinent part, that "[n]o person shall, for the purpose of evading the reporting requirements of [the Bank Secrecy Act (BSA) or any regulation prescribed thereunder]. . . . structure or assist in structuring, or attempt to structure or assist in structuring, any transaction with one or more domestic financial institutions"). The Federal Deposit

The CFTC will not consider transactions, entities, or instruments structured in a manner solely motivated by a legitimate business purpose to constitute willful evasion ("Business Purpose Test"). Additionally, relying on Internal Revenue Service ("IRS") concepts, when determining whether particular conduct is an evasion of the Dodd-Frank Act, the CFTC will consider the extent to which the conduct involves deceit, deception, or other unlawful or illegitimate activity.

a) Business Purpose Test

Interpretation

Consistent with the Proposing Release,[1048] the CFTC recognizes that transactions may be structured, and entities may be formed, in particular ways for legitimate business purposes, without any intention of circumventing the requirements of the Dodd-Frank Act with respect to swaps. Thus, in evaluating whether a person is evading or attempting to evade the swap requirements with respect to a particular instrument, entity, or transaction, the CFTC will consider the extent to which the person has a legitimate business purpose for structuring the instrument or entity or entering into the transaction in that particular manner. Although different means of structuring a transaction or entity may have differing regulatory implications and attendant requirements, absent other indicia of evasion, the CFTC will not consider transactions, entities, or instruments structured in a manner solely motivated by a legitimate business purpose

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Insurance Corporation regulations implementing the BSA require banks to report transactions that "the bank knows, suspects, or has reason to suspect" are "designed to evade any regulations promulgated under the Bank Secrecy Act." 12 CFR 353.3 (2010).

1047 The Internal Revenue Code makes it unlawful for any person willfully to attempt "in any manner to evade or defeat any tax . . . ." 26 U.S.C. 7201. While a considerable body of case law has developed under the tax evasion provision, the statute itself does not define the term, but generally prohibits willful attempts to evade tax.

1048 Proposing Release at 29867.

to constitute evasion. However, to the extent a purpose in structuring an entity or instrument or entering into a transaction is to evade the requirements of Title VII with respect to swaps, the structuring of such instrument, entity, or transaction may be found to constitute willful evasion.[1049]

Although some commenters suggest that the determination that there is a legitimate business purpose, and the use of that concept as a relevant fact in the determination of the possibility of evasion, will not provide appropriate clarity, it is a recognized analytical method and would be useful in the overall analysis of potentially willful evasive conduct.

The CFTC fully expects that a person acting for legitimate business purposes within its respective industry will naturally weigh a multitude of costs and benefits associated with different types of financial transactions, entities, or instruments, including the applicable regulatory obligations. In that regard, and in response to commenters, the CFTC is clarifying that a person's specific consideration of regulatory burdens, including the avoidance thereof, is not dispositive that the person is acting without a legitimate business purpose in a particular case. The CFTC will view legitimate business purpose considerations on a case-by-case basis in conjunction with all other relevant facts and circumstances.

1049 As the CFTC observed in the Proposing Release, a similar concept applies with respect to tax evasion. See Proposing Release at 29867 n. 324. A transaction that is structured to avoid the payment of taxes but that lacks a valid business purpose may be found to constitute tax evasion. See, e.g., Gregory v. Helvering, 293 U.S. 465, 469 (1935) (favorable tax treatment disallowed because transaction lacked any business or corporate purpose). Under the "sham-transaction" doctrine, "a transaction is not entitled to tax respect if it lacks economic effects or substance other than the generation of tax benefits, or if the transaction serves no business purpose." Winn-Dixie Stores, Inc. v. Comm'r, 254 F.3d 1313, 1316 (11th Cir. 2001) (citing Knetsch v. United States, 364 U.S. 361 (1960)). "The doctrine has few bright lines, but 'it is clear that transactions whose sole function is to produce tax deductions are substantive shams.'" Id. (quoting United Parcel Serv. of Am., Inc. v. Comm'r, 254 F.3d 1014, 1018 (11th Cir. 2001)). To be clear, though, while the Proposing Release references the use of the business purpose test in tax law, the CFTC is not using the legitimate business purpose consideration in the same manner as the IRS.

Moreover, the CFTC recognizes that it is possible that a person intending to willfully evade Dodd-Frank may attempt to justify its actions by claiming that they are legitimate business practices in its industry; therefore, the CFTC will retain the flexibility, via an analysis of all relevant facts and circumstances, to confirm not only the legitimacy of the business purpose of those actions but whether the actions could still be determined to be willfully evasive. For example, a person may attempt to disguise a product that may be a swap by employing accounting practices that are not appropriate for swaps. Whether or not the method of accounting or employed accounting practices are determined to be for legitimate business purposes, that alone will not be dispositive in determining whether it is willfully evasive according to either rule 1.3(xxx)(6) or 1.6.

Because transactions and instruments are regularly structured, and entities regularly formed, in a particular way for various, and often times multiple, reasons, it is essential that all relevant facts and circumstances be considered. Where a transaction, instrument, or entity is structured solely for legitimate business purposes, it is not willfully evasive. By contrast, where a consideration of all relevant facts and circumstances reveals the presence of a purpose that is not a legitimate business purpose, evasion may exist.

Comments

Two commenters believed the proposed business purpose test is inappropriate for determining if a transaction is structured to evade Title VII.[1050] One of these commenters stated that the CFTC misunderstood how the "business purpose" test is applied by the IRS in the tax evasion context resulting in misguided proposed interpretive guidance.[1051] As stated above, the

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1050 See CME Letter and WGCEF Letter.

1051 See CME Letter.

CFTC believes that it is appropriate to consider legitimate business purposes in determining if a transaction is structured to evade Title VII. In response to this comment, although the interpretation references the use of legitimate business purpose in tax law, the CFTC is not bound to use the legitimate business purpose consideration in the same manner as the IRS and, accordingly, is not adopting the IRS's interpretation.

Two commenters urged the CFTC to clarify that considering the costs of regulation is a legitimate business purpose when structuring a transaction. Accordingly, they request that the CFTC clarify that entering into a transaction to avoid costly regulations, even though that transaction could otherwise be structured as a swap, will not be considered *per se* evasion/evasive.[1052] Finally, one commenter took issue with the statement that "absent other indicia of evasion, [the CFTC] would not consider transactions, entities, or instruments in a manner solely motivated by a legitimate business purpose to constitute evasion."[1053] Because "transactions, entities, or instruments" are rarely structured a certain way solely for one purpose, this commenter believed such a statement does not give market participants any relief or guidance.[1054] The CFTC has addressed these comments received on the business purpose test through the clarifications to its interpretation discussed above and reiterates that the CFTC will consider all relevant facts and circumstances in determining whether an action is willfully evasive.

b) Fraud, Deceit or Unlawful Activity

Interpretation

1052 See ISDA Letter and WGCEF Letter.

1053 See SIFMA Letter.

1054 Id.

When determining whether a particular activity constitutes willful evasion of the CEA or the Dodd-Frank Act, the CFTC will consider the extent to which the activity involves deceit, deception, or other unlawful or illegitimate activity. This concept was derived from the IRS's delineation of what constitutes tax evasion, as elaborated upon by the courts. The IRS distinguishes between tax evasion and legitimate means for citizens to minimize, reduce, avoid or alleviate the tax that they pay under the Internal Revenue Code.[1055] Similarly, persons that craft derivatives transactions, structure entities, or conduct themselves in a deceptive or other illegitimate manner in order to avoid regulatory requirements should not be permitted to enjoy the fruits of their deceptive or illegitimate conduct.

Although it is likely that fraud, deceit, or unlawful activity will be present where willful evasion has occurred, the CFTC does not believe that these factors are prerequisites to an evasion finding. As stated throughout this release, the presence or absence of fraud, deceit, or unlawful activity is one fact (or circumstance) the CFTC will consider when evaluating a person's activity.

1055 Whereas permissible means of reducing tax (or "tax avoidance," as the IRS refers to the practice) is associated with full disclosure and explanation of why the tax should be reduced under law, tax evasion consists of the willful attempt to evade tax liability, and generally involves "deceit, subterfuge, camouflage, concealment, or some attempt to color or obscure events or to make things seem other than they are." The IRS explains:

> Avoidance of taxes is not a criminal offense. Any attempt to reduce, avoid, minimize, or alleviate taxes by legitimate means is permissible. The distinction between avoidance and evasion is fine, yet definite. One who avoids tax does not conceal or misrepresent. He/she shapes events to reduce or eliminate tax liability and, upon the happening of the events, makes a complete disclosure. Evasion, on the other hand, involves deceit, subterfuge, camouflage, concealment, some attempt to color or obscure events or to make things seem other than they are. For example, the creation of a bona fide partnership to reduce the tax liability of a business by dividing the income among several individual partners is tax avoidance. However, the facts of a particular investigation may show that an alleged partnership was not, in fact, established and that one or more of the alleged partners secretly returned his/her share of the profits to the real owner of the business, who, in turn, did not report this income. This would be an instance of attempted evasion.

IRS, Internal Revenue Manual, part 9.1.3.3.2.1, available at http://www.irs.gov/irm/part9/irm_09-001-003.html#d0e169.

That said, the anti-evasion rules do require willfulness, i.e. "scienter." In response to the commenter who requests the CFTC define "willful conduct," the CFTC will interpret "willful" consistent with how the CFTC has in the past, that a person acts "willfully" when they act either intentionally or with reckless disregard.[1056]

Comments

One commenter, although generally supportive of the use of the IRS "tax evasion" concept as a guidepost for this criterion, requested the CFTC provide examples of legitimate versus evasive conduct in a manner similar to what is contained in the Internal Revenue Manual.[1057] The CFTC does not believe it is appropriate to provide an example because such an example may provide a guidepost for evasion.

Two commenters suggested that a finding of fraud, deceit, or unlawful activity should be a prerequisite to any finding of evasion.[1058] As noted above, the CFTC disagrees that such activity should be a prerequisite to a finding of evasion, but its presence or absence is one relevant fact and circumstance the CFTC will consider. Finally, one commenter requested further guidance defining willful conduct in the context of deliberate and knowing wrongdoing.[1059] As noted above, the CFTC has considered the suggestion that the CFTC provide guidance on what defines "willful behavior," with some commenters submitting that some definitional guidance should be offered or that the standard should be whether or not a

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1056 See In re Squadrito, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,262 (CFTC Mar. 27, 1992) (adopting definition of "willful" in McLaughlin v. Richland Shoe Co., 486 U.S. 128 (1987)).

1057 See CME Letter.

1058 See ISDA Letter and SIFMA Letter.

1059 See ISDA Letter (citing U.S. v. Tarallo, 380 F.3d 1174, 1187 (9th Cir. 2004), and Merck & Co. v. Reynolds, 130 S. Ct. 1784, 1796 (2010)).

transaction is "lawful."[1060] The CFTC agrees with the need for legal clarity and believes that the concept of willfulness is a well-recognized legal concept of which there is substantial case law and legal commentary familiar to the financial industry.[1061]

B. SEC Position Regarding Anti-Evasion Rules

Section 761(b)(3) of the Dodd-Frank Act grants discretionary authority to the SEC to define the terms "security-based swap," "security-based swap dealer," "major security-based swap participant," and "eligible contract participant," with regard to security-based swaps, "for the purpose of including transactions and entities that have been structured to evade" subtitle B of Title VII (or amendments made by subtitle B).

The SEC did not propose rules under section 761(b)(3) regarding anti-evasion but requested comment on whether SEC rules or interpretive guidance addressing anti-evasion with respect to security-based swaps, security-based swap dealers, major security-based swap participants, or ECPs were necessary. Two commenters responded to the request for comment and recommended that the SEC adopt anti-evasion rules and interpretive guidance.[1062] One commenter suggested that the SEC model its anti-evasion rules and interpretive guidance on the CFTC's anti-evasion rules.[1063]

The SEC is not adopting anti-evasion rules under section 761(b)(3) at this time. The SEC notes that since security-based swaps are "securities" for purposes of the federal securities laws, unless the SEC grants a specific exemption,[1064] all of the SEC's existing regulatory authority will

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1060 See CME Letter; ISDA Letter; and WGCEF Letter.

1061 See supra note 1056.

1062 See Barnard Letter and Better Markets Letter.

1063 See Barnard Letter.

1064 See Effective Date and Implementation infra part IX.

apply to security-based swaps. Since existing regulations, including antifraud and anti-manipulation provisions, will apply to security-based swaps, the SEC believes that it is unnecessary to adopt additional anti-evasion rules for security-based swaps under section 761(b)(3) at this time.

VIII. Miscellaneous Issues

A. Distinguishing Futures and Options from Swaps

The Commissions did not propose rules or interpretations in the Proposing Release regarding distinguishing futures from swaps. One commenter requested that the CFTC clarify that nothing in the release was intended to limit a DCM's ability to list for trading a futures contract regardless of whether it could be viewed as a swap if traded over-the-counter or on a SEF, since futures and swaps are indistinguishable in material economic effects.[1065] This commenter further recommended that the CFTC adopt a final rule that further interprets the statutory "swap" definition.[1066]

The CFTC declines to provide the requested clarification or adopt a rule. Prior distinctions that the CFTC relied upon (such as the presence or absence of clearing) to distinguish between futures and swaps may no longer be relevant.[1067] As a result, it is difficult to distinguish between futures and swaps on a blanket basis as the commenter suggested. However,

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1065 See CME Letter.

1066 Id. CME suggested that the CFTC modify the futures contract exclusion in CEA Section 1a(47)(B)(i) so that the modified language would read as follows: (B) EXCLUSIONS.—The term 'swap' does not include— (i) any contract for the sale of a commodity for future delivery listed for trading by a designated contract market (or option on such contract) . . . CME believes that such a rule would clarify the scope of Section 4(a) of the CEA, which makes it illegal to trade a futures contract except on or subject to the rules of a DCM.

CME believed that such a modification would clarify the scope of Section 4(a) of the CEA, 7 U.S.C. 6(a), which makes it unlawful to trade a futures contract except on or subject to the rules of a DCM.

1067 See, e.g., Swap Policy Statement, supra note 214.

a case-by-case approach for distinguishing these products may lead to more informed decision-making by the CFTC. Moreover, the CFTC notes that a DCM may self-certify its contracts pursuant to Part 40 of the CFTC's rules,[1068] subject to the CFTC's oversight authority. If a DCM has a view that a particular product is a futures contract, it may self-certify the contract consistent with that view. The DCM also has a number of other options, including seeking prior approval from the CFTC, requesting an interpretation, or requesting a rulemaking if it is in doubt about whether a particular agreement, contract or transaction should be classified as a futures contract or a swap.

B. Transactions Entered Into by Foreign Central Banks, Foreign Sovereigns, International Financial Institutions, and Similar Entities

The swap definition excludes "any agreement, contract, or transaction a counterparty of which is a Federal Reserve bank, the Federal Government, or a Federal agency that is expressly backed by the full faith and credit of the United States."[1069] Some commenters to the ANPR suggested that the Commissions should exercise their authority to further define the terms "swap" to similarly exclude transactions in which a counterparty is a foreign central bank, a foreign sovereign, an international financial institution ("IFI"),[1070] or similar organization.

1068 17 CFR Part 40.

1069 CEA section 1a(47)(B)(ix), 7 U.S.C. 1a(47)(B)(ix).

1070 For this purpose, we consider the "international financial institutions" to be those institutions defined as such in 22 U.S.C. 262r(c)(2) and the institutions defined as "multilateral development banks" in the Proposal for the Regulation of the European Parliament and of the Council on OTC Derivative Transactions, Central Counterparties and Trade Repositories, Council of the European Union Final Compromise Text, Article 1(4a(a)) (March 19, 2012). There is overlap between the two definitions, but together they include the following institutions: the International Monetary Fund, International Bank for Reconstruction and Development, European Bank for Reconstruction and Development, International Development Association, International Finance Corporation, Multilateral Investment Guarantee Agency, African Development Bank, African Development Fund, Asian Development Bank, Inter-American Development Bank, Bank for Economic Cooperation and Development in the Middle East and North Africa, Inter-American Investment Corporation, Council of Europe Development Bank, Nordic Investment Bank, ANPR commenters advanced international comity, national treatment, limited regulatory resources, limits on the Commissions' respective extraterritorial jurisdiction, and international harmonization as rationales for such an approach. The Proposing Release was silent on this issue.[1071]

Comments

Several commenters asserted that swaps transactions to which an IFI is a counterparty should be excluded from the swap and security-based swap definitions.[1072] In addition to the arguments noted above, commenters asserted that certain IFIs have been granted certain statutory immunities by the United States, and that regulation under the Dodd-Frank Act of their activities would be inconsistent with the grant of these immunities.

The CFTC declines to provide an exclusion from the swap definition along the lines suggested by these commenters.[1073] An exclusion from the swap definition for swap transactions

Caribbean Development Bank, European Investment Bank and European Investment Fund. (The term international financial institution includes entities referred to as multilateral development banks. The International Bank for Reconstruction and Development, the International Finance Corporation and the Multilateral Investment Guarantee Agency are parts of the World Bank Group.) The Bank for International Settlements, which also submitted a comment, is a bank in which the Federal Reserve and foreign central banks are members. Another commenter, KfW, is a corporation owned by the government of the Federal Republic of Germany and the German State governments and backed by the "full faith and credit" of the Federal Republic of Germany.

1071 But see Dissent of Commissioner Sommers, Proposing Release at 29899.

1072 See Letter from Günter Pleines and Diego Devos, Bank for International Settlements, dated July 20, 2011; Letter from Jacques Mirante-Péré and Jan De Bel, Council of Europe Development Bank, dated July 22, 2011; Letter from Isabelle Laurant, European Bank for Reconstruction and Development, dated July 22, 2011; Letter from A. Querejeta and B. de Mazières, European Investment Bank, dated July 22, 2011; Letter from J. James Spinner and Søren Elbech, Inter-American Development Bank, dated July 22, 2011; Letter from Lutze-Christian Funke and Frank Czichowski, KfW, dated August 12, 2011; Letter from Heikki Cantell and Lars Eibeholm, Nordic Investment Bank, dated August 2, 2011; and Letter from Vicenzo La Via, World Bank Group, dated July 22, 2011.

1073 The commenters' suggested exclusion from the swap definition would also exclude their transactions from the security-based swap definition, which is based on the definition of swap.

entered into by foreign sovereigns, foreign central banks, IFIs and similar entities, would mean that swaps entered into by such entities would be completely excluded from Dodd-Frank regulation. Their counterparties, who may be swap dealers or major swap participants, or security-based swap dealers or major security-based swap participants, would have no regulatory obligations with respect to such swaps. These regulated counterparties could develop significant exposures to the foreign sovereigns, foreign central banks, IFIs and similar entities, without the knowledge of the Commissions.

In addition, swaps entered into by foreign sovereigns, foreign central banks, IFIs and similar entities undeniably are swaps. To be sure, the Commissions have adopted rules and interpretations to further define the term "swap" to exclude certain transactions, which prior to the enactment of the Dodd-Frank Act generally would not have been considered swaps. However, the CFTC is not using its authority to further define the term "swap" to effectively exempt transactions that are, in fact, swaps. While, as noted above, Congress included a counterparty-specific exclusion for swaps entered into by the Federal Reserve Board, the Federal government and certain government agencies, Congress did not provide a similar exemption for foreign central banks, foreign sovereigns, IFIs, or similar organizations.

C. Definition of the Terms "Swap" and "Security-Based Swap" as used in the Securities Act

The SEC is adopting a technical rule that provides that the terms "swap" and "security-based swap" as used in the Securities Act[1074] have the same meanings as in the Exchange Act[1075]

1074 See section 2(a)(17) of the Securities Act, 15 U.S.C. 77b(a)(17).

1075 See sections 3(a)(69) of the Exchange Act, 15 U.S.C. 78c(a)(69), and 3(a)(68) of the Exchange Act, 15 U.S.C. 78c(a)(68). The definitions of the terms "swap" and "security-based swap" in the Exchange Act are the same as the definitions of these terms in the CEA. See section 1a of the CEA, 7 U.S.C. 1a.

and the rules and regulations thereunder.[1076] The SEC is adopting such technical rule to assure consistent definitions of these terms under the Securities Act and the Exchange Act.

IX. Effective Date and Implementation

Consistent with sections 754 and 774 of the Dodd-Frank Act, the final rules and interpretations will be effective [INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]. The compliance date for the final rules and interpretations also will be [INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]; with the following exceptions:

- The compliance date for the interpretation regarding guarantees of swaps will be the effective date of the rules proposed in the separate CFTC release when such rules are adopted by the CFTC.
- Solely for the purposes of the Order Granting Temporary Exemptions under the Securities Exchange Act of 1934 in Connection with the Pending Revision of the Definition of "Security" to Encompass Security-Based Swaps[1077] and the Exemptions for Security-Based Swaps,[1078] the compliance date for the final rules

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1076 See rule 194 under the Securities Act.

1077 76 FR 39927 (Jul. 7, 2011) ("Exchange Act Exemptive Order"). The Exchange Act Exemptive Order grants temporary relief and provides interpretive guidance to make it clear that a substantial number of the requirements of the Exchange Act do not apply to security-based swaps as a result of the revised definition of "security" going into effect on July 16, 2011. The Exchange Act Exemptive Order also provided temporary relief from provisions of the Exchange Act that allow the voiding of contracts made in violation of those laws.

1078 Rule 240 under the Securities Act, 17 CFR 230.240, rules 12a-11 and 12h-1(i) under the Exchange Act 1934, 17 CFR 240.12a-11 and 240.12h-1(i), and Rule 4d-12 under the Trust Indenture Act of 1939, 17 CFR 260.4d-12 ("SB Swaps Interim Final Rules"). See also 76 FR 40605 (Jul. 11, 2011). The SB Swaps Interim Final Rules provide exemptions under the Securities Act, the Exchange Act, and the Trust Indenture Act of 1939 for those security-based swaps that prior to July 16, 2011, were security-based swap agreements and are defined as "securities" under the Securities Act and the Exchange Act as of July 16, 2011, due solely to the provisions of the Dodd-Frank Act. The SB Swaps Interim Final Rules exempt offers and sales of further defining the term "security-based swap" will be [INSERT DATE 180 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

The CFTC believes that it is appropriate to make the compliance date for the interpretation regarding guarantees of swaps the same as the effective date of the rules proposed in the separate CFTC release when such rules are adopted by the CFTC in order to relieve market participants from compliance obligations that would arise as a result of the interpretation. As described in the Exchange Act Exemptive Order and as provided in the SB Swaps Interim Final Rules, the exemptions granted pursuant to the Exchange Act Exemptive Order and the SB Swaps Interim Final Rules will expire upon the compliance date of the final rules further defining the terms "security-based swap" and "eligible contract participant." The final rules further defining the term "eligible contract participant," adopted in the Entity Definitions Release,[1079] were published in the Federal Register on May 23, 2012. The compliance date and the effective date for such final rules is the same, July 23, 2012. The SEC believes that establishing a compliance date for the definition of "security-based swap" solely for purposes of the Exchange Act Exemptive Order and the SB Swaps Interim Final Rules that is [INSERT DATE 180 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER] (i.e. 120 days after the effective date) is appropriate because doing so will leave in place the exemptions granted by the Exchange Act Exemptive Order and the SB Swaps Interim Final Rules for a period of time that is sufficient to facilitate consideration of that order and rule. Specifically, the SEC will consider the appropriate treatment of security-based swaps under the

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these security-based swaps from all provisions of the Securities Act, other than the Section 17(a) anti-fraud provisions, as well as exempt these security-based swaps from Exchange Act registration requirements and from the provisions of the Trust Indenture Act of 1939, provided certain conditions are met.

1079 See supra note 12.

provisions of the Exchange Act not amended by the Dodd-Frank Act before expiration of the exemptions set forth in the Exchange Act Exemptive Order, and will consider the appropriate treatment of security-based swaps for purposes of the registration provisions of the Securities Act, the registration provisions of the Exchange Act, and the indenture qualification provisions of the Trust Indenture Act of 1939 before the expiration of the exemptions set forth in the SB Swaps Interim Final Rules.[1080]

If any provision of these final rules or interpretations, or the application thereof to any person or circumstance, is held to be invalid, such invalidity shall not affect other provisions or application of such provisions to other persons or circumstances that can be given effect without the invalid provision or application.

X. Administrative Law Matters – CEA Revisions

A. Paperwork Reduction Act

1. Introduction

The Paperwork Reduction Act of 1995 ("PRA") imposes certain requirements on Federal agencies in connection with their conducting or sponsoring any collection of information as defined by the PRA.[1081] An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

[1080] The SEC has received a request for certain permanent exemptions upon the expiration of the exemptions contained in the Exchange Act Exemptive Order. See SIFMA SBS Exemptive Relief Request (Dec. 5, 2011), which is available at http://www.sec.gov/comments/s7-27-11/s72711-10.pdf. The SEC also has received comments regarding the exemptions under the Securities Act, the Exchange Act, and the Trust Indenture Act of 1939. See Letter from Kenneth E. Bentsen, Jr., Executive Vice President, Public Policy and Advocacy, SIFMA, and Robert Pickel, Chief Executive Officer, ISDA, dated Apr. 20, 2012, which is available at http://www.sec.gov/comments/s7-26-11/s72611-5.pdf. The SEC is reviewing the request for exemptive relief and each related comment and will consider any appropriate actions regarding such request.

[1081] 44 U.S.C. 3501 et seq.

Certain provisions of this rule will result in new collection of information requirements within the meaning of the PRA. With the exception of the new "book-out" confirmation requirement discussed below, the CFTC believes that the burdens that will be imposed on market participants under rules 1.8 and 1.9 already have been accounted for within the SEC's calculations regarding the impact of this collection of information under the PRA and the request for a control number submitted by the SEC to OMB for rule 3a68-2 ("Interpretation of Swaps, Security-Based Swaps, and Mixed Swaps") and rule 3a68-4 ("Regulation of Mixed Swaps: Process for Determining Regulatory Treatment for Mixed Swaps"). In response to this submission, OMB issued control number 3235-0685. The responses to these collections of information will be mandatory.[1082] The CFTC will protect proprietary information according to the Freedom of Information Act and 17 CFR part 145, headed "Commission Records and Information." In addition, the CFTC emphasizes that section 8(a)(1) of the CEA[1083] strictly prohibits the Commission, unless specifically authorized by the CEA, from making public "data and information that would separately disclose the business transactions or market positions of any person and trade secrets or names of customers." The CFTC also is required to protect certain information contained in a government system of records pursuant to the Privacy Act of 1974.

2. Rules 1.8 and 1.9

As discussed in the proposal, Rules 1.8 and 1.9 under the CEA will result in new "collection of information" requirements within the meaning of the PRA. Rule 1.8 under the CEA will allow persons to submit a request for a joint interpretation from the Commissions

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1082 As discussed below, the "collection of information" related to the new "book out" confirmation requirement was not included in the SEC's submission and will be the subject of a request for a control number by the CFTC to OMB.

1083 7 U.S.C. 12(a)(1).

regarding whether an agreement, contract or transaction (or a class thereof) is a swap, security-based swap, or mixed swap. Rule 1.8 provides that a person requesting an interpretation as to the nature of an agreement, contract, or transaction as a swap, security-based swap, or mixed swap must provide the Commissions with the person's determination of the nature of the instrument and supporting analysis, along with certain other documentation, including a statement of the economic purpose for, and a copy of all material information regarding the terms of, each relevant agreement, contract, or transaction (or class thereof). The Commissions also may request the submitting person to provide additional information. In response to the submission, the Commissions may issue a joint interpretation regarding the status of that agreement, contract, or transaction (or class of agreements, contracts, or transactions) as a swap, security-based swap, or mixed swap.

Rule 1.9 of the CEA enables persons to submit requests to the Commissions for joint orders providing an alternative regulatory treatment for particular mixed swaps. Under rule 1.9, a person will provide to the Commissions a statement of the economic purpose for, and a copy of all material information regarding, the relevant mixed swap. In addition, the person will provide the specific alternative provisions that the person believes should apply to the mixed swap, the reasons the person believes it would be appropriate to request an alternative regulatory treatment, and an analysis of: i) the nature and purposes of the specified provisions; ii) the comparability of the specified provisions to other statutory provisions of Title VII of the Dodd-Frank Act and the rules and regulations thereunder; and iii) the extent of any conflicting or incompatible requirements of the specified provisions and other statutory provisions of Title VII and the rules and regulations thereunder. The Commissions also may request the submitting person to provide additional information.

a) Information Provided by Reporting Entities

The burdens imposed by rules 1.8 and 1.9 under the CEA are the same as the burdens imposed by the SEC's rules 3a68-2 and 3a68-4. Therefore, the burdens that will be imposed on market participants under rules 1.8 and 1.9 already have been accounted for within the SEC's calculations regarding the impact of this collection of information under the PRA and the request for a control number submitted by the SEC to OMB.[1084]

b) Information Collection Comments

In the Proposing Release, the CFTC invited public comment on the reporting and recordkeeping burdens discussed above with regard to rules 1.8 and 1.9. Pursuant to 44 U.S.C. 3506(c)(2)(B), the CFTC solicited comments in order to: i) evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the CFTC, including whether the information will have practical utility; ii) evaluate the accuracy of the CFTC's estimate of the burden of the proposed collections of information; iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and iv) minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

No comments were received with respect to the reporting and recordkeeping burdens discussed in the proposing release. In response to the request for a control number by the SEC, OMB issued control number 3235-0685.

3. Book-Out Confirmation

1084 44 U.S.C. 3501-3521. See also 44 U.S.C. 3509 and 3510.

As noted above, the CFTC believes that its interpretation which clarifies that oral book-out agreements must be followed in a commercially reasonable timeframe by a confirmation in some type of written or electronic form would result in a new "collection of information" requirement within the meaning of the PRA. Therefore, the CFTC is submitting the new "book-out" information collection to OMB for review in accordance with 44 U.S.C. 3506(c)(2)(A) and 5 CFR 1320.8(d). The CFTC will, by separate action, publish in the Federal Register a notice on the paperwork burden associated with the interpretation's requirement that oral book-outs be followed in a commercially reasonable timeframe by confirmation in some type of written or electronic form in accordance with 5 CFR 1320.8 and 1320.10. If approved, this new collection of information will be mandatory.

B. Regulatory Flexibility Act

The Regulatory Flexibility Act ("RFA") requires that agencies consider whether the rules they propose will have a significant economic impact on a substantial number of small entities and, if so, provide a regulatory flexibility analysis respecting the impact.[1085] A regulatory flexibility analysis or certification typically is required for "any rule for which the agency publishes a general notice of proposed rulemaking pursuant to" the notice-and-comment provisions of the Administrative Procedure Act, 5 U.S.C. 553(b).

With respect to the proposed release, while the CFTC provided an RFA statement that the proposed rule would have a direct effect on numerous entities, specifically DCMs, SDRs, SEFs, SDs, MSPs, ECPs, FBOTs, DCOs, and certain "appropriate persons" who relied on the Energy Exemption,[1086] the Chairman, on behalf of the CFTC, certified that the rulemaking would not

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[1085] 5 U.S.C. 601 et seq.

[1086] See 76 FR 29868 – 89.

have a significant economic effect on a substantial number of small entities. Comments on that certification were sought.

In the Proposing Release, the CFTC provided that it previously had established that certain entities subject to the CFTC's jurisdiction – namely, DCMs, DCOs and ECPs – are not small entities for purposes of the RFA.[1087] As the CFTC previously explained, because of the central role they play in the regulatory scheme concerning futures trading, the importance of futures trading in the national economy, and the financial requirements needed to comply with the regulatory requirements imposed on them under the CEA, DCMs and DCOs have long been determined not to be small entities.[1088] Based on the definition of ECP in the Commodity Futures Modernization Act of 2000 ("CFMA") and the legislative history underlying that definition, the CFTC determined that ECPs were not small entities.[1089] In light of its past determination, and the increased thresholds on ECPs added by the Dodd-Frank Act making it more difficult for entities to qualify as an ECP, the CFTC determined in its proposed rulemakings that ECPs are not small entities.

Furthermore, the CFTC provided that certain entities that would be subject to the proposed rule – namely SDs, MSPs, SDRs, SEFs, and FBOTs – are entities for which the CFTC had not previously made a size determination for RFA purposes. The CFTC determined that these entities should not be considered small entities based on their size and characteristics

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1087 See respectively, Policy Statement and Establishment of Definitions of "Small Entities" for Purposes of the Regulatory Flexibility Act, supra note 331, at 18619 (DCMs); A New Regulatory Framework for Clearing Organizations, 66 FR 45604, 45609 (Aug. 29, 2001) (DCOs); Opting Out of Segregation, 66 FR 20740, 20743 (Apr. 25, 2001) (ECPs).

1088 See respectively, Policy Statement and Establishment of Definitions of "Small Entities" for Purposes of the Regulatory Flexibility Act, supra note 331, at 18619 (DCMs); A New Regulatory Framework for Clearing Organizations, 66 FR 45604, 45609, Aug. 29, 2001 (DCOs).

1089 See Opting Out of Segregation. 66 FR 20740, 20743, Apr. 25, 2001 (ECPs).

analogous to non-small entities that pre-dated the adoption of Dodd-Frank,[1090] and certified in rulemakings that would have an economic impact on these entities that these entities are not small entities for RFA purposes.[1091]

Finally, the CFTC recognized that, in light of the CFTC's proposed withdrawal of the Energy Exemption, the proposed rule could have an economic impact on certain "appropriate persons" who relied on the Energy Exemption. The Energy Exemption listed certain "appropriate persons" that could rely on the exemption and also required that, to be eligible for this exemption, an "appropriate person must have demonstrable capacity or ability to make or take delivery. The Energy Exemption stated: "in light of the general nature of the current participants in the market, the CFTC believes that smaller commercial firms, which cannot meet [certain] financial criteria, should not be included."[1092] Therefore, the CFTC did not believe that the "appropriate persons" eligible for the Energy Exemption, and who may be affected by its withdrawal, are "small entities" for purposes of RFA. Moreover, as previously discussed, the CFTC is expanding the Brent Interpretation to all nonfinancial commodities for both swaps and future delivery definitions and is clarifying that certain alternative delivery procedures discussed in the Energy Exemption will not disqualify a transaction from the forward contract exclusion under the Brent Interpretation.[1093] Thus, to the extent any entities, small or otherwise, relied on

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1090 See 76 FR 29868 – 89.

1091 See respectively, Registration of Swap Dealers and Major Swap Participants, 77 FR 2613, 2620, Jan. 19, 2012 (swap dealers and major swap participants); Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, 75 FR 63732, 63745, Oct. 18, 2010 (SEFs); Swap Data Repositories, 76 FR 54538, 54575, Sept. 1, 2011; Registration of Foreign Boards of Trade, 76 FR 80674, 80698, Dec. 23, 2011 (FBOTs).

1092 Energy Exemption, supra note 207.

1093 See supra part II.B.2.a)i)(C).

the Energy Exemption, such entities can now rely on the expanded Brent Interpretation to qualify for the forward contract exclusion. Accordingly, the withdrawal of the Energy Exemption will not result in a significant economic impact on any entities.

With respect to this rulemaking, which includes interpretations, as well as general rules of construction and definitions that will largely be used in other rulemakings, the CFTC received one comment respecting its RFA certification. The commenter, an association that represents producers, generators, processors, refiners, merchandisers and commercial end users of nonfinancial energy commodities, including energy and natural gas, contended that the CFTC's overall new jurisdiction under the Dodd-Frank Act over "swaps" and the burdens that the CFTC's rules place on nonfinancial entities, including small entities such as its members[1094] that execute such swaps, can only be determined after the rules and interpretations in the product definitions rulemaking are finalized. Moreover, the commenter asserted that its small entity members seek to continue their use of nonfinancial commodity "swaps" only to hedge the commercial risks of their not-for profit public service activities. The commenter concluded that the CFTC should conduct a regulatory flexibility analysis for the entire mosaic of its rulemakings under the Dodd-Frank Act, taking into consideration the products definition rulemaking.

The commenter did not provide specific information on how the further defining of the terms swap, security-based swap and security-based swap agreement, providing regulations regarding mixed swaps, and providing regulations governing books and records requirements for security-based swap agreements would have a significant impact on a substantial number of

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1094 See ETA Letter. In general, ETA states that the Small Business Administration ("SBA") has determined that many of its members are "small entities" for purposes of the RFA. Id. (references the comment letter filed by the NRECA, APPA and LLPC as the "Not-for-Profit Electric Coalition" in response to the Commodity Option NOPR's (76 FR 6095) assertion that there are no ECPs that are "small entities" for RFA purposes).

small entities. Nonetheless, the CFTC has reevaluated this rulemaking in light of the commenter's statements. Upon consideration, the CFTC declines to consider the economic impacts of the entire mosaic of rules under the Dodd-Frank Act, since an agency is only required to consider the impact of how it exercises its discretion to implement the statute through a particular rule. In all rulemakings, the CFTC performs an RFA analysis for that particular rule.

Moreover, as the commenter mentioned, most of the transactions into which its members enter are based on nonfinancial commodities. The CFTC has provided interpretations in this release clarifying the forward exclusion in nonfinancial commodities from the swap definition (and the forward exclusion from the definition of "future delivery"), including forwards with embedded volumetric options, and separately, has provided for a trade option exemption.[1095] The CFTC also has provided an interpretation that certain customary commercial transactions are excluded from the swap definition.[1096]

Accordingly, for the reasons stated in the proposal and the foregoing discussion in response to the comment received, the CFTC continues to believe that the rulemaking will not have a significant impact on a substantial number of small entities. Therefore, the Chairman, on behalf of the CFTC, hereby certifies pursuant to 5 U.S.C. 605(b) that the rules will not have a significant impact on a substantial number of small entities.

C. Costs and Benefits Considerations

1095 See Commodity Options, 77 FR 25320, Apr. 27, 2012.

1096 To the extent the transactions entered into by ETA members are traded or executed on Regional Transmission Organizations and Independent System Operators, or entered into between entities described in section 201(f) of the Federal Power Act, they may be addressed through the public interest waiver process described in CEA section 4(c)(6).

Section 15(a) of the CEA requires the CFTC to consider the costs and benefits of its actions before promulgating a regulation or issuing certain orders under the CEA.[1097] Section 15(a) further specifies that the costs and benefits shall be evaluated in light of the following five broad areas of market and public concern: (1) protection of market participants and the public; (2) efficiency, competitiveness, and financial integrity of markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. The CFTC considers the costs and benefits resulting from its discretionary determinations with respect to the Section 15(a) factors. The CFTC also considers, qualitatively, costs and benefits relative to the status quo, that is, the pre-Dodd Frank Act regulatory regime, for historical context to help inform the reader.

In the Proposing Release, the CFTC assessed the costs and benefits of the proposed rules in general, followed by assessments of the costs and benefits of each of the rules, taking into account the considerations described above. The CFTC also requested comment on these assessments, and a number of comments were received. In this Adopting Release, the CFTC will again assess the costs and benefits of the rules in general followed by the individual rules in this rulemaking, for each case taking into account the above considerations and the comments received. These costs and benefits, to the extent identified and, where possible, quantified have helped to inform the decisions of and the actions taken by the CFTC that are described throughout this release.

1. Introduction

Prior to the adoption of Title VII, swaps and security-based swaps were by and large unregulated. The Commodity Futures Modernization Act of 2000 ("CFMA") excluded financial

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[1097] 7 U.S.C. 19(a).

over-the-counter swaps from regulation under the CEA, provided that trading occurred only among "eligible contract participants."[1098] Swaps based on exempt commodities -- including energy and metals – could be traded among ECPs without CFTC regulation, but certain CEA provisions against fraud and manipulation continued to apply to these markets. No statutory exclusions were provided for swaps on agricultural commodities by the CFMA, although they could be traded under certain regulatory exemptions provided by the CFTC prior to its enactment. Swaps based on securities were subject to certain SEC enforcement authorities, but the SEC was prohibited from prophylactic regulation of such swaps.

In the fall of 2008, an economic crisis threatened to freeze U.S. and global credit markets. The federal government intervened to buttress the stability of the U.S. financial system.[1099] The crisis revealed the vulnerability of the U.S. financial system and economy to wide-spread systemic risk resulting from, among other things, poor risk management practices of certain financial firms and the lack of supervisory oversight for financial institutions as a whole.[1100] More specifically, the crisis demonstrated the need for regulation of the over-the-counter derivatives markets.[1101]

1098 See 7 U.S.C. 1a(12) (2006).

1099 On October 3, 2008, President Bush signed the Emergency Economic Stabilization Act of 2008, which was principally designed to allow the U.S. Treasury and other government agencies to take action to help to restore liquidity and stability to the U.S. financial system (e.g., the Trouble Asset Relief Program—also known as TARP—under which the U.S. Treasury was authorized to purchase up to $700 billion of troubled assets that weighed down the balance sheets of U.S. financial institutions). See Pub. L. 110-343, 122 Stat. 3765 (2008).

1100 See Financial Crisis Inquiry Commission, "The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States," Jan. 2011, at xxvii, available at http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

1101 Id. at 25 (concluding that "enactment of . . . [the Commodity Futures Modernization Act of 2000 ("CFMA")] to ban the regulation by both the federal and state governments of over-the-counter (OTC) derivatives was a key turning point in the march toward the financial crisis."). See also id.

On July 21, 2010, President Obama signed the Dodd-Frank Act into law. Title VII of the Dodd-Frank Act established a comprehensive new regulatory framework for swaps and security-based swaps. As discussed above, the legislation was enacted, among other reasons, to reduce risk, increase transparency, and promote market integrity within the financial system, including by: (i) providing for the registration and comprehensive regulation of swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants; (ii) imposing clearing and trade execution requirements on swaps and security-based swaps, subject to certain exceptions; (iii) creating rigorous recordkeeping and real-time reporting regimes; and (iv) enhancing the rulemaking and enforcement authorities of the Commissions with respect to, among others, all registered entities and intermediaries subject to the Commissions' oversight.[1102]

Section 721 of the Dodd-Frank Act amends the Commodity Exchange Act ("CEA") by adding definitions of the terms "swap," "security-based swap," and "security-based swap agreement." Section 712(d)(1) provides that the CFTC and the SEC, in consultation with the

at 343 ("Lehman, like other large OTC derivatives dealers, experienced runs on its derivatives operations that played a role in its failure. Its massive derivatives positions greatly complicated its bankruptcy, and the impact of its bankruptcy through interconnections with derivatives counterparties and other financial institutions contributed significantly to the severity and depth of the financial crisis.") and id. at 353 ("AIG's failure was possible because of the sweeping deregulation of [OTC] derivatives, [...] including capital and margin requirements that would have lessened the likelihood of AIG's failure. The OTC derivatives market's lack of transparency and of effective price discovery exacerbated the collateral disputes of AIG and Goldman Sachs and similar disputes between other derivatives counterparties.").

1102 The CFTC has provided a table in the Appendix that cross-references the costs and benefits considerations of the final rules effectuated by the Product Definitions in order to provide more transparency with respect to this qualitative assessment of the programmatic costs. See Appendix, "Rules Effectuated by Product Definitions." The CFTC is not providing a quantitative estimate of total programmatic costs, because it cannot be reliably estimated at this time. Many rules have not been finalized, including capital and margin which may have significant costs. Any estimate made of the programmatic costs of the Product Definitions would be unreliable and therefore may be misleading.

Federal Reserve Board, shall jointly further define those terms. Section 712(a)(8) provides further that the Commissions shall jointly prescribe such regulations regarding "mixed swaps" as may be necessary to carry out the purposes of Title VII of the Dodd-Frank Act ("Title VII"). Section 712(d)(2) requires the Commissions, in consultation with the Federal Reserve Board, to jointly adopt rules governing books and records requirements for security-based swap agreements.

Under the comprehensive framework for regulating swaps and security-based swaps established in Title VII, the CFTC is given regulatory authority over swaps, the SEC is given regulatory authority over security-based swaps, and the Commissions jointly are to prescribe such regulations regarding mixed swaps as may be necessary to carry out the purposes of Title VII. In addition, the SEC is given antifraud authority over, and access to information from, certain CFTC-regulated entities regarding security-based swap agreements, which are a type of swap related to securities over which the CFTC is given regulatory and enforcement authority.

The statutory definitions of "swap" and "security-based swap" in Title VII are detailed and comprehensive. The Dodd-Frank Act directs the Commissions, among other things, to "further define" these terms; it does not direct the Commissions to provide definitions for them, which are already provided for in the statute. Thus, even in the absence of these rules, the Dodd-Frank Act would require regulating products that meet the statutory definitions of these terms as swaps and security-based swaps. Consequently, a large part of the costs and benefits resulting from the regulation of swaps and security-based swaps derives from the Dodd-Frank Act itself and not from these rules that further define swaps.

Several commenters to the ANPR issued by the Commissions regarding the definitions expressed a concern that the product definitions could be read broadly to include certain types of transactions that previously had never been considered swaps or security-based swaps. In response to those comments, the rules and interpretations clarify that certain traditional insurance products, consumer and commercial agreements, and loan participations are not swaps or security-based swaps, which will increase legal certainty and lower the costs of assessing whether a product is a swap or security-based swap for market participants. In this regard, the rules and interpretations are intended to reduce unnecessary burdens on persons using such agreements, contracts, or transactions, the regulation of which under Title VII may not be necessary or appropriate to further the purposes of Title VII.

In addition, the CFTC is clarifying the scope of the forward contract exclusion[1103] for nonfinancial commodities from the statutory swap definition to provide legal certainty for market participants as to which transactions will qualify for the exclusion. In this regard, the CFTC is clarifying the circumstances under which market participants may rely on past CFTC guidance regarding the forward exclusion from the definition of "future delivery," and in particular the Brent Interpretation for booked-out transactions,[1104] with respect to the forward exclusion from the swap definition. The CFTC is extending the Brent Interpretation to all nonfinancial commodities, and is withdrawing the Energy Exemption as proposed,[1105] with certain clarifications. The final interpretation with clarifications in response to comments should enhance legal certainty regarding the forward exclusions.

While the statutory definitions of swap and security-based swap are detailed and comprehensive, the rules further clarify whether particular types of transactions are swaps or

1103 See supra part II.B.2.a).

1104 See supra part II.B.2.a)i)(B).

1105 See supra part II.B.2.a)i)(C).

security-based swaps. For example, foreign exchange forwards and swaps are defined as swaps, subject to the Treasury Secretary's determination to exempt them from the swap definition. The statute provides that certain provisions of the CEA apply to foreign exchange forwards and swaps, even if the Treasury Secretary determines to exempt them, and the rules reflect this. Specifically, these transactions still would be subject to certain requirements for reporting swaps, and swap dealers and major swap participants engaging in such transactions still would be subject to certain business conduct standards. The rules also clarify that, because certain foreign exchange products do not fall within the definitions of foreign exchange swap and forward, such products are not subject to the Treasury Secretary's determination to exempt. Outside of the foreign exchange suite of products, the rules and interpretations clarify that certain transactions are swaps or security-based swaps. These products include forward rate agreements, certain contracts for differences, swaptions and forward swaps. The rules and the interpretations are intended to increase clarity and legal certainty for market participants with respect to these products.

Next this release addresses the relationship between swaps and security-based swaps and how to distinguish them. The Commissions are clarifying whether particular agreements, contracts or transactions that are subject to Title VII of the Dodd-Frank Act (which are referred to as "Title VII Instruments" in this release) are swaps, security-based swaps or both (i.e., mixed swaps). In addition, the Commissions are clarifying the use of the term "narrow-based security index" in the security-based swap definition. In general, the CFTC has jurisdiction over Title VII instruments on broad-based security indexes, while the SEC has jurisdiction over Title VII instruments on narrow-based security indexes. This release clarifies that the existing criteria for determining whether a security index is narrow-based, and the past guidance of the Commissions regarding those criteria in the context of security futures, apply to Title VII instruments. Credit default swaps ("CDS") also are subject to this same jurisdictional division – CDS on broad-based security indexes are regulated by the CFTC, while CDS on narrow-based security indexes (as well as CDS on single name securities or loans) generally are regulated by the SEC. This release provides new criteria tailored to CDS for determining whether a CDS is based on an index that is a narrow-based security index. Also, it explains the term "index" and adopts a final rule governing tolerance and grace periods for Title VII instruments on security indexes traded on trading platforms. These rules and interpretations generally are designed to provide clarity and enhanced legal certainty regarding the appropriate classification of Title VII instruments as swaps, security-based swaps or mixed swaps, so that market participants may ascertain the applicable regulatory requirements more easily.

This release anticipates that mixed swaps, which are both swaps and security-based swaps, will be a narrow category, but lists a few examples of mixed swaps and interprets how to distinguish one type of TRS that is a mixed swap from another that is not. This release addresses the regulatory treatment of bilateral, uncleared mixed swaps where one counterparty is a dual registrant with the CFTC and SEC. It also establishes a process for requesting a joint order from the Commissions to determine the appropriate regulatory treatment of mixed swaps that do not fall into the category of mixed swaps where one counterparty is a dual registrant. Concerning "security-based swap agreements" (or SBSAs), this release explains what types of transactions are SBSAs and includes rules that provide that there will not be additional books and records requirements regarding SBSAs other than those that have been proposed by the CFTC for swaps in order to avoid duplicative regulation and costs.

This release also includes rules establishing a process for members of the public to request a joint interpretation from the Commissions regarding whether a Title VII instrument is a swap, security-based swap or a mixed swap. The process includes a deadline for a decision, as well as a requirement that if the Commissions do not issue a joint interpretation within the prescribed time period, each Commission must publicly provide the reasons for not having done so.

Finally, this release includes anti-evasion rules and related interpretations adopted by the CFTC, which in general would apply to agreements, contracts, transactions and entities that are willfully structured to evade Dodd-Frank requirements.

2. Costs and Benefits of the Definitions--In General

The rules and interpretations in this Adopting Release: further define the terms "swap," "security-based swap," and "security-based swap agreement;" provide for the regulation of "mixed swaps;" and address books and records requirements for security-based swap agreements. In the discussion that follows, the CFTC considers the costs and benefits resulting from its own discretionary determinations with respect to the section 15(a) factors.

There are "programmatic" costs and benefits as well as "assessment" costs of the Product Definitions. Programmatic costs result from subjecting certain agreements, contracts, or transactions to the regulatory regime of Title VII.[1106] Effectiveness of the Products Definitions will trigger effectiveness of any statutory provision or regulation that depends, in whole or in part, on the effectiveness of this final rulemaking. By fulfilling the statutory mandate, many of the programmatic benefits of Title VII and the CFTC's implementing regulations are triggered, including risk reduction, increasing transparency, and promoting market integrity and, by

[1106] See Appendix, "Rules Effectuated by Product Definitions."

extension, the increased possibility of preventing or reducing the severity of another global financial crisis such as occurred in 2008. Delimiting the scope of the terms "swap," "security-based swap," "security-based swap agreement," and "mixed swaps" also helps to determine the scope of activities and entities that will be subject to the various Title VII regulatory requirements. Requirements for clearing and trade execution, capital and margin, business conduct, and reporting and recordkeeping, all of which have been or will be implemented in other CFTC rules, will lead to programmatic costs that have been or will be addressed in the CFTC's rules to implement those requirements. When considering the programmatic costs and benefits of the Product Definitions, the CFTC recognizes the scope of activities and entities affected by the further Product Definitions by reference to the other final rulemakings under Title VII accomplished to date. The costs that parties will incur to assess whether certain agreements, contracts, or transactions are "swaps," "security-based swaps," "security-based swap agreements," or "mixed swaps" that are subject to the Title VII regulatory regime, and, if so, costs to assess whether such Title VII instrument is subject to the regulatory regime of the SEC or the CFTC are referred to herein as assessment costs.

In general, many commenters have suggested that the statutory definitions of swap and security-based swap are overbroad in that they could be viewed to include agreements, contract, and transactions that the market had not considered to be swaps or security-based swaps prior to the enactment of the Dodd-Frank Act, are (or could be) swaps or security-based swaps. Thus, in response to these comments, the CFTC has engaged in a qualitative analysis of various agreements, contracts, and transactions of which the CFTC is aware and that commenters have brought to its attention. Based on this analysis, the CFTC has established rules and interpretations to identify agreements, contracts, and transactions that are swaps or security-based swaps where the statutory definition may be inadequate or ambiguous. In developing the further definitions, the CFTC has endeavored to narrow the scope of the terms "swap" and "security-based swap" without excluding agreements, contracts and transactions that the CFTC has determined should be regulated as swaps and security-based swaps. Narrowing the scope of the statutory definitions should reduce the overall programmatic costs of Title VII because fewer agreements, contracts, and transactions will be subject to the full panoply of Title VII regulation. Narrowing the scope of the statutory definitions should also increase the net programmatic benefits of the CFTC's Title VII regulations because the CFTC is targeting in the Product Definitions rulemaking agreements, contracts and transactions that the CFTC has determined, after considering comments received and undertaking a qualitative analysis, are swaps or security-based swaps. The CFTC anticipates that applying the full panoply of Title VII regulation to only those agreements, contracts or transactions that the CFTC has determined are swaps or security-based swaps will be most effective in achieving the net benefits of Title VII regulation under the Dodd-Frank Act.

a) Costs

The scope of the terms "swap," "security-based swap," "security-based swap agreement," and "mixed swap" is an important factor in determining the range of activities and entities that will be subject to various requirements set forth in the Dodd-Frank Act, such as trade execution, clearing, reporting, registration, business conduct, and capital requirements. Complying with these requirements, which will be implemented in other rules by the CFTC, are programmatic costs, which also have been or will be addressed in the CFTC's rules to implement those requirements.[1107]

[1107] See Appendix, "Rules Effectuated by Product Definitions."

The CFTC believes that the rulemaking to further define the terms "swap," "security-based swap," "security-based swap agreement," and "mixed swap" is consistent with how market participants understand these products. The further definitions increase legal certainty and thereby reduce assessment costs by clarifying that certain products that meet the requirements of the applicable rules and interpretations, such as traditional insurance products, are not swaps.

b) Benefits

Many of the benefits of Title VII and the CFTC's implementing regulations, including risk reduction, increasing transparency, and promoting market integrity are programmatic benefits of the Products Definitions since they are effectuated by Product Definitions. These programmatic benefits are difficult to quantify and measure. Moreover, these benefits can be expected to manifest themselves over the long run and be distributed over the market as a whole.

The CFTC believes that the final rules and interpretations can be consistently applied by substantially all market participants to determine which agreements, contracts, or transactions are, and which are not, swaps, security-based swaps, security-based swap agreements, or mixed swaps. The benefits of the individual rules and interpretations are discussed in their respective sections below.

c) Comments and Consideration of Alternatives

The CFTC requested comment on the costs and benefits of the proposed rules and interpretations regarding the definitions in general for market participants, markets and the public. Further, the CFTC requested comment as to whether there are any aspects of the proposed rules and interpretive guidance regarding the definitions that are both burdensome to apply and not helpful to achieving clarity as to the scope of the defined terms, and whether there are less burdensome means of providing clarity as to the scope of the defined terms.

A commenter[1108] argued that a proper cost-benefit analysis can only be performed once an integrated and complete mosaic of rules is available for analysis and doubted that the definitions impose no independent costs. The CFTC has considered, qualitatively, the costs and benefits of the entire mosaic of CFTC rules under the Dodd-Frank Act in this rulemaking. Due to data limitations and other uncertainty, the CFTC cannot perform a meaningful quantitative analysis, yet. The CFTC considers in this rulemaking the costs and benefits of how the Commissions are exercising their discretion in further defining the Product Definitions because Congress included in the Dodd-Frank Act statutory definitions of these terms, over which the CFTC has no discretion. Moreover, the CFTC has considered the independent costs (i.e. costs imposed through exercising its discretion) that the Products Definitions may impose through its determinations as discussed below.

Another commenter[1109] contended that the costs and benefits considerations in the Proposing Release were not based on any empirical data and are not consistent with the expected costs of compliance anticipated by market participants. However, the CFTC cannot do a comprehensive empirical analysis regarding costs and benefits of the Products Definitions before actual data is available when the swap regulatory regime has been implemented in full. Moreover, the CFTC did use some empirical estimates in its costs and benefits considerations in the Proposing Release, namely in assessment costs for the process to seek an interpretation of whether a product is a swap, security-based swap, or mixed swap, as well as in the process to

1108 See ETA Letter. See also IECA Letter II (requesting a comprehensive costs benefits analysis on all of Title VII).

1109 See WGCEF Letter.

determine regulatory treatment for mixed swaps.[1110] Commenters did not submit data or other information to support an argument that the CFTC's estimates were inaccurate.

Commenters[1111] expressed concern about costs from regulatory uncertainty imposed on swaps market participants resulting from other Title VII rulemakings not yet being final. The consideration of thousands of letters and the process of due deliberation and reasoned decision-making by the CFTC has caused delays. Nevertheless, the CFTC is working with deliberate speed to complete the rulemakings, and eventually this particular type of legal uncertainty will be eliminated.

A commenter[1112] requested that inter-affiliate swaps be exempt from the swap definition, arguing that regulating such swaps may increase costs to consumers and undermine efficiencies from the use of centralized hedging affiliates. The CFTC anticipates that it will address inter-affiliate swaps in a subsequent rulemaking.

Several commenters[1113] argued that foreign central banks, foreign sovereigns, international financial institutions, such as multilateral development banks, and similar organizations should be exempt from swap regulations, since regulations would impose costs on these entities. Specifically, a commenter[1114] asserted that multilateral development banks should not have to register or be subject to clearing and margin requirements and requested that multilateral development banks' transactions be exempted from the definition of a swap. As explained above, these transactions are swaps. In addition, the proposed exclusion is overbroad

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1110 See Proposing Release at 29874.

1111 See FIA Letter; IIB Letter; and ISDA Letter.

1112 See Shell Trading Letter.

1113 See CEB Letter; EIB Letter; and World Bank Letter.

1114 See World Bank Letter.

because it would mean that swaps and security-based swaps entered into by foreign central banks, foreign sovereigns, international financial institutions, and similar organizations would be completely excluded from Dodd-Frank regulation. Their counterparties, who may be swap dealers and other regulated entities, would have no regulatory obligations with respect to such swaps, and could develop significant exposures without the knowledge of the CFTC, other regulators and market participants. If these transactions were not swaps, then no market participant would be obligated to report them to a U.S.-registered swap data repository or real-time report them. This lack of transparency might distort swap pricing and impede proper risk management in as much as the market may not be aware of the risk entailed in these opaque transactions and might thwart price discovery.

The Commissions did not propose rules or interpretations on how to distinguish futures from swaps. A commenter requested that the CFTC clarify that nothing in the release was intended to limit a DCM's ability to list for trading a futures contract regardless of whether it could be viewed as a swap if traded over-the-counter or on a SEF, since futures and swaps are "indistinguishable in material economic effects."[1115] The commenter further recommended that the CFTC adopt a final rule that amends the statutory definition of the term "swap" by adding to the futures contract exclusion in CEA Section 1a(47)(B)(i) the following language after the word "delivery": "listed for trading by a designated contract market." The same commenter believed that such a rule would clarify the scope of Section 4(a) of the CEA,[1116] which makes it illegal to trade a futures contract except on or subject to the rules of a DCM.[1117]

[1115] See CME Letter.

[1116] 7 U.S.C. 6(a).

[1117] See CME Letter.

Although it is potentially more costly to a DCM in terms of providing additional analysis to support listing a futures contract on its exchange, the CFTC is not adopting the distinction the commenter advocates. Prior distinctions that the CFTC relied upon (such as the presence or absence of clearing) to distinguish between futures and swaps may no longer be relevant.[1118] As a result, it is difficult to distinguish between futures and swaps on a blanket basis as the commenter suggested. However, a case-by-case approach for distinguishing these products may lead to more informed decision-making by the CFTC.

The CFTC notes that a DCM may self-certify its contracts pursuant to Part 40 of the CFTC's rules,[1119] subject to the CFTC's oversight authority. If a DCM has a view that a particular product is a futures contract, it may self-certify the contract consistent with that view. The DCM also has a number of other options, including seeking prior approval from the CFTC, requesting an interpretation, or requesting a rulemaking if it is in doubt about whether a particular agreement, contract or transaction should be classified as a futures contract or a swap.

3. Costs and Benefits of Rules and Interpretations Regarding Insurance

Rule 1.3(xxx)(4)(i) under the CEA clarifies that agreements, contracts or transactions that satisfy its provisions will not be swaps or security-based swaps. Specifically, the term "swap" and "security-based swap" does not include an agreement, contract, or transaction under rule 1.3(xxx)(4)(i)(A) that, by its terms or by law, as a condition of performance on the agreement, contract, or transaction: i) requires the beneficiary of the agreement, contract, or transaction to have an insurable interest that is the subject of the agreement, contract, or transaction and thereby carry the risk of loss with respect to that interest continuously throughout the duration of

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1118 See, e.g., Swap Policy Statement, supra note 214

1119 17 CFR Part 40.

the agreement, contract, or transaction; ii) requires that loss to occur and be proved, and that any payment or indemnification therefor be limited to the value of the insurable interest; iii) is not traded, separately from the insured interest, on an organized market or over-the-counter; and iv) with respect to financial guaranty insurance only, in the event of payment default or insolvency of the obligor, any acceleration of payments under the policy is at the sole discretion of the insurer (the "Product Test").

Rule 1.3(xxx)(4)(i)(B) under the CEA provides that for an agreement, contract, or transaction that meets the Product Test to be excluded from the swap and security-based swap definitions as insurance, it must be provided: i) by a person that is subject to supervision by the insurance commissioner (or similar official or agency) of any State or by the United States or an agency or instrumentality thereof, and such agreement, contract, or transaction is regulated as insurance applicable State law or the laws of the United States (the "first prong"); ii) directly or indirectly by the United States, any State, or any of their respective agencies or instrumentalities, or pursuant to a statutorily authorized program thereof (the "second prong"); iii) in the case of reinsurance only, by a person to another person that satisfies the Provider Test, provided that: such person is not prohibited by applicable State law or the laws of the United States from offering such agreement, contract, or transaction to such person that satisfies the Provider Test; the agreement, contract, or transaction to be reinsured satisfies the Product Test or is one of the Enumerated Products; and except as otherwise permitted under applicable State law, the total amount reimbursable by all reinsurers for such agreement, contract, or transaction may not exceed the claims or losses paid by the cedant; or iv) in the case of non-admitted insurance by a person who: is located outside of the United States and listed on the Quarterly Listing of Alien Insurers as maintained by the International Insurers Department of the National

Association of Insurance Commissioners; or meets the eligibility criteria for non-admitted insurers under applicable State law (the "Provider Test").

In response to commenters' requests that the Commissions codify the proposed interpretation regarding certain enumerated types of insurance products in the final rules, the interpretation is being codified in paragraph (i)(C) of rule 1.3(xxx)(4) under the CEA. In addition, in response to comments, the Commissions are expanding and revising the list of traditional insurance products. As adopted, the rule provides that the terms "swap" and "security-based swap" will not include an agreement, contract, or transaction that is provided in accordance with the conditions set forth in the Provider Test and is one of the following types of products (collectively, "Enumerated Products"): surety bonds; fidelity bonds; life insurance; health insurance; long-term care insurance; title insurance; property and casualty insurance; annuities; disability insurance; insurance against default on individual residential mortgages (commonly known as private mortgage insurance, as distinguished from financial guaranty of mortgage pools); and reinsurance (including retrocession) of any of the foregoing. Based on comments received, the Commissions are adding three products to the list of products as proposed, adding reinsurance (including retrocession) of any of the traditional insurance products included in the list, and deleting a requirement applicable to annuities that they must be subject to tax treatment under section 72 of the Internal Revenue Code.

The Commissions are also clarifying that the Product Test, the Provider Test and the Enumerated Products in the rules are a non-exclusive safe harbor (the "Insurance Safe Harbor"), such that if a product fails the Insurance Safe Harbor, that does not necessarily mean that the product is a swap or security-based swap—further analysis may be required in order to make that determination.

Rule 1.3(xxx)(4)(ii) provides a "grandfather" for insurance transactions (as opposed to insurance products), pursuant to which transactions that are entered into on or before the effective date of the Product Definitions will not fall within the definition of swap or security-based swap, provided that, at such time that it was entered into, the transaction was provided in accordance with the Provider Test.

The CFTC is interpreting the term "swap" (that is not a security-based swap or mixed swap) to include a guarantee of such swap, to the extent that a counterparty to a swap position would have recourse to the guarantor in connection with the position. The CFTC is persuaded that when a swap has the benefit of a guarantee, the guarantee is an integral part of that swap. The CFTC finds that a guarantee of a swap (that is not a security-based swap or mixed swap) is a term of that swap that affects the price or pricing attributes of that swap. When a swap counterparty typically provides a guarantee as credit support for its swap obligations, the market will not trade with that counterparty at the same price, on the same terms, or at all without the guarantee. The guarantor's resources are added to the analysis of the swap; if the guarantor is financially more capable than the swap counterparty, the analysis of the swap becomes more dependent on the creditworthiness of the guarantor. The CFTC anticipates that a "full recourse" guarantee would have a greater effect on the price of a swap than a "limited" or "partial recourse" guarantee; nevertheless, the CFTC is determining that the presence of any guarantee with recourse, no matter how robust, is price forming and an integral part of a guaranteed swap. The CFTC's interpretation of the term "swap" to include guarantees of swap does not limit or otherwise affect in any way the relief provided by the Insurance Grandfather. In a separate release, the CFTC will address the practical implications of interpreting the term "swap" to include guarantees of swaps (the "separate CFTC release").

a) Costs

A market participant will need to ascertain whether an agreement, contract, or transaction satisfies the criteria set forth in rule 1.3(xxx)(4). This analysis will have to be performed prior to entering into the agreement, contract, or transaction to ensure that the relief provided by the Insurance Safe Harbor is available. The CFTC expects that potential costs associated with any possible uncertainty cited by commenters as to whether an agreement, contract, or transaction that the participants consider to be insurance could instead be regulated as a swap would be greater without the Insurance Safe Harbor than the cost of the analysis under the final rule herein.

Although the Insurance Safe Harbor is designed to mitigate costs associated with legal uncertainty and misclassification of products, to the extent that it inadvertently fails to exclude certain types of insurance products from the definitions, these failures could lead to costs for market participants entering into agreements, contracts, or transactions. Some insurance products might inadvertently be subjection to regulation as swaps. To the extent that the Insurance Safe Harbor leads to the inadvertent misclassification of some swaps as insurance, costs for market participants entering into agreements, contracts, or transactions that are inadvertently regulated as insurance products, and not as swaps, may increase.[1120] Similarly, insurance products inadvertently mischaracterized as swaps could impose additional costs on market participants, who could be required to meet certain regulatory requirements applicable to swaps.

1120 Improperly characterizing swaps as insurance may theoretically cause market participants that are not licensed insurance companies to become licensed insurance companies, if applicable, thus imposing costs of complying with state insurance regulation.

Assessment costs should be minimal or non-existent for traditional insurance products,[1121] but for a new and novel insurance product that is more complex, the costs of analysis may be greater. Nevertheless, it is anticipated that such cases will be infrequent. Moreover, it may be difficult to assess whether products that do not fall within the Insurance Safe Harbor are swaps or security-based swaps rather than insurance. Market participants may need to request an interpretation from the Commissions regarding such products, or obtain an opinion of counsel, which will involve certain costs.[1122] However, the CFTC expects such cases will arise less frequently in light of the increased clarity provided by the rule. An alternative to a safe harbor approach under the rule—that failure to meet the rule and interpretation would automatically mean that the product is a swap and not insurance—would likely impose greater costs on market participants and result in more frequent misclassification of products.

1121 The CFTC anticipates that traditional insurance products will either be easy to identify from the list of Enumerated Products or will unambiguously satisfy the Products Test.

1122 The CFTC believes that $27,000 represents a reasonable estimate of the upper end of the range of the costs to undertake the legal analysis of the status of an agreement, contract, or transaction as a swap or security-based swap. The average cost incurred by market participants in connection with assessing whether an agreement, contract, or transaction is a swap or security-based swap is based upon the estimated amount of time that staff believes will be required for both in-house counsel and outside counsel to apply the definition. Staff estimates that some agreements, contracts, or transactions will clearly satisfy the Insurance Safe Harbor, Insurance Grandfather and an in-house attorney, without the assistance of outside counsel, will be able to make a determination in less than one hour. Based upon data from SIFMA's *Management & Professional Earnings in the Securities Industry 2011* (modified by SEC staff to account for an 1800-hour-work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead), staff estimates that the average national hourly rate for an in-house counsel is $378. If an agreement, contract, or transaction is more complex, the CFTC estimates the analysis will require approximately 30 hours of in-house counsel time and 40 hours of outside counsel time. The CFTC estimates the costs for outside legal services to be $400 per hour. This is based on an estimated $400 per hour cost for outside legal services. This is the same estimate used by the SEC for these services in the release involving Exemptions for Security-Based Swaps Issued By Certain Clearing Agencies, Release No. 33-9308 (Mar. 30, 2012), 77 FR 20536 (Apr. 5, 2012). Accordingly, on the high end of the range the CFTC estimates the cost to be $27,340 ($11,340 (based on 30 hours of in-house counsel time x $378) + $16,000 (based on 40 hours of outside counsel x $400). The estimate is rounded to two significant digits to avoid the impression of false precision of the estimate.

The CFTC is interpreting the term "swap" (that is not a security-based swap or mixed swap) to include a guarantee of such swap, to the extent that a counterparty to a swap position would have recourse to the guarantor in connection with the position. The CFTC anticipates minimal or no assessment costs from the interpretation with respect to guarantees of swaps.[1123] The CFTC does, however, anticipate that there will be some programmatic costs associated with the requirements that it will propose for guarantees of swaps in the separate CFTC release.[1124] The CFTC will carefully consider those costs in that rulemaking.

b) Benefits

Subjecting traditional insurance products to Title VII could, absent exception, prevent individuals who are not ECPs from obtaining insurance to protect their properties or families against accidental hazards or risks,[1125] or require insurance sold to individuals who are not ECPs to be traded on exchanges and be cleared. The Commissions have found no evidence that Congress intended them to be regulated as swaps or security-based swaps. In light of the above considerations, the Commissions have determined to provide the Insurance Safe Harbor and

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1123 Because a guarantee is a common and well-understood product, that has been used in commerce since long before the existence of swaps markets, the CFTC anticipates that whether a guarantee is present or not will be obvious.

1124 As a result of interpreting the term "swap" (that is not a security-based swap or mixed swap) to include a guarantee of such swap, to the extent that a counterparty to a swap position would have recourse to the guarantor in connection with the position, and based on the reasoning set forth in the Entity Definitions Release in connection with major swap participants, the CFTC will not deem holding companies to be swap dealers as a result of guarantees to certain U.S. entities that are already subject to capital regulation. This interpretation mitigates the programmatic costs imposed on potential swap dealers by not attributing to a guarantor swap positions of a guaranteed entity that is already subject to capital regulation.

1125 An individual is considered an ECP if the individual "has amounts invested on a discretionary basis, the aggregate of which is in excess of – (i) $10,000,000; or (ii) $5,000,000 and who enters into the agreement, contract, or transaction in order to manage the risk associated with an asset owned or liability incurred, or reasonable likely to be owned or incurred, by the individual." Section 1a(18)(A)(xi) of the CEA, 7 U.S.C. 1a(18)(A)(xi).

Insurance Grandfather in the final rules in order to assure market participants that those agreements, contracts, or transactions that meet their conditions will not fall within the swap or security-based swap definitions. Limiting the number of unexpected product classification outcomes for market participants provides the benefit of predictability when entering into their transactions

The business of insurance is already subject to established pre-Dodd-Frank Act regulatory regimes. Requirements that may work well for swaps and security-based swaps may not be appropriate for traditional insurance products. To the extent that the final rules distinguish insurance from swaps and security-based swaps, the CFTC should be able to tailor rules for specific products that are swaps or security-based swaps to achieve Title VII regulatory objectives. In adopting the Insurance Safe Harbor, the CFTC has sought to achieve those net benefits that may be obtained from not supplanting existing insurance regulation that are consistent with the regulatory objectives of Title VII.

Without the Insurance Safe Harbor, market participants might be more uncertain about whether an agreement, contract, or transaction is an insurance product rather than a swap. Rule 1.3(xxx)(4) is intended to reduce the potential uncertainty of what constitutes a swap by setting forth clear and objective criteria for distinguishing an agreement, contract, or transaction that is insurance from a swap. Providing such an objective rule and explanation mitigates the potential additional costs of petitioning the Commissions, or obtaining an opinion of counsel, about whether an agreement, contract, or transaction is insurance or a swap.

The objective criteria provided by the rule also will aid sound risk management practices because it will be easier for market participants to decide whether a particular agreement, contract, or transaction is insurance or a swap.

Further, the CFTC anticipates that the interpretation of the term "swap" to include guarantees of swaps and the separate CFTC release will provide programmatic benefits by enabling the CFTC and market participants to receive more price-forming data about swaps, which may help improve price discovery for swaps. The CFTC will carefully consider these and other benefits in the separate CFTC release.

c) Comments and Consideration of Alternatives

The CFTC requested comment on the costs and benefits of proposed rule 1.3(xxx)(4) and interpretive guidance to distinguish between insurance products and swaps for market participants, markets, and the public. Several commenters[1126] argued that any additional requirement beyond the requirement of the rules that a product is a regulated insurance product creates legal uncertainty and imposes costs. Specifically, a commenter[1127] asserted that it is a burden to introduce conditions that are neither universal nor fundamental, such as showing a continuing risk of loss for some insurance contracts. Another commenter[1128] argued that legal uncertainty may result in conflicting interpretations, which can be a significant burden for financial guaranty transactions that typically require the delivery of a legal opinion.

The Commissions have expanded the list of insurance products excluded from the swap definition to cover certain traditional insurance products that commenters have brought to their attention and that the Commissions have determined are not swaps. The Commissions are also clarifying that the Insurance Safe Harbor does not imply or presume that an agreement, contract or transaction that does not meet its requirements is a swap or security-based swap, but will require further analysis of the applicable facts and circumstances, including the form and

1126 See AFGI Letter; AIA Letter; and ISDA Letter.

1127 See ISDA Letter.

1128 See AFGI Letter.

substance of the agreement, contract, or transaction, to determine whether it is insurance, and thus not a swap or security-based swap. With regard to financial guaranty in particular, the acceleration of payment criterion is designed to reflect market practice and aid appropriate product classification. The Commissions are stating that they intend to interpret concepts upon which the Product Test relies that are derived from state law consistently with the existing and developing laws of the relevant state(s) governing the agreement, contract, or transaction in question. However, the Commissions note their authority to diverge from state law if the Commissions become aware of evasive conduct. While the CFTC cannot anticipate under what circumstances or how often the Commissions might diverge from state law, the CFTC believes that there will be more consistent than inconsistent interpretations. Accordingly, the rules do not present the increased burden or legal uncertainty that these commenters suggested.

Several commenters also requested that the Commissions codify the proposed interpretive guidance regarding enumerated insurance products in rule text on the basis that codification would enhance legal certainty, and thereby reduce costs.[1129] The Commissions have decided to include a list of products in rule text in response to these commenters concerns.

A commenter proposed that the sole test for determining whether an agreement, contract or transaction is insurance should be whether it is subject to regulation as insurance by the insurance commissioner of the applicable state(s).[1130] While the commenter's test is potentially easier and thus may be less costly to apply than the Commissions' test, it would be inadequate because, as explained in section II.B.1.(d) above, it would essentially delete the product prong of the insurance safe harbor, and thus begging the question of how to distinguish insurance from

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1129 See ACLI Letter; NAIC Letter; and RAA Letter.

1130 See MetLife Letter.

swaps and security-based swaps and allowing state insurance regulators to supplant the Commissions' role in further defining, or determining what is, a swap. Further, market participants might misconstrue the commenter's test in close cases to mean that any activity permitted by the insurance commissioner of the relevant state(s) may not be regulated as swaps or security-based swaps. However, insurance companies are in many circumstances permitted by state insurance regulators to enter into swaps or security-based swaps, illustrating that the fact that while an insurance company may enter into an agreement, contract or transaction, it does not necessarily mean that such agreement, contract or transaction is insurance. Further, the domain of insurance regulation may change and then this commenter's test would induce an evolving boundary between state and CFTC regulation.

Several commenters suggested an approach in which insurance products that qualify for the exclusion contained in section 3(a)(8) of the Securities Act of 1933 would be excluded from the swap definition.[1131] One commenter argued that "Section 3(a)(8) has long been recognized as the definitive provision as to where Congress intends to separate securities products that are subject to SEC regulation from 'insurance' and 'annuity' products that are to be left to state insurance regulation" and that the section 3(a)(8) criteria are well understood and have a long history of interpretation by the SEC and the courts.[1132] Other commenters suggest that because section 3(a)(8) includes both a product and a provider requirement, if the Commissions include it in their final rules, it should be a requirement separate from the Product Test and the Provider Test, and should extend to insurance products that are securities.[1133]

1131 See supra note 162

1132 See supra note 163.

1133 See supra note 164.

While the Commissions agree that the section 3(a)(8) criteria have a long history of interpretations by the SEC and the courts, the Commissions find that it is inappropriate to apply the section 3(a)(8) criteria in this context. Although section 3(a)(8) contains some conditions applicable to insurance providers that are similar to the prongs of the Provider Test, it does not contain any conditions that are similar to the prongs of the Product Test. Moreover, section 3(a)(8) provides an exclusion from the Securities Act and the CFTC has no jurisdiction under the federal securities laws. Congress directed both agencies to further define the terms "swap" and "security-based swap." As such, the Commissions find that it is more appropriate to have a standalone rule that incorporates features that distinguish insurance products from swaps and security-based swaps and over which both Commissions will have joint interpretative authority.

Another commenter proposed the following test for an agreement, contract, or transaction to be insurance:

> [It] [e]xists for a specified period of time;
>
> Where the one party to the contract promises to make one or more payments such as money, goods or services;
>
> In exchange for another party's promise to provide a benefit of pecuniary value for the loss, damage, injury, or impairment of an identified interest of the insured as a result of the occurrence of a specified event or contingency outside of the parties' control; and
>
> Where such payment is related to a loss occurring as a result of a contingency or specified event.[1134]

This test may not represent a less costly alternative to the Commissions' test in light of its complexity, and in any event would not distinguish swaps and security-based swaps from insurance more effectively than the Commissions' test for two reasons. The requirements of a

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1134 See NAIC Letter.

specified term and the payment of premiums are present in both insurance products and in agreements, contracts, or transactions that are swaps or security-based swaps, and therefore such requirements do not help to distinguish between them. A test based solely on these requirements, then, would be over-inclusive and exclude from the Dodd-Frank regulatory regime agreements, contacts, and transactions that have not traditionally been considered insurance. Also, the third and fourth requirements of the commenter's test collapse into the Product Prong's requirement that the loss must occur and be proved, and any payment or indemnification therefor must be limited to the value of the insurable interest.

Another commenter offered a 3-part test[1135] in lieu of the Commissions' test:

1).The insurance contract must be issued by an insurance company and subject to state insurance regulation;

2) The insurance contract must be the type of contract issued by insurance companies; and

3) The insurance contract must not be of a type that the CFTC and SEC determine to regulate.[1136]

The commenter stated that its approach does not contain a definition of insurance, and for that reason believes that is preferable to the Commissions' approach, which it believes creates legal uncertainty because any attempted definition of insurance has the potential to be over- or under- inclusive.[1137]

1135 See also CAI Letter and Nationwide Letter.

1136 See ACLI ANPR Letter.

1137 See ACLI Letter.

While the commenter's test may appear simpler on its face, the CFTC does not believe that it represents a less costly alternative. The first two requirements of the commenter's test do not help to distinguish swaps from insurance; the third provides no greater certainty than the Commissions' facts and circumstances approach. Moreover, as discussed in section II.B.1(d) above, the Commissions' rules and related interpretations are not intended to define insurance. Rather, they provide a safe harbor for certain types of traditional insurance products by reference to factors that may be used to distinguish insurance from swaps and security-based swaps. Agreements, contracts, and transactions that do not qualify for the Insurance Safe Harbor may or may not be swaps, depending upon the facts and circumstances. Thus, the Commissions' test neither creates legal uncertainty as suggested by the commenter, nor the costs associated with such uncertainty.

Another commenter proposed different approaches for existing products and new products. According to the commenter, if an existing type of agreement, contract or transaction is currently reportable as insurance in the provider's regulatory and financial reports under a state or foreign jurisdiction's insurance laws, then that agreement, contract or transaction would be insurance rather than a swap or security-based swap. On the other hand, for new products, if this approach is inconclusive, the commenter recommended that the Commissions use the product prong of the Commissions' test only.[1138]

The commenter's proposal may represent a less costly alternative than the Commissions' test. However, rather than treating existing products and new products differently, the Commissions as discussed above are providing "grandfather" protection for agreements, contracts, and transactions entered into on or before the effective date of the Products

1138 See AIA Letter.

Definitions. Moreover, the commenter's test would eliminate the provider test for new products, which the Commissions believe is important to help prevent products that are swaps or security-based swaps from being characterized as insurance.

In sum, the CFTC finds that, while some of the alternatives proposed by commenters may appear less costly to apply than the Commissions' test, in all cases they would sweep out of the Dodd-Frank Act regulatory regime for swaps agreements, contracts, and transactions that have not historically been considered insurance, and that should, in appropriate circumstances, be regulated as swaps or security-based swaps. Accordingly, the CFTC does not find these alternative tests proposed by commenters to be better tools than the Insurance Safe Harbor for limiting the scope of the statutory definitions of swap and security-based swap. Excluding agreements, contracts, and transactions that are, in fact, swaps from the further definition of the term "swap" is inconsistent with the CFTC's regulatory objectives and could increase risk to the U.S. financial system.

Three commenters provided comments regarding the treatment of guarantees of swaps. Two commenters[1139] opposed treating insurance or guarantees of swaps as swaps. Suggesting that the products are not economically similar, one commenter argued that insurance wraps of swaps do not "necessarily replicate the economics of the underlying swap, and only following default could the wrap provider end up with the same payment obligations as a wrapped defaulting swap counterparty."[1140] This commenter also stated that the non-insurance guarantees are not swaps because the result of most guarantees is that the guarantor is responsible for

1139 See AFGI Letter, ISDA Letter.

1140 ISDA Letter.

monetary claims against the defaulting party, which in this commenter's view is a different obligation than the arrangement provided by the underlying swap itself.[1141]

One commenter supported treating financial guaranty insurance of a swap or security-based swap as itself a swap or a security-based swap. This commenter argued that financial guaranty insurance of a swap or security-based swap transfers the risk of counterparty non-performance to the guarantor, making it an embedded and essential feature of the insured swap or security-based swap. This commenter further argued that the value of such swap or security-based swap is largely determined by the likelihood that the proceeds from the financial guaranty insurance policy will be available if the counterparty does not meet its obligations.[1142] This commenter maintained that financial guaranty insurance of swaps and security-based swaps serves a similar function to credit default swaps in hedging counterparty default risk.[1143]

While the CFTC is not further defining guarantees of swaps to be swaps, the CFTC is persuaded that when a swap (that is not a security-based swap or mixed swap) has the benefit of a guarantee, the guarantee and related guaranteed swap should be analyzed together. The events surrounding the failure of AIG Financial Products ("AIGFP") highlight how guarantees can cause major risks to flow to the guarantor.[1144] The CFTC finds that the regulation of swaps and the risk exposures associated with them, which is an essential concern of the Dodd-Frank Act,

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1141 Id.

1142 See Better Markets Letter.

1143 See Better Markets Letter.

1144 "AIGFP's obligations were guaranteed by its highly rated parent company . . . an arrangement that facilitated easy money via much lower interest rates from the public markets, but ultimately made it difficult to isolate AIGFP from its parent, with disastrous consequences." Congressional Oversight Panel, The AIG Rescue, Its Impact on Markets, and the Government's Exit Strategy 20 (2010).

the CFTC did not interpret the term "swap" to include a guarantee of a

would be less eff

swap.

ters cautioned against unnecessary and duplicative regulation. One cause the underlying swap, and the parties to it, will be regulated and tent required by Title VII, there is no need for regulation of non-insurance The other commented that an insurance policy on a swap would be subject to on; without addressing non-insurance guarantees, this commenter stated that federal regulation would be duplicative.[1146] The CFTC disagrees with these ts. As stated above, the CFTC is treating financial guaranty insurance of swaps and all other guarantees of swaps in a similar manner because they are functionally or economically similar products. If a guarantee of a swap is not treated as an integral part of the underlying swap, price forming terms of swaps and the risk exposures associated with the guarantees may remain hidden from regulators and may not be regulated appropriately. Moreover, treating guarantees of swaps as part of the underlying swaps ensures that the CFTC will be able to take appropriate action if, after evaluating information collected with respect to the guarantees and the underlying swaps, such guarantees of swaps are revealed to pose particular problems in connection with the swaps markets. The separate CFTC release clarifies the limited practical effects of the CFTC's interpretation, which should address industry concerns regarding duplicative regulation.

One commenter also argued that regulating financial guaranty of swaps as swaps would cause monoline insurers to withdraw from the market, which could adversely affect the U.S. and

1145 See ISDA Letter.

1146 See AFGI Letter.

international public finance, infrastructure and structured finance markets, g[illegible] related swap often is integral to the insurance of municipal bonds and other secu[illegible] CFTC finds this argument unpersuasive. The CFTC understands that the 2008 glob[illegible] crisis severely affected most monolines and only one remains active in U.S. municipal[illegible] Thus, it appears that the monolines have, for the most part, already exited these markets. [illegible] addition, as stated above, the separate CFTC release clarifies the limited practical effects of th[illegible] CFTC's interpretation, which should address industry concerns.

4. Costs and Benefits of the Withdrawing the Energy Exemption and Interpretation Regarding the Forward Contract Exclusion from the Swap Definition

The CFTC is clarifying that the forward contract exclusion from the swap definition for nonfinancial commodities should be read consistently with the forward contract exclusion from the CEA definition of the term "future delivery." In that regard, the CFTC is retaining the Brent Interpretation and extending it to apply to all nonfinancial commodities, and withdrawing the Energy Exemption, which had extended the Brent Interpretation regarding the forward contract exclusion from the term "future delivery" to energy commodities other than oil, as it is no longer necessary. Although the CFTC is withdrawing the Energy Exemption, the CFTC is providing that certain alternative delivery procedures, such as physical netting agreements, that are mentioned in the Energy Exemption, are consistent with the intent of the book out provision in the Brent Interpretation--provided that the parties had a bona fide intent, when entering into the transactions, to make or take (as applicable) delivery of the commodity covered by those

1147 See AFGI Letter. Of the members of AFGI, only Assured Guaranty (or its affiliates) is currently writing financial guaranty insurance policies on U.S. municipal obligations.

transactions. The CFTC also is providing an interpretation regarding documentation of orally booked-out transactions.

In addition, the CFTC is clarifying that its prior guidance regarding commodity options embedded in forward contracts should be applied as well to the treatment of forward contracts in nonfinancial commodities that contain embedded options under the Dodd-Frank Act. The final interpretation also explains the CFTC's position with regard to forwards with embedded volumetric optionality, including an explanation of how it would treat some of the specific contracts described by commenters, such as full requirements contracts. It also explains the CFTC's view with respect to certain contractual provisions, such as liquidated damages and renewable/evergreen provisions that do not disqualify the transactions in which they are contained from the forward exclusions. The CFTC has also provided an interpretation regarding nonfinancial commodities, including environmental commodities, and interpretations concerning physical exchange transactions, fuel delivery agreements, certain physical commercial agreements, and energy management agreements.

a) Costs

The CFTC's statement that it will construe the forward contract exclusion consistently with respect to the definitions of the terms "swap" and "future delivery," as discussed herein, will not impose any new material costs on market participants. It also will establish a uniform interpretation of the forward contract exclusion from the definitions of both statutory terms, which will avoid the significant costs that some commenters state would result if the forward contract exclusion were construed differently in these two contexts.[1148] In addition, the CFTC's

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1148 See EEI Letter ("Without legal certainty as to the regulatory treatment of their forward contracts, EEI's members and other end users who rely on the forward contract exclusion likely will face higher transaction costs due to greater uncertainty. These increased transaction costs may clarification regarding the continued viability of the alternative delivery procedures in the Energy Exemption should reduce costs to the industry by conferring legal certainty that their transactions may continue to have these procedures without losing their eligibility for the forward exclusions.

As noted in section II.B.2.(a)(ii) above, the CFTC has explained its position regarding nonfinancial commodities. This should help the industry to determine whether their transactions are eligible for the forward exclusions, and consequently reduce costs to the industry for transactions involving non-financial commodities such as renewable energy credits that may be eligible for the forward exclusions. The final interpretation regarding forwards with embedded volumetric optionality should reduce costs to the industry, because these transactions may qualify for the forward exclusions from the swap and "future delivery" definitions. The explanation of how the CFTC will view specific contracts mentioned by commenters under this interpretation should enhance legal certainty and thereby reduce costs.

The clarification that certain contractual provisions do not disqualify transactions from the forward exclusion also should reduce costs to the industry by providing increased legal certainty that these provisions will not render their transactions subject to Dodd-Frank Act regulation. Similar cost reductions should be achieved through enhanced legal certainty provided by the CFTC's interpretations of physical exchange transactions, fuel delivery agreements, and certain physical commercial agreements, all of which may qualify for the forward exclusions under these interpretations. The interpretation regarding energy management agreements, which provides that the fact that a particular transaction is done under the auspices

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include: (i) more volatile or higher commodity prices; and (ii) increased credit costs, in each case caused by changes in market liquidity as end users change the way they transact in the commodity markets. A single regulatory approach that uses the same criteria to confirm that a forward contract is excluded from the Commission's jurisdiction over swaps and futures will reduce this uncertainty and the associated costs to end users." (footnote omitted)).

of such agreements does not alter the nature of that transaction, should likewise enhance legal certainty and reduce costs. While the CFTC's interpretation regarding documentation of oral book-outs—that an oral book-out be followed by a confirmation in a commercially reasonable time in written or electronic form—may impose costs for industries that do not document their orally booked out transactions, the CFTC believes that this requirement is consistent with prudent business practices and is necessary to prevent abuse of the Brent safe harbor.

Market participants will need to assess whether products are forward contracts that qualify for the forward exclusions from the swap and future delivery definitions, and may need to request an interpretation regarding such products, or obtain an opinion of counsel, which will involve certain costs.[1149]

b) Benefits

The CFTC's interpretations regarding the forward exclusions should provide market participants with greater legal certainty regarding whether their transactions qualify for the

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1149 The CFTC believes that $20,000 represents a reasonable estimate of the upper end of the range of the costs to undertake the legal analysis of the status of an agreement, contract, or transaction as a forward contract that qualifies for the forward exclusions. The average cost incurred by market participants in connection with assessing whether an agreement, contract, or transaction is a forward contract is based upon the estimated amount of time that staff believes will be required for both in-house counsel and outside counsel to apply the definition. The staff estimates that costs associated with determining whether an agreement, contract, or transaction is a forward contract will range up to $20,000 after rounding to two significant digits. Staff estimates that some agreements, contracts, or transactions will clearly fall within the Brent safe harbor, and an internal attorney, without the assistance of outside counsel, will be able to make a determination in less than one hour. Based upon data from SIFMA's *Management & Professional Earnings in the Securities Industry 2011* (modified by CFTC staff to account for an 1800-hour-work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead), staff estimates that the average national hourly rate for an internal attorney is $378. If an agreement, contract, or transaction is more complex, the CFTC estimates the analysis will require approximately 20 hours of in-house counsel time and 30 hours of outside counsel time. The CFTC estimates the costs for outside legal services to be $400 per hour. Accordingly, on the high end of the range the CFTC estimates the cost to be $19,560 ($7,560 (based on 20 hours of in-house counsel time x $378) + $12,000 (based on 30 hours of outside counsel x $400) which is then rounded to two significant digits to $20,000.

forward exclusion from the swap definition, which should facilitate commercial merchandising activity. For example, the interpretation regarding forwards with embedded volumetric options should facilitate commercial merchandising activity of the electricity, natural gas, and other industries that employ these contracts where delivery quantities are flexible, while the conditions in the interpretations should help to assure that these contracts are bona fide forwards.

In addition, the interpretation should result in the appropriate classification of transactions as commercial merchandising transactions (and thus forward contracts) that are not subject to Title VII regulation. This will enhance market participants' efficient use of the swaps markets and, as described above, reduce costs on industry. Documenting oral book-outs should promote good business practices and aid the CFTC in preventing evasion through abuse of the forward exclusion. Finally, the CFTC's interpretation regarding commercial market participants should ensure that the forward exclusions may only be used for commercial merchandising activity and not for speculative purposes. [1150]

The CFTC's position regarding nonfinancial commodities should help the industry to determine whether their transactions are eligible for the forward exclusions, which should facilitate commercial merchandising activity for transactions involving non-financial commodities such as renewable energy credits that may be eligible for the forward exclusions.

c) Comments and Consideration of Alternatives

The CFTC requested comment in the Proposing Release on the costs and benefits of the proposed interpretive guidance regarding the forward contract exclusion and the withdrawal of the Energy Exemption for market participants, markets and the public.

1150 If contracts are being used for speculative purposes they are probably swaps and should be subject regulation under Title VII.

Several commenters requested that the CFTC codify its proposed guidance regarding the forward contract exclusion in rule text to provide greater legal certainty, which they argued may mitigate costs.[1151] However, upon consideration, the CFTC is not codifying its interpretation in rule text. As discussed in section II.B.2.(a)(i), above, the CFTC has never codified its prior interpretations of the forward contract exclusion with respect to the future delivery definition as a rule or regulation. Publishing an interpretation in this release is consistent with the manner in which the CFTC has interpreted the forward exclusion in the past. The additional research costs associated with an interpretation as opposed to codification in the Code of Federal Regulations will be small, because the CFTC has placed this interpretation, and all other product interpretations, in this adopting release for the convenience of practitioners. Moreover, courts may rely upon agency interpretations; thus, the CFTC believes that codification would not mitigate costs much.

Some commenters[1152] argued that physical options should be considered forward contracts excluded from the definition of a swap, because increased regulation would cause harm to physical commodity markets without providing significant benefits. The statutory definition of "swap" provides that options – including physical options – are swaps. Accordingly, the CFTC may not exclude such options from the swap definition. Further, treating physical options as forward contracts would be inconsistent with longstanding CFTC precedent. Nonetheless, the CFTC has provided relief using its plenary authority under CEA Section 4c(b)[1153] over commodity options through the trade option exemption. While certain capacity contracts on

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1151 See BGA Letter; COPE Letter; ETA Letter; FERC Staff Letter; and Just Energy Letter.

1152 See Just Energy Letter; NEMA Letter; NGSA/NCGA Letter; ONEOK Letter; and WGCEF Letter.

1153 7 U.S.C. 6c(b).

RTOs and ISOs and certain contracts entered into by section 201(f) entities may be considered options and therefore would be swaps, regulation of these contracts may be addressed through the public interest waiver process in CEA section 4(c)(6).

Several commenters[1154] argued that renewable energy credits should not be swaps; rather, renewable energy credits should be considered nonfinancial commodities eligible for the forward exclusion from the swap definition. They asserted that swap regulations would raise transaction costs making it more difficult and expensive to support renewable energy. The CFTC is clarifying that renewable energy credits are nonfinancial commodities and that transactions therein are eligible for the forward exclusion if they satisfy the terms thereof. So if these transactions meet the forward exclusion, they will bear no increased costs.

A commenter[1155] requested that tolling contracts be considered forwards and not swaps, seeking to avoid unnecessary cost of regulatory uncertainty and unintended conflict between the CFTC and other regulators. The CFTC has not provided blanket interpretations regarding particular products in the rulemaking, but has provided an interpretation regarding the forward contract exclusions provided above in section II.B.2. To the extent a commenter still is uncertain about the treatment of a specific type of transaction, the commenter may request an interpretation from the CFTC.

Another commenter argued more generally that any embedded option (for example, price, quantity, delivery point, delivery date, contract term) that does not permit a unilateral election of financial settlement based upon the value change in an underlying cash market should

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[1154] See 3Degrees Letter; AWEA Letter; CERP Letter; EMA Letter; GreenX Letter; PMAA/NEFI Letter; REMA Letter; and WGCEF Letter.

[1155] See California Utilities Letter.

not render the contract a swap.[1156] While the commenter's approach with respect to "any" embedded option may result in lower costs for market participants because more contracts likely would be excluded as forwards from the swap definition and thus not be subject to regulation under the Dodd-Frank Act, such an expansive approach may inappropriately classify contracts as forwards. The CFTC is providing an interpretation with respect to forwards with embedded volumetric options to address commenters' concerns. The CFTC is also explaining its position above regarding price optionality, optionality with respect to delivery points and delivery dates specifically in response to the commenter's letter, and optionality as to certain contract terms (such as evergreen and renewal provisions) to address particular concerns raised by commenters.

Another commenter suggested that an option to purchase or sell a physical commodity, whether embedded in a forward contract or stand alone, should either (i) fall within the statutory forward exclusion from the swap definition, or (ii) alternatively, if deemed by the CFTC to be a swap, should be exempt from the swap definition pursuant to a modified trade option exemption pursuant to CEA Section 4c(b).[1157] Although this proposal may on its face appear to be simpler than the CFTC's, it is substantively similar to the one the CFTC is adopting. The CFTC has modified the proposed interpretive guidance regarding forwards with embedded options as discussed in section II.B.2.(b)(ii) above; contracts with embedded options that are swaps under the final interpretation may nevertheless qualify for the modified trade option exemption recently adopted by the CFTC.[1158] The CFTC is not adopting an approach that forwards with any type of

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1156 See COPE Letter, Appendix.

1157 See WGCEF Letter; 7 U.S.C. 6c(b).

1158 See Commodity Options, 77 FR 25320, April 27, 2012. 17 CFR 32.3. Encana Marketing (USA) Inc. ("Encana") believes that the guidance on forwards with embedded options should include embedded physical delivery options because it asserts that many of the contracts currently used by participants in the wholesale natural gas market contain an option for the physical delivery of embedded option should fall within the statutory forward exclusion from the swap definition. Such an approach would be overbroad because it would exclude contracts that are not appropriately classified as forwards. The commenter also requested that trade option exemptions be granted for physical commodities. The costs and benefits of the trade option exemption are addressed in that rulemaking.

Another commenter urged the CFTC to broadly exempt commercial forward contracting from swap regulation by generally excluding from the swap definition any forward contract with embedded optionality between end users "whose primary purpose is consistent with that of an 'end user', and in which any embedded option is directly related to 'end use.'"[1159]

While this alternative may appear to be less costly than the CFTC's interpretation, its vagueness may create significant legal uncertainty about the scope of the forward exclusion, which may increase costs on market participants. Even if this approach does represent a lower cost alternative, however, it is overbroad and likely would result in the inappropriate classification of transactions as forward contracts, and thus would not achieve the CFTC's objective of appropriately classifying transactions that should qualify for the forward exclusions.

Another commenter believed that the CFTC's "facts and circumstances" approach to forwards with embedded options does not provide the legal certainty required by nonfinancial entities engaging in commercial contracts in the normal course of business.[1160] The commenter

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natural gas. See Encana Letter. To the extent that Encana's comment goes beyond volumetric optionality, commodity options are discussed above in section II.B.2.(b)(i).

1159 See NMPF Letter.

1160 See ETA Letter at 19 n.47. Similarly, COPE comments that a nonfinancial commodity forward contract that, "by its terms," is intended to settle physically should be permitted to contain optionality without being transformed into a swap unless such optionality negates the physical settlement element of the contract. That is, if one party can exercise an option to settle the contract financially based upon the value change in an underlying cash market, then the intent for further argued that many option-like contract terms could be determined to "target the delivery term" under a facts and circumstances analysis. Accordingly, the commenter believed that the CFTC should provide in its rules that an embedded option or embedded optionality will not result in a nonfinancial forward being a swap unless: (1) delivery is optional; (2) financial settlement is allowed; and (3) transfer and trading of the option separately from the forward is permitted.[1161]

The CFTC has long applied a facts and circumstances approach to the forward exclusion, including with respect to forwards with embedded options, an approach with which market participants are familiar. That approach balances the need for legal certainty against protecting market participants, market integrity and the risk of providing opportunities for evasion.[1162] By contrast, the commenter's bright-line approach may be simpler to apply, but could undermine market integrity and creates greater evasion opportunities. Moreover, the CFTC's additional interpretation noted above, including clarification about the meaning of the phrase "target the delivery term," and forwards with embedded volumetric optionality, provides enhanced legal certainty in response to the commenter's concerns, which should mitigate the costs of the CFTC's approach to market participants.[1163]

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physical settlement is not contained in "the four corners of the contract" and may render the contract a swap. COPE Letter. While COPE's approach may impose less costs on market participants (as more transactions likely would qualify for the forward exclusion, as discussed in section II.B.2.(b)(ii), above, the CFTC has eschewed approaches to the forward exclusion that rely on the "four corners of the contract," which can provide a roadmap to evasion of statutory requirements.

1161 See ETA Letter.

1162 See also NCFC Letter (supporting the CFTC's guidance because it provides legal certainty).

1163 See also Commodity Options, 77 FR 25320, 25324 n. 25, April 27, 2012 (discussing the CFTC's conclusion that an "option[] to redeem" under the USDA Commodity Credit Corporation's marketing loan program constitutes a cotton producer's contractual right to repay its marketing loan and "redeem" the collateral (cotton) to sell in the open market).

Another commenter[1164] stated its view that the full costs of applying the Dodd-Frank regulatory apparatus to physical energy transactions, or of energy companies being forced to abandon full-requirements bilateral contracting will significantly increase the costs to be paid by U.S. consumers. The CFTC is sensitive to these concerns. The CFTC is providing relief for full-requirements contracts so long as they satisfy the conditions set forth in the interpretation.

The CFTC is also providing relief for other types of physical energy contracts that may qualify for the forward exclusions. Separately, the CFTC has provided relief for trade options in another rulemaking.[1165]

5. Loan Participations

In the Proposing Release, the Commissions proposed guidance that they do not interpret the swap and security-based swap definitions to include loan participations in which: i) the purchaser is acquiring a current or future direct or indirect ownership interest in the related loan; and ii) the loan participations are "true participations" (the participant acquires a beneficial ownership interest in the underlying loans). One commenter expressed concern with the second prong of the proposed guidance. Specifically, the commenter said that the "true participation" requirement may result in the improper classification of loan participations as swaps, because LMA-style loan participations may not qualify. Moreover, because of legal uncertainty associated with the "true participation" terminology derived from U.S. bankruptcy law, LSTA-style loan participations may be subject to improper classification as well. The commenter proposed an alternative test described in section II.B.3., above.

1164 See IECA II Letter.

1165 See Commodity Options, 77 FR 25320, April 27, 2012.

The Commissions largely are adopting the recommendation from the commenter regarding the Commissions' proposed guidance concerning loan participations as not swaps or security-based swaps, with certain modifications. This reduces costs for market participants because the Commissions' test for loan participations from the proposal included a "true participation" requirement that commenters suggested is subject to legal uncertainty. Benefits of the rule include enhanced legal certainty that loan participations that meet the requirements of the interpretation are not swaps, which should facilitate loan participation market activity.

6. Interpretation Regarding Commercial/Consumer Transactions

The Commissions are stating that certain customary consumer and commercial transactions that have not previously been considered swaps or security-based swaps do not fall within the statutory definitions of those terms. Specifically with regard to consumer transactions, the Commissions are adopting as proposed the interpretation that certain transactions entered into by consumers (natural persons) as principals or their agents primarily for personal, family or household purposes would not be considered swaps or security-based swaps. The Commissions have added to the list of consumer transactions certain residential fuel storage contracts; service contracts; consumer options to buy, sell or lease real or personal property; and certain consumer guarantees of loans (credit cards, automobile, and mortgage). The Commissions have also clarified that consumer transactions used to purchase nonfinancial energy commodities are not swaps or security-based swaps. With respect to commercial transactions, the Commissions are adopting as proposed the interpretation that certain commercial transactions involving customary business arrangements (whether or not involving a for-profit entity) would not be considered swaps or security-based swaps. The Commissions also are clarifying that commercial loans by the Federal Home Loan Banks and Farm Credit Institutions are not swaps. Finally, the Commissions are explaining the factors characteristic of consumer and commercial transactions that the Commissions will consider in determining whether other consumer and commercial transactions that are not specifically listed in the interpretation should be considered swaps or security-based swaps.

a) Costs

The CFTC believes that the forgoing interpretation should mitigate costs because it increases legal certainty that specific customary consumer and commercial transactions are not swaps or security-based swaps subject to Dodd-Frank regulation. As a result of this interpretation, consumers and industry participants will not have to seek legal advice regarding whether these transactions are swaps or security-based swaps. The interpretation regarding commercial loans made by the Federal Home Loan Banks and Farm Credit Institutions also reduces costs by not subjecting these transactions to additional Dodd-Frank Act regulation. To the extent a customary consumer or commercial transaction is not included in the interpretation, consumers and market participants may incur costs in seeking an interpretation from the Commissions regarding the status of their transactions or an opinion of counsel. However, the CFTC has emphasized that the lists are not exclusive, and has provided the factors it will consider for determining whether other consumer and commercial transactions that are not specifically listed in the interpretation should be considered swaps or security-based swaps, which should assist consumers and market participants in deciding whether to seek an interpretation and thus mitigate these costs.

b) Benefits

The foregoing interpretation provides increased legal certainty benefits for market participants and should ensure that customary consumer and commercial transactions, which have never been considered swaps or security-based swaps, will not be subject to Dodd-Frank Act regulation, and may facilitate consumer and commercial activity. As discussed above, the interpretation regarding the factors that the Commissions will consider in determining whether transactions that are not listed in the interpretation are swaps or security-based swaps should assist market participants in determining whether to seek an interpretation regarding such transactions. Therefore, this interpretation helps to mitigate costs of legal uncertainty.

c) Comments and Consideration of Alternatives

Several commenters believed that the proposed interpretive guidance regarding consumer/commercial transactions does not provide sufficient legal certainty and request that the Commissions codify such guidance in regulations in order to provide greater legal certainty, which may mitigate costs.[1166] The Commissions decline to codify the interpretation into rule text. The interpretation is intended to provide guidance to assist consumers and commercial and non-profit entities in evaluating whether certain arrangements that they enter into will be regulated as swaps or security-based swaps. The interpretation is intended to allow the flexibility necessary, including the consideration of the applicable facts and circumstances by the Commissions, in evaluating consumer and commercial arrangements to ascertain whether they may be swaps or security-based swaps. The representative characteristics and factors taken together are indicators that a consumer or commercial arrangement is not a swap or security-based swap, and the Commissions have provided specific examples demonstrating how these characteristics and factors apply to some common types of consumer and commercial arrangements. However, as the interpretation is not intended to be a bright-line test for determining whether a particular consumer or commercial arrangement is a swap or security-based swap, if the particular arrangement does not meet all of the identified characteristics and factors, the arrangement will be evaluated based on its particular facts and circumstances. Also,

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1166 See ETA Letter; ICEA Letter; and Just Energy Letter.

the courts may rely on the interpretation and as such, the CFTC does not believe that the adoption of rule text as opposed to an interpretation will mitigate costs associated with perceived legal uncertainty.[1167]

A commenter[1168] asserted that federal courts will have to hear more disputes, because proposed CFTC jurisdiction would pre-empt significant aspects of state and federal law concerning the purchase and sale of goods and services. This rulemaking includes safe-harbors from the definition of a swap for customary consumer and commercial transactions. The Commissions have expanded the list of consumer transactions that are excluded from the swap definition. While it may be possible that federal courts will nevertheless hear more disputes, that would be a result of the statutory swap definition and not from the interpretation being adopted by the Commissions (which should reduce the number of such disputes).

Another commenter[1169] agreed with the general factors proposed for identifying agreements, contracts, or transactions that are not swaps, but requested additional clarity with respect to particular transactions. Specifically, the commenter requested that commercial loans and financing facilities with embedded interest rate options should not be considered swaps. To clarify, interest rate options are swaps. As discussed in section II.B.3. above, plain vanilla interest rate options embedded in a loan, such as rate locks, rate caps and rate collars, are not swaps. If a product is more complex, it may be appropriate for the CFTC to consider it in response to a specific request for interpretation.

1167 The additional research costs associated with an interpretation as opposed to codification in the Code of Federal Regulations will be small, because the CFTC has placed this interpretation, and all other products interpretations, in this adopting release for the convenience of practitioners.

1168 See IECA Letter.

1169 See FCC Letter.

7. Residential Exchange Program ("REP")

The REP[1170] was established by Congress "[t]o extend the benefits of low cost Federal System hydro power to residential and small farm electric power consumers throughout the Pacific Northwest Region."[1171] A commenter requests that the CFTC further define the term "swap" to exclude consumer benefits under the Pacific Northwest Electric Power Planning and Conservation Act of 1980 ("Northwest Power Act")[1172] and transactions under the REP[1173] to allow a subsidy to continue to be received by residential and small farm utilities.

The Commissions do not consider the REP transactions described by the commenter to be swaps or security-based swaps. Consequently, this rulemaking clarifies that Dodd-Frank regulatory costs will not be imposed on REPs and allows the subsidy to continue to be provided to residential and small farm utilities.

8. Costs and Benefits of Rule Regarding Foreign Exchange Products and Forward Rate Agreements

CFTC rule 1.3(xxx)(2) under the CEA explicitly defines the term "swap" to include an agreement, contract, or transaction that is a cross-currency swap, currency option, foreign currency option, foreign exchange option, foreign exchange rate option, foreign exchange forward, foreign exchange swap, forward rate agreement, and non-deliverable forward involving foreign exchange, unless such agreement, contract, or transaction is otherwise excluded by section 1a(47)(B) of the CEA. Rule 1.3(xxx)(3) provides that: i) a foreign exchange forward or a foreign exchange swap shall not be considered a swap if the Secretary of the Treasury makes

1170 The BPA refers to the implementation of Section 5(c) of the Northwest Power Act, 16 U.S.C. 839c(c), as the "Residential Exchange Program."

1171 Id. at 3.

1172 16 U.S.C. Chapter 12H.

1173 See Bonneville Letter.

the determination described in CEA section 1a(47)(E)(i); and ii) notwithstanding any such determination, certain provisions of the CEA will apply to such a foreign exchange forward or foreign exchange swap (specifically, the reporting requirements in section 4r of the CEA[1174] and regulations thereunder and, in the case of a swap dealer or major swap participant that is a party to a foreign exchange swap or foreign exchange forward, the business conduct standards in section 4s of the CEA[1175] and regulations thereunder). Rule 1.3(xxx)(3) further clarifies that a currency swap, cross-currency swap, currency option, foreign currency option, foreign exchange option, foreign exchange rate option, or non-deliverable forward involving foreign exchange is not a foreign exchange forward or foreign exchange swap subject to a determination by the Secretary of the Treasury as described in the preamble.

The Commissions are also clarifying that a bona fide foreign exchange spot transaction, i.e., a foreign exchange transaction that is settled on the customary timeline[1176] of the relevant spot market, is not within the definition of the term "swap." In addition, the interpretation clarifies that retail foreign currency options described in CEA Section 2(c)(2)(B) are not swaps. This clarification allows market participants to engage in these transactions with non-ECP customers who would otherwise have to engage in on-exchange transactions.

1174 7 U.S.C. 6r.

1175 7 U.S.C. 6s.

1176 As discussed in section II.C.2.(c) above, in general, a foreign exchange transaction will be considered a bona fide spot transaction if it settles via an actual delivery of the relevant currencies within two business days. However a foreign exchange transaction with a longer settlement period concluding with the actual delivery of the relevant currencies may be considered a bona fide spot transaction depending on the customary timeline of the relevant market. In particular, a foreign exchange transaction that is entered into solely to effect the purchase or sale of a foreign security is a bona fide spot transaction where certain conditions are met.

a) Costs

In complying with rule 1.3(xxx)(2), a market participant will need to ascertain whether an agreement, contract, or transaction is a swap under the definition. This analysis will have to be performed upon entering into the agreement, contract, or transaction. However, any costs associated with this analysis are expected to be less than the costs of doing the same analysis absent the rule, particularly given potential confusion in the event of a determination by the Secretary of the Treasury that foreign exchange forwards and/or foreign exchange swaps not be considered swaps. To the extent that rule 1.3(xxx)(2) improperly includes certain types of agreements, contracts, and transactions in the swap definition, and therefore the imposition of additional requirements and obligations, these requirements and obligations could lead to costs for market participants entering into such agreements, contracts, or transactions. However, the CFTC has carefully considered each of the agreements, contracts and transactions described above that it is further defining as swaps under rule 1.3(xxx)(2) and believe that they are appropriately classified as such, subject to the statutory exclusions.

b) Benefits

Because the statutory definition of the term "swap" includes a process by which the Secretary of the Treasury may determine that certain agreements, contracts, and transactions that meet the statutory definition of a "foreign exchange forward" or "foreign exchange swap," respectively,[1177] shall not be considered swaps, the CFTC is concerned that application of the definition, without further clarification, may cause uncertainty about whether, if the Secretary of the Treasury makes such a determination, certain agreements, contracts, or transactions would be

1177 CEA section 1a(24), 7 U.S.C. 1a(24)(definition of a "foreign exchange forward"); CEA section 1a(25), 7 U.S.C. 1a(25)(definition of a "foreign exchange swap").

swaps. Rule 1.3(xxx)(3) increases legal certainty that a currency swap, cross-currency swap, currency option, foreign currency option, foreign exchange option, foreign exchange rate option, or non-deliverable forward involving foreign exchange, is a swap (unless it is otherwise excluded by the statutory definition of the term "swap"). The rule also increases legal certainty that reporting requirements, and business conduct requirements for swap dealers and major swap participants, are applicable to foreign exchange forwards and foreign exchange swaps even if the Secretary of the Treasury determines that they should not be considered swaps, and is consistent with the statute. The CFTC also is concerned that confusion could be generated by the "forward" label of non-deliverable forwards involving foreign exchange, and forward rate agreements. Rule 1.3(xxx)(2) increases legal certainty that these types of agreements, contracts, and transactions are swaps.

Providing such a rule to market participants to determine whether certain types of agreements, contracts, or transactions are swaps alleviates additional costs to persons of inquiring with the Commissions, or obtaining an opinion of counsel, about whether such agreements, contracts, or transactions are swaps. In addition, such a rule regarding the requirements that apply to foreign exchange forwards and foreign exchange swaps that are subject to a determination by the Secretary of the Treasury similarly alleviates additional costs to persons of inquiring with the Commissions, or obtaining an opinion of counsel, to determine the requirements that are applicable to such foreign exchange forwards and foreign exchange swaps. As with the other rules comprising the Product Definitions, enhanced legal certainty will help market participants to engage in sound risk management practices, which will benefit both market participants and the public.

The interpretation concerning bona fide foreign exchange spot transactions should result in the appropriate classification of such transactions as not subject to Dodd-Frank Act regulation. The interpretation regarding retail foreign currency options subject to CEA Section 2(c)(2)(B) as not swaps provides clarity and reduces costs for market participants, who could not offer the product to non-ECP customers off-exchange in accordance with the provisions of CEA Section 2(c)(2)(B).

In addition, including certain FX transactions, forward rate agreements and certain other transactions in the swap definition protects the public by explicitly subjecting these transactions to Dodd-Frank regulation.

c) Comments and Consideration of Alternatives

The CFTC requested comment as to the costs and benefits of proposed rules 1.3(xxx)(2) and (3). As discussed in the preamble, some commenters[1178] argued that non-deliverable foreign exchange forward transactions should be regulated as foreign exchange forwards, because regulating them as swaps would increase the cost of hedging foreign currency exposures in emerging markets.

Non-deliverable forward transactions do not satisfy the statutory definition of foreign exchange forwards, as explained in section II.C.2.(b)(ii), supra. They do satisfy the swap definition, however. Accordingly, the CFTC lacks discretion not to define them as swaps.

9. Costs and Benefits of Rule Regarding Title VII Instruments on Futures on Foreign Sovereign Debt under Exchange Act Rule 3a12-8

Rule 1.3(bbbb) provides that a Title VII instrument that is based on or references a qualifying foreign futures contract on the debt securities of one or more of the 21 enumerated

1178 See CEIBA Letter; Covington Letter; ISDA Letter; and MFA Letter.

foreign governments is a swap and not a security-based swap if the Title VII instrument satisfies the following conditions:

- The futures contract on which the Title VII instrument is based or that is referenced must be a qualifying foreign futures contract (as defined in rule 3a12-8) on the debt securities of any one or more of the 21 enumerated foreign governments that satisfies the conditions of rule 3a12-8;
- The Title VII instrument is traded on or through a board of trade (as defined in section 1a(6) of the CEA);
- The debt securities on which the qualifying foreign futures contract is based or referenced and any security used to determine the cash settlement amount pursuant to the fourth condition below are not registered under the Securities Act or the subject of any American depositary receipt registered under the Securities Act;
- The Title VII instrument may only be cash settled; and
- The Title VII instrument is not entered into by the issuer of the securities upon which the qualifying foreign futures contract is based or referenced (including any security used to determine the cash payment due on settlement of such Title VII instrument), an affiliate (as defined in the Securities Act and the rules and regulations thereunder)[1179] of the issuer, or an underwriter with respect to such securities.

Only those Title VII instruments that are based on qualifying foreign futures contracts on the debt securities of the 21 enumerated foreign governments and that satisfy these five

1179 See, e.g., rule 405 under the Securities Act, 17 CFR 230.405.

conditions will be swaps. The final rules are intended to provide consistent treatment (other than with respect to method of settlement) of qualifying foreign futures contracts and Title VII instruments based on qualifying foreign futures contracts on the debt securities of the 21 enumerated foreign governments.[1180] The Commissions understand that many of the qualifying foreign futures contracts on the debt securities of the 21 enumerated foreign governments trade with substantial volume through foreign trading venues under the conditions set forth in rule 3a12-8[1181] and permitting swaps on such futures contracts subject to similar conditions would not raise concerns that such swaps could be used to circumvent the conditions of rule 3a12-8 and the federal securities laws concerns that such conditions are intended to protect.[1182] Further, providing consistent treatment for qualifying foreign futures contracts on the debt securities of the 21 enumerated foreign governments and Title VII instruments based on futures contracts on the debt securities of the 21 enumerated foreign governments will allow trading of these instruments through DCMs on which such futures are listed. There may also be cross-margining benefits when different contracts are margined at the same derivatives clearing organization, such as may be the case if a swap on a futures contract and a corresponding futures contract trade on the same DCM. This cross-margining would enhance sound risk management practices.

The CFTC believes that the assessment cost associated with determining whether a swap on certain futures contracts on foreign government securities constitute a swap or security-based

1180 The Commissions note that the final rules provide consistent treatment of qualifying foreign futures contracts on the debt securities of the 21 enumerated foreign governments and Title VII instruments based on qualifying foreign futures contracts on the debt securities of the 21 enumerated foreign governments unless the Title VII instrument is entered into by the issuer of the securities upon which the qualifying foreign futures contract is based or referenced (including any security used to determine the cash payment due on settlement of such Title VII instrument), an affiliate of the issuer, or an underwriter with respect to such securities.

1181 See supra note 716 and accompanying text.

1182 See supra note 712 and accompanying text.

swap under rule 1.3(bbbb) should be minimal. Currently, qualifying foreign futures contracts on debt securities of the 21 enumerated foreign governments are traded on exchanges or boards of trade. Market participants may look at the exchange or board of trade listing to determine what they are. Therefore, the assessment, in accordance with the rule, would primarily focus on whether such swap itself is traded on or through a board of trade; whether the swap is cash-settled; whether the futures is traded on a board of trade; whether any security used to determine the cash settlement amount are not registered under the Securities Act or the subject of any American depositary receipt registered under the Securities Act; and whether the swap is entered into by the foreign government issuing the debt securities upon which the qualifying futures contract is based or referenced, an affiliate of such foreign government or an underwriter of such foreign government securities. All of these determinations may be readily and quickly ascertained by the parties entering into the agreement, contract, or transaction. Therefore, the assessment costs associated with rule 1.3(bbbb) should be nominal because parties should be able to make assessments in less than an hour.

10. Costs and Benefits of Rules and Interpretations Regarding Title VII Instruments where the Underlying Reference is a Security Index

Historically, the market for index CDS did not divide along jurisdictional divisions between the CFTC and SEC;[1183] however, the Dodd-Frank Act created a jurisdictional divide between swaps and security-based swaps. Under the jurisdictional division, the CFTC has jurisdiction over Title VII instruments based on non-narrow-based security indexes while the SEC has jurisdiction over Title VII instruments based on narrow-based security indexes. The

1183 For example, index CDS and single name CDS have typically been traded on the same trading desk, and customers have typically held their positions in a single account. The CFTC notes that the jurisdictional divide will impact among other things portfolio margining.

SEC also has jurisdiction over Title VII instruments based on a single security or loan, and certain events related to an issuer of securities or issuers of securities in a narrow-based security index.

Rule 1.3(yyy)(1) under the CEA provides that, for purposes of the security-based swap definition, the term "narrow-based security index" would have the same meaning as the statutory definition set forth in CEA section 1a(35), and the rules, regulations, and orders issued by the Commissions relating to such definition. As a result, except where the new rules the Commissions are adopting provide for other treatment, market participants generally will be able to use the Commissions' past guidance in determining whether certain Title VII instruments based on a security index are swaps or security-based swaps.

The Commissions are promulgating additional rules and providing interpretations regarding Title VII instruments based on a security index. The interpretations and additional rules set forth new narrow-based security index criteria with respect to indexes composed of securities, loans, or issuers of securities referenced by an index CDS. The interpretations and rules also address the definition of an "index" and the treatment of broad-based security indexes that become narrow-based and narrow-based indexes that become broad-based, including rule provisions regarding tolerance and grace periods for swaps on security indexes that are traded on CFTC-regulated and SEC-regulated trading platforms.

a) Costs

In complying with the rules and interpretations, a market participant will need to ascertain whether a Title VII instrument is a swap or a security-based swap according to the criteria set forth in the definitions of the terms "issuers of securities in a narrow-based security index" and "narrow-based security index" as used in the security-based swap definition. This analysis will have to be performed prior to the execution of, but no later than an offer to enter into, a Title VII instrument, and when the material terms of a Title VII instrument are amended or modified, to ensure compliance with rules 1.3(yyy), 1.3(zzz) or 1.3(aaaa).

However, any such costs are expected to be less than the costs of doing the same analysis absent the rules, which the CFTC believes would be more difficult and lead to greater uncertainty. In particular, rule 1.3(yyy) allows market participants to reduce the costs of determining whether a Title VII instrument based on a security index, other than an index CDS, is a swap or security-based swap by clarifying that they will be able to use the Commissions' past guidance regarding narrow-based security index in making that determination. In the context of index CDS, the Commissions' past guidance regarding narrow-based security indexes does not establish criteria on whether index CDS is a swap or a security-based swap. Accordingly, without further explanation, it would not be clear on which side of the CFTC/SEC jurisdictional divide index CDS would fall. CFTC rules 1.3(zzz) and 1.3(aaaa) allow market participants to reduce the costs of determining whether an index CDS is a swap or a security-based swap by providing a test with objective criteria that is similar to a test with which they already are familiar in the security futures context, yet tailored to index CDS in particular.

Additionally, absent rule 1.3(yyy), which applies the tolerance period rules, if a security index underlying a Title VII instrument traded on a trading platform migrated from being broad-based to being narrow-based, market participants may suffer disruption of their ability to offset or enter into new Title VII instruments, and incur additional costs as a result.

DCMs and SEFs will incur costs in assessing whether an index underlying a Title VII instrument is broad-based, in monitoring the index for migration from broad to narrow-based. There will also be other costs resulting from the migration such as delisting costs. Such migration costs are mitigated by the tolerance period of 45 business days over three calendar months which should reduce the incidence of migration. Similarly, the three-month grace period following an indexes failure of the tolerance period should mitigate delisting and other costs. There will be a range of assessment costs depending on how customized the index underlying an index CDS is.[1184]

In determining whether a Title VII instrument is a swap or a security-based swap, market participants will need to apply the criteria found in CFTC rules 1.3(yyy), 1.3(zzz) and 1.3(aaaa). Market participants may conduct such analysis in-house or employ outside third-party service providers to conduct such analysis. The costs associated with obtaining such outside professional services would vary depending on the relevant facts and circumstances, particularly the composition of the index. The CFTC believes, however, that $20,000 represents a reasonable estimate of the upper end of the range of the costs of obtaining the services of outside professional in undertaking the analysis.[1185] The CFTC believes that some index CDS based on an established index would not need the assistance of outside counsel, and a determination can

1184 Additionally, the number of components in an index may impact the assessment costs based on having to determine whether the indexes components satisfy the various tests within the rule.

1185 The average cost incurred by market participants in connection with assessing whether an agreement, contract, or transaction is a swap or security-based swap is based upon the estimated amount of time that staff believes will be required for both in-house counsel and outside counsel to apply the definition. The staff estimates that costs associated with determining whether an agreement, contract, or transaction is a swap or security-based swap will range up to$20,000 after rounding to two significant digits. Staff estimates that some index CDS will be standard and an internal attorney, without the assistance of outside counsel will be able to make a determination in less than one hour. Based upon data from SIFMA's *Management & Professional Earnings in the Securities Industry 2011* (modified by CFTC staff to account for an 1800-hour-work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead), staff estimates that the average national hourly rate for an internal attorney is $378. If an agreement, contract, or transaction is more complex, the CFTC estimates the analysis will require approximately 20 hours of in-house counsel time and 30 hours of outside counsel time. The CFTC estimates the costs for outside legal services to be $400 per hour. Accordingly, on the high end of the range the CFTC estimates the cost to be $19,560 ($7,560 (based on 20 hours of in-house counsel time x $378) + $12,000 (based on 30 hours of outside counsel x $400) which is then rounded to two significant digits to $20,000.

be made in less than one hour. If an agreement, contract, or transaction is more complex, the CFTC estimates the analysis will require up to approximately 20 hours of in-house counsel time and 30 hours of outside counsel time.

b) Benefits

Rules 1.3(zzz) and 1.3(aaaa) clarify the treatment of an index CDS as either a swap or a security-based swap by setting forth objective criteria for meeting the definition of the terms "issuers of securities in a narrow-based security index" and "narrow-based security index," respectively. These objective rules alleviate additional costs to persons trading index CDS of inquiring with the Commissions, or obtaining an opinion of counsel, to make complex determinations regarding whether an index is broad- or narrow-based, and whether an index CDS based on such an underlying index is a swap or security-based swap.

Also, rules 1.3(zzz) and 1.3(aaaa) should reduce the potential for market participants to use an index CDS to evade regulations, because they set objective requirements relating to the concentration of the notional amount allocated to each reference entity or security included in the index, as well as the eligibility conditions for reference entities and securities. Finally, these rules benefit the public by requiring that the providers of index CDS make publicly available sufficient information regarding the reference entities in an index underlying the index CDS. By requiring that such information be made publicly available, rules 1.3(zzz) and 1.3(aaaa) seek to assure the transparency of the index components that will be beneficial to market participants who trade such instruments and to the public.

Separately, rule 1.3(yyy) addresses exchange-traded swaps based on security indexes where the underlying index migrates from broad-based to narrow-based. The rule includes provisions that many market participants are familiar with from security futures trading. The CFTC believes that by using a familiar regulatory scheme, market participants will be able to more readily understand the rule as compared to a wholly new regulatory scheme. Also, the use of a "tolerance period" for swaps on security indexes that migrate from broad-based to narrow-based also creates greater clarity by establishing a 45-day timeframe (and subsequent grace period) on which market participants may rely. This tolerance period results in cost savings when compared to the alternative scenario where no tolerance period is provided and a migration of an index from broad-based to narrow-based would result in potential impediments to the ability of market participants to offset their swap positions.

Finally, the Commissions are stating that the determination of whether a Title VII instrument is a swap, a security-based swap, or both (i.e., a mixed swap), is made prior to the execution of, but no later than an offer to enter into, the Title VII instrument. If the security index underlying a Title VII instrument migrates from being broad-based to being narrow-based, or vice versa, during the life of a Title VII instrument, the characterization of that Title VII instrument would not change from its initial characterization regardless of whether the Title VII instrument was entered into bilaterally or was executed through a trade on or subject to the rules of a DCM, SEF, FBOT, security-based SEF, or NSE. Absent this interpretation, market participants potentially would need to expend additional resources to continually monitor their swaps to see if the indexes on which they are based have migrated from broad-based to narrow-based. Since the rule provides that the initial determination prevails regardless of whether the underlying index migrates from broad-based to narrow-based, market participants do not need to expend these monitoring costs.

c) Comments and Consideration of Alternatives

A commenter asserted that the regulatory complexity for index CDS is not worth the high compliance costs.[1186] The statute provides that the CFTC has jurisdiction over swaps on broad-based security indices, and the SEC has jurisdiction over swaps on narrow-based security indices, single securities or loans, and certain events related to the issuers of securities. The Commissions need to establish criteria for index CDS, because their past guidance regarding narrow-based security indices does not address them. Without further explanation, it would not be clear on which side of the CFTC/SEC jurisdictional division certain products would fall. The number and concentration limits are derived from criteria that Congress has imposed in the security futures context. The public information availability test does not require that index constituents satisfy all of its requirements; rather, the constituents may satisfy any one of them for the index to be broad-based, and there is a de minimis level for noncompliance.

Another commenter[1187] stated that the proposed interpretation needs to be clearer on loan-based swap transactions and that it is costly to determine whether a particular set of loans or borrowers meets the Commissions' public information availability requirement. The Commissions are clarifying that a TRS on two or more loans is not subject to the broad-based/narrow-based jurisdictional divide, but is a swap under the CFTC's jurisdiction. With respect to loan index CDS, the Commissions believe that the index CDS rules, including the public information availability requirement, should apply to indexes of loans underlying index CDS. However, the Commissions are amending the proposed rules to include loans within the categories of instruments to be aggregated for the total principal amount of debt outstanding

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1186 See ISDA Letter.

1187 See LSTA Letter.

threshold of the public information availability requirement, and will aggregate outstanding debt of affiliates for purposes of the test, which the CFTC believes should address the commenter's concerns.

A commenter[1188] pointed out that there may be costs to relist index-based CDS when the index stops being, or becomes, broad-based. Another commenter[1189] believed that the public information availability test will cause indices to switch between narrow-based and broad-based classification, which could result in unnecessary cost, confusion, and market disruption.

The statutory framework requires delisting and relisting. These costs are mitigated by the tolerance period for migration, which may help to prevent frequent migration of indices from broad-based to narrow-based or vice versa. Moreover, it is the case for both on and off-exchange Title VII instruments that the Commissions are stating that the determination of whether a Title VII instrument on a security index is a swap or security-based swap is made prior to execution, but no later than the offer to enter into the instrument, and remains the same throughout the life of the instrument. Accordingly, even if the public information availability test would cause indexes underlying index CDS to migrate as suggested by a commenter, that will not affect the classification of outstanding index CDS entered into prior to such migration. However, if an amendment or change is made to such outstanding index CDS that would cause it to be a new purchase or sale of such index CDS, that could affect the classification of such outstanding index CDS.

A commenter asserted that extending the "grace period" from three months to six months would ease any disruption or dislocation associated with the delisting process with respect to an

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1188 See MarketAxess Letter.

1189 See Markit Letter.

index that has migrated from broad to narrow, or narrow to broad, and that has failed the tolerance period.[1190] The commenter further suggested that where an index CDS migrates, for entities operating both a SEF and a security-based SEF, such entities should be permitted to move the index from one platform to the other simply by providing a notice to the SEC and CFTC.

The Commissions are adopting the proposed rules without modification. As discussed in Section III.G.5(b) above, the Commissions note that the three-month grace period applicable to security futures was mandated by Congress in that context,[1191] and the commenter has provided no data or evidence for its request that the Commissions diverge from that grace period and provide for a longer grace period with respect to swaps and security-based swaps. The Commissions believe that the three-month grace period is similarly appropriate to apply in the context of an index that has migrated to provide sufficient time to execute off-setting positions. With respect to the commenter's other suggestion that entities operating both a SEF and a security-based SEF should be able to move the index from one platform to another where an index CDS migrates simply by filing a notice with the SEC and CFTC, the Commissions do not believe that this proposal is within the scope of this rulemaking.

Many commenters offered alternatives to the various tests in proposed rules 1.3(zzz) and 1.3(aaaa).[1192] As discussed more fully above in Section III.G.3.(b), the Commissions have incorporated many of the suggested alternatives into the final rules and interpretations and rejected, after careful consideration, other suggested alternatives. For example, three

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1190 See MarketAxess Letter.

1191 See July 2006 Debt Index Rules. The Commissions are not aware of any disruptions caused by the three-month grace period in the context of security futures.

1192 See section III.G.3.(b).

commenters requested that the Commissions revise the affiliation definition that applies when calculating the number and concentration criteria to require a majority control affiliation threshold, rather than the 20 percent threshold in the proposed rules.[1193] As discussed in section III.G.3.(b) above, the Commissions are modifying the affiliation definition that applies when calculating the number and concentration criteria in response to commenters to use an affiliation test based on majority ownership. Based on commenters' letters, the Commissions understand that the current standard CDS documentation and the current approach used by certain index providers for index CDS with respect to the inclusion of affiliated entities in the same index use majority ownership rather than 20 percent ownership to determine affiliation. The Commissions are persuaded by commenters that in the case of index CDS only it is more appropriate to use majority ownership because majority-owned entities are more likely to have their economic interests aligned and be viewed by the market as part of a group. The Commissions believe that revising the affiliation definition in this manner for purposes of calculating the number and concentration criteria responds to commenters' concerns that the percentage control threshold may inadvertently include entities that are not viewed as part of a group. Thus, as revised, the affiliation definition will include only those reference entities or issuers included in an index that satisfy the more than 50 percent (i.e., majority ownership) control threshold.

Due to the high compliance costs resulting from the public information availability test in particular, a commenter[1194] argued that the Commissions should abandon that test. The final rules retain the public information availability test, which does not present significant

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1193 See ISDA Letter; Markit Letter; and SIFMA Letter.

1194 See SIFMA Letter.

compliance costs because it does not require that constituents satisfy all of the requirements and permits a de minimis level of noncompliance.

One commenter offered an alternative to the public information availability test based on the volume of trading.[1195] After careful consideration and as described more fully above in section II.G.3.(b), above, the Commissions are not adopting a volume based test either as a replacement or alternative for the public information availability test. A volume based test would not be readily ascertainable with respect to certain underlying components which are not exchange traded or do not satisfy listing standards. The public information availability test allows for more flexibility with respect to the components included in indexes underlying index CDS than a volume-based test. Individual components in an index CDS may not satisfy a volume-based test but could otherwise satisfy one of the criteria of the public information availability test. The public information availability test is similar to the test in the rules for debt security indexes, which, as noted above, apply in the context of Title VII Instruments. The public information availability test, accordingly, provides a consistent set of rules under which index compilers and market participants can analyze the characterization of index CDS.

In the public information availability test, one commenter proposed moving the outstanding debt threshold from \$1 billion to \$100 million.[1196] As stated above, the CFTC believes that the \$1 billion debt threshold, which is the same amount as the outstanding debt threshold in the rules for debt security indexes, is set at the appropriate level to achieve the

1195 See Markit Letter.

1196 Id.

objective that such entities are likely to have public information available about them.[1197] However, the adopted rules expand on the types of debt that are counted toward the $1 billion debt threshold to include any indebtedness, including loans, so long as such indebtedness in not a revolving credit facility.

In response to a request for comment by the Commissions, two commenters believed that the presence of a third-party index provider would assure that sufficient information is available regarding the index CDS itself, but neither commenter provided an analysis to explain how or whether a third-party index provider would be able to provide information about the underlying securities or issuers of securities in the index.[1198] Accordingly, the Commissions are not adopting this alternative.

A commenter[1199] argued that legal uncertainty would present a burden to market participants absent the Commissions clarifying the status of swaps on shares of exchange traded funds that reference broad-based security indices. However, market participants can request a clarification through the interpretation process established herein by the Commissions.

11. Costs and Benefits of Processes to Determine Whether a Title VII Instrument is a Swap, Security-Based Swap, or Mixed Swap, and to Determine Regulatory Treatment for Mixed Swaps

a) Costs

Rule 1.8 under the CEA allows persons to submit a request for a joint interpretation from the Commissions regarding whether an agreement, contract or transaction (or a class of agreements, contracts, or transactions) is a swap, security-based swap, or mixed swap. The

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1197 See supra part III.G.3(b)(iii); See Securities Offering Reform, Release No. 33-8591 (Jul. 19, 2005), 70 FR 44722 (Aug. 3, 2005) (discussing economic analysis involved in determining the $1 billion threshold for non-convertible securities in the context of well-known seasoned issuers).

1198 See ISDA Letter and SIFMA Letter.

1199 See Anon. Letter.

CFTC estimates the cost of submitting a request for a joint interpretation pursuant to rule 1.8 would be a cost of about $7,700 for internal company or individual time and associated costs of $12,000 for the services of outside professionals.[1200] Once such a joint interpretation is made, however, other market participants that seek to transact in the same agreement, contract, or transaction (or class thereof) would have regulatory clarity about whether it is a swap, security-based swap, or mixed swap, so the CFTC expects the aggregate costs of submitting joint interpretations to decrease over time as joint interpretations are issued and the number of new requests decrease as a result.

Separately, CFTC rule 1.9 under the CEA allows persons to submit a request for a joint order from the Commissions regarding an alternative regulatory treatment for particular mixed swaps. This process applies except with respect to bilateral, uncleared mixed swaps where one of the parties to the mixed swap is dually registered with the CFTC as a swap dealer or major swap participant and with the SEC as a security-based swap dealer or major security-based swap participant. With respect to bilateral uncleared mixed swaps where one of the parties is a dual registrant, the rule provides that such mixed swaps would be subject to the regulatory scheme set forth in rule 1.9 in order to provide clarity as to the regulatory treatment of such mixed swaps.

1200 This estimate is based on information indicating that the average costs associated with preparing and submitting a no-action request to the SEC staff in connection with the identification of whether certain products are securities, which the CFTC believes is a process similar to the process under rule 1.8. The staff estimates that costs associated with such a request will cost approximately $20,000. The CFTC estimates the analysis will require approximately 20 hours of in-house counsel time and 30 hours of outside counsel time. Based upon data from SIFMA's *Management & Professional Earnings in the Securities Industry 2011* (modified by CFTC staff to account for an 1800-hour-work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead), staff estimates that the average national hourly rate for an internal attorney is $378. The CFTC estimates the costs for outside legal services to be $400 per hour. Accordingly, the CFTC estimates the cost to be $20,000 ($7,560 (based on 20 hours of in-house counsel time x $378) + $12,000 (based on 30 hours of outside counsel x $400) rounded to two significant digits to $20,000 to submit a joint request for interpretation.

The CFTC estimates that the cost of submitting a request for a joint order seeking an alternative regulatory treatment for a particular mixed swap would be approximately $31,000.[1201] Absent such a process, though, market participants that desire or intend to enter into such a mixed swap (or class thereof) would be required pursuant to Title VII of the Dodd-Frank Act to comply with all regulatory requirements applicable to both swaps and security-based swaps. The CFTC believes that the cost of such dual regulation would likely be at least as great, if not greater, than the costs of the process set forth in rule 1.9 to request an alternative regulatory treatment for such the mixed swap. The rule regarding bilateral uncleared mixed swaps where at least one party is a dual registrant does not entail any additional costs, and may reduce costs for dual registrants that enter into such mixed swaps by eliminating potentially duplicative or inconsistent regulation.

b) Benefits

The CFTC believes that the rules that enable market participants to submit requests for joint interpretations regarding the nature of various agreements, contracts, or transactions, and requests for joint orders regarding the regulatory treatment of mixed swaps will help to create a more level playing field (since the joint interpretations and joint orders will be available to all

1201 This estimate is based on information indicating that the average costs associated with preparing and submitting a no-action request to the SEC staff in connection with the identification of whether certain products are securities, which the CFTC believes is a process similar to the process under rule 3a68-4(c). The staff estimates that costs associated with such a request will cost approximately $31,000. The CFTC estimates the analysis will require approximately 30 hours of in-house counsel time and 50 hours of outside counsel time. Based upon data from SIFMA's *Management & Professional Earnings in the Securities Industry 2011* (modified by CFTC staff to account for an 1800-hour-work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead), staff estimates that the average national hourly rate for an internal attorney is $378. The CFTC estimates the costs for outside legal services to be $400 per hour. Accordingly, the CFTC estimates the cost to be $31,000 ($11,340 (based on 30 hours of in-house counsel time x $378) + $20,000 (based on 50 hours of outside counsel x $400) rounded to two significant digits to submit a joint request for interpretation.

market participants) regarding which agreements, contracts, or transactions constitute swaps, security-based swaps, or mixed swaps, and the regulatory treatment applicable to particular mixed swaps. The joint interpretations and joint orders will be available to all market participants. The availability of such joint interpretations and joint orders regarding the scope of the definitions and the regulatory treatment of mixed swaps will reduce transaction costs and thereby promote the use of Title VII instruments for risk management and other purposes.

The product interpretation process established by the Commissions has a 120-day deadline. This deadline will facilitate new products coming to market relatively quickly. Further, the process holds the Commissions accountable because they will have to state why they are not providing an interpretation when they decline to do so.

c) Comments and Consideration of Alternatives

A commenter[1202] recommended that the Commissions require that market participants disaggregate mixed swaps and enter into separate simultaneous transactions so that they cannot employ mixed swaps to obscure the underlying substance of transactions.[1203] The Commissions are not adopting any rules or interpretations to require disaggregation of mixed swaps into their separate components, as the Dodd-Frank Act specifically contemplated that there would be mixed swaps comprised of both swaps and security-based swaps. Moreover, the CFTC believes that requiring market participants to disaggregate their agreements, contracts, or transactions into swaps and security-based swaps may limit the freedom of contract or discourage innovation of financial products and potentially increase transaction costs for swap market participants.

1202 See Better Markets Letter.

1203 Id.

12. Costs and Benefits of SBSA Books and Records, and Data, Requirements

CFTC rule 1.7 under the CEA would clarify that there would not be books and records or data requirements regarding SBSAs other than those that would exist for swaps. The rule alleviates any additional books and records or information costs to persons who are required to keep and maintain books and records regarding, or collect and maintain data regarding, SBSAs because the rule does not require such persons to keep or maintain any books and records, or collect and maintain any data, regarding SBSAs that differs from the books, records, and data required regarding swaps.

Specifically, rule 1.7 would require persons registered as SDRs to: i) keep and maintain books and records regarding SBSAs only to the extent that SDRs are required to keep and maintain books and records regarding swaps; and ii) collect and maintain data regarding SBSAs only to the extent that SDRs are required to collect and maintain data regarding swaps. In addition, rule 1.7 would require persons registered as swap dealers or major swap participants to keep and maintain books and records, including daily trading records, regarding SBSAs only to the extent that those persons would be required to keep and maintain books and records regarding swaps.

Because rule 1.7 imposes no requirements with respect to SBSAs other than those that exist for swaps, rule 1.7 would impose no costs other than those that are required with respect to swaps in the absence of rule 1.7. Rule 1.7 provides clarity by establishing uniform requirements regarding books and records, and data collection, requirements for swaps and for SBSAs. No comments were received with respect to Rule 1.7.

13. Costs and Benefits of the Anti-Evasion Rules and Interpretation

The CFTC is exercising the anti-evasion rulemaking authority granted to it by the Dodd-Frank Act. Generally, CFTC rule 1.3(xxx)(6) under the CEA defines as a swap any agreement, contract, or transaction that is willfully structured to evade the provisions of Title VII governing the regulation of swaps. Further, CFTC rule 1.6 under the CEA would prohibit activities conducted outside the United States, including entering into agreements, contracts, and transactions and structuring entities, to willfully evade or attempt to evade any provision of the CEA as enacted by Title VII or the rules and regulations promulgated thereunder.

As opposed to providing a bright-line test, rule 1.3(xxx)(6) would apply to agreements, contracts, and transactions that are willfully structured to evade and rule 1.6 would apply to entering into agreements, contracts, or transactions to evade (or as an attempt to evade) and structuring entities to evade (or as an attempt to evade) subtitle A of Title VII governing the regulation of swaps. Although this test does not provide a bright line, it helps ensure that would-be evaders cannot willfully structure their transactions or entities for the purpose of evading the requirements of subtitle A of Title VII. The CFTC also is explaining some circumstances that may constitute an evasion of the requirements of subtitle A of Title VII, while at the same time preserving the CFTC's ability to determine, on a case-by-case basis, with consideration given to all the facts and circumstances, that other types of transactions or actions constitute an evasion of the requirements of the statute or the regulations promulgated thereunder.

a) Costs

Market participants may incur costs when deciding whether a particular transaction or entity could be construed as being willfully structured to evade subtitle A of Title VII of the Dodd-Frank Act; however, the rules and related interpretations explain what constitutes evasive conduct, which should serve to mitigate such costs.

b) Benefits

Absent the proposed anti-evasion rules and related interpretations, price discovery might be impaired because markets would not be informed about those transactions, since through evasion such transactions would not comply with Dodd-Frank Act regulatory requirements. Additionally, certain risks could increase in a manner that the CFTC would not be able to measure accurately. The anti-evasion rules and related interpretations will bring the appropriate scope of transactions and entities within the regulatory framework established by the Dodd-Frank Act, which will better allow the CFTC to assure transparency and protect the U.S. financial system from certain risks that could go undetected through evasive conduct.

c) Comments and Consideration of Alternatives

A commenter[1204] asserted that a market participant should be able to enter into a transaction or structure an instrument or entity to avoid higher regulatory burdens and attendant costs as long as the transaction or entity has an overriding business purpose. Another commenter[1205] noted that the CFTC recognized in the Proposing Release that choosing to do a security-based swap over a swap to lessen a regulatory burden does not constitute evasion in itself, but expressed the view that this should not be limited to a choice between structuring a transaction as a swap and security. In this commenter's view, parties must be able to legitimately consider all relevant factors, including the cost and burden of regulation, in making their structuring choices. Another commenter[1206] requested that the CFTC make clear that movements away from swaps towards physical trades that reduce regulatory burdens will not be considered evasion under the final rule. A different commenter[1207] argued that the anti-evasion proposal is overly broad and unnecessarily limits the ability of market participants to choose

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1204 See CME Letter.

1205 See ISDA Letter.

1206 See COPE Letter.

1207 See SIFMA Letter.

between legitimate structuring alternatives. Finally, another commenter[1208] believes that the proposed rules will create an "impossible burden" on the innocent (non-evading) party.

Activity conducted solely for a legitimate business purpose, absent other indicia of evasion, does not constitute evasion as described in the CFTC's interpretation. The CFTC has clarified that consideration of regulatory burdens, including evidence of regulatory avoidance, is not dispositive of whether there has been evasion or not, but should be considered along with all other relevant facts and circumstances. For example, activities structured as securities instead of swaps and transactions that meet the forward exclusion are not evasion per se. The CFTC has clarified that it will impose appropriate sanctions on the willful evader for violation of the CEA and CFTC regulations and not on non-evading parties.

A commenter suggests that an alternative standard for a finding of evasion should be "whether the transaction is lawful or not" under the CEA, CFTC rules and regulations, orders, or other applicable federal, state or other laws.[1209] While the commenter's alternative standard for evasion may impose lower costs on market participants because it is a bright-line test, the CFTC is not adopting it. The commenter's alternative standard would blur the distinction between whether a transaction (or entity) is lawful and whether it is structured in a way to evade Dodd-Frank and the CEA. The anti-evasion rules provided herein are concerned with the latter conduct, not the former.[1210] Thus, the CFTC does not believe it is appropriate to limit the enforcement of its anti-evasion authority to only unlawful transactions.

<u>CEA Section 15(a) Summary</u>:

1208 <u>See</u> IECA Letter II.

1209 <u>See</u> WGCEF Letter.

1210 If a transaction is unlawful, the CFTC (or another authority) may be able to bring an action alleging a violation of the applicable rule, regulation, order or law.

(1) Protection of market participants and the public

Including certain foreign exchange transactions, forward rate agreements and certain other transactions in the swap definition protects the public by subjecting these transactions to Dodd-Frank regulation. Similarly, the anti-evasion rules protect market participants against evasive conduct that would take away the protection afforded to them under Dodd-Frank regulation.

(2) Efficiency, competitiveness, and the financial integrity of markets

The CFTC believes that the final rules and interpretations can be consistently applied by substantially all market participants to determine which agreements, contracts, or transactions are, and which are not, swaps, security-based swaps, security-based swap agreements, or mixed swaps. This may improve resource allocation efficiency as market participant may not have to incur the cost of petitioning the Commissions or obtaining an opinion of counsel to determine the status of agreements, contracts or transactions as frequently as would be necessary without the rules or interpretations.

Moreover, the Commissions' statement that the determination of whether a Title VII instrument is a swap, a security-based swap, or both (i.e., a mixed swap), is made prior to the execution of, but no later than an offer to enter into, the Title VII instrument , and remains the same throughout the instrument's life (absent amendment of the instrument), improves resource allocation efficiency because, without this interpretation, market participants potentially would need to expend additional resources to continually monitor their swaps to see if the indexes on which they are based have migrated from broad-based to narrow-based. The tolerance and grace periods for index CDS traded on CFTC and SEC-regulated trading platforms should lower the frequency of index migration and attendant costs, also improving resource allocation efficiency.

(3) Price discovery

Not exempting swaps from foreign central banks, foreign sovereigns, international financial institutions, such as multilateral development banks, and similar organizations helps improve transparency and price discovery through disclosure that might otherwise not occur. Market participants will be informed about the prices of these transactions. Furthermore, they will be better informed about the risks that these transactions entail.

The CFTC's interpretation of the term "swap" to include guarantees of swaps that are not security-based swaps or mixed swaps and the separate CFTC release will enable the CFTC and market participants to receive more price-forming data about such swaps, which help improve price discovery for swaps. Without anti-evasion rules, price discovery might be impaired, since market participants would otherwise not be informed about relevant but evasive swap transactions.

(4) Sound risk management practices

Properly classifying transactions as swaps or not swaps may lead to sound risk management practices, because the added clarity provided by the rules and interpretations herein will enable market participants to consider whether a particular agreement, contract, or transaction is a swap, prior to entering into such agreement, contract or transaction.

The business of insurance is already subject to established pre-Dodd-Frank Act regulatory regimes. Requirements that may work well for swaps and security-based swaps may not be appropriate for traditional insurance products. To the extent that the final rules distinguish insurance from swaps and security-based swaps, the CFTC believes that the Commissions should be able to tailor rules for specific products that are swaps or security-based swaps to achieve Title VII regulatory objectives. In adopting the Insurance Safe Harbor, the CFTC believes that the Commissions seek to achieve those net benefits that may be obtained from not supplanting existing insurance regulation.

Documenting oral book-outs should promote good business practices and aid the CFTC in preventing evasion through abuse of the forward exclusion.

Title VII instruments on qualifying foreign futures contracts on debt securities of one of the 21 enumerated foreign governments is a swap and not a security-based swap if the Title VII instrument satisfies certain conditions. The classification may provide cross-margining benefits when swap contracts and the futures contract are margined at the same derivatives clearing organization, and thus, may enhance sound risk management practices.

Other Public Interest Considerations

Documenting oral book-outs should promote good business practices and aid the CFTC in preventing evasion through abuse of the forward exclusion.

The product interpretation process established by the Commissions has a 120-day deadline. This deadline will facilitate new products coming to market relatively quickly. Further, the process holds the Commissions accountable, because they will have to state why they are not providing an interpretation when they decline to do so.

The rule for books and records requirements for SBSAs does not impose new recordkeeping requirements on SBSAs, but relies on existing recordkeeping requirements for swaps, which avoids unnecessary regulation.

Appendix – Rules Effectuated by the Product Definitions		
Rulemaking	**Description of Rule**	**Citation to Cost Benefit Considerations**
Agricultural Swaps	Makes no distinction between agricultural swaps and other swaps	76 FR 49291, 49297, Aug. 10, 2011
Commodity Options	Exempts subject to conditions certain options on physical commodities where parties are commercials or ECPs. The option results in physical delivery of the underlying.	77 FR 25320, 25331, Apr. 27, 2012
CPO/CTA compliance obligations	Rescinds the exemption from CPO registration; rescinds relief from the certification requirement for annual reports provided to operators of certain pools offered only to qualified eligible persons (QEPs; modifies the criteria for claiming relief); and require the annual filing of notices claiming exemptive relief under several sections of the Commission's regulations. Finally, the adopted amendments include new risk disclosure requirements for CPOs and CTAs.	77 FR 11252, 11275, Feb. 24, 2012
Business Conduct Standards for SDs and MSPs With Counterparties	Applies to SDs and (except where indicated) MSPs and prohibits certain abusive practices, requires disclosures of material information to counterparties and requires SDs/MSPs to undertake certain due diligence relating to their dealings with counterparties. Certain rules do not apply to transactions initiated on a swap execution facility (SEF) or designated contract market (DCM) when the SD/MSP does not know the identity of the counterparty prior to execution.	77 FR 9734, 9805, Feb. 17, 2012
SD and MSP Recordkeeping, Reporting, and Duties Rules; FCMs and IBs Conflicts of Interest Rules; and Chief Compliance Officer Rules for SDs, MSPs, and FCMs	Establishes reporting, recordkeeping, and daily trading records requirements for SDs and MSPs; establishes and governs the duties of SDs and MSPs; establishes conflicts of interest requirements for SDs, MSPs, FCMs, and IBs; establishes the designation, qualifications, and duties of the chief compliance officers (CCOs) of FCMs, SDs, and MSPs and describes the required contents of the annual report detailing a registrant's compliance policies and activities, to be prepared by the chief compliance officer and furnished to the CFTC.	77 FR 20128, 20166, Apr. 3, 2012
Position Limits for Futures and Swaps	Establishes limits on speculative positions in 28 selected physical commodity futures and swaps	76 FR 71626, 71662, Nov. 18, 2011
Real-Time Public Reporting of Swap Transaction Data	Establishes regulations concerning the real-time public reporting of swap transactions and pricing data.	77 FR 1182, 1232, Jan. 9, 2012

Swap Data Recordkeeping and Reporting Requirements	Establishes swap data recordkeeping and reporting requirements for registered entities and counterparties.	77 FR 2136, 2176, Jan. 13, 2012
Swap Data Repositories: Registration Standards, Duties and Core Principles	Establishes regulations concerning the registration and regulation of swap data repositories.	76 FR 54538, 54572, Sept. 1, 2011
Registration of SDs and MSPs	Establishes the process for the registration of SDs and MSPs.	77 FR 2613, 2623, Jan. 19, 2012

XI. Administrative Law Matters – Exchange Act Revisions

A. Economic Analysis

1. Overview

The SEC is sensitive to the costs and benefits of its rules. In adopting the final rules in this release, the SEC has been mindful of the costs and benefits associated with these rules which provide fundamental building blocks for the Title VII regulatory regime established by Congress. In addition, section 3(f) of the Exchange Act requires the SEC, whenever it engages in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote competition, efficiency, and capital formation.[1211] Moreover, section 23(a)(2) of the Exchange Act requires the SEC, when adopting rules under the Exchange Act, to consider the impact such rules would have on competition. Section 23(a)(2) also prohibits the SEC from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.[1212] The SEC requested comment on all aspects of the costs and benefits of the proposed rules in the Proposing Release,[1213] and any effect these rules may have on competition, efficiency, and capital formation.

These final rules implement the mandate of Title VII that the CFTC and the SEC, in consultation with the Federal Reserve Board, jointly further define the terms "swap," "security-based swap," and "security-based swap agreement."[1214] The rules adopted in this release may be divided into three categories:

1211 15 U.S.C. 78c(f).

1212 15 U.S.C. 78w(a)(2).

1213 See Proposing Release at 29885.

1214 See section 712(d)(1) of the Dodd-Frank Act.

First, the Commissions are adopting rules that will assist market participants in determining whether particular agreements, contracts, and transactions fall within or outside the swap and security-based swap definitions (i.e., identifying products subject to Title VII). The final rules provide: (1) an Insurance Safe Harbor for those agreements, contracts, and transactions that the Commissions believe Congress does not intend to be Title VII instruments;[1215] (2) a "grandfather" for those insurance agreements, contracts, or transactions (as opposed to insurance product categories) entered into on or before the effective date of the Product Definitions provided that, when the parties entered into such agreement, contract, or transaction, when the parties entered into such agreement, contract, or transaction, it was provided in accordance with the Provider Test;[1216] and (3) further definition of the term "swap" to specifically list certain enumerated products and not include certain foreign exchange forwards and foreign exchange swaps.[1217]

Second, the Commissions are adopting rules that will assist market participants in determining whether a particular Title VII instrument is a swap subject to CFTC regulation, a security-based swap subject to SEC regulation, or a mixed swap subject to regulation by the CFTC and the SEC (i.e., mapping the jurisdictional divide between the CFTC and the SEC). Specifically, Title VII instruments that are CDS referencing a security index or a group or index of issuers of securities or obligations of issuers of securities may be swaps subject to CFTC regulation or security-based swaps subject to SEC regulation, depending on whether such Title VII instruments are based on events relating to "issuers of securities in a narrow-based security

[1215] See supra part II.B.1.

[1216] See supra part II.B.1.c).

[1217] See supra part II.C.2.

index" or events relating to securities in a "narrow-based security index".[1218] The final rules further define the terms "issuers of securities in a narrow-based security index" and "narrow-based security index" for purposes of this analysis.[1219] Further, the Commissions are adopting rules that provide tolerance and grace periods for Title VII instruments based on a security index that are traded on certain trading platforms where the security index may temporarily move from being within the "narrow-based security index" definition to being outside (e.g.,. moving from narrow-based to broad-based, or vice versa.)[1220] Additionally, the Commissions are providing clarification that a Title VII instrument based on a qualifying foreign futures contract on the debt securities of one or more of the 21 enumerated foreign governments is a swap and not a security-based swap, if certain conditions are met.[1221]

Third, the Commissions are adopting rules that provide: (1) a regulatory framework for certain mixed swaps and a process for market participants to request that the Commissions issue a joint order determining the appropriate regulatory treatment of certain other mixed swaps[1222] and (2) a process for market participants to request a joint interpretation from the Commissions regarding whether a particular Title VII instrument is a swap, security-based swap, or mixed swap.[1223] The final rules also provide that market participants have no additional books and records requirements for SBSAs other than those for swaps.[1224]

1218 See section 3(a)(68)(A)(ii)(III) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(ii)(III).

1219 See supra part III.G.

1220 See supra part III.G.5.

1221 See supra part III.E.

1222 See supra part IV.

1223 See supra part VI.

1224 See supra part V.

In considering the economic consequences of the final rules, the SEC acknowledges the regulatory regime that was in place prior to the enactment of Title VII. Prior to the enactment of Title VII, swaps and security-based swaps were by-and-large unregulated. The Commodity Futures Modernization Act of 2000 ("CFMA") created a regulatory regime that prohibited the SEC from regulating security-based swap agreements,[1225] though it provided the SEC with limited enforcement authority over such instruments with respect to fraud, manipulation, and insider trading.[1226] Title VII created an entirely new regulatory regime to regulate swaps, security-based swap agreements and security-based swaps.

1225 The CFMA added section 206A to the GLBA, 15 U.S.C. 78c note, to define the term "swap agreement" to mean any agreement, contract, or transaction between ECPs, the material terms of which (other than price and quantity) are subject to individual negotiation, that fall within certain categories of transactions. Additionally, the CFMA added section 206B to the GLBA, 15 U.S.C. 78c note, which defined a "security-based swap agreement" to mean a swap agreement (as defined in section 206A of the GLBA) on which a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein. Furthermore, the CFMA added section 206C to the GLBA, 15 U.S.C. 78c note, which defined a "non-security-based swap agreement" to mean any swap agreement (as defined in section 206A of the GLBA) that is not a security-based swap agreement (as defined in section 206B of the GLBA). Title VII amended the definition of the term "swap agreement" (discussed in footnote 1284) and repealed the definition of the terms "security-based swap agreement" and "non-security-based agreement." See sections 762(a) and (b) of the Dodd-Frank Act. However, Title VII also added a new definition of the term "security-based swap agreement" in section 3(a)(78) of the Exchange Act, 15 U.S.C. 78c(a)(78), that is generally consistent with the repealed definition, except that the new definition excludes security-based swaps. Accordingly, Title VII provides jurisdiction to the CFTC for security-based swap agreements, such as Title VII Instruments based on broad-based securities indexes, and also retains the SEC's jurisdiction over such instruments in instances of fraud, manipulation, or insider trading.

1226 The CFMA excluded from the definition of the term "security" the term "security-based swap agreement" as well as the term "non-security based swap agreement" (as those terms are defined in section 206B and 206C (respectively) of the GLBA, 15 U.S.C. 78c note). See sections 2A(a) and (b)(1) of the Securities Act, 15 U.S.C. 77b-1(a) and (b)(1), and sections 3A(a) and (b)(1) of the Exchange Act, 15 U.S.C. 78c-1(a) and (b)(1). Furthermore, the CFMA explicitly prohibited the SEC from registering, or requiring, recommending, or suggesting the registration under the Securities Act and the Exchange Act of any security-based swap agreement (as defined in section 206B of the GLBA). See section 2A(b)(2) of the Securities Act, 15 U.S.C. 77b-1(b)(2), and section 3A(b)(2) of the Exchange Act, 15 U.S.C. 78c-1(b)(2). The CFMA also made explicit that the SEC is prohibited from either (1) promulgating, interpreting, or enforcing rules or (2) issuing orders of general applicability under the Securities Act or Exchange Act in a manner that imposes or specifies reporting or recordkeeping requirements, procedures, or standards as prophylactic

2. Economic Analysis Considerations

The rules adopted in this release implicate different types of potential costs and benefits. First, there are costs, as well as benefits, arising from subjecting certain agreements, contracts, or transactions to the regulatory regime of Title VII. The SEC refers to these costs and benefits as "programmatic" costs and benefits. Additionally, there are costs that parties will incur to assess whether certain agreements, contracts, or transactions are indeed subject to the Title VII regulatory regime, and, if so, costs to assess whether such Title VII instrument is subject to the regulatory regime of the SEC or the CFTC. The SEC refers to these costs as "assessment" costs.[1227]

The programmatic costs and benefits and the assessment costs raise distinct analytic issues. First, the SEC recognizes that the Product Definitions, while integral to the regulatory requirements that will be imposed on the swap and security-based swap markets pursuant to Title VII, do not themselves establish the scope or nature of those substantive requirements or their related costs and benefits. The SEC anticipates that the rules implementing the substantive requirements under Title VII will be subject to their own economic analysis, but final rules have

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measures against fraud, manipulation, or insider trading with respect to any security-based swap agreement (as defined in section 206B of the GLBA). However, the CFMA did provide the SEC with limited enforcement authority under section 10(b) of the Exchange Act, 15 U.S.C. 78j(b), and the rules promulgated thereunder that prohibit fraud, manipulation, or insider trading (but not rules imposing or specifying reporting or record-keeping requirements, procedures, or standards as prophylactic measures against fraud, manipulation, or insider trading). Furthermore, the CFMA applies judicial precedents under sections 9, 10(b), 15, 16, 20, and 21A of the Exchange Act, 15 U.S.C. 78i, 78j(b), 78o, 78p, 78t, and 78u-1, as well as section 17(a) of the Securities Act, 15 U.S.C. 77q(a), to security-based swap agreements (as defined in section 206B of the GLBA) to the same extent as they apply to securities.

1227 The SEC expects that the benefits resulting from further defining the terms "swap," "security-based swap," and "mixed swap" will likely accrue primarily at the programmatic level. To the extent appropriate, given the purposes of Title VII, the Commissions have sought to mitigate the costs persons will incur in connection with determining whether the instrument is a swap, security-based swap, or mixed swap.

not yet been adopted that would subject agreements, contracts, or transactions, or entities that act as intermediaries (such as security-based swap dealers ("SBS dealers") or major security-based swap participants ("MSBSPs")) or provide market infrastructures (such as clearing agencies, trade repositories and trade execution facilities), to such substantive requirements. The costs and benefits described below are therefore those that may arise in connection with: (1) determining whether certain agreements, contracts, or transactions are Title VII instruments (i.e., the assessment costs) and (2) subjecting those agreements, contracts, or transactions that are Title VII instruments, determined based on the statutory definitional lines that the Commissions are further defining, to a complete and fully effective complement of Title VII statutory and regulatory requirements. In addition, the discussion below addresses the costs and benefits arising from security-based swaps being within the definition of security under the Securities Act and the Exchange Act. Once a Title VII Instrument is determined to be a security-based swap, the security-based swap will be a security subject to the full panoply of the federal securities laws. Such treatment will give rise to costs and benefits, including those that apply to securities generally. Security-based swaps may be subject to additional costs to the extent that there are overlapping regulatory requirements arising from the Title VII regulatory requirements and those federal securities laws requirements that apply to securities generally. The SEC has already taken action to address some of such overlapping or inconsistent requirements[1228] and will continue to evaluate other needed actions, if any, to minimize any such overlapping regulatory implications.

[1228] See Order Pursuant to Sections 15F(b)(6) and 36 of the Securities Exchange Act of 1934 Granting Temporary Exemptions and Other Temporary Relief, Together With Information on Compliance Dates for New Provisions of the Securities Exchange Act of 1934 Applicable to Security-Based Swaps, and Request for Comment, Release No. 34-64678 (June 15, 2011), 76 FR 36287 (June 22, 2011); Exchange Act Exemptive Order; and SB Swaps Interim Final Rules.

Second, in determining the appropriate scope of these rules, the SEC considers the types of agreements, contracts, or transactions that should be regulated as swaps, security-based swaps, or mixed swaps under Title VII in light of the purposes of the Dodd-Frank Act, the overall regulatory framework, the historical treatment of the instruments and other regulatory frameworks, and the data currently available to the SEC. The SEC has sought to further define the terms "swap," "security-based swap," and "mixed swap" to address the status of agreements, contracts, and transactions that are appropriate to regulate as swaps, security-based swaps and mixed swaps within the purposes of Title VII and not to include those agreements, contracts, and transactions that historically have not been considered to be swaps or security-based swaps thereby not imposing unnecessary or inappropriate Title VII costs and burdens on parties engaging in agreements, contracts, and transactions. In addition, the SEC recognizes that these rules may have effects on competition, efficiency, and capital formation as a result of certain agreements, contracts, and transactions being determined to fall under or outside the Title VII regulatory regime, or as a result of the jurisdictional divide between the SEC and CFTC as mandated by the statute.

In the sections below, the SEC begins by recognizing that the Title VII regulatory regime has programmatic benefits and costs, as well as assessment costs. These costs and benefits have informed the decisions and the actions taken that are described throughout the release. Accordingly, the analysis below includes references to the discussions of the decisions and actions taken by the Commissions set forth above in other parts of this release. Finally the SEC discusses the effects of these rules on competition, efficiency, and capital formation.

3. Programmatic Benefits and Costs

By enacting Title VII, Congress created a regulatory regime for swaps and security-based swaps that previously did not exist.[1229] Title VII amendments to the Exchange Act impose, among other requirements, the following: (1) registration and comprehensive oversight of SBS dealers and MSBSPs;[1230] (2) reporting of security-based swaps to a registered security-based swap data repository ("SB SDR"), or to the SEC (if the security-based swap is uncleared and no SB SDR will accept the security-based swap for reporting), and dissemination of the security-based swap market data to the public;[1231] (3) clearing of security-based swaps at a registered clearing agency (or a clearing agency that is exempt from registration) if the SEC makes a determination that such security-based swaps are required to be cleared, unless an exception from the mandatory clearing requirement applies;[1232] and (4) if a security-based swap is subject

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1229 See supra part XI.A.1.

1230 See section 15F of the Exchange Act, 15 U.S.C. 78o-10.

1231 See section 3(a)(75) of the Exchange Act, 15 U.S.C. 78c(a)(75) (defining the term "security-based swap data repository"); section 13(m) of the Exchange Act, 15 U.S.C. 78m(m) (regarding public availability of security-based swap data); section 13(n) of the Exchange Act, 15 U.S.C. 78m(n) (regarding requirements related to SB SDRs); and section 13A of the Exchange Act, 15 U.S.C. 78m-1 (regarding reporting and recordkeeping requirements for certain security-based swaps). See also Security-Based Swap Data Repository Registration, Duties, and Core Principles, Release No. 34-63347 (Nov. 19, 2010), 75 FR 77306 (Dec. 10, 2010); corrected at 75 FR 79320 (Dec. 20, 2010) and 76 FR 2287 (Jan. 13, 2011) ("SDR Proposing Release"); and Regulation SBSR – Reporting and Dissemination of Security-Based Swap Information, Release No. 34-63346 (Nov. 19, 2010), 75 FR 75208 (Dec. 2, 2010) ("Regulation SBSR Proposing Release"). In each proposing release the SEC invited comment with respects to the costs and benefits of each of the proposed rules. The costs associated with these and other substantive rules, along with any comments received by the SEC addressing the costs of the proposed rules, are being addressed in more detail in connection with the applicable rulemakings.

1232 See section 3C(a)(1) of the Exchange Act, 15 U.S.C. 78c-3(a)(1). See also Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b-4 and Form 19b-4 Applicable to All Self-Regulatory Organizations, 75 FR 82490 (Dec. 30, 2010) ("Clearing Procedures Proposing Release"). In the Clearing Procedures Proposing Release the SEC invited comment with respects to the costs and benefits of each of the proposed rules. The costs associated with these and other substantive rules, along with any comments received by the SEC to the clearing requirement, execution of the security-based swap transaction on an exchange, on a security-based swap execution facility ("SB SEF") registered under the Exchange Act,[1233] or on an SB SEF that has been exempted from registration by the SEC under the Exchange Act,[1234] unless no SB SEF or exchange makes such security-based swap available for trading.[1235] In addition, Title VII amends the Securities Act and the Exchange Act to include security-based swaps in the definition of "security" for the purposes of those statutes.[1236] As a result, security-based swaps are subject to the full panoply of the federal securities laws. Title VII also added specific provisions to the Securities Act and Exchange Act affecting how security-based swaps may be sold. For example, Title VII amended section 5 of the Securities Act to require that a registration statement meeting the requirements of the Securities Act be in effect before there can be an offer to sell, offer to buy, purchase or sale of a security-based swap from or to any person

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addressing the costs of the proposed rules, are being addressed in more detail in connection with the applicable rulemakings.

1233 See section 3D of the Exchange Act, 15 U.S.C. 78c-4.

1234 See section 3D(e) of the Exchange Act, 15 U.S.C. 78c-4(e).

1235 See sections 3C(g) and (h) of the Exchange Act, 15 U.S.C. 78c-3(g) and (h). See also section 3(a)(77) of the Exchange Act, 15 U.S.C. 78c(77) (defining the term "security-based swap execution facility"). See also Registration and Regulation of Security-Based Swap Execution Facilities, Release No. 34-63825 (Feb. 2, 2011), 76 FR 10948 (Feb. 28, 2011) ("SB SEF Proposing Release"). In the SB SEF Proposing Release each proposing release the SEC invited comment with respects to the costs and benefits of each of the proposed rules. The costs associated with these and other substantive rules, along with any comments received by the SEC addressing the costs of the proposed rules, are being addressed in more detail in connection with the applicable rulemakings.

1236 See sections 761(a)(2) and 768(a)(1) of the Dodd-Frank Act (amending sections 3(a)(10) of the Exchange Act, 15 U.S.C. 78c(a)(10), and 2(a)(1) of the Securities Act, 15 U.S.C. 77b(a)(1), respectively). The Dodd-Frank Act also amended the Securities Act to provide that any offer or sale of a security-based swap by or on behalf of the issuer of the securities upon which such security-based swap is based or is referenced, an affiliate of the issuer, or an underwriter, shall constitute a contract for sale of, sale of, offer for sale, or offer to sell such securities. See section 768(a) of the Dodd-Frank Act (amending section 2(a)(3) of the Securities Act, 15 U.S.C. 77b(a)(3)).

who is not an ECP.[1237] In addition, Title VII added section 6(l) to the Exchange Act to require that any security-based swap transaction with or for a person that is not an ECP must be effected on a national securities exchange.[1238]

The creation of regulatory regimes for agreements, contracts, or transactions that are defined as a swap or security-based swap will result in an array of programmatic benefits. However, if an agreement, contract or transaction falls within the swap or security-based swap definition, the parties to the agreement, contract, or transaction also may incur a number of upfront and ongoing costs associated with the regulation of Title VII instruments and transactions. These programmatic benefits and costs, discussed in more detail below, relate to Title VII registration; business conduct standards, compliance, operation and governance; clearing, trade execution, and reporting and processing; investor protection provisions of Title VII and the application of the federal securities laws.[1239]

1237 15 U.S.C. 77e.

1238 See section 6(l) of the Exchange Act, 15 U.S.C. 78f(l).

1239 For example, dealers and major participants will be subject to business conduct requirements of section 15F of the Exchange Act, and thus will be required, among other things, to determine that their counterparty meets certain eligibility standards before entering into security-based swaps with them and to disclose information about material risks and characteristics, material incentives, conflicts of interest, the daily mark, and clearing rights. See Business Conduct Standards for Security-Based Swaps Dealer and Major Security-Based Swap Participants, Release No. 34-64766 (June 29, 2011), 76 FR 42396, 42406, 42410 (July 18, 2011) ("Business Conduct Standards Proposing Release"). Also, for example, in connection with registration requirements the SEC expects security-based swap dealers and major security-based swap participants to incur costs in connection with completing and filing forms, providing related certifications, addressing additional requirements in connection with associated persons, as well as certain additional costs. See Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, Release No. 34-65543 (Oct. 12, 2011), 76 FR 65784, 65813-18 (Oct. 24, 2011) ("SB Swap Participant Registration Proposing Release"). In each proposing release the SEC invited comment with respects to the costs and benefits of each of the proposed rules. The costs associated with these and other substantive rules, along with any comments received by the SEC addressing the costs of the proposed rules, are being addressed in more detail in connection with the applicable rulemakings.

a) Title VII Registration of Entities Involved in Security-Based Swaps

As a result of Title VII imposing a new regulatory regime on security-based swaps, in addition to making such security-based swaps securities under the Securities Act and the Exchange Act, Title VII will require the registration of entirely new types of registrants with the SEC, including SBS dealers and MSBSPs,[1240] SB SEFs,[1241] SB SDRs,[1242] and clearing agencies registered to clear security-based swaps.[1243] The SEC expects that registrants will incur costs in gathering information, accurately completing forms and filing these forms with the SEC.[1244] Registration will provide the SEC with information regarding registrants which will enable the SEC to oversee the SEC's security-based swap registrants.

b) Business Conduct Standards, Compliance, Operation, and Governance

Title VII imposes requirements on registrants that did not exist prior to the adoption of Title VII, including core principles, duties and/or standards that are related to the type of registrant and its function.[1245] For example, Title VII includes core principles for SB SEFs,

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1240 See section 15F(b)(5) of the Exchange Act, 15 U.S.C. 78o-10(b)(5).

1241 See section 3D(a) of the Exchange Act, 15 U.S.C. 78c-4.

1242 See section 13(n)(1) of the Exchange Act, 15 U.S.C. 78m(n)(1).

1243 See section 17A(g) of the Exchange Act, 15 U.S.C. 78q-1(g).

1244 The SEC has proposed rules related to the registration requirements for each of these new registrants. See SB Swap Participant Registration Proposing Release; SB SEF Proposing Release; SDR Proposing Release; and Clearing Agency Standards for Operation and Governance, Release No. 34-64017 (Mar. 3, 2011), 76 FR 14472 (Mar. 16, 2011) ("Clearing Agency Standards Proposing Release"). In each proposing release the SEC invited comment with respects to the costs and benefits of each of the proposed rules. The costs associated with these and other substantive rules, along with any comments received by the SEC addressing the costs of the proposed rules, are being addressed in more detail in connection with the applicable rulemakings.

1245 See sections 3D(d), 13(n)(5) and (7), and 15F(h) and (j) of the Exchange Act, 15 U.S.C. 78c-4(d), 78m(n)(5) and (7), and 78o-10(h) and (j).

many of which require SB SEFs to establish and enforce rules specific to the trading of security-based swaps.[1246] Similarly, Title VII assigns duties (in addition to core principles) that are specific to the nature of SB SDRs, e.g. the acceptance and maintenance of data related to security-based swaps.[1247] The provisions of Title VII related to SB SEFs and SB SDRs are designed to provide transparency in the security-based swap market.

Title VII also imposes a number of requirements on registered SBS dealers and MSBSPs, such as external business conduct requirements.[1248] Specifically, section 15F(h)(3)(B) of the Exchange Act establishes certain disclosure requirements for SBS dealers and MSBSPs,[1249] and section 15F(h)(3)(C) of the Act requires that communications by these entities meet certain standards of fairness and balance.[1250] The level of protection becomes higher for special entities[1251] to whom dealers offer security-based swaps.[1252] For example, an SBS dealer that acts

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1246 See sections 3D(d)(2), (3), (4), (6), and (8) of the Exchange Act, 15 U.S.C. 78c-4(d)(2), (3), (4), (6), and (8). See also SB SEF Proposing Release. In the SB SEF Proposing Release the SEC invited comment with respects to the costs and benefits of each of the proposed rules. The costs associated with these and other substantive rules, along with any comments received by the SEC addressing the costs of the proposed rules, are being addressed in more detail in connection with the applicable rulemakings.

1247 See section 13(n)(5) of the Exchange Act, 15 U.S.C. 78m(n)(5). See also SDR Proposing Release. In the SDR Proposing Release the SEC invited comment with respects to the costs and benefits of each of the proposed rules. The costs associated with these and other substantive rules, along with any comments received by the SEC addressing the costs of the proposed rules, are being addressed in more detail in connection with the applicable rulemakings.

1248 The SEC has proposed rules regarding business conduct standards for security-based swap dealers and major security-based swap participants. See Business Conduct Standards Proposing Release. In the Business Conduct Standards Proposing Release the SEC invited comment regarding the costs and benefits associated with the proposed rules. The costs associated with these and other substantive rules, along with any comments received by the SEC addressing the costs of the proposed rules, are being addressed in more detail in connection with the applicable rulemakings.

1249 See section 15F(h)(3)(B) of the Exchange Act, 15 U.S.C. 78o-10(h)(3)(B).

1250 See section 15F(h)(3)(C) of the Exchange Act, 15 U.S.C. 78o-10(h)(3)(C).

1251 Title VII amends the Exchange Act to define a special entity as: (1) a Federal agency; (2) a State, State agency, city, county, municipality, or other political subdivision of a State; (3) any as an advisor to a special entity has a duty to act in the best interest of the special entity and is required to make reasonable efforts to obtain such information as is necessary for the SBS dealer to make a reasonable determination that any security-based swap recommended by the SBS dealer is in the best interests of the special entity.[1253] In addition, section 15F(j)(5) of the Exchange Act imposes requirements intended to address potential conflicts of interest that may arise in transactions between a SBS dealer or MSBSP and its counterparty.[1254] Title VII also imposes upon SBS dealers and MSBSPs requirements to implement risk management policies and procedures that are designed to prevent them from taking on excessive risk and to enable them to better deal with market fluctuations that might otherwise endanger their financial health.[1255]

Section 15F(e) of the Exchange Act as added by section 764(a) of the Dodd Frank Act, imposes capital and margin requirements on dealers and major participants,[1256] which are designed to reduce the financial risks of these institutions and contribute to the stability of the security-based swap market in particular and the U.S. financial system more generally.[1257] With

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employee benefit planned, as defined in section 3 of the Employee Retirement Income Security Act of 1974; or (4) any governmental plan, as denied in section 3 of the Employee Retirement Income Security Act of 1974; or any endowment, including an endowment that is an organization in section 501(c)(3) of the Internal Revenue Code of 1986. See section 15F(h)(2)(C) of the Exchange Act, 15 U.S.C. 78o-10(h)(2)(C).

1252 See sections 15F(h)(2), (h)(4), and (h)(5) of the Exchange Act, 15 U.S.C. 78o-10(h)(2), (h)(4), and (h)(5).

1253 See section 15F(h)(4)(B) and (C) of the Exchange Act, 15 U.S.C. 78o-10(h)(4)(B) and (C).

1254 See section 15F(j)(5) of the Exchange Act, 15 U.S.C. 78o-10(j)(5).

1255 See section 15F(j)(2) of the Exchange Act, 15 U.S.C. 78o-10(j)(2).

1256 See section 15F(e) of the Exchange Act, 15 U.S.C. 78o-10(e).

1257 See Entity Definitions Release at 30723, supra note 12.

respect to a security-based swap submitted for clearing, counterparties will be required to post initial margin and maintenance margin to secure its obligations under the trade.

Section 3E of the Exchange Act, among other things, requires registered brokers, dealers and SBS dealers that collect initial and variation margin from counterparties to cleared security-based swap transactions to maintain that collateral in segregated accounts.[1258] With respect to uncleared swaps, section 3E gives a counterparty to a SBS dealer or MSBSP that collects collateral the right to request segregation of initial margins and maintenance of such initial margins in accordance with rules promulgated by the SEC.[1259] These protections provide market participants who enter into transactions with these entities confidence that their collateral accounts will remain separate from the SBS dealer or MSBSP's assets in the event of bankruptcy.[1260]

c) Clearing, Trade Execution, Reporting and Processing

Section 763 of the Dodd-Frank Act adds section 3C to the Exchange Act, which deals with clearing for security-based swaps.[1261] Prior to the enactment of Title VII, swaps which traded on a bilateral basis were subject to counterparty credit risk, which may not have been fully

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1258 See 15 U.S.C. 78c-5.

1259 Id.

1260 Id.

1261 See 15 U.S.C. 78c-3. See also Clearing Procedures Proposing Release; Clearing Agency Standards Proposing Release; End-User Exception of Mandatory Clearing of Security-Based Swaps, Release No. 34-63556 (Dec. 15, 2010), 75 FR 79992 (Dec. 21, 2010) ("End-User Exception Proposing Release"); and Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps under Regulation MC, Release No. 34-63107, (Oct. 14, 2010), 75 FR 65882 (Oct. 26, 2010) ("Proposed Regulation MC"). In each proposing release the SEC invited comment with respects to the costs and benefits of each of the proposed rules. The SEC has received comments on the cost and benefits of these proposed rules. The costs associated with these and other substantive rules are being addressed in more detail in connection with the applicable rulemakings.

mitigated by the posting of collateral.[1262] Section 3C of the Exchange Act requires that security-based swaps, with some exceptions, be cleared through a central counterparty ("CCP") registered with the SEC.[1263] Clearing a security-based swap places a CCP between the parties to a trade and reduces the counterparty risk.

Title VII also requires the execution of clearable security-based swaps on exchanges or SB SEFs if such security-based swaps are available to trade and the reporting of trades to an SB SDR and dissemination of trading data to the public.[1264] Title VII also imposes requirements relating to the operations of the SB SEFs and SDRs.[1265] Section 15F(i) of the Exchange Act establishes regulatory standards for certain [registered security-based swap entities] related to the confirmation, processing, netting, documentation, and valuation of security-based swaps, which should enhance the efficiency of the trade execution and processing of security-based swaps.[1266]

Furthermore, sections 15F(f), (g), and (j)(3) of the Exchange Act impose certain reporting, recordkeeping, and regulatory disclosure requirements on SBS dealers and

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[1262] See U.S. Gov't Accountability Office, *Systemic Risk: Regulatory Oversight and Recent Initiatives to Address Risk Posed by Credit Default Swaps*, GAO-09-397T, at 13 (Mar. 5, 2009).

[1263] 15 U.S.C. 78c-3. Such clearing agencies also are required to register. See section 17A(g) of the Exchange Act, 15 U.S.C. 78q-1(g).

[1264] See sections 3C(h) and 13(m) of the Exchange Act, 15 U.S.C. and 13m(m). See also Regulation SBSR Proposing Release; and SDR Proposing Release.

[1265] See SDR Proposing Release; and SB SEF Proposing Release. In each proposing release the SEC invited comment with respects to the costs and benefits of each of the proposed rules. The costs associated with these and other substantive rules, along with any comments received by the SEC addressing the costs of the proposed rules, are being addressed in more detail in connection with the applicable rulemakings.

[1266] See section 15F(i) of the Exchange Act, 15 U.S.C. 78o-10(i). See also Trade Acknowledgment and Verification on Security-Based Swap Transactions, Release No. 34-63727 (Jan. 14, 2011), 76 FR 3859 (Jan. 21, 2011) ("Trade Documentation Proposing Release"). In the Trade Documentation Proposing Release the SEC invited comment with respects to the costs and benefits of each of the proposed rules. The costs associated with these and other substantive rules, along with any comments received by the SEC addressing the costs of the proposed rules, are being addressed in more detail in connection with the applicable rulemakings.

MSBSPs.[1267] Specifically, Title VII imposes on parties to a security-based swap the responsibility to "report security-based swap transaction information to the appropriate registered entity in a timely manner as may be prescribed by the [SEC]."[1268] Title VII's reporting, recordkeeping, and disclosure requirements should enhance the volume and quality of information available in the market and facilitate effective oversight by the SEC.

d) Investor Protection Provisions of Title VII and the Application of the Federal Securities Laws

Prior to the enactment of Title VII, the SEC had the ability to bring actions based on fraud, manipulation or insider trading relating to security-based swap agreements (as defined in section 206B of the GLBA[1269]) but did not have any other regulatory authority over swaps, security-based swaps or market participants involved in security-based swap transactions.[1270] Title VII provides the SEC with antifraud enforcement authority over SBSAs under Title VII and gives the SEC the authority to regulate security-based swap transactions and the security-based

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1267 See section 15F(f) of the Exchange Act, 15 U.S.C. 78o-10(f) (reporting and recordkeeping requirements); section 15F(g) of the Exchange Act, 15 U.S.C. 78o-10(g) (daily trading records requirements); section 15F(j)(3) of the Exchange Act, 15 U.S.C. 78o-10(j)(3) (requirements related to the disclosure of information to regulators). See also Regulation SBSR Proposing Release. In the Regulation SBSR Proposing Release the SEC invited comment with respects to the costs and benefits of each of the rules proposed in the release. The costs associated with these and other substantive rules, along with any comments received by the SEC addressing the costs of the proposed rules, are being addressed in more detail in connection with the applicable rulemakings.

1268 See section 13(m)(1)(F) of the Exchange Act, 15 U.S.C. 13m(m)(1)(F). See also Regulation SBSR Proposing Release. In the Regulation SBSR Proposing Release the SEC invited comment with respects to the costs and benefits of each of the proposed rules. The costs associated with these and other substantive rules, along with any comments received by the SEC addressing the costs of the proposed rules, are being addressed in more detail in connection with the applicable rulemakings.

1269 15 U.S.C. 78c note.

1270 See supra part XI.A.1, notes 1225 and 1226.

swaps market, including the authority to prevent or deter fraud, manipulation or deceptive conduct and take other actions.[1271]

By including security-based swaps in the definition of security under the Securities Act and the Exchange Act and repealing the restrictions on regulating security-based swap agreements as securities, Title VII extended the investor protections under the federal securities laws to security-based swaps. In particular, Title VII amends the Exchange Act and the Securities Act to include security-based swaps within the definition of the term "security."[1272] Accordingly, security-based swaps are securities and benefit from the investor protections provided by the federal securities laws.[1273] In addition to the antifraud and anti-manipulation provisions, these protections include the registration, disclosure and civil liability provisions of the Securities Act and the disclosure provisions of the Exchange Act. Title VII specifically provides protections to non-ECPs by adding section 5(e) to the Securities Act, which requires that a registration statement must be in effect before a person can offer to sell, offer to purchase from, or otherwise enter into security-based swaps with non-ECPs.[1274] Any security-based swap

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1271 See supra part XI.A.1, notes 1225 and 1226 and part I. See also Prohibition Against Fraud, Manipulation, and Deception in Connection with Security-Based Swaps, Release No. 34-63236 (Nov. 3, 2010), 75 FR 68560 (Nov. 8, 2010) ("SB Swap Antifraud Proposing Release"). In the SB Swap Antifraud Proposing Release the SEC invited comment with respects to the costs and benefits of each of the proposed rules. The costs associated with these and other substantive rules, along with any comments received by the SEC addressing the costs of the proposed rules, are being addressed in more detail in connection with the applicable rulemakings.

1272 See section 2(a)(1) of the Securities Act and section 3(a)(10) of the Exchange Act, 15 U.S.C. 77b(a)(1) and 15 U.S.C. 78c(a)(10).

1273 See, e.g., Order Granting Temporary Exemptions under the Securities Exchange Act of 1934 in Connection with the Pending Revision of the Definition of "Security" to Encompass Security-Based Swaps, and Request for Comment, 76 FR 39927 (July 7, 2011) (discussing the effect of the amendment to the definition of the term "security" to include security-based swaps under the Exchange Act and granting certain temporary relief and providing interpretive guidance).

1274 See section 768(b) of the Dodd Frank act (adding section 5(e) of the Securities Act, 15 U.S.C. 77e(d)).

with or for a person that is not an ECP must be effected on a national securities exchange.[1275] Furthermore, Title VII ensures that a security-based swap cannot be used to avoid registration or investor protection under the Securities Act by providing that if a security-based swap is entered into by an issuer's affiliate or underwriter, the offer and sale of the underlying security must comply with the Securities Act.[1276]

The programmatic benefits related to investor protection under the federal securities laws have corresponding costs including costs associated with compliance with the registration and disclosure regime of the Securities Act if an exemption from such registration provisions is not available.[1277]

The above programmatic benefits and costs that will flow from regulation of the security-based swap market mandated by Title VII will be significant, although very difficult to quantify and measure.[1278] Moreover, the benefits can be expected to manifest themselves over the long

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1275 See section 6(l) of the Exchange Act, 15 U.S.C. 78f(l).

1276 See section 768(a) of the Dodd-Frank Act (amending section 2(a)(3) of the Securities Act, 15. U.S.C. 77b(a)(3)).

1277 For offers and sales to non-ECPs, the statute requires registration of the security-based swap transaction.

1278 One commenter suggested that the best measure of the benefits of the Dodd-Frank Act is the cost of the 2008 financial crisis. This commenter provided, as an example, an estimate from the Bank of England that the cost of the 2008 financial crisis in terms of lost output was between $60 trillion and $200 trillion. See Letter from Dennis Kelleher, Better Markets to the CFTC, June 3, 2011, regarding the reopening and extension of comment periods for rulemaking implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act. The SEC recognizes that this estimate addresses the aggregate cost of the financial crisis. It is also recognized that others have expressed concern regarding the potential cost of the requirements of Dodd-Frank. See, e.g., letters from SIFMA, the American Bankers Association, the Financial Services Roundtable and the Clearing House Association, dated February 13, 2012 (commenting on Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 76 FR 68846 (Nov. 7, 2011)) and The Financial Services Roundtable, dated October 17, 2011 (commenting on Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant", 75 FR 80174 (Dec. 21, 2010)).

run and be distributed over the market as a whole. The programmatic costs and benefits associated with substantive rules applicable to security-based swaps under Title VII are being addressed in more detail in connection with the applicable rulemakings implementing Title VII. There are programmatic costs that may arise from the application of other provisions of the federal securities laws to security-based swaps, security-based swap transactions and market participants involved in such security-based swap transactions, including costs arising from potential overlapping regulatory requirements. The SEC already has taken interim actions to mitigate such overlapping and potentially conflicting regulatory requirements and will be carefully evaluating any future actions that may be necessary and appropriate to address such overlapping or conflicting requirements.

4. Costs and Benefits Associated with Specific Rules

a) Insurance Safe Harbor and Grandfather for Insurance Products (Rules 3a69-1 under the Exchange Act)

i) Programmatic Benefits and Costs

The Commissions are adopting rules that establish an Insurance Safe Harbor and an Insurance Grandfather for certain agreements, contracts, and transactions that meet the conditions and tests set forth in rule 3a69-1 under the Exchange Act.[1279] The agreements, contracts, and transactions that satisfy the Insurance Safe Harbor or Insurance Grandfather under the Exchange Act will fall outside the statutory swap and security-based swap definitions.[1280] The SEC believes that the conditions and tests set forth in the Insurance Safe Harbor represent

1279 See supra part II.B.1.

1280 Id.

the characteristics of many types of traditional insurance products.[1281] As stated above, the Commissions are not aware of anything in the legislative history or Title VII itself to suggest that Congress intended for traditional insurance products to be regulated as swaps or security-based swaps.[1282]

Typically, insurance has not been regulated under the federal securities laws; although variable life insurance and annuities are securities and are regulated under the federal securities laws.[1283] Although a broad reading of the swap definition could encompass traditional insurance, the SEC does not believe that such a reading is consistent with Congressional intent.[1284] To include products that meet the Insurance Safe Harbor or Insurance Grandfather in the swap or security-based swap definition would subject traditional insurance products to the Title VII regime which the SEC does not believe is intended by Congress. Imposing programmatic costs

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1281 Id.

1282 Id.

1283 See generally section 3(a)(8) of the Securities Act, 15 U.S.C. 77c(a)(8), and section 12(g) of the Exchange Act, 15 U.S.C. 78l(g). The SEC has previously stated its view that Congress intended any insurance contract falling within section 3(a)(8) to be excluded from all provisions of the Securities Act notwithstanding the language of the Securities Act indicating that section 3(a)(8) is an exemption from the registration but not the antifraud provisions. See Definition of "Annuity Contract or Optional Annuity Contract", 49 FR 46750, 46753 (Nov. 28, 1984). See also Tcherepnin v. Knight, 389 U.S. 332, 342 n.30 (1967) (Congress specifically stated that "insurance policies are not to be regarded as securities subject to the provisions of the [Securities] act," (quoting H.R. Rep. 85, 73rd Cong., 1st Sess. 15 (1933)). See also supra note 42.

1284 Section 206A of the GLBA, 15 U.S.C. 78c note defined the term "swap agreement" and the CFMA had two requirements in addition to the definition of "swap" itself: (1) the transaction is between ECPs (as defined prior to enactment of the Dodd-Frank Act); and (2) the material terms of the swap agreement (other than price and quantity) are subject to individual negotiation. Section 762 of the Dodd-Frank Act removed these requirements from the definition of swap agreement. See supra part XI.A.1, notes 1225 and 1226. The definition of swap in Title VII of the Dodd-Frank Act is not conditioned on the existence of either of the two requirements, although swap or security-based swap transactions with non-ECPs are subject to additional restrictions under the federal securities laws and the Commodity Exchange Act. See CEA section 1a(47), 7 U.S.C. 1a(47). Insurance policies are typically not subject to individual negotiation. Additionally, the average insurance purchaser may not qualify as an ECP. See CEA section 1a(18)(A)(xi), 7 U.S.C. 1a(18)(A)(xi).

on the insurance industry, such as those associated with compliance with the registration, compliance, and operation and governance requirements as described above, in addition to the Securities Act and Exchange Act requirements applicable to security-based swap transactions involving non-ECPs, would increase the business costs of insurance providers, which costs could be passed on to the consumers who need such insurance. In addition, because of the above costs as well as the Securities Act and Exchange Act restrictions applicable to offers and sales of security-based swaps to non-ECPs, including products that meet the Insurance Safe Harbor in the swap or security-based swap definition could potentially affect the ability of insurance providers to continue to offer insurance products and disrupt contracts that satisfy the Insurance Grandfather that are used every day in the American economy. For example, if Title VII applied to traditional insurance products, people who purchased insurance to protect their property or families against accidental hazards or risks would need to be qualified as ECPs[1285] or the offer and sale of the insurance products that were security-based swaps would need to be registered with the SEC[1286] and traded on an exchange;[1287] and for swaps that are under the CFTC jurisdiction would only be able to be sold on or subject to the rules of a board of trade. In addition, insurance providers that offer insurance products exceeding the de minimis threshold (as adopted in the Entities Release) applicable to swap dealers and security-based swap dealers

1285 An individual is considered an ECP if the individual "has amounts invested on a discretionary basis, the aggregate of which is in excess of – (i) $10,000,000; or (ii) $5,000,000 and who enters into the agreement, contract, or transaction in order to manage the risk associated with an asset owned or liability incurred, or reasonable likely to be owned or incurred, by the individual." CEA section 1a(18)(A)(xi), 7 U.S.C. 1a(18)(A)(xi).

1286 See section 5(e) of the Securities Act, 15 U.S.C. 77e(d).

1287 See CEA section 2(e), 7 U.S.C. 2(e), and section 6(l) of the Exchange Act, 15 U.S.C. 78f(l).

would be required to register as swap dealers or SBS dealers[1288] and be subject to the substantive requirements that result from such registration.

The rules adopted in this release provide continuity in the regulatory treatment of agreements, contracts, and transactions that are insurance and fall outside the swap and security-based swap definitions. Market participants will be able to continue to rely on their existing understanding of insurance laws and regulations to engage in business activities relating to the insurance agreements, contracts, and transactions that satisfy the Insurance Safe Harbor or Insurance Grandfather.

ii) Assessment Costs

Market participants will need to assess whether a particular agreement, contract, or transaction satisfies the Insurance Safe Harbor or Insurance Grandfather, prior to execution, but no later than when the parties offer to enter into the agreement, contract, or transaction. If such agreement, contract, or transaction satisfies rules 3a69-1 under the Exchange Act, it would fall outside the swap and security-based swap definitions. If such agreement, contract, or transaction does not satisfy the Insurance Safe Harbor or Insurance Grandfather, it would need to be analyzed based upon its own facts and circumstances in order to determine whether it falls within or outside the swap or security-based swap definition. For agreements, contracts, or transactions entered into subsequent to the effective date of such rule, this analysis will have to be performed prior to execution but no later than when the parties offer to enter into the agreement, contract, or transaction to customers to ensure compliance with Title VII. Incurring these assessment costs

1288 See Registration of Swap Dealers and Major Swap Participants, 77 FR 2613, corrected at 77 FR 3590 (regarding swap dealers and major swap participants); SB Swap Participant Proposing Release, supra note 1239, (regarding SBS dealers and MSBSPs).

with respect to these agreements, contracts, or transactions would not have been required in most cases prior to Title VII for two primary reasons. First, as security-based swaps were not regulated prior to Title VII, there was no need to determine whether an agreement, contract or transaction fell within or outside the definition of security-based swap agreement in the CFMA. Second, the need for parties to assess individual types of insurance for purposes of determining whether the federal securities laws apply would be limited because, as previously stated, typically, insurance has not been regulated under the federal securities laws, although variable life insurance and annuities are securities and are regulated under the federal securities laws.[1289]

The SEC believes that rule 3a69-1 under the Exchange Act reduces the assessment costs that would otherwise exist without these rules. Without rule 3a69-1 under the Exchange Act, market participants would still need to assess whether or not the agreement, contract, or transaction they are offering falls within the swap or security-based swap definition. More time and effort would likely be spent on the assessment because of lack of any safe harbor or grandfather to rely on. Without rule 3a69-1 under the Exchange Act, market participants may feel the need to request joint interpretations from the Commissions before they invest resources in insurance business, even with respect to agreements, contracts, or transactions that would otherwise meet the Insurance Safe Harbor or Insurance Grandfather.

The SEC recognizes that the assessment costs associated with rule 3a69-1 under the Exchange Act may include costs related to obtaining legal advice on whether an agreement, contract, or transaction meets the requirements of the Insurance Safe Harbor or Insurance Grandfather. The SEC has sought to minimize the costs of this analysis by adopting an approach

[1289] See supra note 1283.

that incorporates the characteristics of traditional insurance into the straightforward Product Test and Provider Test, as described in the discussions of relevant rules above.

The SEC believes there will be minimal assessment costs for parties to determine whether an agreement, contract, or transaction is among those specifically enumerated in rule 3a69-1 under the Exchange Act[1290] or that falls within the Insurance Grandfather.[1291]

With respect to rule 3a69-1 under the Exchange Act, the SEC believes that at least some market participants are likely to seek legal counsel for interpretation of various aspects of the rule, particularly when structuring new or novel insurance products. The costs associated with obtaining such legal counsel would vary depending on the relevant facts and circumstances, including the complexity of the agreement, contract, or transaction and whether an interpretation from the Commissions is requested. The SEC believes that the range of costs to undertake the legal analysis required to determine whether the Insurance Safe Harbor or Insurance Grandfather applies to an agreement, contract, or transaction will range from $378 to $27,000, with $27,000 representing a reasonable estimate of the upper end of the range of the costs.[1292]

1290 See supra part II.B.1.

1291 See supra part II.B.1.c).

1292 The average cost incurred by market participants in connection with assessing whether an agreement, contract, or transaction is a swap or security-based swap is based on the estimated amount of time that staff believes will be required for both in-house counsel and outside counsel to apply rule 3a69-1. Staff estimates that some agreements, contracts, or transactions will clearly satisfy the Insurance Safe Harbor, Insurance Grandfather and an in-house attorney, without the assistance of outside counsel, will be able to make a determination in one hour. Based upon data from SIFMA's *Management & Professional Earnings in the Securities Industry 2011* (modified by SEC staff to account for an 1800-hour-work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead), staff estimates that the average national hourly rate for an in-house counsel is $378. If an agreement, contract, or transaction is more complex, the SEC estimates the analysis will require approximately 30 hours of in-house counsel time and 40 hours of outside counsel time. The SEC estimates the costs for outside legal services to be $400 per hour. This is based on an estimated $400 per hour cost for outside legal services. This is the same estimate used by the SEC for these services in the release involving Exemptions for Security-Based Swaps Issued By Certain Clearing Agencies, Release No. 33-9308 (Mar. 30,

iii) Alternatives

The SEC could have determined to not further define the terms "swap" and "security-based swap" to address the status of traditional insurance products. If the Commissions did not further define the terms "swap" and "security-based swap" to address the status of traditional insurance products by adopting the Insurance Safe Harbor or the Insurance Grandfather certain insurance providers would have treated their insurance products as swaps or security-based swap, thereby incurring programmatic costs that would otherwise be avoidable. Other insurance providers could misinterpret the application of the definition of swap to certain agreements, contracts, or transactions to determine that they fall outside such definition of swap or security-based swap, in which case the amount of Title VII programmatic benefits and costs with respect to such products may potentially decrease. As stated above, without rule 3a69-1 under the Exchange Act, there also would be higher assessment costs to determine whether an agreement, contract, or transaction falls within or outside the swap or security-based swap definition.[1293]

The Commissions received several comments in support of alternatives to rule 3a69-1 under the Exchange Act as proposed[1294]. The alternatives suggested by commenters include:

- a test based on whether the agreement, contract, or transaction is subject to regulation as insurance by the insurance commissioner of the applicable state(s).[1295]

2012), 77 FR 20536 (Apr. 5, 2012). Accordingly, on the high end of the range the SEC estimates the cost to be $27,340 ($11,340 (based on 30 hours of in-house counsel time x $378) + $16,000 (based on 40 hours of outside counsel x $400). This estimate is rounded by two significant digits to avoid the impression of false precision of the estimate.

1293 See supra part XI.A.4(a)(ii).

1294 See supra part II.B.1.d), for a discussion of each of the proposed alternatives.

1295 See ACLI Letter; AFGI Letter; AIA Letter; MetLife Letter and Travelers Letter.

- a test based on the application of section 3(a)(8) of the Securities Act[1296] to the agreement, contract, or transaction.[1297]
- various alternative tests that add (or exclude) requirements to the Product Test and the Provider Test.[1298]

The Commissions have considered each of these alternatives proposed by commenters and are adopting the final rule as discussed above.[1299] The Commissions are not adopting the specific alternative tests as proposed by commenters. In considering each of these alternatives, the SEC has taken into account the costs and benefits associated with each alternative.

In the SEC's view, as discussed above,[1300] because these alternative tests do not adequately distinguish traditional insurance products from Title VII instruments, they could result in an over-inclusive Insurance Safe Harbor or Insurance Grandfather and fail to include in the Title VII regulatory regime agreements, contracts, and transactions that Congress intended to be regulated as swaps or security-based swaps.[1301] Therefore, the programmatic benefits of the Title VII regime would not be fully realized if any of the alternatives were adopted.

b) Narrow-Based Security Index Rules (Rules 3a68-1a, 3a68-1b, and 3a68-3(a) under the Exchange Act)

i) Programmatic Costs and Benefits

1296 15 U.S.C. 77c(a)(8).

1297 See ACLI Letter at 7; AFGI Letter at 3; CAI Letter at 21-25 and Nationwide Letter at 4.

1298 See ACLI Letter; AIA Letter; Nationwide Letter and NAIC Letter.

1299 See supra part II.B.1.

1300 See supra part II.B.1.d).

1301 For a more detailed discussion of the comments, including those that suggested alternatives, and the Commissions' response, see supra part II.B.1.d).

As previously stated, Title VII created a jurisdictional division between the CFTC and the SEC. The CFTC has jurisdiction over swaps, whereas the SEC has jurisdiction over security-based swaps. In most instances it is clear based on a plain reading of the statute whether a Title VII instrument is a swap or security-based swap (e.g., a CDS referencing a single security or issuer is a security-based swap).[1302] In other instances, such as index CDS, whether a Title VII instrument is a swap or security-based swap depends on whether such instrument is based on a "narrow-based security index" or events relating to "issuers of securities in a narrow-based security index".[1303] The Commissions are adopting rules 3a68-1a and 3a68-1b under the Exchange Act to further define the terms "issuers of securities in a narrow-based security index" and "narrow-based security index" for purposes of analyzing CDS.[1304] Additionally, the Commissions are adopting rule 3a68-3(a) under the Exchange Act to define narrow-based security index, except as otherwise provided in rules 3a68-1a and 3a68-1b, consistent with the statutory definition set forth in section 3(a)(55) of the Exchange Act and the rules, regulations and orders of the SEC thereunder.

As discussed above, there are programmatic costs and benefits that flow from being a Title VII instrument.[1305] The overall programmatic costs and benefits flowing from an agreement, contract, or transaction being a swap or a security-based swap may be impacted by the similarities and differences in the Commissions' regulatory programs for swaps and security-based swaps. Generally, the Title VII regulatory regimes of the CFTC and SEC are expected to be broadly similar and complementary. Title VII requires the SEC and the CFTC to consult and

[1302] See section 3(a)(68)(A)(II) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(II).

[1303] See section 3(a)(68)(A)(I) and (III) of the Exchange Act, 15 U.S.C. 78c(a)(68)(A)(I) and (III).

[1304] See supra part III.G.3.b).

[1305] See supra part XI.A.3.

coordinate for the purposes of assuring regulatory consistency and comparability with respect to rules adopted and orders issued pursuant to Title VII to the extent possible.[1306] Title VII provides that the Commissions should treat functionally or economically similar products or entities in a similar manner in such rules or orders, but does not require identical rules.[1307] The Commissions may, therefore, diverge substantively on certain rulemakings. In certain areas, the SEC believes it may be appropriate for Title VII's application to security-based swaps to be different from its application to the swaps that will be regulated by the CFTC, as the relevant products, entities and market themselves are different, or because the relevant statutory provisions are different. The SEC believes, however, that the programmatic costs and benefits (which will be discussed in subsequent releases adopting substantive rules) that will flow from the application of rules under either jurisdiction as a result of applying rules 3a68-1a, 3a68-1b, and 3a68-3(a) under the Exchange Act are expected to be broadly similar and complementary.

In addition, since Title VII specifically provides that security-based swaps are securities and grants the SEC the exclusive authority to regulate security-based swaps (other than as to mixed swaps for which the SEC shares jurisdiction with the CFTC), in adopting rules 3a68-1a, 3a68-1b, and 3a68-3(a) under the Exchange Act to further define the terms "narrow-based security index," and "issuers of securities in a narrow-based security index", the SEC is mindful of the programmatic costs and benefits specifically associated with security-based swaps falling under the federal securities laws regime and being regulated by the SEC. These programmatic benefits include, for example, the applicability of the Securities Act registration, disclosure, and civil liability scheme, as well as the SEC's authority to take action to protect investors and

1306 See section 712(a)(1) and (a)(2) of the Dodd-Frank Act.

1307 See section 712(a)(7)(A) and (B) of the Dodd-Frank Act.

prevent fraud and market manipulation. These benefits could in some cases have corresponding costs associated with the application of the Securities Act related to registration, disclosure and civil liability scheme and the registration, disclosure and liability provisions of the Exchange Act. For example, if an issuer of an underlying security enters into a security-based swap it will have to comply with the Securities Act registration requirements both for the security-based swap and the underlying security unless an exemption from registration is available. As another example, if market participants wish to sell security-based swaps to non-ECPs they will have to comply with the registration requirements of the Securities Act. Any person that would be required to comply with the registration requirements of the Securities Act with respect to security-based swaps will incur the costs of such registration, including legal and accounting costs. Additionally, such person will become subject to the periodic reporting requirements of the Exchange Act, unless already subject to such requirements, and incur the costs associated with such Exchange Act periodic reporting.

ii) Assessment Costs

Market participants will need to ascertain whether an agreement, contract or transaction based on an index is a swap or a security-based swap, prior to execution, but no later than when the parties offer to enter into it, according to the criteria set forth in the definitions of the terms "narrow-based security index" and "issuers of securities in a narrow-based security index." The SEC expects that this assessment will be made each time an index is considered to be used or created for purposes of transactions based on such index, and each time the material terms of the index on which the agreement, contract, or transaction is based are amended or modified.[1308]

[1308] See generally supra part III.G.

These assessment costs with respect to agreements, contracts, or transactions based on indexes did not arise prior to the enactment of Title VII. The SEC believes that such assessment costs may vary depending on the composition of the index that may underlie agreement, contract, or transaction. For example, the number of components in an index may impact the assessment costs because of the need to determine whether the index's components satisfy the various tests within the rule. However, once such assessment is performed and the narrow-based or broad-based characteristics have been established with respect to an index, unless the characteristic of such index changes, any market participants engaging in agreements, contracts, or transactions referencing such index would not need to incur any material assessment costs, other than to confirm that the index has not changed in a way that would change its classification from narrow-based to broad-based or vice versa.

Although the assessment cost associated with rules 3a68-1a, 3a68-1b, and 3a68-3(a) under the Exchange Act may vary, the SEC estimates that costs associated with undertaking the determination of whether an agreement, contract or transaction based on an index is a swap or security-based swap will range from \$378 to \$20,000.[1309] The SEC believes that some agreements, contracts, or transactions based on an established index would not need the

1309 The average cost incurred by market participants in connection with assessing whether an agreement, contract, or transaction is a swap or security-based swap is based on the estimated amount of time that staff believes will be required for both in-house counsel and outside counsel to apply the definition. Staff estimates that the average national hourly rate for an in-house counsel is \$378 based on data from SIFMA's *Management & Professional Earnings in the Securities Industry 2011* (modified by SEC staff to account for an 1800-hour-work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead). The SEC estimates the costs for outside legal services to be \$400 per hour. This is the same estimate used by the SEC for these services in the release involving Exemptions for Security-Based Swaps Issued By Certain Clearing Agencies, Release No. 33-9308 (Mar. 30, 2012), 77 FR 20536 (Apr. 5, 2012). Accordingly, on the high end of the range the SEC estimates the cost to be \$19,560 (\$7,560 (based on 20 hours of in-house counsel time x \$378) + \$12,000 (based on 30 hours of outside counsel x \$400). This estimate is rounded by two significant digits to avoid the impression of false precision of the estimate.

assistance of outside counsel, and a determination can be made in one hour. If an agreement, contract, or transaction is more complex, the SEC estimates the analysis will require approximately 20 hours of in-house counsel time and 30 hours of outside counsel time. Accordingly, if an agreement, contract or transaction is based on a newly structured customized index or basket to suit a particular investment or hedging need, the SEC estimates that the assessment may be at or close to the upper end of the estimated range, as part of the structuring of such customized index or basket.[1310]

iii) Alternatives

The Commissions received many comments on proposed rules 3a68-1a and 3a68-1b and have incorporated many of the suggested alternatives into the final rules and rejected, after careful consideration, other suggested alternatives, as fully discussed in section III.G.3.b. The policy choices made with respect to accepting or rejecting the alternatives suggested by the commenters have been informed by the cost and benefit considerations. In particular, as stated above, the SEC is mindful of the programmatic costs and benefits specifically associated with security-based swaps falling under the federal securities laws regime.[1311]

One alternative to rules 3a68-1a and 3a68-1b is for the Commissions to not further define the terms "issuers of securities in a narrow-based security index" or "narrow-based security index." The SEC believes the assessment cost associated with determining whether an index

1310 For example, the legal costs associated with the analysis of whether an index or basket CDS is a swap or security-based swap will include, among other things, analysis of the weighting of each index or basket component, the aggregate weighting of any five non-affiliated reference entities included in the index or basket, whether a predominant percentage (by weighting) of the issuers included in the index or basket satisfy the public information availability test and whether any issuer included in the index or basket with 5% or more weighting satisfies the public information availability test.

1311 See supra part XI.4.(b)(i).

CDS is a swap or security-based swap would be greater in the absence of rules 3a68-1a and 3a68-1b. Without these rules, market participants would still need to analyze index components and it would be difficult to apply the statutory language of "issuer of securities in a narrow-based security index" in section 3(a)(68)(A)(ii)(III) of the Exchange Act to index CDS, given that the existing statutory definition of "narrow-based security index" and the past guidance are focused on equity security indexes, volatility indexes and debt security indexes, none of which are specifically tailored for index CDS.[1312] Absent rules 3a68-1a and 3a68-1b, it is very likely that market participants would need to request interpretations from the Commissions. Rules 3a68-1a and 3a68-1b provide tailored and objective criteria, similar to the criteria used in the context of futures contracts on volatility indexes and debt security indexes, to assist market participants in determining whether an index CDS is based on issuers of securities in a narrow-based security index.[1313] These rules will allow market participants to make determinations without requesting interpretations from the Commissions and, therefore, should reduce the assessment costs.

Commenters expressed concern associated with the public information availability test and suggested that the public information availability test not be incorporated into the final rule for various reasons.[1314] As discussed above[1315], the Commissions are adopting the public information availability test with some modifications.

The SEC believes there are many programmatic benefits associated with the public information availability test. As noted above, the public information availability test is intended as the substitute test for the ADTV provision in the statutory narrow-based security index

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1312 See supra part III.G.3.

1313 Id.

1314 See LSTA Letter (with respect to loans), Markit Letter, ISDA Letter and SIFMA Letter.

1315 See supra part III.G.3.b)iii)

definition[1316]. The ADTV test is designed to take into account the trading of equity securities and, because the listing standards for equity securities require that the security be registered under the Exchange Act, the issuer of the equity security will be subject to the periodic reporting requirements of the Exchange Act. Due to the specific provisions of the statutory ADTV test, the Commissions have determined that the ADTV test is not a useful test for purposes of determining whether an index of reference entities or debt securities is a "narrow-based security index" because the components of the index are either reference entities, which do not "trade," or debt instruments, which commonly are not listed, and, therefore, do not have a significant trading volume.[1317] Applying the ADTV test in the existing statutory narrow-based security index definition would not serve any purposes. However, the basis for such provision, that there is sufficient trading in the securities, public information about, and therefore market following of, the issuer of the securities, applies to index CDS. As a substitute for such ADTV test, the SEC believes that there should be public information available about a predominant percentage of the reference entities included in the index, or, in the case of an index CDS on an index of securities, about the issuers of the securities or the securities underlying the index. The SEC believes that this should reduce the likelihood that non-narrow-based indexes referenced in index CDS, or the component securities, or the named issuers of securities in that index would be used as a surrogate for the reference entities securities without complying with the federal securities laws. In particular, the SEC believes that the public information availability test should reduce the likelihood that the index CDS could be used to circumvent the registration provisions of the Securities Act and provisions of the Exchange Act through the use of CDS based on such

1316 Id.

1317 Id.

indexes, manipulate the reference entities securities or the securities in the index and reduce the potential for misuse of material non-public information through the use of CDS based on such indexes..[1318] If a CDS is based on an index that does not satisfy the public information availability test,[1319] such index CDS will be a security-based swap and thus subject to the federal securities laws and the SEC's oversight.[1320]

Some commenters indicated that the determinations of public availability of information would be costly but did not quantify such costs or explain the difficulty in making an assessment of whether information was publicly available[1321]. The SEC recognizes that there will be assessment costs associated with application of the public information availability test. The SEC notes that the public information availability test applies only for purposes of determining whether an index is a "narrow-based security index." The SEC would expect that market participants would look to the index provider to make the assessment or, if the index or basket is customized by the market participant that the creator of the index would take into account the public information availability of the index components in creating the custom index or basket. As a result, while the SEC recognizes that there will be costs in evaluating whether the index components satisfy the tests, including the public information availability test, the SEC believes that the index provider (or the creator of the custom index or basket) would already be evaluating

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1318 Id.

1319 So long as the effective notional amounts allocated to reference entities or securities included in the index that satisfy the public information availability test comprise at least 80 percent of the index's weighting, failure by a reference entity or security included in the index to satisfy the public information availability test would be disregarded if the effective notional amounts allocated to that reference entity or security comprise less than 5 percent of the index's weighting. See paragraph (b) of rules 1.3(zzz) and 1.3(aaaa) under the CEA and rule 3a68-1a and 3a68-1b under the Exchange Act.

1320 See id.

1321 See LSTA Letter (with respect to loans); and SIFMA Letter the index components to determine whether the provider's index criteria were satisfied and, as part of such evaluation, would be able to ascertain whether the public information availability test is satisfied.

One commenter raised a specific concern about the assessment cost relating to applying the public information availability test to indexes of loans or borrowers and stated that unlike index of securities, which are generally subject to national or exchange-based reporting and disclosure regimes, a higher proportion of the components of an index of loans or borrowers may not be registered securities or reporting companies under the Exchange Act and therefore, this commenter stated that it would be more difficult or costly to determine whether an index of loans or borrowers meets the public information availability test.[1322] The SEC has modified the public information availability test to expand the categories of instrument to be aggregated for purposes of the outstanding indebtedness criterion and to change the method of calculating affiliation for purposes of the public information availability test. The SEC believes that these modifications will mitigate the assessment costs that the commenter is concerned about.[1323]

The SEC believes that the overall assessment costs of including a public information availability test are justified in light of its benefits of preventing the index CDS from being used as a surrogate for the underlying securities or securities of the referenced issuer of securities. This should, in turn, prevent circumvention of the application of the Securities Act to index CDS transactions, and prevent fraud, manipulation and misuse of material non-public information.

1322 See July LSTA Letter. See also supra part III.G.3(b)(iii).

1323 See supra part III.G.3.b)iii).

One commenter suggested replacing the public information availability test with a volume trading test.[1324] The Commissions are not adopting a volume-trading test based on the CDS components of the index or on the index itself, either as a replacement for the public information availability test or as an alternative means of satisfying it. A volume trading test based on CDS is not practicable to use to determine the character of such index CDS because the character of the index CDS would have to be determined prior to any transaction in the Title VII Instrument. Given that there would be no trading volume at the time such determination is made, the index CDS would fail a volume-trading test in all cases[1325] and the assessment costs incurred in connection with such test would not serve any purpose. There also would be assessment costs in determining how many transactions in the CDS index or each CDS component of the index existed, and it is not apparent that any such trade information is either publicly available or verifiable at this time. In addition, the SEC also believes that a volume test based either on the CDS components of the index or the CDS index itself would not be an appropriate substitute for or an alternative to a public information availability test with respect to the referenced entity, issuer of securities, or underlying security because such a volume-based test would not provide transparency on such underlying entities, issuers of securities or securities.[1326] The volume of transactions in a particular CDS or the CDS index does not relate to whether there is public information about the reference entity or reference security underlying the CDS or CDS index. Therefore, a volume-trading test would not achieve the programmatic benefits described above with respect to the public information availability test.

1324 See Markit Letter.

1325 See supra part III.G.3.b)iii).

1326 Id.

Similarly, the Commissions also rejected commenters' suggestion that the presence of a third-party index provider would assure that sufficient information is available regarding the index CDS itself without the need for a public information availability test.[1327] As stated above, the public information availability test is intended to assure the availability of information about the components of the index, the underlying securities and issuers of the securities.[1328] The existence of a third-party index provider does not imply any greater likelihood that such public information is available.[1329] Although the existence of a third-party index provider as a substitute for the public information availability test would reduce assessment costs of the market participants using such an index (other than the index provider who must evaluate compliance with index criteria), the SEC does not believe that the existence of the third party index provider is a substitute for the public information availability test. The SEC believes that the information a third-party index provider makes available about the construction of an index, index rules, components, and predetermined adjustments provides information only about the index and is not a substitute for the public availability of information about the issuers of the securities or the securities in the index.[1330] In addition, the SEC does not believe that the existence of a third-party index provider indicates any likelihood that such public information is available about the components of the index, which the SEC believes is important to reduce the potential for manipulation of the component securities of an index, or the named issuers of securities in an index, the misuse of non-public information about such an index, the component

1327 See ISDA Letter; and SIFMA Letter. Neither commenter provided any analysis to explain how or whether a third-party index provider would be able to provide information about the underlying securities or issuers of securities in the index.

1328 See supra part III.G.3.b)iii).

1329 Id.

1330 Id.

securities or the reference entities and circumvention of other provisions of the federal securities laws through the use of CDS based on such an index.[1331] Further, the SEC notes that a third-party index provider may create customized indexes at the behest of market participants, including as part of its regular business and be paid by such market participants for its index customization and creation services.[1332] Accordingly, the SEC does not believe that a third party index test is an appropriate alternative for the public information availability test and the costs to market participants is justified by the programmatic benefits such test provides.[1333]

As more fully discussed above in section III.G.3.b.iii, in considering other alternatives, including whether to revise or maintain the public information availability test, the SEC has consistently considered the programmatic benefits described above and the importance of assuring that there is information available with respect to the issuers of securities constituting a predominant percentage of an index on which a CDS is based if such index is not going to be considered a "narrow-based security index."

c) Swaps on Certain Futures Contracts on Foreign Sovereign Debt (Rule 3a68-5 Under the Exchange Act)

i) Programmatic Benefits and Costs

Rule 3a68-5 provides that a Title VII instrument that is based on qualifying foreign futures contracts on debt securities of one of the 21 enumerated foreign governments is a swap and not a security-based swap if the Title VII instrument satisfies certain conditions.[1334] This rule is intended to prevent such Title VII instruments from being used to circumvent both the

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1331 Id.

1332 Id. See also Proposing Release at 29852.

1333 Id.

1334 See supra part III.E.

conditions of rule 3a12-8 and the federal securities laws protections underlying such conditions.[1335] The conditions provided in rule 3a68-5 are intended to address these concerns. As discussed above, certain of the qualifying foreign futures contracts on the debt securities of one of the 21 enumerated foreign governments that satisfy the conditions of rule 3a12-8 trade with significant volume through foreign trading venues.[1336] Treating Title VII Instruments on such qualifying foreign futures contracts, subject to the conditions provided in rule 3a68-5, as swaps and not security-based swaps would not raise the concerns that such swaps could be used to circumvent rule 3a12-8, the federal securities laws concerns that such conditions are intended to protect, or allow circumvention of the provisions of the Securities Act applicable to security-based swaps (including those applicable to security-based swaps entered into by issuer of securities underlie such security-based swaps, their affiliates, or underwriters of their securities).[1337] There are certain programmatic costs associated with the rule that market participants will need to be cognizant of. For example, although rule 3a12-8 allows qualifying foreign futures to be physically settled outside the United States, the conditions of rule 3a68-5 require that the swap be cash settled in order to be a swap and not a security-based swap. This has the potential cost of not permitting settlement on the same terms as the qualifying foreign future. However, the SEC believes that, as with other Title VII Instruments, if the Title VII Instrument can be physically settled with securities, it will be a security-based swap. The other condition in rule 3a68-5 that may impact the characterization of the Title VII Instrument is that the Title VII Instrument cannot be entered into by the foreign government, its affiliates, or an

[1335] See supra note 717 and accompanying text.

[1336] Id.

[1337] Id.

underwriter of its securities. This condition is intended to preserve the programmatic benefit of the application of the Securities Act to transactions in Title VII Instruments entered into by issuers of securities, their affiliates and underwriters. Moreover, the final rule provides consistent treatment of qualifying foreign futures contracts on the debt securities of the 21 enumerated foreign governments and Title VII instruments based on such futures contracts on the debt securities of the 21 enumerated foreign governments, which will allow instruments to trade through designated contract markets.

ii) Assessment Costs

The SEC believes that the assessment cost associated with determining whether a swap on certain futures contracts on foreign government securities constitute a swap or security-based swap under rule 3a68-5 should be minimal. Currently, qualifying foreign futures contracts on debt securities of the 21 enumerated foreign governments are traded on exchanges or boards of trade. Market participants may look at the exchange or board of trade listing to determine what they are. Therefore, the assessment, in accordance with the rule, would primarily focus on whether such swap itself is traded on or through a board of trade; whether the swap is cash-settled; whether the futures is traded on a board of trade; whether any security used to determine the cash settlement amount are not registered under the Securities Act or the subject of any American depositary receipt registered under the Securities Act; and whether the swap is entered into by the foreign government issuing the debt securities upon which the qualifying futures contract is based or referenced, an affiliate of such foreign government or an underwriter of such foreign government securities. All of these determinations may be readily ascertained by the parties entering into the agreement, contract, or transaction. Therefore, the assessment costs associated with rule 3a68-5 under the Exchange Act should be nominal because parties should be able to make assessments under rule 3a68-5 in less than an hour.

d) Tolerance and Grace Period for Swaps and Security-Based Swaps Traded on Regulated Trading Platforms (Rule 3a68-3 under the Exchange Act)

i) Programmatic Benefits and Costs

In addition to defining narrow-based security index consistent with the statutory definition set forth in section 3(a)(55) of the Exchange Act and the rules, regulations and orders of the SEC thereunder, Rule 3a68-3 under the Exchange Act establishes a tolerance and grace period for swaps and security-based swaps to address the treatment of indexes that migrate from broad-based to narrow-based or narrow-based to broad-based, so that market participants will know which regulatory jurisdiction will apply to such Title VII instruments.[1338]

There are programmatic costs and benefits associated with tolerance and grace periods. Because swaps may only trade on designated contract markets ("DCM"), swap execution facilities ("SEF"), and foreign boards of trade ("FBOT"), and security-based swaps may trade only on registered national securities exchanges ("NSE") and SB SEFs, a tolerance and grace period creates the benefit of permitting the index provider to substitute certain index components in order to maintain the characteristic of such index being narrow-based or broad-based and allow market participants to continue to enter into the Title VII instrument on which such index is based.[1339] The associated programmatic costs are primarily related to the monitoring of index migrations performed by various trading platforms. Such monitoring costs would be part of the operation costs that a trading platform would incur in connection with implementing Title VII

[1338] See supra part III.G.5.

[1339] Id.

regardless of whether rule 3a68-3 under the Exchange Act is adopted. Absent rule 3a68-3 under the Exchange Act, trading platforms still need to have the technology necessary to monitor and conduct surveillance for index migration, as well as create internal policies and procedures relating to such migration. On the other hand, without a tolerance and grace period, if a market participant wishes to offset a security-based swap to hedge its index CDS position on an SEC-regulated trading platform where the underlying security index has migrated from narrow-based to broad-based, the participant would be prohibited from doing so because a Title VII instrument based on the index would be a swap, and is ineligible for trading on an NSE or SB SEF.

ii) Assessment Costs

Rule 3a68-3 under the Exchange Act provides a tolerance and grace period and does not require any determination to be made beyond the programmatic cost to monitor for migration as described above. The SEC believes that the assessment costs associated with rule 3a68-3 under the Exchange Act should be nominal on the parties entering into an agreement, contract, or transaction.

iii) Alternatives

One commenter stated its view that extending the "grace period" from three months to six months would ease any disruption or dislocation associated with the delisting process with respect to an index that has migrated from broad-based to narrow-based, or narrow-based to broad-based, and such migration is not reversed during the tolerance period.[1340] The commenter did not provide any data, evidence, or other justification for its request. The Commissions are adopting the three-month grace period as proposed, which was the time frame used by Congress in the context of migration of indexes underlying security futures to address the same issue

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1340 See MarketAxess Letter. See also supra part III.G.5.b).

caused by index migration.[1341] The SEC believes that the three-month grace period gives parties to a swap or security-based swap on an index that has migrated sufficient time to execute offsetting positions and believes that it is appropriate to maintain the three-month period that is the applicable grace period for security futures.

e) Request for Interpretation Process (Rule 3a68-2 Under the Exchange Act)

i) Programmatic Benefits and Costs

Rule 3a68-2 under the Exchange Act allows persons to submit a request for a joint interpretation from the Commissions regarding whether an agreement, contract or transaction (or a class of agreements, contracts, or transactions) is a swap, security-based swap, or mixed swap. As stated above,[1342] if an agreement, contract, or transaction is a swap or a security-based swap the overall programmatic costs and benefits that may arise from the Commissions' regulatory programs are expected to be broadly similar and complementary.[1343] However, in implementing Title VII the Commissions may diverge on rules and requirements stemming from the Title VII regulatory regime. Accordingly, a party to an agreement, contract, or transaction will need to know the appropriate classification, e.g. whether it is a swap or security-based swap, in order to know which regulatory regime and corresponding requirements is applicable. The Dodd-Frank Act requires that, with respect to the definitions of swaps, security-based swaps, and mixed swaps, the Commissions must jointly interpret such definitions. This rule, by providing a mechanism for the Commissions to provide such joint interpretations, allows parties to understand the timing and process for seeing such joint interpretation. Regardless of this rule,

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1341 See section 3(a)(55)(C)(iii)(II) of the Exchange Act, 15 U.S.C. 77c(a)(55)(C)(iii)(II).

1342 See supra part X.4(b)(i).

1343 Id.

the programmatic costs and benefits that flow from being a swap or security-based swap remain the same for parties requesting a joint interpretation. But, the rule allows for parties to the agreement, contract, or transaction to request through a joint interpretation from the Commissions, what regulatory regime would apply or whether the agreement, contract, or transaction is within the definition of swap or security-based swap.

ii) Assessment Costs

The SEC estimates the costs of submitting a request for a joint interpretation pursuant to rule 3a68-2 under the Exchange Act would be approximately $20,000.[1344] The use of inside counsel in lieu of outside counsel would reduce this estimate. Once such a joint interpretation is made, however, other market participants that seek to transact in the same agreement, contract, or transaction (or class thereof) would be able to rely on such interpretation in determining whether their agreement, contract or transaction is a swap, security-based swap or mixed swap. Accordingly, assessment costs may be affected by the number of parties seeing an interpretation or whether prior interpretations with respect to the same or similar agreements, contracts, or transactions have been sought.

1344 As stated in the Proposing Release at 29878, n.354, this estimate is based on information indicating that the average costs associated with preparing and submitting a no action request to the SEC staff, which the SEC believes is a process similar to the process under rule 3a68-2 under the Exchange Act. The staff estimates that costs associated with a request pursuant to rule 3a68-2 will cost approximately $19,560. The SEC estimates the analysis will require approximately 20 hours of in-house counsel time and 30 hours of outside counsel time. Based upon data from SIFMA's *Management & Professional Earnings in the Securities Industry 2011* (modified by SEC staff to account for an 1800-hour-work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead), staff estimates that the average national hourly rate for an in-house attorney is $378. The SEC estimates the costs for outside legal services to be $400 per hour. This is the same estimate used by the SEC for these services in the release involving Exemptions for Security-Based Swaps Issued By Certain Clearing Agencies, Release No. 33-9308 (Mar. 30, 2012), 77 FR 20536 (Apr. 5, 2012). Accordingly, the SEC estimates the cost to be $19,560 ($7,560 (based on 20 hours of in-house counsel time x $378) + $12,000 (based on 30 hours of outside counsel x $400) to submit a joint request for interpretation. This estimate is rounded by two significant digits to avoid the impression of false precision of the estimate.

f) Definition of Swap (Rule 3a69-2 Under the Exchange Act)

i) Programmatic Benefits and Costs

Rule 3a69-2(a) under the Exchange Act states that the term swap has the meaning set forth in section 3(a)(69) of the Exchange Act.[1345] Rule 3a69-2(b) under the Exchange Act explicitly defines the term "swap" to include an agreement, contract, or transaction that is a cross-currency swap, currency option, foreign currency option, foreign exchange option, foreign exchange rate option, foreign exchange forward, foreign exchange swap, forward rate agreement, or non-deliverable forward involving foreign exchange, unless such agreement, contract, or transaction is otherwise excluded by section 1a(47)(B) of the CEA.[1346] Rule 3a69-2(c) under the Exchange Act provides that: (1) a foreign exchange forward or a foreign exchange swap shall not be considered a swap if the Secretary of the Treasury makes the determination described in section 1a(47)(E)(i) of the CEA;[1347] and (2) notwithstanding any such determination, certain provisions of the CEA will apply to such a foreign exchange forward or foreign exchange swap (specifically, the reporting requirements in section 4r of the CEA[1348] and regulations thereunder and, in the case of a swap dealer or major swap participant that is a party to a foreign exchange swap or foreign exchange forward, the business conduct standards in section 4s of the CEA[1349] and regulations thereunder). Rule 3a69-2(c) under the Exchange Act further clarifies that a currency swap, cross-currency swap, currency option, foreign currency option, foreign exchange option, foreign exchange rate option, or non-deliverable forward involving foreign exchange is

1345 15 U.S.C. 78c(a)(69).

1346 7 U.S.C. 1a(47)(B).

1347 7 U.S.C. 1a(47)(E)(i).

1348 7 U.S.C. 6r.

1349 7 U.S.C. 6s.

not a foreign exchange forward or foreign exchange swap subject to a determination by the Secretary of the Treasury as described in the preamble.

Rule 3a69-2 is parallel to rule 1.3(xxx)(2) under the CEA. In order to determine whether an agreement, contract, or transaction is a "swap" or "security-based swap", it is necessary for the Commissions to adopt parallel rules that will apply to a Title VII instrument. Therefore, rule 3a69-2 is included under the Exchange Act. The definition of swap is the starting point for determining the status of a Title VII Instrument as a swap, security-based swap, or mixed swap. To the extent that the specific agreements, contracts, and transactions listed in section 1a(47)(B) of the CEA are swaps, the programmatic costs and benefits that flow from such agreements, contracts or transactions being a Title VII instrument under rule 3a69-2 will be determined by the substantive rules adopted by the CFTC mandated by Title VII. If any such agreements, contracts, or transactions are security-based swaps, the programmatic costs and benefits will be the same as with other security-based swaps.

ii) Assessment Costs

Since this rule lists some of the types of agreements, contracts or transactions already listed in section 1a(47)(B) of the CEA[1350] and the determination made by the Secretary of the Treasury, the SEC does not believe there would be assessment costs in addition to those incurred by market participants in determining whether an agreement, contract or transaction falls within the definition of swap.

g) Mixed Swaps (Rule 3a68-4 under the Exchange Act)

i) Programmatic Benefits and Costs

[1350] 7 U.S.C. 1a(47)(B).

Rule 3a68-4(a) under the Exchange Act defines a "mixed swap" in the same manner as the term is defined in both the CEA and Exchange Act. Furthermore, rule 3a68-4(b) under the Exchange Act establishes the regulatory framework for mixed swaps with which parties to bilateral uncleared mixed swaps (i.e., mixed swaps that are neither executed on or subject to the rules of a DCM, NSE, SEF, SB SEF, or FBOT nor cleared through a DCO or clearing agency), as to which at least one of the parties is dually registered with both the CFTC and the SEC, will need to comply. The SEC believes that paragraph (b) of rule 3a68-4 under the Exchange Act will augment the programmatic benefits of the Title VII regulatory regime. The rule addresses potentially duplicative regulatory requirements for dually-registered dealers and major participants that are subject to regulation by both the CFTC and the SEC, while requiring dual registrants to comply with the regulatory requirements the Commissions believe are necessary to provide sufficient regulatory oversight for mixed swaps transactions entered into by such dual registrants. It eliminates potentially duplicative regulation and reduces the programmatic costs associated with regulatory implementation and compliance in the context of mixed swaps by providing that a bilateral uncleared mixed swap would be subject to all applicable provisions of the federal securities laws (and the SEC rules and regulations promulgated thereunder) but would be subject only to certain CEA provisions (and the CFTC rules and regulations promulgated thereunder).

Rule 3a68-4(c) under the Exchange Act establishes a process for persons to request that the Commissions issue a joint order, with respect to parallel provisions[1351] applicable to mixed

1351 For purposes of paragraph (c) of rule 3a68-4 under the Exchange Act, "parallel provisions" means comparable provisions of the CEA and the Exchange Act that were added or amended by Title VII with respect to security-based swaps and swaps, and the rules and regulations thereunder.

swaps, to permit such persons (and any other person or persons that subsequently lists, trades, or clears that class of mixed swap) to comply with the parallel provisions of either the CEA or the Exchange Act and related rules and regulations (collectively "specified parallel provisions"), instead of being required to comply with parallel provisions in both the CEA and the Exchange Act. This process applies except with respect to bilateral, uncleared mixed swaps where one of the parties to the mixed swap is dually registered with the CFTC as a swap dealer or major swap participant and with the SEC as a security-based swap dealer or major security-based swap participant, for which the regulatory framework is established under rule 3a68-4(c). The SEC has recognized the programmatic benefits associated with rule 3a68-4(c) and believes that in the mixed swap area, the process established by rule 3a68-4(c) would eliminate potentially duplicative regulatory requirements and reduce the compliance costs associated with mixed swaps.

ii) Assessment Costs

With respect to rule 3a68-4(b) under the Exchange Act, one cost is that parties to a mixed swap would need to determine whether they satisfy the conditions set forth in such rule in order to ascertain the regulatory treatment of the mixed swap. Such assessment includes determining whether the mixed swap is neither executed on nor subject to the rules of a DCM, NSE, SEF, SB SEF or FBOT, whether the mixed swap will not be submitted for clearing, and whether one party to the mixed swap is a dually registered dealer or major participant. The SEC believes that the above determinations would be based on readily ascertainable facts and the assessment costs associated with such determinations should be minimal.

With respect to rule 3a68-4(c) under the Exchange Act, parties to mixed swaps have the option to decide whether to submit a request for issuing a joint order, weighing the benefits realized from the joint order against the cost of submitting such request. If parties to mixed swaps decide to submit a request, the SEC estimates the total costs of preparing and submitting a party's request to the Commissions pursuant to rule 3a68-4(c) under the Exchange Act will be $31,000 per request for mixed swaps for which a request for a joint interpretation pursuant to rule 3a68-4(c) was not previously made.[1352] The use of inside counsel in lieu of outside counsel would reduce this estimate. Absent such a process, though, market participants that desire or intend to offer or enter into such a mixed swap (or class thereof) would not have the option to request for the Commissions' joint interpretation and absent a joint interpretation, they would be required pursuant to Title VII to comply with all regulatory requirements applicable to both swaps and security-based swaps.

iii) Alternatives

One commenter recommended that the Commissions require that market participants disaggregate mixed swaps and enter into separate simultaneous transactions so that they cannot employ mixed swaps to obscure the underlying substance of transactions.[1353] This commenter

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1352 As discussed in the Proposing Release at 29878, note 356, this estimate is based on information indicating that the average costs associated with preparing and submitting a no-action request to the SEC staff, which the SEC believes is a process similar to the process under rule 3a68-4(c). The staff estimates that costs associated with such a request will cost approximately $31,340. The SEC estimates the analysis will require approximately 30 hours of in-house counsel time and 50 hours of outside counsel time. Based upon data from SIFMA's *Management & Professional Earnings in the Securities Industry 2011* (modified by SEC staff to account for an 1800-hour-work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead), staff estimates that the average national hourly rate for an in-house attorney is $378. The SEC estimates the costs for outside legal services to be $400 per hour. This is the same estimate used by the SEC for these services in the release involving Exemptions for Security-Based Swaps Issued By Certain Clearing Agencies, Release No. 33-9308 (Mar. 30, 2012), 77 FR 20536 (Apr. 5, 2012). Accordingly, the SEC estimates the cost to be $31,340 ($11,340 (based on 30 hours of in-house counsel time x $378) + $20,000 (based on 50 hours of outside counsel x $400) to submit a joint request for interpretation. This estimate is rounded by two significant digits to avoid the impression of false precision of the estimate.

1353 See Better Markets Letter.

stated that "the regulatory complexity of dealing with a mixed swap far outweighs the legitimate benefits to counterparties from documenting the transactions as mixed swaps."[1354] This commenter asserted that some benefits of requiring disaggregation include more useful price reporting; increased transparency; regulatory reporting and monitoring that will align with the transaction database of the counterparties; and the thwarting of illegitimate motivations, such as obfuscation of prices and fees. Regardless of the benefits of disaggregation raised by the commenter, Title VII specifically contemplates that there would be mixed swaps comprised of both swaps and security-based swaps. The SEC believes that requiring parties to disaggregate mixed swaps into separate components is not consistent with Congressional intent and may result in certain programmatic costs, such as limiting the types of derivatives products and transactions market participants may offer and enter into and increasing transaction costs (such as documentation costs) by disaggregating a mixed swap into multiple separate transactions.

h) Books and Records Requirement for SBSAs (Rule 3a69-3 under the Exchange Act)

i) Programmatic Benefits and Costs

Rule 3a69-3 under the Exchange Act provides that there are no additional books and records, or data, requirements regarding SBSAs beyond those required for swaps. The SEC recognized the following programmatic benefits and costs in adopting this rule.

As discussed above, SBSAs are swaps over which the CFTC has primary regulatory authority, but for which the SEC has antifraud, anti-manipulation, and certain other authority.[1355] There will be programmatic benefits and costs as a result of the SDRs, swap dealers and major swap participants implementing and complying with the books and records requirements

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1354 Id.

1355 See supra part V.

provided in sections 21 and 4s of the CEA.[1356] The programmatic benefits and costs will flow from the substantive rules adopted by the CFTC regarding record keeping requirements for swaps. SBSAs are swaps and will be subject to these books and records requirements. The SEC believes that the rules proposed by the CFTC would provide sufficient books and records regarding SBSAs[1357], and that additional books and records requirements for SBSAs may be duplicative and would not produce corresponding benefits warranting such additional costs. Rule 3a69-3 under the Exchange Act avoids any additional programmatic costs, especially the additional compliance and operation costs that would be incurred by SDRs, swap dealers and major swap participants in the area of data maintenance and recordkeeping, beyond those which have already been prescribed by the CFTC's rules.

ii) Assessment Costs

The SEC does not believe that any assessment costs associated with rule 3a69-3 under the Exchange Act would be material.

5. Effects on Competition, Efficiency and Capital Formation

Section 3(f) of the Exchange Act requires the SEC, whenever it engages in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action would

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1356 7 U.S.C. 24a and 6s. Pursuant to sections 21(b)(2) and 4s(f)(1)(B)(ii) of the CEA, the CFTC has adopted rules with respect to data collection and maintenance by SDR and books and records requirements for swap dealers and major swap participants. See Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants, 77 FR 20128 (April 3, 2012); and Swap Data Recordkeeping and Reporting Requirements, 77 FR 2136 (January 13, 2012).

1357 See Proposing Release at 29863. See also supra part V.

promote efficiency, competition, and capital formation.[1358] In addition, section 23(a)(2) of the Exchange Act[1359] requires the SEC, when adopting rules under the Exchange Act, to consider the impact such rules would have on competition. Section 23(a)(2) of the Exchange Act also prohibits the SEC from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

The Commissions are further defining "swap" and "security-based swap" pursuant to section 712(d)(1) of the Dodd-Frank Act.[1360] In the Proposing Release, the SEC stated that the SEC preliminarily believed that the proposed Exchange Act rules would not impose significant burden on competition, that they would create efficient processes, and that they would not have adverse effects on capital formation.[1361] In the Proposing Release, the SEC requested comment on each of these issues,[1362] and no commenters responded to specifically address these issues.

The SEC recognizes that the most significant impact of the swap and security-based swap definitions will derive from these definitions serving as the foundation for implementing the Title VII regulatory regime, particularly given the significant impacts that Title VII will have on the security-based swap market. In adopting these definitional rules, the SEC has sought to fairly reflect the statutory definitions and their underlying intent to implement the regulatory framework Congress intended to impose on the derivatives markets by enacting Title VII.

The scope of the definitions will affect the ultimate regulatory effects on competition, efficiency, and capital formation that will accompany the full implementation of Title VII. The

1358 15 U.S.C. 78c(f).

1359 15 U.S.C. 78w(a)(2).

1360 The SEC is also acting pursuant to its rulemaking authority provided by sections 3 and 23(a) of the Exchange Act.

1361 See Proposing Release at 29885-87.

1362 Id. at 29887.

SEC anticipates analyzing these effects in the adopting releases for the particular regulations. Below is a general discussion of the impacts on competition, efficiency, and capital formation as a result of the rules being adopted in this release.

The final rules being adopted relate primarily to further defining the terms "swap," "security-based swap," and "mixed swap" to determine (i) the instruments that will be subject to the Title VII regulatory regime and (ii) the jurisdictional line between Title VII instruments regulated by the SEC and those regulated by the CFTC. There also are procedural rules regarding interpretive requests and joint orders from the Commissions, and recordkeeping relating to SBSAs. The SEC believes that these procedural rules are related to the status of a product and the regulatory treatment of a mixed swaps, and therefore, the effects of these rules on competition, efficiency, and capital formation are subsumed in the overall impact of the rules defining the perimeter of the Title VII regulatory regime, and those of the rules relating to the jurisdictional line between the SEC and CFTC.

a) The Status of Products

The status of products as inside the Title VII regulatory perimeter (i.e., swaps and security-based swaps) or outside the regulatory perimeter will have impacts on market participants. These rules will impact the status of certain market participants currently acting as intermediaries in the security-based swap market, subjecting them to regulatory oversight and registration. As the SEC has noted, the market among intermediaries for security-based swaps is highly concentrated. The concentration in large part appears to reflect the fact that larger entities possess competitive advantages in engaging in over-the-counter security-based swap dealing activities, particularly with respect to having sufficient financial resources to provide potential counterparties with adequate assurances of financial performance.[1363] At the same time, as noted by commenters to the Entities Definition Release, some entities engage in smaller volumes of security-based swap dealing activity.[1364]. Some small and mid-size banks, for example, routinely provide such services involving relatively small notional amounts to their customers.[1365] Although these relatively small dealers in general may not compete directly with the largest dealers (because they service a different segment of the market), they may be expected to play a role in helping certain types of customers (such as customers with a relatively small need for security-based swaps) enter into security-based swaps, thus promoting the availability of these products.[1366] This availability may assist market participants (as end users), as discussed below, in engaging security-based swap activities that may be related to their businesses or financing needs.

As the SEC has noted before, persons who fall within the definitions of "security-based swap dealer" and "major security-based swap participant" will incur a range of programmatic costs by virtue of their status as a registered dealer or major participant and certain assessment costs regarding their security-based swap activities. To the extent the costs associated with these statutorily mandated requirements are relatively fixed or large enough, they may negatively affect competition within the security-based swap market.[1367] This may, for example, lead smaller dealers or entities for whom dealing is not a core business to keep their security-based swap dealing activity below the volume threshold required to be registered with the SEC or exit

1363 See Entity Definitions Release, at 30740.

1364 Id.

1365 Id.

1366 Id.

1367 Id.

the market if the profit from the security-based swap dealing activity cannot justify the cost incurred to comply with the Title VII requirements; both scenarios could cause customers to have less access to the market or to incur higher costs in accessing the market. Such costs might also deter the entry of new firms into the market. If sufficiently high, these costs of compliance may increase concentration among dealers.[1368]

Certain aspects of the regulation of products defined as security-based swaps may enhance competition in the market for security-based swaps. For example, the proposed business conduct standards, if adopted as proposed, including those for disclosure of material risks and for fair and balanced communications, may reduce information asymmetries between security-based swap dealers, major security based swap participants, and their counterparties. The reduction of information asymmetries should promote price efficiency, promote more informed decision-making, and reduce the incidence of fraudulent or misleading representations.[1369]

In addition, as the SEC noted in the Entity Definitions Release, the current security-based swap market is subject to the potential for risk spillovers and systemic risk, which can occur when the financial sector as a whole (or certain key segments) is exposed to a significant amount of concentrated financial risk, either through direct counterparty relationships or the deterioration of asset values, and such exposure gives rise to the systemic chain effect of one firm's financial distress or losses leading to financial distress or losses of the entire financial sector as a whole.[1370] With respect to transactions involving security-based swaps, security-based swap

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1368 Id.

1369 See Business Conduct Standards Proposing Release, 76 FR 42396-42459, at 42452. See also supra part XI.A.3.

1370 See Entity Definitions Release, at 30740.

dealers and major security-based swap participants will be regulated and, as noted in the Entity Definitions Release, such regulation and requirements are expected to increase market participants' confidence in the dealers' and major participants' ability to perform their obligations.[1371]

The effect of the definitions on efficiency and capital formation is linked to their effect on competition. Markets that are competitive, with fair and transparent pricing and equal access to security-based swaps, may be expected to promote the efficient allocation of capital. Similarly, definitions that promote, or do not unduly restrict, competition can be accompanied by regulatory benefits that minimize the risk of market failure and thus promote efficiency and capital formation within the market.[1372]

As discussed above, certain Title VII requirements and rules relating to intermediaries, such as internal and external business conduct standards, if adopted as proposed, are expected to reduce information asymmetries and promote price efficiency. These business conduct standards, if adopted as proposed, would also help regulators perform their functions in an effective manner. The resulting increase in market integrity could affect capital formation in U.S. capital markets positively.[1373]

Other entities also will be affected by the scope of the security-based swap definition, including clearing agencies that currently, and in the future will, clear security-based swaps, the security-based swap data repositories that collect security-based swap data, and the SB SEFs and exchanges that are transaction venues for security-based swaps, subjecting these entities to

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1371 Id. at 30723 -30724

1372 See Entity Definitions Release, at 30742.

1373 See Business Conduct Standards Proposing Release, at 42452; SDR Proposing Release, at 77365.

regulation and oversight by the SEC.[1374] For example, The SEC has noted that the intent of the proposed rules concerning standards for clearing agency operations and governance standards of clearing agencies is to promote the prompt and accurate clearance and settlement of securities transactions, including security-based swap transactions, by requiring certain minimum standards at clearing agencies.[1375] The SEC stated that it preliminarily believes that these requirements would ensure resilient and cost-effective clearing agency operations as well as promote transparent and effective clearing agency governance that would consequently support confidence among market participants in clearing agencies' ability to serve as efficient mechanisms for clearance and settlement and to facilitate capital formation.[1376]

Similarly, the SEC has previously stated that the core principles, duties, and requirements imposed by Title VII and the proposed rules on SB SEFs will foster innovation in the security-based swap market by allowing entities that seek to become SB SEFs to structure diverse platforms for the trading of security-based swaps,[1377] increase pre-trade price transparency, and establish fair, objective, and not unreasonably discriminatory standards for granting impartial access to trading on the SB SEFs,[1378] thereby furthering higher efficiency, promoting competition, and encouraging capital formation.[1379] The SEC also noted that any resulting increase in market integrity proceeding from the rules intended to support the statutorily-mandated regulatory obligations of SB SEFs would likely increase market participants'

1374 See supra part XI.A.3.

1375 See Clearing Agency Standards Proposing Release, at 14535.

1376 Id.

1377 See SB SEF Proposing Release, at 11049.

1378 Id.

1379 Id. at 11049-50.

confidence in the soundness and fairness of the security-based swap market.[1380] Such increased confidence likely would stimulate financial investment in SB swaps by corporate entities and others that may find that more transparent venues for the trading of SB swaps would allow them to purchase SB swaps to offset business risks and to meet hedging objectives.[1381] Further, to the extent that market participants utilize SB swaps to better manage portfolio risks with respect to positions in underlying securities, the extent that they are willing to participate in the SB swap market may impact their willingness to participate in the underlying asset's market.[1382] Therefore, the Commission stated its preliminarily belief that the proposed rules would help encourage capital formation.[1383]

Furthermore, in the proposing release regarding SDRs,[1384] the SEC noted that, by allowing multiple SDRs to provide data collection, maintenance, and recordkeeping services, the rules are intended to promote competition among SDRs. The SEC also stated that the proposed rules promote data collection, maintenance, and recordkeeping according to existing best practices that are used in similar capital market institutions and are likely to positively affect transparency in credit markets and would help capital formation in the broader capital markets whose participants rely on security-based swap markets to meet their hedging objectives.[1385]

Other parties to security-based swap transactions may be affected by the definitions as well. Title VII amends the Exchange Act and the Securities Act to include security-based swap

1380 Id. at 11049.

1381 Id.

1382 Id. at 11050

1383 Id.

1384 See SDR Proposing Release, at 77365.

1385 Id.

within the definition of the term "security."[1386] End-users will have the benefit and protection of the existing federal securities laws, including the Exchange Act and Securities Act provisions added by Title VII. As a result of the amendment to the Securities Act regarding security-based swap transactions entered into by issuers of the securities underlying the security-based swap, and their affiliates and underwriters,[1387] such issuers, affiliates, and underwriters cannot use security-based swaps without also complying with the Securities Act provisions with respect to the underlying securities. Furthermore, Title VII provides protections to non-ECPs by adding provisions to both the Securities Act and the Exchange Act that require security-based swap transactions with such non-ECPs to be covered by an effective registration statement under the Securities Act and traded on a national securities exchange, and for brokers and dealers engaging in transactions with non-ECPs to be registered as such under section 15 of the Exchange Act. To the extent counterparties, including issuers of the underlying securities, or their affiliates or underwriters, determine to engage in such transactions, other counterparties may have a greater willingness to engage in such transactions because of the protections afforded by the Securities Act registration, disclosure, and civil liability scheme. An increased interest by end-users may create effects on competition.

While other securities-related derivatives have the same limitations on issuers, affiliates, and underwriters using the derivative to avoid the Securities Act application to the underlying securities at the time the transaction is entered into, these other derivatives, such as security options and security futures, do not contain the same limitation on transactions with non-ECPs. Although security options and security futures must be traded on a national securities exchange

[1386] See section 2(a)(1) of the Securities Act and section 3(a)(10) of the Exchange Act, 15 U.S.C. 77b(a)(1) and 15 U.S.C. 78c(a)(10).

[1387] See supra part XI.A.3.

as one condition to avail themselves of an exemption from registration under the Securities Act,[1388] other exemptions from registration under the Securities Act may be available for transactions in security options sold to non-ECPs that are not available to security-based swap transactions with non-ECPs.

There also may be effects on efficiency and capital formation by facilitating end-users' use of security-based swaps for investment or hedging of risks relating to investments or business operations, thereby affecting liquidity and costs in connection with the issuance of equity and debt securities. The further definitions may promote capital formation by facilitating these hedging and investment activities. For example, in the context of CDS, as credit risk is correlated, lenders who made loans and investors in debt securities may find it desirable to hedge credit risks on their loan or securities portfolios by purchasing protection through single-name or index CDS.[1389] Although basis risk may exist in this type of trade, it should be effective at reducing counterparty exposure.[1390]

b) Jurisdictional Divide Impacts

There may be competitive impacts that arise due to the jurisdictional divide between the CFTC and the SEC that Congress imposed in Title VII. While the competitive impacts of the substantive rules will be addressed as part of each substantive rulemaking, the SEC acknowledges that such competitive effects may exist as a consequence of the statutory jurisdictional divide. These competitive impacts may arise due to capital and margin treatment, for example, which may affect demand for security-based swaps as compared to other types of security instruments. In addition, to the extent there are differences in regulatory treatment

1388 See section 3(a)(14) of the Securities Act and Rule 238 under the Securities Act.

1389 See Entity Definitions Release, at 30742.

1390 Id.

between security-based swaps and other securities-based or securities-related instruments, there will be competition across the markets affecting all market participants.

As one example of the possible competitive effects of the jurisdictional divide, section 3E(a) of the Exchange Act provides that only a registered broker, dealer, or security-based swap dealer may accept margin from customers to secure cleared security-based swap transactions,[1391] and that the broker, dealer, or security-based swap dealer shall treat and deal with all margin received from a customer as belonging to the customer.[1392] Similarly, section 4d(f) of the Commodity Exchange Act requires that only a registered futures commission merchant may accept margin from customers to secure cleared swap transactions[1393] and that the futures commissions merchant shall treat and deal with margin received from a customer as belonging to the customer.[1394] The SEC understands that many members of clearing agencies are dually-registered broker-dealers and futures commission merchants and that much of the clearing of security-based swaps may occur through such dually-registered entities.[1395] Because collateral for swaps and security-based swaps are required under applicable statutory requirements to be maintained in two separate accounts under the CEA and Exchange Act, respectively, the

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1391 See section 3E(a) of the Exchange Act, 15 U.S.C. 78c-5(a).

1392 See section 3E(b)(1) of the Exchange Act, 15 U.S.C. 78c-5(b)(1)

1393 See section 4d(f)(1) of the CEA, 7 U.S.C. 6d(f)(1).

1394 See section 4d(f)(2)(A) of the CEA, 7 U.S.C. 6d(f)(2)(A).

1395 See, e.g., letter to the SEC from ICE Clear Credit LLC, dated November 7, 2011 ("ICE Clear Credit Letter"), available at http://www.sec.gov/rules/petitions/2011/petn4-641.pdf (requesting exemptive relief from the application of section 15(c)(3) of the Exchange Act and Rule 15c3-3 thereunder to allow ICE Clear Credit, and its members that are dually-registered broker-dealers and futures commission merchants, to, among other things: (1) hold customer assets used to margin, secure, or guarantee customer positions consisting of cleared credit default swaps that include swaps and security-based swaps in a commingled customer omnibus account subject to section 4d(f) of the CEA; and (2) calculate margin for this commingled customer account on a portfolio margin basis); see also section 4d(F)(1) of the CEA (making it unlawful for any person to, among other things, accept money and securities from a swaps customer for a cleared swap unless such person has registered with the CFTC as a futures commission merchant).

derivatives portfolio of a customer will be separated into a swap portfolio and a security-based swap portfolio, with two separate margin accounts and without the benefits of netting swaps against security-based swaps for purposes of calculating margin requirements. Absent the adoption of a margin and segregation approach that would permit a customer to hold both swaps and security-based swaps in a single customer account, a customer who clears swaps and security-based swaps through a clearing member who is dually-registered as a futures commission merchant with the CFTC and a broker-dealer with the SEC may have to deliver collateral to the clearing member with respect to the customer's cleared swap portfolio and also deliver collateral as margin to the clearing member with respect to its security-based swap portfolio even if the positions in the swap portfolio offset the risk arising from the positions in the security-based swap portfolio. This will impact customers' liquidity, as opposed to holding swap and security-based swap positions in one single account,[1396] and increase customers' transaction costs. Such an increase will affect customers' ability to use security-based swaps and may drive them to seek less expensive alternatives. Decrease in demand for security-based swaps may increase dealer competition in the security-based swap market for the remaining business, or result in dealers exiting the market.

In addition, there may be competitive impacts on security-based swap dealers, major security-based swap participants, clearing agencies, security-based swap data repositories and security-based swap execution facilities (or national securities exchanges) if they provide services for both security-based swaps and swaps, as their businesses will be divided based on

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[1396] See ICE Clear Credit Letter at 6, 13-14. See also Statement of General Policy on the Sequencing of the Compliance Dates for Final Rules Applicable to Security-Based Swaps Adopted Pursuant to the Securities Exchange Act of 1934 and the Dodd-Frank Wall Street Reform and Consumer Protection Act, 77 FR 35625 n.138 (June 14, 2012).

the jurisdictional line between swaps and security-based swaps. For registered entities whose derivatives activities involve products that reference indexes or baskets, they will incur assessment costs[1397] and, to the extent that SEC and CFTC regulations diverge, they will incur additional regulatory compliance costs[1398] to implement two sets of regulations that would not otherwise be incurred if the jurisdictional divide did not exist. The SEC recognizes that these costs may affect existing market participants' considerations whether to continue to operate their business, and new entrants' desire to enter into new business, across two separate regulatory regimes and if they determine that the incremental costs of operating the derivatives business under two separate regulatory regimes would outweigh potential revenues, they may exit certain products to limit the application of regulatory requirements to solely those of the CFTC or the SEC. This could result in a redistribution of the swaps or security-based swaps dealing activity in the derivatives market and lead to further concentration of security-based swap dealing activity.

The SEC understands that Congress intended to create two parallel regulatory regimes for the derivatives market that complement each other. Each regulatory regime will have the benefit of the regulatory expertise of the respective agency. The rules further defining swap, security-based swap, and mixed swap do not by themselves create negative competitive impacts other than those which potentially could be imposed if the Commissions' substantive requirements differ substantially.

Finally, the rules being adopted may have effects on efficiency and capital formation. For example, the rules defining the terms "issuers of securities in a narrow-based security index" and "narrow-based security index" for purposes of the jurisdictional divide are intended to,

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1397 See the discussion of assessment costs of various rules and interpretations, supra part XI.A.4.

1398 See supra parts XI.A.3and XI.A.4.

among other things, minimize the likelihood that an index on which a CDS is based that is outside of the SEC's jurisdiction can be used as a surrogate or substitute for the underlying security, or with respect to securities of the referenced issuer, or to manipulate the market for such securities. Such provisions will provide greater protection to the reference issuers or the issuers of the securities in the index that the index CDS cannot be used in a manner that will adversely affect such issuers and their ability to raise capital.

In conclusion, the SEC believes the rules and interpretations adopted here would not have overall adverse effects on efficiency, competition, or capital formation.

B. Paperwork Reduction Act

1. Background

Rules 3a68-2 and 3a68-4(c) under the Exchange Act contain new "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995.[1399] The SEC has submitted them to the Office of Management and Budget ("OMB") for review in accordance with the PRA.[1400] The titles for the collections of information are: (1) Interpretation of Swaps, Security-Based Swaps, and Mixed Swaps and (2) Regulation of Mixed Swaps: Process for determining regulatory treatment for mixed swaps (OMB Control No. 3235-0685). An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

The rules containing these two collections of information are being adopted pursuant to the Exchange Act. The rules establish a process through which a person can submit a request to the Commissions that the Commissions provide a joint interpretation of whether an agreement,

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[1399] 44 U.S.C. 3501 et seq.

[1400] 44 U.S.C. 3507(d) and 5 CFR 1320.11

contract, or transaction (or class thereof) is a swap, security-based swap, or both (i.e., a mixed swap). The rules also establish a process with respect to mixed swaps through which a person can submit a request to the Commissions that the Commissions issue a joint order permitting the requesting person (and any other person or persons that subsequently lists, trades, or clears that class of mixed swap) to comply, as to parallel provisions only, with specified parallel provisions, instead of being required to comply with parallel provisions of both the CEA and the Exchange Act. The hours and costs associated with preparing and sending these requests will constitute reporting and cost burdens imposed by each collection of information.

In the Proposing Release, the SEC requested comment on the collection of information requirements.[1401] As discussed in connection with rules 3a68-2 and 3a68-4(c) under the Exchange Act, under the Exchange Act the final rules require the same information to be collected as proposed.[1402] As noted above, the Commissions received approximately 86 comment letters on the Proposing Release.[1403] The SEC did not receive any comments that directly address its Paperwork Reduction Act analysis or its burden estimates. However, the SEC did receive comments regarding confidentiality of information submitted as a result of the collection of information requirements. These comments do not directly address the SEC's Paperwork Reduction Act analysis, but they do implicate those aspects of the analysis regarding confidentiality. These comments are discussed below.[1404]

1401 See Proposing Release at 29877, 29879.

1402 See discussion of rules 3a68-2 and 3a68-4(c) supra parts VI and IV.B.3.

1403 See supra part I.

1404 See infra part XI.B.3.

2. Summary of Collection of Information Under Rules 3a68-2and 3a68-4(c) Under the Exchange Act

First, the SEC is adopting new rule 3a68-2 under the Exchange Act, which will allow persons to submit a request for a joint interpretation from the Commissions regarding whether an agreement, contract, or transaction (or a class thereof) is a swap, security-based swap, or both (i.e., a mixed swap). Under rule 3a68-2 under the Exchange Act, a person will provide to the Commissions all material information regarding the terms of, and a statement of the economic characteristics and purpose of, each relevant agreement, contract, or transaction (or class thereof), along with that person's determination as to whether each such agreement, contract, or transaction (or class thereof) should be characterized as a swap, security-based swap, or both (i.e., a mixed swap), including the basis for such a determination. The Commissions also may request the submitting person to provide additional information.

The Commissions may issue in response a joint interpretation or joint notice of proposed rulemaking regarding the status of that agreement, contract, or transaction (or class thereof) as a swap, security-based swap, or both (i.e., a mixed swap). Any joint interpretation, like any joint notice of proposed rulemaking, will be public and may discuss the material information regarding the terms of the relevant agreement, contract, or transaction (or class thereof), as well as any other information the Commissions deem material to the interpretation. Requesting persons also will be permitted to withdraw a request made pursuant to rule 3a68-2 under the Exchange Act at any time before the Commissions have issued a joint interpretation or joint notice of proposed rulemaking in response to the request.

Persons will submit requests pursuant to rule 3a68-2 under the Exchange Act on a voluntary basis. However, if a person submits a request, all of the information required under the rule, including any additional information requested by the Commissions, must be submitted to the Commissions, except to the extent a person withdraws the request pursuant to the rule.

Second, the SEC is adopting rule 3a68-4(c) under the Exchange Act, which will allow persons to submit requests to the Commissions for joint orders regarding the regulation of a particular mixed swap (or class thereof). Under rule 3a68-4(c) under the Exchange Act, a person will provide to the Commissions all material information regarding the terms of, and the economic characteristics and purpose of, the specified (or specified class of) mixed swap. In addition, a person will provide the specified parallel provisions, the reasons the person believes such specified parallel provisions are appropriate for the mixed swap (or class thereof), and an analysis of: (1) the nature and purposes of the parallel provisions that are the subject of the request; (2) the comparability of such parallel provisions; and (3) the extent of any conflicts or differences between such parallel provisions. The Commissions also may request the submitting person to provide additional information.

The Commissions may issue in response a joint order, after public notice and opportunity for comment, permitting the requesting person (and any other person or persons that subsequently lists, trades, or clears that class of mixed swap) to comply, as to parallel provisions only, with the specified parallel provisions (or another subset of the parallel provisions that are the subject of the request, as the Commissions determine is appropriate), instead of being required to comply with parallel provisions of both the CEA and the Exchange Act. Any joint order will be public and may discuss the material information regarding the terms of the relevant agreement, contract, or transaction (or class thereof), as well as any other information the Commissions deem material to the interpretation. Requesting persons also will be permitted to withdraw a request made pursuant to rule 3a68-4(c) under the Exchange Act at any time before the Commissions have issued a joint order in response to the request.

Persons will submit requests pursuant to rule 3a68-4(c) under the Exchange Act on a voluntary basis. However, if a person submits a request, all of the information required under the rule, including any additional information requested by the Commissions, must be submitted to the Commissions, except to the extent a person withdraws the request pursuant to the rule.

3. Reasons for and Use of Information

The SEC will use the information collected pursuant to rule 3a68-2 under the Exchange Act to evaluate agreements, contracts, or transactions (or classes thereof) in order to provide joint interpretations or joint notices of proposed rulemaking with the CFTC regarding whether these agreements, contracts, or transactions (or classes thereof) are swaps, security-based swaps, or both (i.e., mixed swaps) as defined in the Dodd-Frank Act. The SEC will use the information collected pursuant to rule 3a68-4(c) under the Exchange Act to evaluate a specified, or a specified class of, mixed swap in order to provide joint orders or joint notices of proposed rulemaking with the CFTC regarding the regulation of that particular mixed swap or class of mixed swap. The information provided to the SEC pursuant to rules 3a68-2 and 3a68-4(c) under the Exchange Act also will allow the SEC to monitor the development of new OTC derivatives products in the marketplace and determine whether additional rulemaking or interpretive guidance is necessary or appropriate.

As discussed above, some commenters expressed concern about the public availability of information regarding the joint interpretive process and asked that the parties be able to seek confidential treatment of their submissions.[1405] As stated above, under existing rules of both

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1405 See supra part VI.

Commissions, requesting parties may seek confidential treatment for joint interpretive requests from the SEC and the CFTC in accordance with the applicable existing rules relating to confidential treatment of information.[1406] Also as stated above, even if confidential treatment has been requested, all joint interpretive requests, as well all joint interpretations and any decisions not to issue a joint interpretation (along with the explanation of the grounds for such decision), will be made publicly available at the conclusion of the review period.[1407]

4. Respondents

As discussed in the Proposing Release, the SEC believes that the relevant categories of persons that will submit requests under rule 3a68-2 under the Exchange Act will be swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants; SEFs, security-based SEFs and DCMs trading swaps; and SDRs, SBSDRs, DCOs clearing swaps, and clearing agencies clearing security-based swaps.[1408] The SEC estimates that the total number of such persons will be 475.[1409] Similarly, the SEC believes that the relevant

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1406 See 17 CFR 200.81 and 17 CFR 140.98. See also supra part VI.

1407 See supra part VI.

1408 See Proposing Release at 29876.

1409 This total number includes an estimated 250 swap dealers, 50 major swap participants, 50 security-based swap dealers, 10 major security-based swap participants, 35 SEFs, 20 security-based SEFs, 12 DCOs, 17 DCMs, 15 SDRs, 10 SBSDRs, and 6 clearing agencies, as set forth by the CFTC and SEC, respectively, in their other Dodd-Frank Act rulemaking proposals. See Entity Definitions Release, supra note 12(regarding security-based swap dealers and major security-based swap participants); Registration of Swap Dealers and Major Swap Participants, supra note 1288 (regarding swap dealers and major security-based swap participants); SDR Proposing Release, supra note 1231 (regarding SBSDRs); Swap Data Repositories, supra note 6 (regarding SDRs); Core Principles and Other Requirements for Swap Execution Facilities, 76 FR 1214, Jan. 7, 2011 (regarding SEFs); Registration and Regulation of Security-Based Swap Execution Facilities, 76 FR 10948, Feb. 28, 2011 (regarding security-based SEFs); Derivatives Clearing Organization General Provisions and Core Principles, 76 FR 69334 (Nov. 8, 2011); Core Principles and Other Requirements for Designated Contract Markets, 75 FR 80572, Dec. 22, 2010 (regarding DCMs); Clearing Agency Standards for Operation and Governance, 76 FR 14472, Mar. 16, 2011 (regarding clearing agencies).

categories of persons that will submit a request under rule 3a68-4(c) under the Exchange Act will be SEFs, security-based SEFs, and DCMs trading swaps and estimates that the total number of such persons will be 72.[1410]

However, based on the SEC's experience and information received from commenters to the ANPR[1411] and during meetings with the public to discuss the Product Definitions generally, and taking into consideration the certainty provided by the rules and interpretive guidance in this release, the SEC believes that the number of requests for a joint interpretation to the Commissions pursuant to rule 3a68-2 under the Exchange Act will be small.[1412] With respect to proposed rule 3a68-4(c) under the Exchange Act, the SEC also estimates the number of requests for joint orders will be small.[1413] Pursuant to the Commissions' rules and interpretive guidance, a number of persons that engage in agreements, contracts, or transactions that are swaps, security-based swaps, or both (i.e., a mixed swap) will be certain that their agreements, contracts, or transactions are, indeed, swaps, security-based swaps, or both, (i.e., mixed swaps) and will not request an interpretation pursuant to rule 3a68-2 under the Exchange Act. Also, as the Commissions provide joint interpretations regarding whether agreements, contracts, or transactions (or classes thereof) are or are not swaps, security-based swaps, or both (i.e., mixed swaps), the SEC expects that the number of requests for interpretation will decrease over time. The SEC believes that the rules and interpretive guidance regarding swaps, security-based swaps, and mixed swaps the Commissions are adopting, as well as the additional guidance issued pursuant to joint interpretations and orders under rules 3a68-2 and 3a68-4(c) under the Exchange

1410 Id.

1411 See supra note 12 and accompanying text.

1412 See infra note 1414 and accompanying text.

1413 See infra note 1415and accompanying text.

Act, will result in a narrow pool of potential respondents, approximately 50,[1414] to the collection of information requirements of proposed rule 3a68-2 under the Exchange Act. Although the SEC does not have precise figures for the number of requests that persons will submit after the first year, the SEC believes it is reasonable to estimate that there likely will be fewer than 10 requests on average in each ensuing year.

Similarly, because the SEC believes that both the category of mixed swap transactions and the number of market participants that engage in mixed swap transactions are small, the SEC believes that the pool of potential persons requesting a joint order regarding the regulation of a specified, or specified class of, mixed swap pursuant to proposed rule 3a68-4(c) under the Exchange Act will be small. In addition, depending on the characteristics of a mixed swap (or class thereof), a person may choose not to submit a request pursuant to rule 3a68-4(c) under the Exchange Act. The SEC also notes that any joint order issued by the Commissions will apply to any person that subsequently lists, trades, or clears that specified, or specified class of, mixed swap, so that requests for joint orders could diminish over time. Also, persons may submit requests for an interpretation under rule 3a68-4(c) under the Exchange Act that do not result in an interpretation that the agreement, contract, or transaction (or class thereof) is a mixed swap.[1415] Also, those requests submitted pursuant to rule 3a68-2 under the Exchange Act that result in an interpretation that the agreement, contract, or transaction (or class thereof) is not a mixed swap will reduce the pool of possible persons submitting a request regarding the

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1414 The SEC believes that there will be approximately 50 requests in the first year. See discussion infra part XI.B.5. The SEC recognizes that one person might submit more than one request but for purposes of the PRA is considering the submitter of each such request as a separate person.

1415 The SEC believes it is reasonable to estimate that it will receive 20 requests in the first year and, as with rule 3a68-2 under the Exchange Act, it will count the submitter of each request as a separate person. See id.

regulation of particular mixed swaps (or class thereof) pursuant to rule 3a68-4(c) under the Exchange Act.

Furthermore, although certain requests made pursuant to rule 3a68-4(c) under the Exchange Act may be made without a previous request for a joint interpretation pursuant to rule 3a68-2 under the Exchange Act, the SEC believes that most requests under rule 3a68-2 under the Exchange Act that result in the interpretation that an agreement, contract, or transaction (or class thereof) is a mixed swap will result in a subsequent request for alternative regulatory treatment pursuant to rule 3a68-4(c) under the Exchange Act. The SEC believes that 90 percent, or 18 of the estimated 20 requests pursuant to rule 3a68-4(c) under the Exchange Act in the first year would be such "follow-on" requests.

In addition, not only the requesting party, but also any other person that subsequently lists, trades, or clears that mixed swap, will be subject to, and must comply with, the joint order regarding the regulation of the specified, or specified class of, mixed swap, as issued by the Commissions. Therefore, the SEC believes that the number of requests for a joint order regarding the regulation of mixed swaps, particularly involving specified classes of mixed swaps, will decrease over time. As discussed above, the SEC believes that as the Commissions provide joint orders regarding alternative regulatory treatment, the number of requests received will decrease over time. The SEC believes it is reasonable to estimate that there likely will be five requests on average in each ensuing year.

5. Paperwork Reduction Act Burden Estimates

Rules 3a68-2 and 3a68-4(c) under the Exchange Act require submission of certain information to the Commissions to the extent persons elect to request an interpretation and/or alternative regulatory treatment. Rules 3a68-2 and 3a68-4(c) under the Exchange Act each require certain information that a requesting party must include in its request to the Commissions in order to receive a joint interpretation or order, as applicable.

a) Rule 3a68-2 Under the Exchange Act

Rule 3a68-2 will apply only to requests made by persons that desire an interpretation from the Commissions. For each agreement, contract, or transaction (or class thereof) for which a person requests the Commissions' joint interpretation under rule 3a68-2 under the Exchange Act, the requesting person will be required to provide certain information, as discussed above.[1416]

As discussed above, the SEC believes it is reasonable to estimate that 50 requests will be received in the first year. For purposes of the PRA, the SEC estimates the total paperwork burden associated with preparing and submitting a person's request to the Commissions pursuant to rule 3a68-2 under the Exchange Act will be 20 hours per request and associated costs of $12,000 for outside professionals, which the SEC believes will consist of services provided by attorneys.[1417] These total costs include all collection burdens associated with the rule, including burdens related to the initial determination requirements.

1416 See discussion supra part VI.

1417 See discussion supra part XI.A.4.e)ii). This estimate is based on information indicating that the average burden associated with preparing and submitting a no-action request to the SEC staff in connection with the identification of whether certain products are securities, which the SEC believes is a process similar to the process under rule 3a68-2 under the Exchange Act, is approximately 20 hours and associated costs of $12,000. Assuming these costs correspond to legal fees, which the SEC estimates at an hourly cost of $400, the SEC estimates that this cost is equivalent to approximately 30 hours ($12,000/$400). The estimated internal or company time burden for rule 3a68-2 under the Exchange Act has not changed from that included in the Proposing Release, but the estimated burden of the cost for outside professionals for rule 3a68-2 under the Exchange Act has been revised from that included in the Proposing Release to reflect updated data regarding hourly costs for the services of outside professionals. The estimate of the dollar burden for rule 3a68-2 under the Exchange Act in the Proposing Release was based on data from SIFMA's "Management & Professional Earnings in the Securities Industry 2009." See Proposing Release at 29876, note 345. The hourly rate used to estimate the PRA burdens is discussed above. See supra note 1344.

Assuming 50 requests in the first year, the SEC estimates that this will result in an aggregate burden for the first year of 1000 hours of company time (50 requests x 20 hours/request) and $600,000 for the services of outside professionals (e.g., attorneys) (50 requests x 30 hours/request x $400). The estimated internal or company time burden for rule 3a68-2 under the Exchange Act has not changed from that included in the Proposing Release.[1418] However, the estimated burden of the cost for outside professionals for rule 3a68-2 under the Exchange Act has been revised from that included in the Proposing Release to reflect updated data regarding the hourly cost for an attorney.[1419]

As discussed above, the SEC believes that there will be 10 requests on average in each ensuing year, which results in an aggregate burden in each ensuing year of 200 hours of company time (10 requests x 20 hours/request) and $120,000 for the services of outside professionals (e.g., attorneys) (10 requests x 30 hours/request x $400).[1420]

b) Rule 3a68-4(c) Under the Exchange Act

Rule 3a68-4(c) under the Exchange Act will require any party requesting a joint order regarding the regulation of a specified, or specified class of, mixed swap under the rule to include certain information about the agreement, contract, or transaction (or class thereof) that is a mixed swap, including the specified parallel provisions that the person believes should apply to the mixed swap (or class thereof), the reasons the person believes the specified parallel provisions will be appropriate for the mixed swap.[1421]

1418 See Proposing Release at 29876, 29877-78.

1419 See id.

1420 See discussion supra part XI.B.4.

1421 See discussion supra part IV.B.3.

As discussed above, the SEC believes the number of requests that persons will submit pursuant to rule 3a68-4(c) under the Exchange Act is quite small given the limited types of agreements, contracts, and transactions (or classes thereof) the Commissions believe will constitute mixed swaps and that it will receive 20 requests in the first year.[1422] For purposes of the PRA, the SEC estimates the total paperwork burden associated with preparing and submitting a party's request to the Commissions pursuant to rule 3a68-4(c) under the Exchange Act will be 30 hours and associated costs of $20,000 for the services of outside professionals, which the SEC believes will consist of services provided by attorneys,[1423] per request for mixed swaps for which a request for a joint interpretation pursuant to rule 3a68-4(c) under the Exchange Act was not previously made.[1424] These total costs include all collection burdens associated with the rule, including burdens related to the initial determination requirements. Assuming 20 requests in the first year, the SEC estimates that this will result in an aggregate burden for the first year of 600 hours of company time (20 requests x 30 hours/request) and $400,000 for the services of outside professionals (20 requests x 50 hours/request x $400).[1425]

1422 See supra note 1415 and accompanying text.

1423 See supra note 1352.

1424 This estimate is based on information indicating that the average burden associated with preparing and submitting a no-action request to the SEC staff in connection with the regulatory treatment of certain securities products, which the SEC believes is a process similar to the process under rule 3a68-4(c) under the Exchange Act, is approximately 30 hours and associated costs of $20,000. Assuming these costs correspond to legal fees, which the SEC estimates at an hourly cost of $400 as discussed above, the SEC estimates that this cost is equivalent to approximately 50 hours ($20,000/$400). As with rule 3a68-2 under the Exchange Act, the estimated internal or company time burdens for rule 3a68-4(c) under the Exchange Act have not changed from those included in the Proposing Release, but the estimated burdens of the cost for outside professionals for rule 3a68-4(c) under the Exchange Act have been revised from those included in the Proposing Release to reflect updated data regarding hourly costs for the services of outside professionals.

1425 See supra note 1415 and accompanying text.

As discussed above, the SEC believes that most requests under rule 3a68-2 under the Exchange Act that result in the interpretation that an agreement, contract, or transaction (or class thereof) is a mixed swap will result in a subsequent request for alternative regulatory treatment pursuant to rule 3a68-4(c) under the Exchange Act.

Also as discussed above, the SEC believes that 90 percent, or 18 of the estimated 20 requests pursuant to rule 3a68-4(c) under the Exchange Act in the first year, as discussed above will be "follow-on" requests. For mixed swaps for which a request for a joint interpretation pursuant to rule 3a68-2 under the Exchange Act was previously made, the SEC estimates the total paperwork burden under the PRA associated with preparing and submitting a party's request to the Commissions pursuant to rule 3a68-4(c) under the Exchange Act will be 10 hours fewer and $6,000 less per request than for mixed swaps for which a request for a joint interpretation pursuant to rule 3a68-2 under the Exchange Act was not previously made because certain, although not all, of the information required to be submitted and necessary to prepare pursuant to rule 3a68-4(c) under the Exchange Act will have been required to be submitted and necessary to prepare pursuant to rule 3a68-2 under the Exchange Act.[1426] The SEC estimates that this will result in an aggregate burden for such "follow-on" requests in the first year of 360 hours of company time (18 requests x 20 hours/request) and $252,000 for the services of outside professionals (18 requests x 35 hours/request x $400) and an aggregate burden for all requests in

[1426] This estimate takes into account that certain information regarding the mixed swap (or class thereof), namely the material terms and the economic purpose, will have already been gathered and prepared as part of the request submitted pursuant to proposed rule 3a68-2 under the Exchange Act. The SEC estimates that these items constitute approximately 10 hours fewer and a reduction in associated costs of $6,000. Assuming these costs correspond to legal fees, which the SEC estimates at an hourly cost of $400, the SEC estimates that this cost is equivalent to approximately 15 hours ($6,000/$400). As noted above, these amounts are revised from those included in the Proposing Release to reflect updated data regarding the hourly costs for the services of outside professionals.

the first year of 420 hours of company time (2 requests x 30 hours/request and 18 requests x 20 hours/request) and $292,000 for the services of outside professionals (2 requests x 50 hours/request x $400 and 18 requests x 35 hours/request x $400).

The estimated internal or company time burden for rule 3a68-4(c) under the Exchange Act has not changed from that included in the Proposing Release.[1427] However, the estimated burden of the cost for outside professionals for rule 3a68-4(c) has been revised from that included in the Proposing Release to reflect updated data regarding the hourly cost for an attorney.[1428]

As discussed above, the SEC believes that there will be five requests on average in each ensuing year. Assuming five requests in each ensuing year, the SEC estimates that this will result in an aggregate burden in each ensuing year of 150 hours of company time (5 requests x 30 hours/request) and $100,000 for the services of outside professionals (5 requests x 50 hours/request x $400). As discussed above, however, assuming that approximately 90 percent, or 4 of the estimated 5 requests pursuant to rule 3a68-4(c) under the Exchange Act in each ensuing year are "follow-on" requests to requests for joint interpretation from the Commissions under rule 3a68-4(c) under the Exchange Act, the SEC estimates that this will result in an aggregate burden for such "follow-on" requests in each ensuing year of 80 hours of company time (4 requests x 20 hours/request) and $56,000 for the services of outside professionals (4 requests x 35 hours/request x $400) and an aggregate burden for all requests in each ensuing year of 110 hours of company time (1 request x 30 hours/request and 4 requests x 20 hours/request)

1427 See Proposing Release at 29876, 29878-79.

1428 See id.

and $76,000 for the services of outside professionals (1 request x 50 hours/request x $40] and 4 requests x 35 hours/request x $400).

C. Regulatory Flexibility Act Certification

The Regulatory Flexibility Act ("RFA")[1429] requires Federal agencies, in promulgating rules, to consider the impact of those rules on small entities. Section 603(a)[1430] of the Administrative Procedure Act,[1431] as amended by the RFA, generally requires the SEC to undertake a regulatory flexibility analysis of all proposed rules, or proposed rule amendments, to determine the impact of such rulemaking on "small entities."[1432] Section 605(b) of the RFA provides that this requirement shall not apply to any proposed rule or proposed rule amendment, which if adopted, would not have a significant economic impact on a substantial number of small entities.[1433]

For purposes of SEC rulemaking in connection with the RFA, a small entity includes: (1) when used with reference to an "issuer" or a "person," other than an investment company, an "issuer" or "person" that, on the last day of its most recent fiscal year, had total assets of $5 million or less[1434] and (2) a broker-dealer with total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited

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1429 5 U.S.C. 601 et seq.

1430 5 U.S.C. 603(a).

1431 5 U.S.C. 551 et seq.

1432 Although section 601(b) of the RFA defines the term "small entity," the statute permits the Commissions to formulate their own definitions. The SEC has adopted definitions for the term small entity for the purposes of SEC rulemaking in accordance with the RFA. Those definitions, as relevant to this proposed rulemaking, are set forth in Rule 0-10, 17 CFR 240.0-10. See Statement of Management on Internal Accounting Control, 47 FR 5215, Feb. 4, 1982.

1433 See 5 U.S.C. 605(b).

1434 See 17 CFR 240.0-10(a).

financial statements were prepared pursuant to rule 17a-5(d) under the Exchange Act,[1435] or, if not required to file such statements, a broker-dealer with total capital (net worth plus subordinated liabilities) of less than $500,000 on the last day of the preceding fiscal year (or in the time that it has been in business, if shorter); and is not affiliated with any person (other than a natural person) that is not a small entity.[1436] Under the standards adopted by the Small Business Administration, small entities in the finance and insurance industry include the following: (1) for entities engaged in credit intermediation and related activities, entities with $175 million or less in assets;[1437] (2) for entities engaged in non-depository credit intermediation and certain other activities, entities with $7 million or less in annual receipts;[1438] (3) for entities engaged in financial investments and related activities, entities with $7 million or less in annual receipts;[1439] (4) for insurance carriers and entities engaged in related activities, entities with $7 million or less in annual receipts;[1440] and (5) for funds, trusts, and other financial vehicles, entities with $7 million or less in annual receipts.[1441]

The Proposing Release stated that, based on the SEC's existing information about the swap markets, the SEC believed that the swap markets, while broad in scope, are largely dominated by entities such as those that would qualify as swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants (collectively, "swap

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1435 See 17 CFR 240.17a-5(d).

1436 See 17 CFR 240.0-10(c).

1437 See 13 CFR 121.201 (Subsector 522).

1438 See id. at Subsector 522.

1439 See id. at Subsector 523.

1440 See id. at Subsector 524.

1441 See id. at Subsector 525.

market dealers and major participants") and that the SEC believed that such entities exceed the thresholds defining "small entities" set out above.[1442]

The Proposing Release also stated that, although it is possible that other persons may engage in swap and security-based swap transactions, the SEC did not believe that any of these entities would be "small entities" as defined in rule 0-10 under the Exchange Act[1443] and that feedback from industry participants about the swap markets indicates that only persons or entities with assets significantly in excess of $5 million (or with annual receipts significantly in excess of $7 million) participate in the swap markets.[1444]

The Proposing Release further stated that, to the extent that a small number of transactions did have a counterparty that was defined as a "small entity" under SEC rule 0-10, the SEC believed it is unlikely that the proposed rules and interpretive guidance would have a significant economic impact on that entity because the proposed rules and interpretive guidance simply would address whether certain products fall within the swap definition, address whether certain products are swaps, security-based swaps, SBSAs, or mixed swaps, provide a process for requesting interpretations of whether agreements, contracts, and transactions are swaps, security-based swaps, and mixed swaps, provide a process for requesting alternative regulatory treatment for mixed swaps, and specify that the books and records for SBSAs are those that are applicable to all entities.[1445]

1442 See Proposing Release at 29887.

1443 See 17 CFR 240.0-10(a).

1444 See Proposing Release at 29887.

1445 See Proposing Release at 29887-88.

As a result, the SEC certified that the proposed rules and interpretive guidance would not have a significant economic impact on a substantial number of small entities for purposes of the RFA, and requested written comments regarding this certification.[1446]

In response to the Proposing Release, one commenter, representing a number of market participants, submitted a comment to the CFTC related to the RFA.[1447] The commenter did not address the letter to the SEC or provide comments regarding the SEC's RFA analysis.[1448]

The SEC continues to believe that the types of entities that would participate in the swap markets – which generally would be swap market dealers and major participants – would not be "small entities" for purposes of the RFA. The final rules and interpretive guidance do not themselves impose any compliance obligations. Instead they describe the categories of agreements, contracts, and transactions that are outside the scope of the Product Definitions and delineate the jurisdictional divide between the SEC's and the CFTC's regulatory regime. Accordingly, the SEC certifies that the final rules and interpretive guidance would not have a significant economic impact on a substantial number of small entities for purposes of the RFA.

XII. Statutory Basis and Rule Text

List of Subjects

17 CFR Part 1

Definitions, General swap provisions.

17 CFR Parts 230 and 240

Reporting and recordkeeping requirements, Securities.

1446 See Proposing Release at 29888.

1447 See Letter from the National Rural Electric Cooperative Association, the American Public Power Association, the Large Public Power Council, the Edison Electric Institute, and the Electric Power Supply Association (July 22, 2011).

1448 See id.

Commodity Futures Trading Commission

Pursuant to the Commodity Exchange Act, 7 U.S.C. 1 et seq., as amended by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010) ("Dodd-Frank Act"), and sections 712(a)(8), 712(d), 721(a), 721(b), 721(c), 722(d), and 725(g) of the Dodd-Frank Act, the CFTC is adopting rules 1.3(xxx) through 1.3(bbbb) and 1.6 through 1.9 under the Commodity Exchange Act.

Text of Final Rules

For the reasons stated in the preamble, the CFTC is amending Title 17, Chapter I, of the Code of Federal Regulations, as follows:

PART 1—GENERAL REGULATIONS UNDER THE COMMODITY EXCHANGE ACT

1. The authority citation for part 1 is revised to read as follows:

Authority: 7 U.S.C. 1a, 2, 5, 6, 6a, 6b, 6c, 6c, 6e, 6f, 6g, 6h, 6i, 6j, 6k, 6l, 6m, 6n, 6o, 6p, 6r, 7, 7a, 7b, 8, 9, 10, 12, 12a, 12c, 13a, 13a-1, 16, 16a, 21, 23, and 24.

2. Amend Sec. 1.3 by adding paragraphs (xxx), (yyy), (zzz), (aaaa) and (bbbb) to read as follows:

§ 1.3 Definitions

* * * * *

(xxx) Swap. (1) In general. The term swap has the meaning set forth in section 1a(47) of the Commodity Exchange Act.

(2) Inclusion of particular products. (i) The term swap includes, without limiting the meaning set forth in section 1a(47) of the Commodity Exchange Act, the following agreements, contracts, and transactions:

(A) A cross-currency swap;

(B) A currency option, foreign currency option, foreign exchange option and foreign exchange rate option;

(C) A foreign exchange forward;

(D) A foreign exchange swap;

(E) A forward rate agreement; and

(F) A non-deliverable forward involving foreign exchange.

(ii) The term swap does not include an agreement, contract, or transaction described in paragraph (xxx)(2)(i) of this section that is otherwise excluded by section 1a(47)(B) of the Commodity Exchange Act.

(3) Foreign exchange forwards and foreign exchange swaps. Notwithstanding paragraph (xxx)(2) of this section:

(i) A foreign exchange forward or a foreign exchange swap shall not be considered a swap if the Secretary of the Treasury makes a determination described in section 1a(47)(E)(i) of the Commodity Exchange Act.

(ii) Notwithstanding paragraph (xxx)(3)(i) of this section:

(A) The reporting requirements set forth in section 4r of the Commodity Exchange Act and regulations promulgated thereunder shall apply to a foreign exchange forward or foreign exchange swap; and

(B) The business conduct standards set forth in section 4s(h) of the Commodity Exchange Act and regulations promulgated thereunder shall apply to a swap dealer or major swap participant that is a party to a foreign exchange forward or foreign exchange swap.

(iii) For purposes of section 1a(47)(E) of the Commodity Exchange Act and this § 1.3(xxx), the term foreign exchange forward has the meaning set forth in section 1a(24) of the Commodity Exchange Act.

(iv) For purposes of section 1a(47)(E) of the Commodity Exchange Act and this § 1.3(xxx), the term foreign exchange swap has the meaning set forth in section 1a(25) of the Commodity Exchange Act.

(v) For purposes of sections 1a(24) and 1a(25) of the Commodity Exchange Act and this § 1.3(xxx), the following transactions are not foreign exchange forwards or foreign exchange swaps:

(A) A currency swap or a cross-currency swap;

(B) A currency option, foreign currency option, foreign exchange option, or foreign exchange rate option; and

(C) A non-deliverable forward involving foreign exchange.

(4) Insurance. (i) This paragraph is a non-exclusive safe harbor. The terms swap as used in section 1a(47) of the Commodity Exchange Act and security-based swap as used in section 1a(42) of the Commodity Exchange Act do not include an agreement, contract, or transaction that:

(A) By its terms or by law, as a condition of performance on the agreement, contract, or transaction:

(1) Requires the beneficiary of the agreement, contract, or transaction to have an insurable interest that is the subject of the agreement, contract, or transaction and thereby carry the risk of loss with respect to that interest continuously throughout the duration of the agreement, contract, or transaction;

(2) Requires that loss to occur and to be proved, and that any payment or indemnification therefor be limited to the value of the insurable interest;

(3) Is not traded, separately from the insured interest, on an organized market or over-the-counter; and

(4) With respect to financial guaranty insurance only, in the event of payment default or insolvency of the obligor, any acceleration of payments under the policy is at the sole discretion of the insurer; and

(B) Is provided:

(1)(i) By a person that is subject to supervision by the insurance commissioner (or similar official or agency) of any State or by the United States or an agency or instrumentality thereof, and (ii) such agreement, contract, or transaction is regulated as insurance under applicable State law or the laws of the United States;

(2)(i) Directly or indirectly by the United States, any State or any of their respective agencies or instrumentalities, or (ii) pursuant to a statutorily authorized program thereof; or

(3) In the case of reinsurance only, by a person to another person that satisfies the conditions set forth in paragraph (xxx)(4)(i)(B) of this section, provided that:

(i) Such person is not prohibited by applicable State law or the laws of the United States from offering such agreement, contract, or transaction to such person that satisfies the conditions set forth in paragraph (xxx)(4)(i)(B) of this section;

(ii) The agreement, contract, or transaction to be reinsured satisfies the conditions set forth in paragraph (xxx)(4)(i)(A) or paragraph (xxx)(4)(i)(C) of this section; and

(iii) Except as otherwise permitted under applicable State law, the total amount reimbursable by all reinsurers for such agreement, contract, or transaction may not exceed the claims or losses paid by the person writing the risk being ceded or transferred by such person; or

(4) In the case of non-admitted insurance, by a person who:

(i) is located outside of the United States and listed on the Quarterly Listing of Alien Insurers as maintained by the International Insurers Department of the National Association of Insurance Commissioners; or

(ii) meets the eligibility criteria for non-admitted insurers under applicable State law; or

(C) Is provided in accordance with the conditions set forth in paragraph (xxx)(4)(i)(B) of this section and is one of the following types of products:

(1) surety bond;

(2) fidelity bond;

(3) life insurance;

(4) health insurance;

(5) long term care insurance;

(6) title insurance;

(7) property and casualty insurance;

(8) annuity;

(9) disability insurance;

(10) insurance against default on individual residential mortgages; and

(11) reinsurance of any of the foregoing products identified in paragraphs (1) through (10) above; or

(ii) The terms swap as used in section 1a(47) of the Commodity Exchange Act and security-based swap as used in section 1a(42) of the Commodity Exchange Act do not include an agreement, contract, or transaction that was entered into on or before the effective date of paragraph (xxx)(4) of this section, and that, at such time that it was entered into, was provided in accordance with the conditions set forth in paragraph (xxx)(4)(i)(B) of this section.

(5) State. For purposes of paragraph (xxx)(4) of this section, the term State means any state of the United States, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, or any other possession of the United States.

(6) Anti-Evasion:

(i) An agreement, contract, or transaction that is willfully structured to evade any provision of Subtitle A of the Wall Street Transparency and Accountability Act of 2010, including any amendments made to the Commodity Exchange Act thereby (Subtitle A), shall be deemed a swap for purposes of Subtitle A and the rules, regulations, and orders of the Commission promulgated thereunder.

(ii) An interest rate swap or currency swap, including but not limited to a transaction identified in paragraph (xxx)(3)(v) of this section, that is willfully structured as a foreign exchange forward or foreign exchange swap to evade any provision of Subtitle A shall be deemed a swap for purposes of Subtitle A and the rules, regulations, and orders of the Commission promulgated thereunder.

(iii) An agreement, contract, or transaction of a bank that is not under the regulatory jurisdiction of an appropriate Federal banking agency (as defined in section 1a(2) of the Commodity Exchange Act), where the agreement, contract, or transaction is willfully structured as an identified banking product (as defined in section 402 of the Legal Certainty for Bank

Products Act of 2000) to evade the provisions of the Commodity Exchange Act, shall be deemed a swap for purposes of the Commodity Exchange Act and the rules, regulations, and orders of the Commission promulgated thereunder.

(iv) The form, label, and written documentation of an agreement, contract, or transaction shall not be dispositive in determining whether the agreement, contract, or transaction has been willfully structured to evade as provided in paragraphs (xxx)(6)(i) through (xxx)(6)(iii) of this section.

(v) An agreement, contract, or transaction that has been willfully structured to evade as provided in paragraphs (xxx)(6)(i) through (xxx)(6)(iii) of this section shall be considered in determining whether a person that so willfully structured to evade is a swap dealer or major swap participant.

(vi) Notwithstanding the foregoing, no agreement, contract, or transaction structured as a security (including a security-based swap) under the securities laws (as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47))) shall be deemed a swap pursuant to this § 1.3(xxx)(6) or shall be considered for purposes of paragraph (xxx)(6)(v) of this section.

(yyy) Narrow-based security index as used in the definition of "security-based swap."

(1) In general. Except as otherwise provided in paragraphs (zzz) and (aaaa) of this section, for purposes of section 1a(42) of the Commodity Exchange Act, the term narrow-based security index has the meaning set forth in section 1a(35) of the Commodity Exchange Act, and the rules, regulations and orders of the Commission thereunder.

(2) Tolerance period for swaps traded on designated contract markets, swap execution facilities, and foreign boards of trade. Notwithstanding paragraph (yyy)(1) of this section, solely for purposes of swaps traded on or subject to the rules of a designated contract market, swap

execution facility, or foreign board of trade, a security index underlying such swaps shall not be considered a narrow-based security index if:

(i) (A) A swap on the index is traded on or subject to the rules of a designated contract market, swap execution facility, or foreign board of trade for at least 30 days as a swap on an index that was not a narrow-based security index; or

(B) Such index was not a narrow-based security index during every trading day of the six full calendar months preceding a date no earlier than 30 days prior to the commencement of trading of a swap on such index on a market described in paragraph (yyy)(2)(i)(A) of this section; and

(ii) The index has been a narrow-based security index for no more than 45 business days over three consecutive calendar months.

(3) Tolerance period for security-based swaps traded on national securities exchanges or security-based swap execution facilities. Notwithstanding paragraph (yyy)(1) of this section, solely for purposes of security-based swaps traded on a national securities exchange or security-based swap execution facility, a security index underlying such security-based swaps shall be considered a narrow-based security index if:

(i)(A) A security-based swap on the index is traded on a national securities exchange or security-based swap execution facility for at least 30 days as a security-based swap on a narrow-based security index; or

(B) Such index was a narrow-based security index during every trading day of the six full calendar months preceding a date no earlier than 30 days prior to the commencement of trading of a security-based swap on such index on a market described in paragraph (yyy)(3)(i)(A) of this section; and

(ii) The index has been a security index that is not a narrow-based security index for no more than 45 business days over three consecutive calendar months.

(4) Grace period.

(i) Solely with respect to a swap that is traded on or subject to the rules of a designated contract market, swap execution facility, or foreign board of trade, an index that becomes a narrow-based security index under paragraph (yyy)(2) of this section solely because it was a narrow-based security index for more than 45 business days over three consecutive calendar months shall not be a narrow-based security index for the following three calendar months.

(ii) Solely with respect to a security-based swap that is traded on a national securities exchange or security-based swap execution facility, an index that becomes a security index that is not a narrow-based security index under paragraph (yyy)(3) of this section solely because it was not a narrow-based security index for more than 45 business days over three consecutive calendar months shall be a narrow-based security index for the following three calendar months.

(zzz) Meaning of "issuers of securities in a narrow-based security index" as used in the definition of "security-based swap" as applied to index credit default swaps.

(1) Notwithstanding paragraph 1.3(yyy)(1) of this section, and solely for purposes of determining whether a credit default swap is a security-based swap under the definition of "security-based swap" in section 3(a)(68)(A)(ii)(III) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(68)(A)(ii)(III), as incorporated in section 1a(42) of the Commodity Exchange Act, the term issuers of securities in a narrow-based security index means issuers of securities included in an index (including an index referencing loan borrowers or loans of such borrowers) in which:

(i)(A) There are nine or fewer non-affiliated issuers of securities that are reference entities included in the index, provided that an issuer of securities shall not be deemed a reference entity included in the index for purposes of this section unless:

(1) A credit event with respect to such reference entity would result in a payment by the credit protection seller to the credit protection buyer under the credit default swap based on the related notional amount allocated to such reference entity; or

(2) The fact of such credit event or the calculation in accordance with paragraph (zzz)(1)(i)(A)(1) of this section of the amount owed with respect to such credit event is taken into account in determining whether to make any future payments under the credit default swap with respect to any future credit events;

(B) The effective notional amount allocated to any reference entity included in the index comprises more than 30 percent of the index's weighting;

(C) The effective notional amount allocated to any five non-affiliated reference entities included in the index comprises more than 60 percent of the index's weighting; or

(D) Except as provided in paragraph (zzz)(2) of this section, for each reference entity included in the index, none of the criteria in paragraphs (zzz)(1)(i)(D)(1) through (8) of this section is satisfied:

(1) The reference entity included in the index is required to file reports pursuant to section 13 or section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d));

(2) The reference entity included in the index is eligible to rely on the exemption provided in rule 12g3-2(b) under the Securities Exchange Act of 1934 (17 CFR 240.12g3-2(b));

(3) The reference entity included in the index has a worldwide market value of its outstanding common equity held by non-affiliates of $700 million or more;

(4) The reference entity included in the index (other than a reference entity included in the index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)) has outstanding notes, bonds, debentures, loans, or evidences of indebtedness (other than revolving credit facilities) having a total remaining principal amount of at least $1 billion;

(5) The reference entity included in the index is the issuer of an exempted security as defined in section 3(a)(12) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(12)) (other than any municipal security as defined in section 3(a)(29) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(29)));

(6) The reference entity included in the index is a government of a foreign country or a political subdivision of a foreign country;

(7) If the reference entity included in the index is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)), such asset-backed security was issued in a transaction registered under the Securities Act of 1933 (15 U.S.C. 77a et seq.) and has publicly available distribution reports; and

(8) For a credit default swap entered into solely between eligible contract participants as defined in section 1a(18) of the Commodity Exchange Act:

(i) The reference entity included in the index (other than a reference entity included in the index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77))) makes available to the public or otherwise makes available to such eligible contract participant information about the reference entity included in the index pursuant to rule 144A(d)(4) under the Securities Act of 1933 (17 CFR 230.144A(d)(4));

(ii) Financial information about the reference entity included in the index (other than a reference entity included in the index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77))) is otherwise publicly available; or

(iii) In the case of a reference entity included in the index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)), information of the type and level included in publicly available distribution reports for similar asset-backed securities is publicly available about both the reference entity included in the index and such asset-backed security; and

(ii)(A) The index is not composed solely of reference entities that are issuers of exempted securities as defined in section 3(a)(12) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(12)), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(29))), as in effect on the date of enactment of the Futures Trading Act of 1982); and

(B) Without taking into account any portion of the index composed of reference entities that are issuers of exempted securities as defined in section 3(a)(12) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(12)), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(29))), the remaining portion of the index would be within the term "issuer of securities in a narrow-based security index" under paragraph (zzz)(1)(i) of this section.

(2) Paragraph (zzz)(1)(i)(D) of this section will not apply with respect to a reference entity included in the index if:

(i) The effective notional amounts allocated to such reference entity comprise less than five percent of the index's weighting; and

(ii) The effective notional amounts allocated to reference entities included in the index that satisfy paragraph (zzz)(1)(i)(D) of this section comprise at least 80 percent of the index's weighting.

(3) For purposes of this § 1.3(zzz):

(i) A reference entity included in the index is affiliated with another reference entity included in the index (for purposes of paragraph (zzz)(3)(iv) of this section) or another entity (for purposes of paragraph (zzz)(3)(v) of this section) if it controls, is controlled by, or is under common control with, that other reference entity included in the index or other entity, as applicable; provided that each reference entity included in the index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)) will not be considered affiliated with any other reference entity included in the index or any other entity that is an issuing entity of an asset-backed security.

(ii) Control for purposes of this section means ownership of more than 50 percent of the equity of a reference entity included in the index (for purposes of paragraph (zzz)(3)(iv) of this section) or another entity (for purposes of paragraph (zzz)(3)(v) of this section), or the ability to direct the voting of more than 50 percent of the voting equity of a reference entity included in the index (for purposes of paragraph (zzz)(3)(iv) of this section) or another entity (for purposes of paragraph (zzz)(3)(v) of this section).

(iii) In identifying a reference entity included in the index for purposes of this section, the term reference entity includes:

(A) An issuer of securities;

(B) An issuer of securities that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)); and

(C) An issuer of securities that is a borrower with respect to any loan identified in an index of borrowers or loans.

(iv) For purposes of calculating the thresholds in paragraphs (zzz)(1)(i)(A) through (1)(i)(C) of this section, the term reference entity included in the index includes a single reference entity included in the index or a group of affiliated reference entities included in the index as determined in accordance with paragraph (zzz)(3)(i) of this section (with each reference entity included in the index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)) being considered a separate reference entity included in the index).

(v) For purposes of determining whether one of the criterion in either paragraphs (zzz)(1)(i)(D)(1) through (zzz)(1)(i)(D)(4) of this section or paragraphs (zzz)(1)(iv)(D)(8)(i) and (a)(1)(iv)(D)(8)(ii) of this section is met, the term reference entity included in the index includes a single reference entity included in the index or a group of affiliated entities as determined in accordance with paragraph (zzz)(3)(i) of this section (with each issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)) being considered a separate entity).

(aaaa) Meaning of "narrow-based security index" as used in the definition of "security-based swap" as applied to index credit default swaps.

(1) Notwithstanding paragraph 1.3(yyy)(1) of this section, and solely for purposes of determining whether a credit default swap is a security-based swap under the definition of "security-based swap" in section 3(a)(68)(A)(ii)(I) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(68)(A)(ii)(I), as incorporated in section 1a(42) of the Commodity Exchange Act, the term narrow-based security index means an index in which:

(i)(A) The index is composed of nine or fewer securities or securities that are issued by nine or fewer non-affiliated issuers, provided that a security shall not be deemed a component of the index for purposes of this section unless:

(1) A credit event with respect to the issuer of such security or a credit event with respect to such security would result in a payment by the credit protection seller to the credit protection buyer under the credit default swap based on the related notional amount allocated to such security; or

(2) The fact of such credit event or the calculation in accordance with paragraph (aaaa)(1)(i)(A)(1) of this section of the amount owed with respect to such credit event is taken into account in determining whether to make any future payments under the credit default swap with respect to any future credit events;

(B) The effective notional amount allocated to the securities of any issuer included in the index comprises more than 30 percent of the index's weighting;

(C) The effective notional amount allocated to the securities of any five non-affiliated issuers included in the index comprises more than 60 percent of the index's weighting; or

(D) Except as provided in paragraph (aaaa)(2) of this section, for each security included in the index, none of the criteria in paragraphs (1)(i)(D)(1) through (8) is satisfied:

(1) The issuer of the security included in the index is required to file reports pursuant to section 13 or section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d));

(2) The issuer of the security included in the index is eligible to rely on the exemption provided in rule 12g3-2(b) under the Securities Exchange Act of 1934 (17 CFR 240.12g3-2(b));

(3) The issuer of the security included in the index has a worldwide market value of its outstanding common equity held by non-affiliates of $700 million or more;

(4) The issuer of the security included in the index (other than an issuer of the security that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77))) has outstanding notes, bonds, debentures, loans or evidences of indebtedness (other than revolving credit facilities) having a total remaining principal amount of at least $1 billion;

(5) The security included in the index is an exempted security as defined in section 3(a)(12) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(12)) (other than any municipal security as defined in section 3(a)(29) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(29)));

(6) The issuer of the security included in the index is a government of a foreign country or a political subdivision of a foreign country;

(7) If the security included in the index is an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)), the security was issued in a transaction registered under the Securities Act of 1933 (15 U.S.C. 77a et seq.) and has publicly available distribution reports; and

(8) For a credit default swap entered into solely between eligible contract participants as defined in section 1a(18) of the Commodity Exchange Act:

(i) The issuer of the security included in the index (other than an issuer of the security that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77))) makes available to the public or otherwise makes available to such eligible contract participant information about such issuer pursuant to rule 144A(d)(4) of the Securities Act of 1933 (17 CFR 230.144A(d)(4));

(ii) Financial information about the issuer of the security included in the index (other than an issuer of the security that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77))) is otherwise publicly available; or

(iii) In the case of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)), information of the type and level included in public distribution reports for similar asset-backed securities is publicly available about both the issuing entity and such asset-backed security; and

(ii)(A) The index is not composed solely of exempted securities as defined in section 3(a)(12) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(12)), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(29))), as in effect on the date of enactment of the Futures Trading Act of 1982); and

(B) Without taking into account any portion of the index composed of exempted securities as defined in section 3(a)(12) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(12)), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Securities Exchange Act of 1934 (15

U.S.C. 78c(a)(29))), the remaining portion of the index would be within the term "narrow-based security index" under paragraph (aaaa)(1)(i) of this section.

(2) Paragraph (aaaa)(1)(i)(D) of this section will not apply with respect to securities of an issuer included in the index if:

(i) The effective notional amounts allocated to all securities of such issuer included in the index comprise less than five percent of the index's weighting; and

(ii) The securities that satisfy paragraph (aaaa)(1)(i)(D) of this section comprise at least 80 percent of the index's weighting.

(3) For purposes of this § 1.3(aaaa):

(i) An issuer of securities included in the index is affiliated with another issuer of securities included in the index (for purposes of paragraph (aaaa)(3)(iv) of this section) or another entity (for purposes of paragraph (aaaa)(3)(v) of this section) if it controls, is controlled by, or is under common control with, that other issuer or other entity, as applicable; provided that each issuer of securities included in eh index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)) will not be considered affiliated with any other issuer of securities included in the index or any other entity that is an issuing entity of an asset-backed security.

(ii) Control for purposes of this section means ownership of more than 50 percent of the equity of an issuer of securities included in the index (for purposes of paragraph (aaaa)(3)(iv) of this section) or another entity (for purposes of paragraph (aaaa)(3)(v) of this section), or the ability to direct the voting of more than 50 percent of the voting equity an issuer of securities included in the index (for purposes of paragraph (aaaa)(3)(iv) of this section) or another entity (for purposes of paragraph (aaaa)(3)(v) of this section).

(iii) In identifying an issuer of securities included in the index for purposes of this section, the term issuer includes:

(A) An issuer of securities; and

(B) An issuer of securities that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)).

(iv) For purposes of calculating the thresholds in paragraphs (zzz)(1)(i)(A) through (1)(i)(C) of this section, the term issuer of the security included in the index includes a single issuer of securities included in the index or a group of affiliated issuers of securities included in the index as determined in accordance with paragraph (aaaa)(3)(i) of this section (with each issuer of securities included in the index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)) being considered a separate issuer of securities included in the index).

(v) For purposes of determining whether one of the criterion in either paragraphs (aaaa)(1)(i)(D)(1) through (aaaa)(1)(i)(D)(4) of this section or paragraphs (aaaa)(1)(iv)(D)(8)(i) and (aaaa)(1)(iv)(D)(8)(ii) of this section is met, the term issuer of the security included in the index includes a single issuer of securities included in the index or a group of affiliated entities as determined in accordance with paragraph (aaaa)(3)(i) of this section (with each issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)) being considered a separate entity).

(bbbb) Futures contracts on certain foreign sovereign debt. The term security-based swap as used in section 3(a)(68) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(68)), as incorporated in section 1a(42) of the Commodity Exchange Act, does not include an agreement, contract, or transaction that is based on or references a qualifying foreign futures contract (as defined in rule 3a12-8 under the Securities Exchange Act of 1934 (17 CFR 240.3a12-8)) on the debt securities of any one or more of the foreign governments enumerated in rule 3a12-8 under the Securities Exchange Act of 1934 (17 CFR 240.3a12-8), provided that such agreement, contract, or transaction satisfies the following conditions:

(1) The futures contract that the agreement, contract, or transaction references or upon which the agreement, contract, or transaction is based is a qualifying foreign futures contract that satisfies the conditions of rule 3a12-8 under the Securities Exchange Act of 1934 (17 CFR 240.3a12-8) applicable to qualifying foreign futures contracts;

(2) The agreement, contract, or transaction is traded on or through a board of trade (as defined in the Commodity Exchange Act);

(3) The debt securities upon which the qualifying foreign futures contract is based or referenced and any security used to determine the cash settlement amount pursuant to paragraph (bbbb)(4) of this section were not registered under the Securities Act of 1933 (15 U.S.C. 77 et seq.) or the subject of any American depositary receipt registered under the Securities Act of 1933;

(4) The agreement, contract, or transaction may only be cash settled; and

(5) The agreement, contract or transaction is not entered into by the issuer of the debt securities upon which the qualifying foreign futures contract is based or referenced (including any security used to determine the cash payment due on settlement of such agreement, contract or transaction), an affiliate (as defined in the Securities Act of 1933 (15 U.S.C. 77 et seq.) and the rules and regulations thereunder) of the issuer, or an underwriter of such issuer's debt securities.

* * * * *

4. Add §§ 1.6 through 1.9 to read as follows:

Sec.

1.6	Anti-evasion
1.7	Books and records requirements for security-based swap agreements
1.8	Interpretation of swaps, security-based swaps, and mixed swaps
1.9	Regulation of mixed swaps

* * * * *

§ 1.6 Anti-Evasion.

(a) It shall be unlawful to conduct activities outside the United States, including entering into agreements, contracts, and transactions and structuring entities, to willfully evade or attempt to evade any provision of the Commodity Exchange Act as enacted by Subtitle A of the Wall Street Transparency and Accountability Act of 2010 or the rules, regulations, and orders of the Commission promulgated thereunder (Subtitle A).

(b) The form, label, and written documentation of an agreement, contract, or transaction, or an entity, shall not be dispositive in determining whether the agreement, contract, or transaction, or entity, has been entered into or structured to willfully evade as provided in paragraph (a) of this section.

(c) An activity conducted outside the United States to evade as provided in paragraph (a) of this section shall be subject to the provisions of Subtitle A.

(d) Notwithstanding the foregoing, no agreement, contract, or transaction structured as a security (including a security-based swap) under the securities laws (as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47))) shall be deemed a swap pursuant to this § 1.6.

§ 1.7 Books and records requirements for security-based swap agreements.

(a) A person registered as a swap data repository under section 21 of the Commodity Exchange Act and the rules and regulations thereunder:

(1) Shall not be required to keep and maintain additional books and records regarding security-based swap agreements other than the books and records regarding swaps required to be kept and maintained pursuant to section 21 of the Commodity Exchange Act and the rules and regulations thereunder; and

(2) Shall not be required to collect and maintain additional data regarding security-based swap agreements other than the data regarding swaps required to be collected and maintained by such persons pursuant to section 21 of the Commodity Exchange Act and the rules and regulations thereunder.

(b) A person shall not be required to keep and maintain additional books and records, including daily trading records, regarding security-based swap agreements other than the books and records regarding swaps required to be kept and maintained by such persons pursuant to section 4s of the Commodity Exchange Act and the rules and regulations thereunder if such person is registered as:

(1) A swap dealer under section 4s(a)(1) of the Commodity Exchange Act and the rules and regulations thereunder;

(2) A major swap participant under section 4s(a)(2) of the Commodity Exchange Act and the rules and regulations thereunder;

(3) A security-based swap dealer under section 15F(a)(1) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-10(a)(1)) and the rules and regulations thereunder; or

(4) a major security-based swap participant under section 15F(a)(2) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-10(a)(2)) and the rules and regulations thereunder.

(c) The term security-based swap agreement has the meaning set forth in section 1a(47)(A)(v) of the Commodity Exchange Act.

§ 1.8 Requests for interpretation of swaps, security-based swaps, and mixed swaps.

(a) In general. Any person may submit a request to the Commission and the Securities and Exchange Commission to provide a joint interpretation of whether a particular agreement, contract, or transaction (or class thereof) is:

(1) A swap, as that term is defined in section 1a(47) of the Commodity Exchange Act and the rules and regulations promulgated thereunder;

(2) A security-based swap, as that term is defined in section 1a(42) of the Commodity Exchange Act and the rules and regulations promulgated thereunder; or

(3) A mixed swap, as that term is defined in section 1a(47)(D) of the Commodity Exchange Act and the rules and regulations promulgated thereunder.

(b) Request process. In making a request pursuant to paragraph (a) of this section, the requesting person must provide the Commission and the Securities and Exchange Commission with the following:

(1) All material information regarding the terms of the agreement, contract, or transaction (or class thereof);

(2) A statement of the economic characteristics and purpose of the agreement, contract, or transaction (or class thereof);

(3) The requesting person's determination as to whether the agreement, contract, or transaction (or class thereof) should be characterized as a swap, a security-based swap, or both, (i.e., a mixed swap), including the basis for such determination; and

(4) Such other information as may be requested by the Commission or the Securities and Exchange Commission.

(c) Request withdrawal. A person may withdraw a request made pursuant to paragraph (a) of this section at any time prior to the issuance of a joint interpretation or joint proposed rule by the Commission and the Securities and Exchange Commission in response to the request; provided, however, that notwithstanding such withdrawal, the Commission and the Securities and Exchange Commission may provide a joint interpretation of whether the agreement, contract, or transaction (or class thereof) is a swap, a security-based swap, or both (i.e., a mixed swap).

(d) Request by the Commission or the Securities and Exchange Commission. In the absence of a request for a joint interpretation under paragraph (a) of this section:

(1) If the Commission or the Securities and Exchange Commission receives a proposal to list, trade, or clear an agreement, contract, or transaction (or class thereof) that raises questions as to the appropriate characterization of such agreement, contract, or transaction (or class thereof) as a swap, a security-based swap, or both (i.e., a mixed swap), the Commission or the Securities and Exchange Commission, as applicable, promptly shall notify the other of the agreement, contract, or transaction (or class thereof); and

(2) The Commission or the Securities and Exchange Commission, or their Chairmen jointly, may submit a request for a joint interpretation as described in paragraph (a) of this section; such submission shall be made pursuant to paragraph (b) of this section, and may be withdrawn pursuant to paragraph (c) of this section.

(e) Timeframe for joint interpretation.

(1) If the Commission and the Securities and Exchange Commission determine to issue a joint interpretation as described in paragraph (a) of this section, such joint interpretation shall be issued within 120 days after receipt of a complete submission requesting a joint interpretation under paragraph (a) or (d) of this section.

(2) The Commission and the Securities and Exchange Commission shall consult with the Board of Governors of the Federal Reserve System prior to issuing any joint interpretation as described in paragraph (a) of this section.

(3) If the Commission and the Securities and Exchange Commission seek public comment with respect to a joint interpretation regarding an agreement, contract, or transaction (or class thereof), the 120-day period described in paragraph (e)(1) of this section shall be stayed during the pendency of the comment period, but shall recommence with the business day after the public comment period ends.

(4) Nothing in this section shall require the Commission and the Securities and Exchange Commission to issue any joint interpretation.

(5) If the Commission and the Securities and Exchange Commission do not issue a joint interpretation within the time period described in paragraph (e)(1) or (e)(3) of this section, each of the Commission and the Securities and Exchange Commission shall publicly provide the reasons for not issuing such a joint interpretation within the applicable timeframes.

(f) Joint proposed rule.

(1) Rather than issue a joint interpretation pursuant to paragraph (a) of this section, the Commission and the Securities and Exchange Commission may issue a joint proposed rule, in consultation with the Board of Governors of the Federal Reserve System, to further define one or more of the terms swap, security-based swap, or mixed swap.

(2) A joint proposed rule described in paragraph (f)(1) of this section shall be issued within the timeframe for issuing a joint interpretation set forth in paragraph (e) of this section.

§ 1.9 Regulation of mixed swaps.

(a) In general. The term mixed swap has the meaning set forth in section 1a(47)(D) of the Commodity Exchange Act.

(b) Regulation of bilateral uncleared mixed swaps entered into by dually-registered dealers or major participants. A mixed swap: (i) that is neither executed on nor subject to the rules of a designated contract market, national securities exchange, swap execution facility, security-based swap execution facility, or foreign board of trade; (ii) that will not be submitted to a derivatives clearing organization or registered or exempt clearing agency to be cleared; and (iii) where at least one party is registered with the Commission as a swap dealer or major swap participant and also with the Securities and Exchange Commission as a security-based swap dealer or major security-based swap participant, shall be subject to:

(1) The following provisions of the Commodity Exchange Act, and the rules and regulations promulgated thereunder:

(i) Examinations and information sharing: sections 4s(f) and 8 of the Commodity Exchange Act;

(ii) Enforcement: sections 2(a)(1)(B), 4(b), 4b, 4c, 4s(h)(1)(A), 4s(h)(4)(A), 6(c), 6(d), 6c, 6d, 9, 13(a), 13(b), and 23 of the Commodity Exchange Act;

(iii) Reporting to a swap data repository: section 4r of the Commodity Exchange Act;

(iv) Real-time reporting: section 2(a)(13) of the Commodity Exchange Act;

(v) Capital: section 4s(e) of the Commodity Exchange Act; and

(vi) Position Limits: section 4a of the Commodity Exchange Act; and

(2) The provisions of the federal securities laws, as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47)), and the rules and regulations promulgated thereunder.

(c) Process for determining regulatory treatment for other mixed swaps.

(1) In general. Any person who desires or intends to list, trade, or clear a mixed swap (or class thereof) that is not subject to paragraph (b) of this section may request the Commission and the Securities and Exchange Commission to issue a joint order permitting the requesting person (and any other person or persons that subsequently lists, trades, or clears that mixed swap) to comply, as to parallel provisions only, with specified parallel provisions of either the Commodity Exchange Act or the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.), and the rules and regulations thereunder (collectively, specified parallel provisions), instead of being required to comply with parallel provisions of both the Commodity Exchange Act and the Securities Exchange Act of 1934. For purposes of this paragraph (c), parallel provisions means comparable provisions of the Commodity Exchange Act and the Securities Exchange Act of 1934 that were added or amended by the Wall Street Transparency and Accountability Act of 2010 with respect to swaps and security-based swaps, and the rules and regulations thereunder.

(2) Request Process. A person submitting a request pursuant to paragraph (c)(1) of this section must provide the Commission and the Securities and Exchange Commission with the following:

(i) All material information regarding the terms of the specified, or specified class of, mixed swap;

(ii) The economic characteristics and purpose of the specified, or specified class of, mixed swap;

(iii) The specified parallel provisions, and the reasons the person believes such specified parallel provisions would be appropriate for the mixed swap (or class thereof); and

(iv) An analysis of:

(A) The nature and purposes of the parallel provisions that are the subject of the request;

(B) The comparability of such parallel provisions;

(C) The extent of any conflicts or differences between such parallel provisions; and

(D) Such other information as may be requested by the Commission or the Securities and Exchange Commission.

(3) Request withdrawal. A person may withdraw a request made pursuant to paragraph (c)(1) of this section at any time prior to the issuance of a joint order under paragraph (c)(4) of this section by the Commission and the Securities and Exchange Commission in response to the request.

(4) Issuance of orders. In response to a request under paragraph (c)(1) of this section, the Commission and the Securities and Exchange Commission, as necessary to carry out the purposes of the Wall Street Transparency and Accountability Act of 2010, may issue a joint order, after notice and opportunity for comment, permitting the requesting person (and any other person or persons that subsequently lists, trades, or clears that mixed swap) to comply, as to parallel provisions only, with the specified parallel provisions (or another subset of the parallel provisions that are the subject of the request, as the Commissions determine is appropriate), instead of being required to comply with parallel provisions of both the Commodity Exchange Act and the Securities Exchange Act of 1934. In determining the contents of such joint order, the Commission and the Securities and Exchange Commission may consider, among other things:

(i) The nature and purposes of the parallel provisions that are the subject of the request;

(ii) The comparability of such parallel provisions; and

(iii) The extent of any conflicts or differences between such parallel provisions.

(5) Timeframe.

(i) If the Commission and the Securities and Exchange Commission determine to issue a joint order as described in paragraph (c)(4) of this section, such joint order shall be issued within 120 days after receipt of a complete request for a joint order under paragraph (c)(1) of this section, which time period shall be stayed during the pendency of the public comment period provided for in paragraph (c)(4) of this section and shall recommence with the business day after the public comment period ends.

(ii) Nothing in this section shall require the Commission and the Securities and Exchange Commission to issue any joint order.

(iii) If the Commission and the Securities and Exchange Commission do not issue a joint order within the time period described in paragraph (c)(5)(i) of this section, each of the Commission and the Securities and Exchange Commission shall publicly provide the reasons for not issuing such a joint order within that timeframe.

Securities and Exchange Commission

Pursuant to the Securities Act, 15 U.S.C. 77a et seq., and particularly, sections 19 and 28 thereof, and the Exchange Act, 15 U.S.C. 78a et seq., and particularly, sections 3 and 23 thereof, and sections 712(a)(8), 712(d), 721(a), 761(a) of the Dodd-Frank Act, the SEC is adopting rule 194 under the Securities Act and rules 3a68-1a through 3a68-5 and 3a69-1 through 3a69-3 under the Exchange Act.

Text of Final Rules

For the reasons stated in the preamble, the SEC is amending Title 17, Chapter II of the Code of the Federal Regulations as follows:

PART 230 – GENERAL RULES AND REGULATIONS, SECURITIES ACT OF 1933

1. The authority citation for Part 230 continues to read, in part, as follows:

Authority: 15 U.S.C. 77b, 77b note, 77c, 77d, 77f, 77g, 77h, 77j, 77r, 77s, 77z-3, 77sss, 78c, 78d, 78j, 78l, 78m, 78n, 78o, 78o-7 note, 78t, 78w, 78ll(d), 78mm, 80a-8, 80a-24, 80a-28, 80a-29, 80a-30, 80a-37, and Pub. L. 111-203, §712, 124 Stat. 1376 (2010) unless otherwise noted.

* * * * *

2. Section 230.194 is added to read as follows:

§ 230.194 Definitions of the terms "swap" and "security-based swap" as used in the Act.

(a) The term swap as used in section 2(a)(17) of the Act (15 U.S.C. 77b(a)(17)) has the same meaning as provided in section 3(a)(69) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(69)) and the rules and regulations thereunder.

(b) The term security-based swap as used in section 2(a)(17) of the Act (15 U.S.C. 77b(a)(17)) has the same meaning as provided in section 3(a)(68) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(68)) and the rules and regulations thereunder.

PART 240 – GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

3. The general authority citation for Part 240 is revised to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77jjj, 77kkk, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78n-1, 78o, 78o-4, 78o-8, 78p, 78q, 78s, 78u-5, 78w, 78x, 78dd(b), 78dd(c), 78ll, 78mm, 80a-20, 80a-

23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, 7201 et seq., and 8302; 18 U.S.C. 1350; 12 U.S.C. 5221(e)(3), and Pub. L. 111-203, §712, 124 Stat. 1376 (2010), unless otherwise noted.

* * * * *

4. Add an undesignated center heading and §§ 240.3a68-1a through 240.3a68-5 and §§ 240.3a69-1 through 240.3a69-3 to read as follows:

Further Definition of Swap, Security-Based Swap, and Security-Based Swap Agreement; Mixed Swaps; Security-Based Swap Agreement Recordkeeping

240.3a68-1a Meaning of "issuers of securities in a narrow-based security index" as used in section 3(a)(68)(A)(ii)(III) of the Act.
240.3a68-1b Meaning of "narrow-based security index" as used in section 3(a)(68)(A)(ii)(I) of the Act.
240.3a68-2 Requests for interpretation of swaps, security-based swaps, and mixed swaps.
240.3a68-3 Meaning of "narrow-based security index" as used in the definition of "security-based swap."
240.3a68-4 Regulation of mixed swaps.
240.3a68-5 Regulation of certain futures contracts on foreign sovereign debt.
240.3a69-1 Safe Harbor Definition of "security-based swap" and "swap" as used in sections 3(a)(68) and 3(a)(69) of the Act—insurance.
240.3a69-2 Definition of "swap" as used in section 3(a)(69) of the Act—additional products.
240.3a69-3 Books and records requirements for security-based swap agreements.

* * * * *

§ 240.3a68-1a Meaning of "issuers of securities in a narrow-based security index" as used in section 3(a)(68)(A)(ii)(III) of the Act.

(a) Notwithstanding § 240.3a68-3(a), and solely for purposes of determining whether a credit default swap is a security-based swap under section 3(a)(68)(A)(ii)(III) of the Act (15 U.S.C. 78c(a)(68)(A)(ii)(III)), the term issuers of securities in a narrow-based security index as used in section 3(a)(68)(A)(ii)(III) of the Act means issuers of securities included in an index (including an index referencing loan borrowers or loans of such borrowers) in which:

(1)(i) There are nine or fewer non-affiliated issuers of securities that are reference entities included in the index, provided that an issuer of securities shall not be deemed a reference entity included in the index for purposes of this section unless:

(A) A credit event with respect to such reference entity would result in a payment by the credit protection seller to the credit protection buyer under the credit default swap based on the related notional amount allocated to such reference entity; or

(B) The fact of such credit event or the calculation in accordance with paragraph (a)(1)(i)(A) of this section of the amount owed with respect to such credit event is taken into account in determining whether to make any future payments under the credit default swap with respect to any future credit events;

(ii) The effective notional amount allocated to any reference entity included in the index comprises more than 30 percent of the index's weighting;

(iii) The effective notional amount allocated to any five non-affiliated reference entities included in the index comprises more than 60 percent of the index's weighting; or

(iv) Except as provided in paragraph (b) of this section, for each reference entity included in the index, none of the criteria in paragraphs (a)(1)(iv)(A) through (a)(1)(iv)(H) of this section is satisfied:

(A) The reference entity included in the index is required to file reports pursuant to section 13 or section 15(d) of the Act (15 U.S.C. 78m or 78o(d));

(B) The reference entity included in the index is eligible to rely on the exemption provided in § 240.12g3-2(b);

(C) The reference entity included in the index has a worldwide market value of its outstanding common equity held by non-affiliates of $700 million or more;

(D) The reference entity included in the index (other than a reference entity included in the index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77))) has outstanding notes, bonds, debentures, loans, or evidences of indebtedness (other than revolving credit facilities) having a total remaining principal amount of at least $1 billion;

(E) The reference entity included in the index is the issuer of an exempted security as defined in section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12)) (other than any municipal security as defined in section 3(a)(29) of the Act (15 U.S.C. 78c(a)(29)));

(F) The reference entity included in the index is a government of a foreign country or a political subdivision of a foreign country;

(G) If the reference entity included in the index is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)), such asset-backed security was issued in a transaction registered under the Securities Act of 1933 (15 U.S.C. 77a et seq.) and has publicly available distribution reports; and

(H) For a credit default swap entered into solely between eligible contract participants as defined in section 3(a)(65) of the Act (15 U.S.C. 78c(a)(65)):

(1) The reference entity included in the index (other than a reference entity included in the index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77))) makes available to the public or otherwise makes available to such eligible contract participant information about the reference entity included in the index pursuant to § 230.144A(d)(4)) of this chapter;

(2) Financial information about the reference entity included in the index (other than a reference entity included in the index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77))) is otherwise publicly available; or

(3) In the case of a reference entity included in the index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)), information of the type and level included in publicly available distribution reports for similar asset-backed securities is publicly available about both the reference entity included in the index and such asset-backed security; and

(2)(i) The index is not composed solely of reference entities that are issuers of exempted securities as defined in section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12)), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Act (15 U.S.C. 78c(a)(29))), as in effect on the date of enactment of the Futures Trading Act of 1982); and

(ii) Without taking into account any portion of the index composed of reference entities that are issuers of exempted securities as defined in section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12)), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Act (15 U.S.C. 78c(a)(29))), the remaining portion of the index would be within the term "issuer of securities in a narrow-based security index" under paragraph (a)(1) of this section.

(b) Paragraph (a)(1)(iv) of this section will not apply with respect to a reference entity included in the index if:

(1) The effective notional amounts allocated to such reference entity comprise less than five percent of the index's weighting; and

(2) The effective notional amounts allocated to reference entities included in the index that satisfy paragraph (a)(1)(iv) of this section comprise at least 80 percent of the index's weighting.

(c) For purposes of this section:

(1) A reference entity included in the index is affiliated with another reference entity included in the index (for purposes of paragraph (c)(4) of this section) or another entity (for purposes of paragraph (c)(5) of this section) if it controls, is controlled by, or is under common control with, that other reference entity included in the index or other entity, as applicable; provided that each reference entity included in the index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)) will not be considered affiliated with any other reference entity included in the index or any other entity that is an issuing entity of an asset-backed security.

(2) Control for purposes of this section means ownership of more than 50 percent of the equity of a reference entity included in the index (for purposes of paragraph (c)(4) of this section) or another entity (for purposes of paragraph (c)(5) of this section), or the ability to direct the voting of more than 50 percent of the voting equity of a reference entity included in the index (for purposes of paragraph (c)(4) of this section) or another entity (for purposes of paragraph (c)(5) of this section).

(3) In identifying a reference entity included in the index for purposes of this section, the term reference entity includes:

(i) An issuer of securities;

(ii) An issuer of securities that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)); and

(iii) An issuer of securities that is a borrower with respect to any loan identified in an index of borrowers or loans.

(4) For purposes of calculating the thresholds in paragraphs (a)(1)(i) through (a)(1)(iii) of this section, the term reference entity included in the index includes a single reference entity included in the index or a group of affiliated reference entities included in the index as determined in accordance with paragraph (c)(1) of this section (with each reference entity included in the index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)) being considered a separate reference entity included in the index).

(5) For purposes of determining whether one of the criterion in either paragraphs (a)(1)(iv)(A) through (a)(1)(iv)(D) of this section or paragraphs (a)(1)(iv)(H)(1) and (a)(1)(iv)(H)(2) of this section is met, the term reference entity included in the index includes a single reference entity included in the index or a group of affiliated entities as determined in accordance with paragraph (c)(1) of this section (with each issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)) being considered a separate entity).

§ 240.3a68-1b Meaning of "narrow-based security index" as used in section 3(a)(68)(A)(ii)(I) of the Act.

(a) Notwithstanding § 240.3a68-3(a), and solely for purposes of determining whether a credit default swap is a security-based swap under section 3(a)(68)(A)(ii)(I) of the Act (15 U.S.C. 78c(a)(68)(A)(ii)(I)), the term narrow-based security index as used in section 3(a)(68)(A)(ii)(I) of the Act means an index in which:

(1)(i) The index is composed of nine or fewer securities or securities that are issued by nine or fewer non-affiliated issuers, provided that a security shall not be deemed a component of the index for purposes of this section unless:

(A) A credit event with respect to the issuer of such security or a credit event with respect to such security would result in a payment by the credit protection seller to the credit protection buyer under the credit default swap based on the related notional amount allocated to such security; or

(B) The fact of such credit event or the calculation in accordance with paragraph (a)(1)(i)(A) of this section of the amount owed with respect to such credit event is taken into account in determining whether to make any future payments under the credit default swap with respect to any future credit events;

(ii) The effective notional amount allocated to the securities of any issuer included in the index comprises more than 30 percent of the index's weighting;

(iii) The effective notional amount allocated to the securities of any five non-affiliated issuers included in the index comprises more than 60 percent of the index's weighting; or

(iv) Except as provided in paragraph (b) of this section, for each security included in the index none of the criteria in paragraphs (a)(1)(iv)(A) through (a)(1)(iv)(H) of this section is satisfied:

(A) The issuer of the security included in the index is required to file reports pursuant to section 13 or section 15(d) of the Act (15 U.S.C. 78m or 78o(d));

(B) The issuer of the security included in the index is eligible to rely on the exemption provided in §240.12g3-2(b);

(C) The issuer of the security included in the index has a worldwide market value of its outstanding common equity held by non-affiliates of $700 million or more;

(D) The issuer of the security included in the index (other than an issuer of the security that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77))) has outstanding notes, bonds, debentures, loans, or evidences of indebtedness (other than revolving credit facilities) having a total remaining principal amount of at least $1 billion;

(E) The security included in the index is an exempted security as defined in section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12)) (other than any municipal security as defined in section 3(a)(29) of the Act (15 U.S.C. 78c(a)(29)));

(F) The issuer of the security included in the index is a government of a foreign country or a political subdivision of a foreign country;

(G) If the security included in the index is an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)), the security was issued in a transaction registered under the Securities Act of 1933 (15 U.S.C. 77a et seq.) and has publicly available distribution reports; and

(H) For a credit default swap entered into solely between eligible contract participants as defined in section 3(a)(65) of the Act (15 U.S.C. 78c(a)(65)):

(1) The issuer of the security included in the index (other than an issuer of the security that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77))) makes available to the public or otherwise makes available to such eligible contract participant information about such issuer pursuant to § 230.144A(d)(4)) of this chapter;

(2) Financial information about the issuer of the security included in the index (other than an issuer of the security that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77))) is otherwise publicly available; or

(3) In the case of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)), information of the type and level included in public distribution reports for similar asset-backed securities is publicly available about both the issuing entity and such asset-backed security; and

(2)(i) The index is not composed solely of exempted securities as defined in section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12)), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Act (15 U.S.C. 78c(a)(29))), as in effect on the date of enactment of the Futures Trading Act of 1982); and

(ii) Without taking into account any portion of the index composed of exempted securities as defined in section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12)), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in section 3(a)(29) of the Act (15 U.S.C. 78c(a)(29))), the remaining portion of the index would be within the term "narrow-based security index" under paragraph (a)(1) of this section.

(b) Paragraph (a)(1)(iv) of this section will not apply with respect to securities of an issuer included in the index if:

(1) The effective notional amounts allocated to all securities of such issuer included in the index comprise less than five percent of the index's weighting; and

(2) The securities that satisfy paragraph (a)(1)(iv) of this section comprise at least 80 percent of the index's weighting.

(c) For purposes of this section:

(1) An issuer of securities included in the index is affiliated with another issuer of securities included in the index (for purposes of paragraph (c)(4) of this section) or another entity (for purposes of paragraph (c)(5) of this section) if it controls, is controlled by, or is under common control with, that other issuer or other entity, as applicable; provided that each issuer of securities included in the index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)) will not be considered affiliated with any other issuer of securities included in the index or any other entity that is an issuing entity of an asset-backed security.

(2) Control for purposes of this section means ownership of more than 50 percent of the equity of an issuer of securities included in the index (for purposes of paragraph (c)(4) of this section) or another entity (for purposes of paragraph (c)(5) of this section), or the ability to direct the voting of more than 50 percent of the voting equity an issuer of securities included in the index (for purposes of paragraph (c)(4) of this section) or another entity (for purposes of paragraph (c)(5) of this section).

(3) In identifying an issuer of securities included in the index for purposes of this section, the term issuer includes:

(i) An issuer of securities; and

(ii) An issuer of securities that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)).

(4) For purposes of calculating the thresholds in paragraphs (a)(1)(i) through (a)(1)(iii) of this section, the term issuer of the security included in the index includes a single issuer of securities included in the index or a group of affiliated issuers of securities included in

the index as determined in accordance with paragraph (c)(1) of this section (with each issuer of securities included in the index that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)) being considered a separate issuer of securities included in the index).

(5) For purposes of determining whether one of the criterion in either paragraphs (a)(1)(iv)(A) through (a)(1))(iv)(D) of this section or paragraphs (a)(1)(iv)(H)(1) and (a)(1)(iv)(H)(2) of this section is met, the term issuer of the security included in the index includes a single issuer of securities included in the index or a group affiliated entities as determined in accordance with paragraph (c)(1) of this section (with each issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)) being considered a separate entity).

§ 240.3a68-2 Requests for interpretation of swaps, security-based swaps, and mixed swaps.

(a) In general. Any person may submit a request to the Commission and the Commodity Futures Trading Commission to provide a joint interpretation of whether a particular agreement, contract, or transaction (or class thereof) is:

(1) A swap, as that term is defined in section 3(a)(69) of the Act (15 U.S.C. 78c(a)(69)) and the rules and regulations promulgated thereunder;

(2) A security-based swap, as that term is defined in section 3(a)(68) of the Act (15 U.S.C. 78c(a)(68)) and the rules and regulations promulgated thereunder; or

(3) A mixed swap, as that term is defined in section 3(a)(68)(D) of the Act and the rules and regulations promulgated thereunder.

(b) Request process. In making a request pursuant to paragraph (a) of this section, the requesting person must provide the Commission and the Commodity Futures Trading Commission with the following:

(1) All material information regarding the terms of the agreement, contract, or transaction (or class thereof);

(2) A statement of the economic characteristics and purpose of the agreement, contract, or transaction (or class thereof);

(3) The requesting person's determination as to whether the agreement, contract, or transaction (or class thereof) should be characterized as a swap, a security-based swap, or both (i.e., a mixed swap), including the basis for such determination; and

(4) Such other information as may be requested by the Commission or the Commodity Futures Trading Commission.

(c) Request withdrawal. A person may withdraw a request made pursuant to paragraph (a) of this section at any time prior to the issuance of a joint interpretation or joint proposed rule by the Commission and the Commodity Futures Trading Commission in response to the request; provided, however, that notwithstanding such withdrawal, the Commission and the Commodity Futures Trading Commission may provide a joint interpretation of whether the agreement, contract, or transaction (or class thereof) is a swap, a security-based swap, or both (i.e., a mixed swap).

(d) Request by the Commission or the Commodity Futures Trading Commission. In the absence of a request for a joint interpretation under paragraph (a) of this section:

(1) If the Commission or the Commodity Futures Trading Commission receives a proposal to list, trade, or clear an agreement, contract, or transaction (or class thereof) that raises questions as to the appropriate characterization of such agreement, contract, or transaction (or class thereof) as a swap, a security-based swap, or both (i.e., a mixed swap), the Commission or

the Commodity Futures Trading Commission, as applicable, promptly shall notify the other of the agreement, contract, or transaction (or class thereof); and

(2) The Commission or the Commodity Futures Trading Commission, or their Chairmen jointly, may submit a request for a joint interpretation as described in paragraph (a) of this section; such submission shall be made pursuant to paragraph (b) of this section, and may be withdrawn pursuant to paragraph (c) of this section.

(e) Timeframe for joint interpretation.

(1) If the Commission and the Commodity Futures Trading Commission determine to issue a joint interpretation as described in paragraph (a) of this section, such joint interpretation shall be issued within 120 days after receipt of a complete submission requesting a joint interpretation under paragraph (a) or (d) of this section.

(2) The Commission and the Commodity Futures Trading Commission shall consult with the Board of Governors of the Federal Reserve System prior to issuing any joint interpretation as described in paragraph (a) of this section.

(3) If the Commission and the Commodity Futures Trading Commission seek public comment with respect to a joint interpretation regarding an agreement, contract, or transaction (or class thereof), the 120-day period described in paragraph (e)(1) of this section shall be stayed during the pendency of the comment period, but shall recommence with the business day after the public comment period ends.

(4) Nothing in this section shall require the Commission and the Commodity Futures Trading Commission to issue any joint interpretation.

(5) If the Commission and the Commodity Futures Trading Commission do not issue a joint interpretation within the time period described in paragraph (e)(1) or (e)(3) of this section,

each of the Commission and the Commodity Futures Trading Commission shall publicly provide the reasons for not issuing such a joint interpretation within the applicable timeframes.

(f) Joint proposed rule.

(1) Rather than issue a joint interpretation pursuant to paragraph (a) of this section, the Commission and the Commodity Futures Trading Commission may issue a joint proposed rule, in consultation with the Board of Governors of the Federal Reserve System, to further define one or more of the terms swap, security-based swap, or mixed swap.

(2) A joint proposed rule described in paragraph (f)(1) of this section shall be issued within the timeframe for issuing a joint interpretation set forth in paragraph (e) of this section.

§ 240.3a68-3 Meaning of "narrow-based security index" as used in the definition of "security-based swap."

(a) In general. Except as otherwise provided in § 240.3a68-1a and § 240.3a68-1b, for purposes of section 3(a)(68) of the Act (15 U.S.C. 78c(a)(68)), the term narrow-based security index has the meaning set forth in section 3(a)(55) of the Act (15 U.S.C. 78c(a)(55)), and the rules, regulations, and orders of the Commission thereunder.

(b) Tolerance period for swaps traded on designated contract markets, swap execution facilities and foreign boards of trade. Notwithstanding paragraph (a) of this section, solely for purposes of swaps traded on or subject to the rules of a designated contract market, swap execution facility, or foreign board of trade pursuant to the Commodity Exchange Act (7 U.S.C. 1 et seq.), a security index underlying such swaps shall not be considered a narrow-based security index if:

(1)(i) A swap on the index is traded on or subject to the rules of a designated contract market, swap execution facility, or foreign board of trade pursuant to the Commodity Exchange

Act (7 U.S.C. 1 et seq.) for at least 30 days as a swap on an index that was not a narrow-based security index; or

(ii) Such index was not a narrow-based security index during every trading day of the six full calendar months preceding a date no earlier than 30 days prior to the commencement of trading of a swap on such index on a market described in paragraph (b)(1)(i) of this section; and

(2) The index has been a narrow-based security index for no more than 45 business days over three consecutive calendar months.

(c) Tolerance period for security-based swaps traded on national securities exchanges or security-based swap execution facilities. Notwithstanding paragraph (a) of this section, solely for purposes of security-based swaps traded on a national securities exchange or security-based swap execution facility, a security index underlying such security-based swaps shall be considered a narrow-based security index if:

(1)(i) A security-based swap on the index is traded on a national securities exchange or security-based swap execution facility for at least 30 days as a security-based swap on a narrow-based security index; or

(ii) Such index was a narrow-based security index during every trading day of the six full calendar months preceding a date no earlier than 30 days prior to the commencement of trading of a security-based swap on such index on a market described in paragraph (c)(1)(i) of this section; and

(2) The index has been a security index that is not a narrow-based security index for no more than 45 business days over three consecutive calendar months.

(d) Grace period.

(1) Solely with respect to a swap that is traded on or subject to the rules of a designated contract market, swap execution facility or foreign board of trade pursuant to the Commodity Exchange Act (7 U.S.C. 1 et seq.), an index that becomes a narrow-based security index under paragraph (b) of this section solely because it was a narrow-based security index for more than 45 business days over three consecutive calendar months shall not be a narrow-based security index for the following three calendar months.

(2) Solely with respect to a security-based swap that is traded on a national securities exchange or security-based swap execution facility, an index that becomes a security index that is not a narrow-based security index under paragraph (yyy)(3) of this section solely because it was not a narrow-based security index for more than 45 business days over three consecutive calendar months shall be a narrow-based security index for the following three calendar months.

§ 240.3a68-4 Regulation of mixed swaps.

(a) In general. The term mixed swap has the meaning set forth in section 3(a)(68)(D) of the Act (15 U.S.C. 78c(a)(68)(D)).

(b) Regulation of bilateral uncleared mixed swaps entered into by dually-registered dealers or major participants. A mixed swap:

(1) That is neither executed on nor subject to the rules of a designated contract market, national securities exchange, swap execution facility, security-based swap execution facility, or foreign board of trade;

(2) That will not be submitted to a derivatives clearing organization or registered or exempt clearing agency to be cleared; and

(3) Where at least one party is registered with the Commission as a security-based swap dealer or major security-based swap participant and also with the Commodity Futures Trading Commission as a swap dealer or major swap participant, shall be subject to:

(i) The following provisions of the Commodity Exchange Act (7 U.S.C. 1 et seq.), and the rules and regulations promulgated thereunder, set forth in the rules and regulations of the Commodity Futures Trading Commission:

(A) Examinations and information sharing: 7 U.S.C. 6s(f) and 12;

(B) Enforcement: 7 U.S.C. 2(a)(1)(B), 6(b), 6b, 6c, 6s(h)(1)(A), 6s(h)(4)(A), 9, 13b, 13a-1, 13a-2, 13, 13c(a), 13c(b), 15 and 26;

(C) Reporting to a swap data repository: 7 U.S.C. 6r;

(D) Real-time reporting: 7 U.S.C. 2(a)(13);

(E) Capital: 7 U.S.C. 6s(e); and

(F) Position Limits: 7 U.S.C. 6a; and

(ii) The provisions of the federal securities laws, as defined in section 3(a)(47) of the Act (15 U.S.C. 78c(a)(47)), and the rules and regulations promulgated thereunder.

(c) Process for determining regulatory treatment for other mixed swaps.

(1) In general. Any person who desires or intends to list, trade, or clear a mixed swap (or class thereof) that is not subject to paragraph (b) of this section may request the Commission and the Commodity Futures Trading Commission to issue a joint order permitting the requesting person (and any other person or persons that subsequently lists, trades, or clears that mixed swap) to comply, as to parallel provisions only, with specified parallel provisions of either the Act (15 U.S.C. 78a et seq.) or the Commodity Exchange Act (7 U.S.C. 1 et seq.), and the rules and regulations thereunder (collectively, specified parallel provisions), instead of being required to comply with parallel provisions of both the Act and the Commodity Exchange Act. For purposes of this paragraph (c), parallel provisions means comparable provisions of the Act and the Commodity Exchange Act that were added or amended by the Wall Street Transparency and

Accountability Act of 2010 with respect to security-based swaps and swaps, and the rules and regulations thereunder.

(2) Request process. A person submitting a request pursuant to paragraph (c)(1) of this section must provide the Commission and the Commodity Futures Trading Commission with the following:

(i) All material information regarding the terms of the specified, or specified class of, mixed swap;

(ii) The economic characteristics and purpose of the specified, or specified class of, mixed swap;

(iii) The specified parallel provisions, and the reasons the person believes such specified parallel provisions would be appropriate for the mixed swap (or class thereof); and

(iv) An analysis of:

(A) The nature and purposes of the parallel provisions that are the subject of the request;

(B) The comparability of such parallel provisions;

(C) The extent of any conflicts or differences between such parallel provisions; and

(D) Such other information as may be requested by the Commission or the Commodity Futures Trading Commission.

(3) Request withdrawal. A person may withdraw a request made pursuant to paragraph (c)(1) of this section at any time prior to the issuance of a joint order under paragraph (c)(4) of this section by the Commission and the Commodity Futures Trading Commission in response to the request.

(4) Issuance of orders. In response to a request under paragraph (c)(1) of this section, the Commission and the Commodity Futures Trading Commission, as necessary to carry out the purposes of the Wall Street Transparency and Accountability Act of 2010, may issue a joint order, after notice and opportunity for comment, permitting the requesting person (and any other person or persons that subsequently lists, trades, or clears that mixed swap) to comply, as to parallel provisions only, with the specified parallel provisions (or another subset of the parallel provisions that are the subject of the request, as the Commissions determine is appropriate), instead of being required to comply with parallel provisions of both the Act (15 U.S.C. 78a et seq.) and the Commodity Exchange Act (7 U.S.C. 1 et seq.). In determining the contents of such joint order, the Commission and the Commodity Futures Trading Commission may consider, among other things:

(i) The nature and purposes of the parallel provisions that are the subject of the request;

(ii) The comparability of such parallel provisions; and

(iii) The extent of any conflicts or differences between such parallel provisions.

(5) Timeframe.

(i) If the Commission and the Commodity Futures Trading Commission determine to issue a joint order as described in paragraph (c)(4) of this section, such joint order shall be issued within 120 days after receipt of a complete request for a joint order under paragraph (c)(1) of this section, which time period shall be stayed during the pendency of the public comment period provided for in paragraph (c)(4) of this section and shall recommence with the business day after the public comment period ends.

(ii) Nothing in this section shall require the Commission and the Commodity Futures Trading Commission to issue any joint order.

(iii) If the Commission and the Commodity Futures Trading Commission do not issue a joint order within the time period described in paragraph (c)(5)(i) of this section, each of the Commission and the Commodity Futures Trading Commission shall publicly provide the reasons for not issuing such a joint order within that timeframe.

§ 240.3a68-5 Regulation of certain futures contracts on foreign sovereign debt.

Futures contracts on certain foreign sovereign debt. The term security-based swap as used in section 3(a)(68) of the Act (15 U.S.C. 78c(a)(68)) does not include an agreement, contract, or transaction that is based on or references a qualifying foreign futures contract (as defined in §240.3a12-8 on the debt securities of any one or more of the foreign governments enumerated in §240.3a12-8, provided that such agreement, contract, or transaction satisfies the following conditions:

(a) The futures contract that the agreement, contract, or transaction references or upon which the agreement, contract, or transaction is based is a qualifying foreign futures contract that satisfies the conditions of §240.3a12-8 applicable to qualifying foreign futures contracts;

(b) The agreement, contract, or transaction is traded on or through a board of trade (as defined in 7 U.S.C. 2);

(c) The debt securities upon which the qualifying foreign futures contract is based or referenced and any security used to determine the cash settlement amount pursuant to paragraph (4) of this section were not registered under the Securities Act of 1933 (15 U.S.C. 77 et seq.) or the subject of any American depositary receipt registered under the Securities Act of 1933;

(d) The agreement, contract, or transaction may only be cash settled; and

(e) The agreement, contract or transaction is not entered into by the issuer of the debt securities upon which the qualifying foreign futures contract is based or referenced (including any security used to determine the cash payment due on settlement of such agreement, contract or transaction), an affiliate (as defined in the Securities Act of 1933 (15 U.S.C. 77 et seq.) and the rules and regulations thereunder) of the issuer, or an underwriter of such issuer's debt securities.

§ 240.3a69-1 Safe Harbor Definition of "security-based swap" and "swap" as used in sections 3(a)(68) and 3(a)(69) of the Act—insurance

(a) This paragraph is a non-exclusive safe harbor. The terms security-based swap as used in section 3(a)(68) of the Act (15 U.S.C. 78c(a)(68)) and swap as used in section 3(a)(69) of the Act (15 U.S.C. 78c(a)(69)) do not include an agreement, contract, or transaction that:

(1) By its terms or by law, as a condition of performance on the agreement, contract, or transaction:

(i) Requires the beneficiary of the agreement, contract, or transaction to have an insurable interest that is the subject of the agreement, contract, or transaction and thereby carry the risk of loss with respect to that interest continuously throughout the duration of the agreement, contract, or transaction;

(ii) Requires that loss to occur and to be proved, and that any payment or indemnification therefor be limited to the value of the insurable interest;

(iii) Is not traded, separately from the insured interest, on an organized market or over the counter; and

(iv) With respect to financial guaranty insurance only, in the event of payment default or insolvency of the obligor, any acceleration of payments under the policy is at the sole discretion of the insurer; and

(2) Is provided:

(i)(A) By a person that is subject to supervision by the insurance commissioner (or similar official or agency) of any State, as defined in section 3(a)(16) of the Act (15 U.S.C. 78c(a)(16)), or by the United States or an agency or instrumentality thereof; and

(B) Such agreement, contract, or transaction is regulated as insurance under applicable State law or the laws of the United States;

(ii)(A) Directly or indirectly by the United States, any State or any of their respective agencies or instrumentalities; or

(B) Pursuant to a statutorily authorized program thereof; or

(iii) In the case of reinsurance only by a person to another person that satisfies the conditions set forth in paragraph (a)(2) of this section, provided that:

(A) Such person is not prohibited by applicable State law or the laws of the United States from offering such agreement, contract, or transaction to such person that satisfies the conditions set forth in paragraph (a)(2) of this section;

(B) The agreement, contract, or transaction to be reinsured satisfies the conditions set forth in paragraph (a)(1) or (3) of this section; and

(C) Except as otherwise permitted under applicable State law, the total amount reimbursable by all reinsurers for such agreement, contract, or transaction may not exceed the claims or losses paid by the person writing the risk being ceded or transferred by such person; or

(iv) In the case of non-admitted insurance by a person who:

(A) Is located outside of the United States and listed on the Quarterly Listing of Alien Insurers as maintained by the International Insurers Department of the National Association of Insurance Commissioners; or

(B) Meets the eligibility criteria for non-admitted insurers under applicable State law; or

(3) Is provided in accordance with the conditions set forth in paragraph (a)(2) of this section and is one of the following types of products:

(i) surety bond;

(ii) fidelity bond;

(iii) life insurance;

(iv) health insurance;

(v) long term care insurance;

(vi) title insurance;

(vii) property and casualty insurance;

(viii) annuity;

(ix) disability insurance;

(x) insurance against default on individual residential mortgages; and

(xi) reinsurance of any of the foregoing products identified in paragraphs (i) through (x) of this section.

(b) The terms security-based swap as used in section 3(a)(68) of the Act (15 U.S.C. 78c(a)(68)) and swap as used in section 3(a)(69) of the Act (15 U.S.C. 78c(a)(69)) do not include an agreement, contract, or transaction that was entered into on or before the effective date of this section and that, at such time that it was entered into, was provided in accordance with the conditions set forth in paragraph (a)(2) of this section.

§ 240.3a69-2 Definition of "swap" as used in section 3(a)(69) of the Act—additional products.

(a) In general. The term swap has the meaning set forth in section 3(a)(69) of the Act (15 U.S.C. 78c(a)(69)).

(b) Inclusion of particular products. (1) The term swap includes, without limiting the meaning set forth in section 3(a)(69) of the Act (15 U.S.C. 78c(a)(69)), the following agreements, contracts, and transactions:

(i) A cross-currency swap;

(ii) A currency option, foreign currency option, foreign exchange option and foreign exchange rate option;

(iii) A foreign exchange forward;

(iv) A foreign exchange swap;

(v) A forward rate agreement; and

(vi) A non-deliverable forward involving foreign exchange.

(2) The term swap does not include an agreement, contract, or transaction described in paragraph (b)(1) of this section that is otherwise excluded by section 1a(47)(B) of the Commodity Exchange Act (7 U.S.C. 1a(47)(B)).

(c) Foreign exchange forwards and foreign exchange swaps. Notwithstanding paragraph (b)(2) of this section:

(1) A foreign exchange forward or a foreign exchange swap shall not be considered a swap if the Secretary of the Treasury makes a determination described in section 1a(47)(E)(i) of the Commodity Exchange Act (7 U.S.C. 1a(47)(E)(i)).

(2) Notwithstanding paragraph (c)(1) of this section:

(i) The reporting requirements set forth in section 4r of the Commodity Exchange Act (7 U.S.C. 6r) and regulations promulgated thereunder shall apply to a foreign exchange forward or foreign exchange swap; and

(ii) The business conduct standards set forth in section 4s(h) of the Commodity Exchange Act (7 U.S.C. 6s) and regulations promulgated thereunder shall apply to a swap dealer or major swap participant that is a party to a foreign exchange forward or foreign exchange swap.

(3) For purposes of section 1a(47)(E) of the Commodity Exchange Act (7 U.S.C. 1a(47)(E)) and this section, the term foreign exchange forward has the meaning set forth in section 1a(24) of the Commodity Exchange Act (7 U.S.C. 1a(24)).

(4) For purposes of section 1a(47)(E) of the Commodity Exchange Act (7 U.S.C. 1a(47)(E)) and this section, the term foreign exchange swap has the meaning set forth in section 1a(25) of the Commodity Exchange Act (7 U.S.C. 1a(25)).

(5) For purposes of sections 1a(24) and 1a(25) of the Commodity Exchange Act (7 U.S.C. 1a(24) and (25)) and this section, the following transactions are not foreign exchange forwards or foreign exchange swaps:

(i) A currency swap or a cross-currency swap;

(ii) A currency option, foreign currency option, foreign exchange option, or foreign exchange rate option; and

(iii) A non-deliverable forward involving foreign exchange.

§ 240.3a69-3 Books and records requirements for security-based swap agreements.

(a) A person registered as a swap data repository under section 21 of the Commodity Exchange Act (7 U.S.C. 24a) and the rules and regulations thereunder:

(1) Shall not be required to keep and maintain additional books and records regarding security-based swap agreements other than the books and records regarding swaps required to be kept and maintained pursuant to section 21 of the Commodity Exchange Act (7 U.S.C. 24a) and the rules and regulations thereunder; and

(2) Shall not be required to collect and maintain additional data regarding security-based swap agreements other than the data regarding swaps required to be collected and maintained by such persons pursuant to section 21 of the Commodity Exchange Act (7 U.S.C. 24a) and the rules and regulations thereunder.

(b) A person shall not be required to keep and maintain additional books and records, including daily trading records, regarding security-based swap agreements other than the books and records regarding swaps required to be kept and maintained by such persons pursuant to section 4s of the Commodity Exchange Act (7 U.S.C. 6s) and the rules and regulations thereunder if such person is registered as:

(1) A swap dealer under section 4s(a)(1) of the Commodity Exchange Act (7 U.S.C. 6s(a)(1)) and the rules and regulations thereunder;

(2) A major swap participant under section 4s(a)(2) of the Commodity Exchange Act (7 U.S.C. 6s(a)(2)) and the rules and regulations thereunder;

(3) A security-based swap dealer under section 15F(a)(1) of the Act (15 U.S.C. 78o-10(a)(1)) and the rules and regulations thereunder; or

(4) A major security-based swap participant under section 15F(a)(2) of the Act (15 U.S.C. 78o-10(a)(2)) and the rules and regulations thereunder.

(c) The term security-based swap agreement has the meaning set forth in section 3(a)(78) of the Act (15 U.S.C. 78c(a)(78)).

Product Definitions Contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act—CFTC Voting Summary and Statements of CFTC Commissioners

Note: The following appendices will not appear in the Code of Federal Regulations

CFTC Voting Summary

On this matter, Chairman Gensler and Commissioners Sommers, O'Malia and Wetjen voted in the affirmative; Commissioner Chilton voted in the negative.

Statement of CFTC Chairman Gary Gensler

I support the final rulemaking to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) requirement to further define "swap" and other products that come under swaps market reform. The Commodity Futures Trading Commission (CFTC) worked closely with the Securities and Exchange Commission (SEC), in consultation with the Federal Reserve, on the final rules and interpretations to further define "swaps," "security-based swaps," "mixed swaps" and "security-based swap agreements."

The statutory definition as laid out by Congress of swap is very detailed. These final rules and interpretations are consistent with that detailed definition and Congressional intent. For example, interest rate swaps, currency swaps, commodity swaps, including energy, metals and agricultural swaps, and broad-based index swaps, such as index credit default swaps, are all swaps. Consistent with Congress's definition of swaps, the rule also defines options as swaps.

In preparing this final rulemaking, staff worked to address the more than 140 comments that were submitted by the public in response to the product further definition proposal. Many of

PART 241 – INTERPRETATIVE RELEASES RELATING TO THE SECURITIES EXCHANGE ACT OF 1934 AND GENERAL RULES AND REGULATIONS THEREUNDER

5. Part 241 is amended by adding Release No. 34–67453 and the release date of July 18, 2012, to the list of interpretative releases.

By the Commodity Futures Trading Commission.

David A. Stawick

David A. Stawick
Secretary

Date: July 18, 2012

By the Securities and Exchange Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Date: July 18, 2012

the commenters asked the Commissions to specifically provide guidance on what is not a swap or security-based swap.

For example, under the Commodity Exchange Act, the CFTC does not regulate forward contracts. Over the decades, there have been a series of orders, interpretations and cases that market participants have come to rely upon regarding the exception from futures regulation for forwards and forwards with embedded options. Consistent with that history, the Dodd-Frank Act excluded from the definition of a swap "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled." The Commission is interpreting that exclusion in a manner that is consistent with Commission precedent and, in response to commenters, is providing increased clarity on the forward exclusion from futures regulation. The final release provides guidance regarding forwards with embedded volumetric options, like those used within the electricity markets, and is requesting comment on this interpretation.

Further, consistent with the Dodd-Frank Act, insurance products will not be regulated as swaps. Similarly, this final rulemaking clarifies that certain consumer and commercial arrangements that historically have not been considered swaps, such as consumer mortgage rate locks, contracts to lock in the price of home heating oil and contracts relating to inventory or equipment, also will not be regulated as swaps.

The rule provides clarity on the dividing line between "swaps" and "security-based swaps" or both, i.e. mixed swaps. The rule also provides a process for requesting joint interpretations in circumstances where there are questions. These dividing lines and the process will benefit market participants, as they will provide greater clarity as to what regulatory requirements apply when they transact in the derivatives markets.

Lastly, the final release includes specific provisions that guard against transactions that are willfully structured to evade Dodd-Frank Act swaps market reforms.

I'd like to express my appreciation for their dedication to completing this rule to Chairman Mary Schapiro and her fellow Commissioners at the SEC, as well as the staff, including Robert Cook, Brian Bussey, Amy Starr, Donna Chambers, Christie March, Andy Schoeffler, Wenchi Hu, John Guidroz and Sarah Otte.

I'd also like to thank the CFTC's hardworking staff: Julian Hammar, Lee Ann Duffy, David Aron, Terry Arbit, Eric Juzenas and Stephen Kane.

Dissent of CFTC Commissioner Chilton on Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping

I respectfully dissent from this joint final rule and interpretive guidance because I have reservations about certain aspects of the Commodity Futures Trading Commission's ("Commission") interpretive guidance on forward contracts. Apart from this specific area, I agree with the joint release and would support its adoption.

I am dissenting from the interpretive guidance for two chief reasons. First, I believe that the Commission should make stronger efforts to ensure market participants claim the forward contract exclusion only under appropriate circumstances, consistent with its interpretive guidance. The Commission should apply a rebuttable presumption that contracts do not have as their predominant feature actual delivery in instances where market participants often do not follow the delivery settlement term in a contract. The Commission should set forth the conditions for a safe harbor, consistent with its interpretation of the forward contract exclusion, for market participants that often do not terminate "forward" contracts through physical delivery that includes some affirmative statement to the Commission explaining the circumstances leading to non-delivery. This safe harbor, in my view, would encourage market participants to submit information that would vastly improve the ability of the Commission to ensure that market participants claiming the forward contract exclusion are doing so appropriately, consistent with the law and Commission and staff interpretation of the law.

Second, the Commission has failed to provide adequate legal certainty to market participants engaging in contracts with embedded volumetric commodity options, particularly those that can terminate without physical delivery. Contracts with embedded commodity options that can negate the physical delivery term have optionality that targets the delivery term of the contract and therefore cannot be seen as having as a predominant feature actual delivery, a necessary element in any forward contract under applicable Commission precedent. The Commission has failed to perform an analysis of these types of contracts in an excess of caution that may invite confusion, at best, and evasion, at worst.

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")[1] imposes new safeguards on hitherto unregulated markets. These safeguards increase the integrity of the markets by, e.g., improving market transparency and thereby deterring abuses of the sorts seen in recent decades. These safeguards inevitably increase compliance costs, particularly in the initial phase of implementation. As I can predict with absolute certainty, bad actors (à la Amaranth) will be drawn to dark markets in search of spoils. Less ill-intentioned or

[1] See Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010). The text of the Dodd-Frank Act may be accessed at http://www.cftc.gov/LawRegulation/OTCDERIVATIVES/index.htm.

"grey" actors may follow them in search of lower compliance costs. The Commission should not cede swaths of jurisdiction because such markets have not hitherto given rise to concerns.2

The Commission proposed3 and is now adopting an approach to the forward contract exclusion that draws on "the principles underlying" the Brent Interpretation.4 I agree generally with this approach (I voted in the affirmative on releasing the proposal). In addition, the Commission recognizes that the underlying purpose of a transaction is a critical factor in determining whether a given transaction is more appropriately classified as a forward or swap (or commodity option).5 I commend this clarification and hope it is applied or further clarified in a

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2 See Financial Crisis Inquiry Commission, "The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States," Jan. 2011, at 25, available at http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf ("concluding that "enactment of . . . [the Commodity Futures Modernization Act of 2000 ("CFMA")] to ban the regulation by both the federal and state governments of over-the-counter (OTC) derivatives was a key turning point in the march toward the financial crisis.").

3 See Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 76 FR 29818, 29829, May 23, 2011.

4 Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 FR ___, ___ ("Adopting Release"); Statutory Interpretation Concerning Forward Transactions, 55 FR 39188, Sept. 25, 1990 ("Brent Interpretation"). I note that the Commission did not endorse the outcome of the Brent Interpretation.

5 I recognize (and perhaps the Commission has quietly recognized as well) the merit in the dissent of former Commissioner Fowler West to the Brent Interpretation and am heartened to find elements of his analytical approach in this release. Commissioner West, among other things, emphasized the importance of the underlying purpose of a transaction in a forward contract analysis. Id., Dissent of Commissioner Fowler West, available at http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/fwestdissent092090.pdf (because, among other things, 15-day Brent contracts are entered into for the purpose of hedging or speculation rather than for the purpose of transferring ownership in crude oil they do not sufficiently resemble forward contracts to be excluded from the CEA) citing CFTC v. Co. Petro Marketing Group, Inc., 680 F.2d 573, 580 (9th Cir. 1982). Commissioner West's dissent presaged the Brent market aberrations of the 1990s and early 2000s that some tied to squeezes of the Brent delivery complex through a hoarding of "forwards" that made leveraged cash-settled contract positions designed to benefit from such aberrations very profitable. While I endorse the Commission's approach to affirming the principles contained in the Brent Interpretation, I believe future interpretive guidance should apply the lessons of the past two-plus decades of market and regulatory history and apply the Brent Interpretation principles in that light. In this dissent,

way that affirms the principles underlying the Brent Interpretation without endorsing the outcome of the Brent Interpretation.

1. Safe Harbor for "Forwards" that Often do not Terminate with Actual Delivery

I believe that the Commission should make stronger efforts to ensure market participants claim the forward contract exclusion only under appropriate circumstances. I am concerned that the forward contract exclusion may be abused if not intentionally evaded by the lack of safeguards to ensure its appropriate application.[6] This concern is exacerbated by the fact that actors claiming the forward contract exclusion are not subject to any reporting requirements, nor have we even provided for a safe harbor that encourages such reporting. In light of the transparency the CEA now provides for futures, options, and swaps markets, the regulatory differential between these regulated markets and unregulated markets, like forward markets, is going to encourage regulatory arbitrage. Despite substantial progress in improving the Commission's visibility into regulated markets, the Commission has failed to set forth interpretive guidance that ensures that, at the minimum, it can see and understand the transactions that market participants claim as being subject to the forward contract exclusion. I believe the Commission should be more active when it comes to ensuring that the forward contract exclusion is properly applied, particularly in instances where an ostensible "forward" closely resembles, in form, purpose, or economic substance regulated products.

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however, I do not need to go so far as to reinterpret the principles underlying the Brent Interpretation: even based on a conservative review of our precedent I feel we did not provide the market adequate clarity.

6 See Adopting Release.

The Commission has endorsed the purpose of a transaction as a factor in determining a contract's eligibility for the forward contract exclusion.[7] The Brent Interpretation or the Commission's re-interpretation of it notwithstanding, I believe that when few "forward" contracts for a given market participant result in delivery, then there is sufficient ground for the Commission to have doubt about the appropriateness of the forward contract exclusion claim. Moreover, under such circumstances the Commission should have doubt about the underlying purpose of the claimed "forwards." Therefore, the Commission should apply a rebuttable presumption that the market participant may not be engaging in transactions that have as their predominant feature actual delivery.

At the same time, the Commission should specify the means by which this presumption may be rebutted. I believe that the Commission provide for a safe harbor for market participants that regularly engage in transactions they believe to qualify for the forward contract exclusion that, nonetheless, often do not terminate with delivery (e.g., in less than 20% of instances as measured by number of "forward" contracts or by potential total quantity under all "forward" contracts). This non-delivery could be of the result of, for example, exercised embedded volumetric optionality or through book-outs. Market participants claiming this safe harbor should include a brief, periodic statement that explains the reason why their forward transactions, in general terms or with more specificity as is necessary for the Commission to determine whether the presumption that the market participant is inappropriately claiming the forward contract exclusion is rebutted.

I request comment on my proposed safe harbor concept. I encourage the Commission to adopt some version of this safe harbor in order to allay the very real concerns I and, indeed,

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7 See Adopting Release.

many market participants and many in the public have expressed to me that unregulated forwards markets could become a refuge for those that thrive in opacity. Our regulations implementing the Dodd-Frank Act will vastly improve transparency in regulated futures, options, and swaps markets. Unfortunately, our interpretive guidance today does little to ensure even any visibility for regulators in how players in the physical commodity markets, so critical to the Commission's mission, are claiming the forward contract exclusion: the unwatched back door out of the transparency-related requirements of the CEA.

2. Legal Certainty for Certain Commodity Options

Section 4c(b) of the CEA provides:

> No person shall offer to enter into, enter into or confirm the execution of, any transaction involving any commodity regulated under this chapter which is of the character of, or is commonly known to the trade as, an ''option'', "privilege'", ''indemnity'', ''bid'', ''offer'', ''put'', ''call'', ''advance guaranty'', or ''decline guaranty'', contrary to any rule, regulation, or order of the Commission prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission shall prescribe. Any such order, rule, or regulation may be made only after notice and opportunity for hearing, and the Commission may set different terms and conditions for different markets.[8]

Through this decades-old provision, Congress gave the Commission jurisdiction and plenary rulemaking authority over physical commodity option transactions.[9] The Dodd-Frank Act not only preserved this plenary authority over commodity options, but also reaffirmed the reach of the CEA over commodity options. Section 721 of the Dodd-Frank Act added section 1a(47) to the CEA, defining "swap'' to include not only ''any agreement, contract, or transaction

8 CEA section 4c(b), 7 U.S.C. 6c(b).

9 CEA section 4c(b) has been in the Act in substantially the same form since it was added by the Commodity Futures Trading Commission Act of 1974. See Public Law 93–463, October 23, 1974.

commonly known as,'' among other things, ''a commodity swap,''[10] but also ''[an] option of any kind that is for the purchase or sale, or based on the value, of 1 or more * * * commodities * * *''[11], i.e. commodity options.[12] While commodity options are subject to the Commission's plenary jurisdiction, the Commission has limited jurisdiction over forward contracts.[13]

In the Brent Interpretation, the Commission found certain Brent oil contracts to be eligible for the forward contract exclusion, notwithstanding the fact that such transactions "may ultimately result in performance through the payment of cash as an alternative to actual physical

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10 See CEA section 1a(47)(A)(iii), 7 U.S.C. 1a(47)(A)(iii).

11 See CEA section 1a(47)(A)(i), 7 U.S.C. 1a(47)(A)(i). Note that the swap definition excludes options on futures (which must be traded on a DCM pursuant to part 33 of the Commission's regulations) (see CEA section 1a(47)(B)(i), 7 U.S.C. 1a(47)(B)(i)), but it includes options on physical commodities (whether or not traded on a DCM) (see CEA section 1a(47)(A)(i), 7 U.S.C. 1a(47)(A)(i)).

12 The Commission's regulations define a commodity option transaction or commodity option as ''any transaction or agreement in interstate commerce which is or is held out to be of the character of, or is commonly known to the trade as, an 'option,' 'privilege,' 'indemnity,' 'bid,' 'offer,' 'call,' 'put,' 'advance guaranty' or 'decline guaranty'.'' 17 CFR 1.3(hh).

13 See CEA section 1a(47)(B)(ii), 7 U.S.C. 1a(47)(B)(ii) (excluding from the definition of "swap" contracts involving "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled."). See also CEA section 8(d), 7 U.S.C. 12(d), which directs the CFTC to investigate the marketing conditions of commodities and commodity products and byproducts, including supply and demand for these commodities, cost to the consumer, and handling and transportation charges; CEA sections 6(c), 6(d) and 9(a)(2), 7 U.S.C. 9, 13b, and 13(a)(2), which proscribe any manipulation or attempt to manipulate the price of any commodity in interstate commerce; and CEA section 6(c) as amended by section 753 of the Dodd-Frank Act, which contains prohibitions regarding manipulation and false reporting with respect to any commodity in interstate commerce, including prohibiting any person to (i) "use or employ, or attempt to use or employ . . . any manipulative or deceptive device or contrivance" (section 6(c)(1)); (ii) "to make any false or misleading statement of material fact" to the CFTC or "omit to state in any such statement any material fact that is necessary to make any statement of material fact made not misleading in any material respect" (section 6(c)(2)); and (iii) "manipulate or attempt to manipulate the price of any swap, or of any commodity in interstate commerce . . ." (section 6(c)(3)). See also Rule 180.1(a) under the CEA, 17 CFR 180.1(a) (broadly prohibiting in connection with a commodity in interstate commerce manipulation, false or misleading statements or omissions of material fact to the Commission, fraud or deceptive practices or courses of business, and false reporting).

transfer or delivery of the commodity." The Commission found that when delivery obligations under a forward were terminated pursuant to a separate and individually negotiated "book-out" agreement, the parties escaped the physical delivery obligation traditionally required to claim the forward contract exclusion. The Commission also emphasized two features (among others) of the Brent oil contracts at issue: (1) the absence of a contractual right to offset (or to terminate without delivery) the transaction "by the terms of the contracts as initially entered into" and (2) the counterparties had to incur "substantial economic risks of a commercial nature" relating to actual delivery in order to claim the exclusion. Underlying the Brent Interpretation, other CFTC precedent, and the Commission's approach to the interpretive guidance on the forward contract exclusion is the essential feature of forward contracts: actual delivery (and not potential delivery).[14]

The Commission has failed to provide adequate legal certainty to market participants engaging in contracts with embedded volumetric commodity options, particularly those that can terminate without physical delivery. Contracts that are composed of a forward delivery obligation component combined with an embedded commodity option that can render delivery optional ("zero-delivery" embedded volumetric options) are not forwards because the predominant feature of the contract cannot be actual delivery under these circumstances (more literally, the predominant feature is potential delivery which is an essential characteristic of commodity options). Such contracts include a contractual right to offset through the exercise of the volumetric option that can extinguish the delivery obligation. Because such contracts have a commodity option component that mitigates the risk incurred from an underlying forward delivery obligation, these contracts may fail to meet the incurring "economic risks of a

[14] See Adopting Release.

commercial nature" element. Moreover, the purpose of the delivery optionality in these types of contracts shares a common purpose with commodity options: to provide market participants a means to hedge commodity quantity risk of a commercial nature. The Commission should therefore clarify, in any future interpretive guidance, that zero-delivery embedded volumetric options are generally commodity options because the delivery obligation is not obligatory.

The confluence of these features, as analyzed under a conservative reading of the Brent Interpretation, leads me to conclude that contracts with embedded zero-delivery option ·components cannot be said to have actual delivery as their essential feature. Other relevant Commission precedent is consistent with this analysis. Most recently, in In re Wright, a forward contract containing pricing optionality was found to be a forward contract because the optionality:

> (i) May be used to adjust the forward contract price, but do not undermine the overall nature of the contract as a forward contract; (ii) do not target the delivery term, so that the predominant feature of the contract is actual delivery; and (iii) cannot be severed and marketed separately from the overall forward contract in which they are embedded.[15]

In re Wright is distinguishable because it involves pricing optionality, not volumetric optionality–the latter a feature the Commission has not hitherto opined on in the context of the forward contract exclusion. As the emphasized section of the block quote immediately above discusses, the interpretation there turned on the fact that the optionality in the In re Wright options did "not target the delivery term." Optionality that can result in zero delivery "targets the delivery term," in direct contrast to the In re Wright options. I commend the Commission for

[15] See In re Wright, CFTC Docket No. 97-02, 2010 WL 4388247 (Oct. 25, 2010) (emphasis added). See also Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options, 50 FR 39656 (Sept. 30, 1985) (finding that hedge-to-arrive contracts with pricing optionality could be categorized as forwards so long as it created a binding delivery obligation that could only be annulled in the event of a crop failure, in which case liquidated damages may apply).

not overextending (to put it charitably) In re Wright to cover zero-delivery volumetric optionality, as argued by some commenters. Nonetheless, the Commission did not clarify that a contract that provides for optionality that can render delivery optional cannot therefore have as its predominant feature actual delivery because the optionality "targets the delivery term."[16]

Instead of, in my opinion, a proper application of the statute and precedent, the Commission has adopted a seven-element interpretation that applies to contracts with embedded volumetric optionality. This interpretative approach would potentially allow contracts with zero-delivery option components to nonetheless claim the forward contract exclusion when:

1. the embedded optionality does not undermine the overall nature of the agreement, contract, or transaction as a forward contract;

2. the predominant feature of the agreement, contract, or transaction is actual delivery;

3. the embedded optionality cannot be severed and marketed separately from the overall agreement, contract, or transaction in which it is embedded;

4. the seller of a nonfinancial commodity underlying the agreement, contract, or transaction with embedded volumetric optionality intends, at the time it enters into the agreement, contract, or transaction, to deliver the underlying nonfinancial commodity if the optionality is exercised;

5. the buyer of a nonfinancial commodity underlying the agreement, contract or transaction with embedded volumetric optionality intends, at the time it enters

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16 In re Wright, CFTC Docket No. 97-02, 2010 WL 4388247 (Oct. 25, 2010).

into the agreement, contract, or transaction, to take delivery of the underlying nonfinancial commodity if it exercises the embedded volumetric optionality;

6. both parties are commercial parties; and

7. the exercise or non-exercise of the embedded volumetric optionality is based primarily on physical factors, or regulatory requirements, that are outside the control of the parties and are influencing demand for, or supply of, the nonfinancial commodity.

The first two elements, in particular, invoke the Brent Interpretation and related precedent.[17] The seventh and most problematic element seems to imply that supply and demand, i.e., economic factors, could be a primary factor in the exercise or non-exercise of an embedded volumetric option. I fear how broadly this element could be interpreted by those predisposed to interpret the CEA in an opportunistic light. When can supply and demand factors not be correlated with physical factors? Does this mean that if delivery renders such a contract unprofitable for a party to such a contract that they can elect not to deliver? If that is the case, then the contract is a commodity option.[18]

I would amend the seventh element by making it clear the exercise or non-exercise for physical factors that influence demand and supply can negate the delivery obligation only in exceptional circumstances. If delivery renders a contract merely unprofitable and the contract permits a party to elect not to deliver, such a contract is not a forward and is a commodity option.

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17 See Adopting Release.

18 See, e.g., 50 FR 39656, 39660.

In addition, I would require, consistent with the third, "severability," element, that in order to claim the forward contract exclusion where the contract at issue contains a zero-delivery embedded volumetric option, the parties must sever the forward contract component, which has as its purpose the delivery of commodities, from the remaining commodity option component, which has as its purpose the management of the commodity quantity risk associated with operating a commercial enterprise.[19] The commodity option component of these transactions could be eligible for a trade option exemption[20] that exempts (and importantly, does not exclude) them from many CEA requirements.[21]

Moreover, while the Adopting Release's guidance is the first of its kind and therefore an incremental step toward more legal certainty, it doesn't directly address embedded zero-delivery volumetric optionality specifically or any of the conceivable specific variations of such contracts. I believe this to be a flaw; a flaw that did not exist in a previous version of this document.

The Commission should affirm in any relevant future interpretive guidance the formal features in the Brent Interpretation's forward contract exclusion, e.g., that the delivery obligation cannot be offset based on terms contained in the contract, that any delivery obligation be appropriately booked-out (in a separate transaction), or that the contract involve incurring

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19 These forward contract and commodity option hybrid contracts can, as I understand it, generally be severed into two separate forward and commodity option contracts. Some commenters suggested that many "peaking" contracts involve volumetric optionality that cannot be severed, but I have yet to be convinced that the same party that is the "seller" under these contracts cannot simply become the appropriate counterparty when such contracts are severed into a forward contract component and a commodity option component that can offset or book-out the buyer's obligation to take delivery.

20 Commodity Options, 77 FR 25320, Apr. 27, 2012, codified at 17 CFR 32.3.

21 As of July 10, 2012, the Commission has received 12 comments on the interim final rule setting forth the trade option exemption.

"substantial economic risks of a commercial nature."[22] In the absence of the Commission's courage to provide for more legal certainty on these kinds of transactions, I stress the application of the third, severability, element in the Commission's seven-element interpretation and note that as long as a market participant can decompose a pre-Dodd-Frank Act transaction into components, such action would not be in violation of the CEA if the resulting agreements, contracts, or transactions (1) neatly fall into forward, commodity option, or other swap contract buckets and (2) are dealt with as such.[23]

I look forward to receiving and reviewing comments on the Commission's interpretation, in particular those submitted in response to Question Seven.[24] I also welcome comments on this statement too, of course, particularly as it relates to zero-delivery embedded volumetric options. I am particularly interested in understanding under what circumstances such embedded option contracts and other contracts can be structured to evade Dodd-Frank Act requirements in a way that creates plausible deniability for one or both counterparties that they did not "willfully"

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22 The Commission's inclusion of the underlying purpose of a transaction as a factor in determining its classification as a forward, commodity option, or other form of swap. The Commission will, under the interpretive guidance, consider the "purpose of the claimed forward" and whether its purpose is to sell physical commodities, hedge risk, or speculate. See Adopting Release.

23 See Adopting Release, fn 337 ("When a forward contract includes an embedded option that is severable from the forward contract, the forward can remain subject to the forward contract exclusion, if the parties document the severance of the embedded option component and the resulting transactions, i.e. a forward and an option. Such an option would be subject to the CFTC's regulations applicable to commodity options.").

24 Id. ("Do the agreements, contracts, and transactions listed in question no. 6 above have embedded optionality in the first instance? Based on descriptions by commenters, it appears that they may have a binding obligation for delivery, but have no set amount specified for delivery. Instead, delivery (including the possibility of nominal or zero delivery) is determined by the terms and conditions contained within the agreement, contract, or transaction (including, for example, the satisfaction of a condition precedent to delivery, such as a commodity price or temperature reaching a level specified in the agreement, contract, or transaction). That is, the variation in delivery is not driven by the exercise of embedded optionality by the parties. Do the agreements, contracts, and transactions listed in question no. 6 exhibit these kinds of characteristics? If so, should the CFTC consider them in some manner other than its forward interpretation? Why or why not?").

intend to structure a transaction in a manner intended to evade. Should the Commission, instead of my proposed approach, follow a rebuttable presumption approach with respect to zero-delivery embedded option contracts whereby the presumption can be rebutted by a certification of facts that indicate a true commercial purpose for the transaction?

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 67465 / July 19, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14957

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

I.

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

II.

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

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

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

proceedings, and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

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

1. Czarnik, age 43, is an attorney licensed to practice in New York.

2. On July 12, 2012, a final judgment was entered against Czarnik in the civil action entitled SEC v. Stephen J. Czarnik (Civil Action No. 10-CV-745) in the United States District Court for the Southern District of New York, permanently enjoining Czarnik, by consent, from future violations of Section 5 of the Securities Act of 1933 ("Securities Act"). In addition, Czarnik was enjoined from participating in an offering of penny stock for a period of five years, and was permanently barred from providing professional legal opinions in connection with the offer or sale of securities claiming an exemption under Regulation D of the Securities Act.

3. The Commission's third amended complaint alleged, among other things, that Czarnik, a securities lawyer, was a necessary and substantial participant in the unregistered distributions of several penny stocks in violation of Section 5 of the Securities Act. Czarnik drafted opinion letters for these offerings stating that they were exempt from registration pursuant to Rule 504(b)(1)(iii) of Regulation D. The Commission alleged that the offerings did not comply with that rule because the offerings were not limited to *bonafide* accredited investors.

IV.

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

Accordingly, it is hereby ORDERED, effective immediately, that Czarnik is suspended from appearing or practicing before the Commission as an attorney. After three years from the date of this Order, Czarnik may request that the Commission consider his reinstatement by submitting an application (attention: Office of General Counsel) to resume appearing or practicing before the Commission as an attorney. The Commission will consider an application by Respondent to resume appearing or practicing before the Commission provided that Czarnik is not subject to any suspension or disbarment of an attorney by any court of the United States or of any state, territory, district, commonwealth, or possession, and that he has not been convicted of a felony or misdemeanor involving moral turpitude as set forth in Rule 102(e)(2) of the Commission's Rules of Practice.

By the Commission.

Elizabeth M. Murphy
Secretary

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

Commissioner Gallagher not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 67472 / July 19, 2012

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3394 / July 19, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14958

In the Matter of **HURON CONSULTING GROUP INC., GARY L. BURGE, CPA, AND WAYNE E. LIPSKI, CPA,** **Respondents.**	**ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER AND REMEDIAL SANCTIONS**

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 Huron Consulting Group Inc., Gary L. Burge, and Wayne E. Lipski (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 themselves and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making

Findings, and Imposing a Cease-and-Desist Order and Remedial Sanctions ("Order"), as set forth below.

III.

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

SUMMARY

1. Huron Consulting Group Inc. ("Huron" or the "Company"), a provider of financial and operational consulting services, Gary L. Burge ("Burge"), Huron's former Chief Financial Officer ("CFO") and Treasurer, and Wayne E. Lipski ("Lipski"), Huron's former Controller and Chief Accounting Officer ("CAO"), failed to properly record compensation expense for redistributions of sales proceeds by the selling shareholders of four companies that Huron acquired. Due to the improper accounting, Huron's financial statements for 2006 through 2008 and the first quarter of 2009 were materially misstated. Huron also failed to maintain effective internal controls to ensure the appropriate recording and reporting of those redistributions. Accordingly, Huron violated the reporting, books and records, and internal controls provisions of the Exchange Act, and Burge and Lipski were a cause of Huron's violations.

2. From May 2005 through July 2008, Huron acquired ten consulting firms, including: Speltz & Weis, LLC ("S&W"); MSGalt & Company, LLC ("Galt"); Wellspring Partners LTD ("WP"); and Callaway Partners, LLC ("Callaway"). The selling shareholders ("SSHs") of S&W, Galt, WP and Callaway received acquisition sales proceeds from Huron and subsequently redistributed a portion of them to other Huron employees and among themselves ("Redistributions"). Contrary to Generally Accepted Accounting Principles ("GAAP"), Huron did not record compensation expense for these payments. For each of these Redistributions, Huron should have recorded compensation expense because the Redistributions were (1) contingent on the employees' continued employment with Huron, (2) based on the achievement of personal performance measures, or (3) were not "clearly for a purpose other than compensation."[1]

3. In January 2008, Huron's independent accountant ("Auditor") discussed SEC Staff Accounting Bulletin ("SAB") Topic 5T, which referenced accounting principles applicable to the Redistributions, with Huron, Burge and Lipski. Thereafter, Huron, Burge and Lipski did not determine the full impact of the accounting principles referenced in SAB Topic 5T on the Company's financials. More specifically, although Burge and Lipski analyzed certain Redistributions, their analysis was inadequate. Also, although they knew about other Redistributions, and other previously contemplated Redistributions, they did not revisit them. Finally, they did not adequately consider or determine whether there were any additional prior Redistributions or contemplated Redistributions that needed to be analyzed.

4. Because Huron failed to properly account for the Redistributions, Huron filed periodic reports with the Commission that overstated its pre-tax income by 3.70% for 2005, 6.09%

[1] Statement of Financial Accounting Standards No. 123R, *Share-Based Payment*, paragraph 11.

for 2006, 30.45% for 2007, 68.59% for 2008, and 25.29% for the first quarter of 2009. In August 2009, Huron restated its financial statements for fiscal years 2006, 2007 and 2008 and the first quarter of 2009, reducing its net income by approximately $56 million.[2]

RESPONDENTS

5. **Huron Consulting Group Inc.** is a Delaware corporation with its principal place of business in Chicago, Illinois. It provides financial and operational consulting services to clients in diverse industries, including healthcare, business, and legal. At all relevant times, Huron's common stock was registered with the Commission pursuant to Section 12(b) of the Exchange Act, and traded on the NASDAQ Global Select Market system under the symbol "HURN."

6. **Gary L. Burge**, CPA, age 58, of Wheaton, Illinois, joined Huron in November 2002 as CFO and thereafter also became CAO and Treasurer. He resigned from Huron on December 31, 2009. Burge has been a registered Certified Public Accountant ("CPA") in Illinois since 2010.

7. **Wayne E. Lipski**, CPA, 55, of Naperville, Illinois, joined Huron in October 2003 as Controller, and became its CAO in May 2009. He resigned from Huron on July 31, 2009. Lipski has been a registered CPA in Illinois since 2006.

FACTS

Huron's Restatement

8. On July 31, 2009, Huron announced that it intended to restate its financial statements to properly account for redistributions of acquisition sales proceeds by the SSHs to other Huron employees and among themselves in amounts that were not consistent with their ownership percentages. Huron also announced the departure of its Chief Executive Officer ("CEO") and Lipski, and that Burge had stepped down as CFO. On August 3, 2009, the first trading day after the Company's announcement, Huron stock closed at $13.69, a 69.13% decrease from the previous trading day's closing price of $44.35. On August 17, 2009, the Company filed a Form 10-K/A with restated financial statements for fiscal years 2006, 2007 and 2008 and the first quarter of 2009, which reduced Huron's net income for the restated periods by approximately $56 million.

9. In determining to restate its financial statements, Huron relied on SAB Topic 5T, *Accounting for Expenses or Liabilities Paid by Principal Stockholder(s)*. SAB Topic 5T provides guidance by Commission staff on how to account for the Redistributions, through the principle that expenses incurred by economic interest holders on behalf of an issuer should be recorded as

[2] Huron's restated 2006 financial statements reflect $1,143,333 of non-cash compensation expense that should have been recognized in 2005.

expenses by the issuer.[3] While SAB Topic 5T has been updated periodically to reflect changes in the underlying referenced accounting standards, including the issuance of Statement of Financial Accounting Standards ("SFAS") No. 123R, *Share-Based Payment*, in 2004, the underlying accounting principle has remained unchanged. In SAB Topic 5T, the staff references paragraph 11 of SFAS No. 123R, which considers the accounting for share-based payments made to issuer employees by related parties or holders of an economic interest. Specifically, SFAS No. 123R states that "share-based payments awarded to an employee of the reporting entity by a related party or holder of an economic interest in the entity as compensation for services provided to the entity are share-based payment transactions to be accounted for under this Statement unless the transfer is clearly for a purpose other than compensation for services to the reporting entity." The staff notes in SAB Topic 5T that the problem of separating the benefit to the economic interest holder from the benefit to the issuer, as addressed in SFAS No. 123R, is "not limited to transactions involving stock compensation."

10. Huron analogized the Redistributions to the transaction involving a primary shareholder as discussed in SAB Topic 5T. The Company concluded that the Redistributions that were subject to continuing employment requirements were considered compensation payments made for the benefit of Huron. Huron concluded that the Redistributions that related to the individual's performance within Huron subsequent to the acquisition, or that were not "clearly for a purpose other than compensation for services" to Huron, were considered compensation payments made for services provided to Huron. SFAS No. 123R, paragraph 11. As such, Huron should have recognized additional compensation expense for all of these Redistributions.

<u>In 2005, Huron, Burge and Lipski Knew that the S&W SSHs Contemplated Sharing Sales Proceeds with Non-SSHs</u>

11. On or about May 9, 2005, Huron acquired S&W. The purchase consideration included cash paid at closing and notes payable paid in annual installments. Among the S&W consultants that joined Huron after the acquisition were the two SSHs and six key managing directors ("S&W Key MDs").

12. During the S&W acquisition negotiations, Burge, Lipski, and others at Huron learned that the S&W SSHs contemplated sharing their acquisition sales proceeds with non-SSHs. In March 2005, Burge and others at Huron received a draft acquisition term sheet that detailed an S&W "Special Bonus" plan, under which S&W would use sales proceeds to pay bonuses to S&W Key MDs and non-MDs at the time of the acquisition's closing. In April 2005, Burge and Lipski corresponded amongst themselves and with another Huron employee about a proposed provision in the S&W purchase agreement providing for Huron to make the payments (*i.e.*, for Huron to serve as "paymaster"). At Burge's request, Lipski also opined on the accounting implications for such payments.

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[3] SAB Topic 5T was originally issued in September 1988 through Staff Accounting Bulletin No. 79. SAB Topic 5T was amended in part by Staff Accounting Bulletin No. 107 to update references made to other accounting literature.

13. One week before the acquisition closed, on May 2, Burge, Lipski, and others at Huron, were forwarded an email from S&W's attorney stating that some of the payments would be "conditioned on [S&W's] performance (tied to the earn-out and sales attribution)," and that all payments would be "conditioned on continued employment with Huron."

14. The executed S&W purchase agreement did not include a provision that Huron would distribute sales proceeds to S&W employees.

15. On the day that the S&W acquisition closed, S&W established a Deferred Bonus Plan under which the S&W Key MDs were entitled to receive a portion of the S&W sales proceeds if they remained Huron employees. Under this Plan, the S&W SSHs gave the S&W Key MDs a portion of the S&W Notes: $1,016,667 for fiscal year 2006 and $774,723 for fiscal year 2007. For fiscal year 2006, S&W also gave $100,000 of its sales proceeds to twelve non-MD employees who joined Huron in connection with the acquisition. Because all of these payments were contingent on employment, Huron should have recognized non-cash compensation expense for them: $1,116,667 for 2006; and $774,723 for 2007.

<u>In 2007, Huron, Burge and Lipski Knew that the Galt SSHs Paid Some of the Galt Employees' 2006 Bonuses</u>

16. On or about March 31, 2006, Huron acquired Galt. The purchase consideration included cash paid at closing, a holdback to be paid if certain target revenues were met, and the ability for the SSHs to receive annual earn-out payments contingent on Galt meeting certain financial targets ("Earn-Outs").

17. In December 2006, Burge, Lipski, and others at Huron learned that the Huron and Galt SSHs' 2006 bonus plans were at odds. Huron wanted the Galt practice to meet a 55% gross margin target, which allowed for a 2006 Galt employee bonus pool of $380,000. Galt told Huron that its bonus pool estimate was $1.544 million.

18. Burge and Lipski were involved in discussions regarding Huron awarding employees with full bonuses while still achieving the Galt gross margin target. Initially, Huron proposed to the Galt SSHs that they reduce a guaranteed bonus that was contractually owed to them. Shortly thereafter, Huron proposed requiring the Galt SSHs to pay a portion of the total bonus amount that the Galt SSHs wanted to pay, instead. In the end, the Galt SSHs paid bonuses to employees employed by Galt at the time of the acquisition, and Huron paid bonuses to employees who were hired by the Galt practice after the acquisition.

19. On January 25, 2007, Huron's Managing Director of Financial Planning & Analysis ("MD of FP&A") sent Burge and Lipski a spreadsheet outlining the final structure. It stated that of the Galt employee bonus pool, the Galt SSHs would pay $1.119 million and Huron would pay $199,000. A note next to the line with Huron's amount stated: "Reduce Consultant Bonus Pool for '06 to deliver 55% Gross Margin." The spreadsheet showed that if Huron were to pay the entire proposed Galt bonus amount, then the Galt practice's gross margin would be 45.2%.

20. The Galt SSHs used $1,184,847 of their personal funds to pay 2006 bonuses to Galt non-SSHs. At the time of the Restatement, Huron concluded that the Galt SSHs' payment was not "clearly for a purpose other than compensation" and therefore, under SAB Topic 5T, it should have recorded this payment as additional non-cash compensation expense in 2006.

<u>In 2007, Huron, Burge and Lipski Generally Knew that the WP SSHs Formed a Trust to Receive and Distribute the WP Earn-Outs</u>

21. On or about January 2, 2007, Huron acquired WP. The purchase consideration included cash paid at closing and the ability for the SSHs to receive Earn-Outs. Huron paid Earn-Outs to WP for fiscal years 2007 and 2008.

22. On April 16, 2007, the WP SSHs entered into the WP Partners Trust Agreement ("WP Trust Agreement"), which provided that a specific percentage of the total WP Earn-Outs for a given year would be distributed to the SSHs based on their ownership interest and that the remainder would be distributed to the SSHs and any other managing directors designated by the trustees (three of the WP SSHs) based on their performance. The WP Trust Agreement provided that "[o]nly Managing Directors employed by [Huron] on the last date of the relevant Calculation Period may receive distributions of Performance Earn-Out Payments."

23. Burge, Lipski, and others at Huron generally knew that WP had formed a trust that would receive and distribute the WP Earn-Outs.

<u>In 2007, Huron and Burge Knew that the Callaway SSHs Contemplated Sharing Earn-Outs with Non-SSHs</u>

24. On or about July 28, 2007, Huron acquired Callaway. The purchase consideration included cash paid at closing and the ability for the SSHs to receive Earn-Outs.

25. During the Callaway acquisition negotiations, Burge learned that the Callaway SSHs contemplated sharing their Earn-Outs with non-SSHs. In April 2007, Callaway's investment banker told Burge that "[Callaway's investment banker has] assumed in other Huron transactions that the ownership of the earnout has roughly mirrored the ownership of the selling shareholders, which would not be the case here." They then discussed whether this might raise accounting issues for Huron. Ultimately, Huron never paid the Callaway SSHs any Earn-Outs. As discussed below, in 2008, Huron and the Callaway SSHs entered into an Amendment to Callaway's Asset Purchase Agreement that relieved Huron of its continuing obligation to pay the Callaway SSHs any Earn-Outs.

In 2007, Huron, Burge and Lipski Knew that the Callaway SSHs Paid Bonuses to Non-SSHs

26. During the Callaway acquisition negotiations, Burge, Lipski, and others at Huron learned from an acquisition due diligence report that the Callaway SSHs had a written plan that awarded acquisition sales proceeds to non-SSHs ("Callaway Awards").

27. Immediately before the closing of the Callaway acquisition, Callaway entered into agreements entitled Bonus, Termination of Grant and Release Agreements with eleven Callaway non-SSHs and two SSHs ("Callaway Agreements"). These agreements rescinded the Callaway Awards, granted bonuses to the thirteen individuals, and stated that Callaway would use sales proceeds to pay the bonuses. The Callaway Agreements had a clawback provision requiring the recipients to repay a portion of their bonuses if they voluntarily terminated their employment with Huron before two years after the acquisition.

28. With the closing of the acquisition, pursuant to the Callaway Agreements, the Callaway SSHs redistributed $8,120,000 of their up-front cash payment to non-SSHs. Huron should have recorded non-cash compensation expense for the portion of the redistributed amounts that were subject to a clawback provision: $1,353,333 for 2007; $3,248,000 for 2008; and $812,000 for the first quarter of 2009.

29. Around October 2007, Auditor conducted an audit of Callaway's financial statements for 2006 and reviewed Callaway's financial statements for the six-month period ended June 30, 2007. Huron's Director of External Reporting ("External Reporting Director") was the coordinator between Auditor and the Callaway accounting department.

30. During the audit and review of Callaway, External Reporting Director told Lipski that Callaway was rescinding the Callaway Awards and was using the acquisition's initial cash payment to pay bonuses instead. Lipski and External Reporting Director then had a conversation with Auditor and Callaway representatives about this fact. Lipski told Burge about this conversation.

31. Neither Burge nor Lipski asked for, or saw, any agreements underlying the bonuses and were therefore unaware of the clawback provision.

32. Huron and Burge also knew that the Callaway SSHs used sales proceeds to pay bonuses to project managers. Shortly after the acquisition closed, a Callaway SSH sent an email to Burge and others at Huron stating: "FYI, we extended $300k of special recognition bonuses (coming from our proceeds) to our Delivery folks (PM's). Half paid this week, half in a month." Thirty days after the Callaway acquisition closed, the Callaway SSHs distributed $150,000 of its up-front cash payment to twelve Callaway project managers who became Huron employees. Lipski was unaware of these bonuses. Auditor received a spreadsheet listing these bonuses, including their distribution dates. At the time of the Restatement, Huron concluded that these bonuses were contingent on the non-SSHs' employment with Huron and therefore, that it should have recorded non-cash compensation expense of $150,000 for them in 2007.

<u>During Huron's Year-End 2007 Closing Process, Burge and Lipski Discussed the Applicability of SAB Topic 5T with Auditor</u>

33. In early December 2007, Burge, Lipski, and others at Huron learned that the WP and Galt SSHs were planning to share their 2007 Earn-Outs with three non-SSHs who were hired by the acquired companies after the acquisitions closed ("Three Non-SSHs"). They discussed these payments and initially concluded that, based primarily on EITF 95-8, Huron would need to recognize the payments as compensation expense.

34. On December 20, after additional internal discussions between Burge, Lipski, and others, External Reporting Director called Auditor's engagement manager ("Engagement Manager") and asked for accounting guidance on redistributing Earn-Outs. Although she did not initially ask about the specific redistributions to the Three Non-SSHs, within a week the focus shifted to them.

35. On January 4, 2008, Engagement Manager emailed SAB Topic 5T to Lipski and External Reporting Director, and stated that he believed that under it, SSHs would be "holders of an economic interest" in Huron and that the Earn-Out redistributions to the Three Non-SSHs would need to be expensed because "the payment[s] [are] caused by a relationship that is not completely unrelated to Huron and . . . benefits Huron."

36. The next day, Lipski emailed Burge, MD of FP&A, and External Reporting Director, and shared Engagement Manager's guidance. Lipski stated that under SAB Topic 5T, "[w]hen a party with an economic interest in an entity...pays for items on the behalf of the entity where the payment has some sort of any benefit to the entity...those payments...must be expense[d] by the company in their income statement."

37. On January 14, Engagement Manager emailed Lipski and External Reporting Director, providing another overview of SAB Topic 5T and applying it to the Earn-Out redistributions to the Three Non-SSHs. He stated: "[E]xpense accounting 'is required in this and other transactions where a principal stockholder (also defined as holders of an economic interest) pays an expense for the company, unless the stockholder's action is caused by a relationship or obligation completely unrelated to his position as a stockholder or such action clearly does not benefit the company.'"

38. Burge, Lipski, and External Reporting Director later spoke with Engagement Manager and Auditor's engagement partner and concluded that Huron would need to expense the Earn-Out redistributions to the Three Non-SSHs.

39. After Burge, Lipski, CEO, and External Reporting Director discussed having the Company, not the Galt and WP SSHs, make the payments to the Three Non-SSHs, Huron directly paid "Galt Non-SSH 1" and "WP Non-SSH 1," and recorded the payments as compensation

expense. The last of the Three Non-SSHs – "WP Non-SSH 2" - was not immediately due a payment.

Burge and Lipski Did Not Adequately Analyze Certain Redistributions They Knew About

40. After Burge and Lipski discussed SAB Topic 5T with Auditor, they did not adequately analyze certain Redistributions. As discussed below, although they learned facts indicating that the Galt SSHs were planning to pay Galt Non-SSH 1 a 2007 bonus, they failed to adequately verify whether the Galt SSHs ultimately made an additional payment to him. They also failed to consider whether Huron properly accounted for tax gross-ups that the Company paid the Galt SSHs. In addition, they concluded that payments to two WP Non-SSHs did not have accounting ramifications without adequately performing the necessary factual analysis. Finally, although in the spring of 2008 they were told that the Callaway SSHs were planning to share Earn-Out settlement proceeds with non-SSHs, they failed to determine whether there was an employment contingency attached to these payments.

The Galt SSHs Directly Paid Galt Non-SSH 1 a 2007 Bonus

41. Almost immediately after Huron decided to expense the bonus payment to Galt Non-SSH 1, Lipski emailed a Galt SSH ("Galt SSH 1"), copying Burge, asking for an estimate of Non-SSH 1's bonus so that Huron could accrue an expense for it. Because Galt SSH 1 did not provide an estimate, Lipski proposed that Huron accrue an estimated bonus amount of $800,000 based on Non-SSH 1's past compensation and payments made to similarly situated Galt employees, with the plan of making an adjustment at the same time the "Huron company bonus pool calculation" was finalized. Burge concurred with this approach.

42. After Lipski once again asked for, and did not receive, a bonus estimate, he emailed Galt SSH 1, copying Burge, and told him that Huron accrued $800,000 for the bonus. Lipski also asked Galt SSH 1 to "agree to let Huron pay the $800,000 accrued bonus (assuming he gets at least $800,000) directly to [Galt Non-SSH 1]..."

43. In a February 15, 2008 email, Galt SSH 1 confirmed with CEO that Huron would pay the accrued bonus of $800,000 to Galt Non-SSH 1. He also detailed an adjustment to the Earn-Out calculation that would eliminate any tax implications resulting from the payment. CEO forwarded this email to Burge, Lipski, and MD of FP&A.

44. By March 22, Lipski learned that the Galt SSHs were going to directly pay Galt Non-SSH 1 an additional 2007 bonus (incremental to the amount accrued by Huron). On March 13, Galt Non-SSH 1 called Huron's Director of Tax ("Dir. of Tax") and told her that the Galt SSHs awarded him an additional bonus, and that he expected Huron to gross him up for any taxes associated with it. Dir. of Tax emailed Lipski communicating the substance of this call. She then emailed Galt Non-SSH 1 asking for the date and amount of the bonus payment. Galt Non-SSH 1 responded within minutes that he had not yet received the payment and would send another email

once he did. Galt Non-SSH 1 did not tell Dir. of Tax the actual bonus amount. On March 22, Dir. of Tax forwarded Lipski her email string with Galt Non-SSH 1.

45. Burge and Lipski failed to adequately verify whether the Galt SSHs directly paid Non-SSH 1 an additional 2007 bonus. On March 28, Lipski emailed Galt SSH 1, copying Burge and CEO, and stated: "I need to know/confirm if any additional amounts were paid (or to be paid) or any future commitment (short or long-term) was or will be made to [Galt Non-SSH 1] in regards to the $6 million (or future) Galt Earn-out payments...[S]hould you have any additional plans/thoughts for potential current or future earn-out distributions for [Galt Non-SSH 1] (or any other non-original Galt owner) it would be appreciated if you communicate those thoughts now." Galt SSH 1 responded that same day to Lipski in one sentence: "There are no commitments for payments to [Galt Non-SSH 1]." Lipski forwarded the response to Burge and others at Huron; Burge then forwarded the response to others at Huron. Burge and Lipski did not seek any additional information.

46. For Galt Non-SSH 1's 2007 performance, he received a $2,562,421 bonus: Huron paid him $800,000 and the Galt SSHs used their Earn-Outs to pay him an additional $1,762,421. For fiscal year 2008, Huron paid Galt Non-SSH 1 $800,000. At the time of the Restatement, Huron concluded that the Galt SSHs payment to Galt Non-SSH 1 for 2007 was not "clearly for a purpose other than compensation" and therefore, under SAB Topic 5T, it should have recorded this payment as additional non-cash compensation expense that year.

<u>Huron Paid the Galt SSHs a Gross-Up for Adverse Tax Consequences</u>

47. Huron paid the Galt SSHs a gross-up for the adverse tax consequences resulting from the Company paying Galt Non-SSH 1 a 2007 and 2008 bonus of $800,000 each year. These payments were not made pursuant to the Galt asset purchase agreement. At the time of the Restatement, Huron concluded that the payments were not "clearly for a purpose other than compensation" and therefore, under SAB Topic 5T, it should have recorded additional compensation expense for them: $38,190 for 2007 and $44,082 for 2008.

48. Burge and Lipski were aware of the adjustments. CEO forwarded them the February 15, 2008 email from Galt SSH 1 detailing the tax adjustment. Then, on February 28, MD of FP&A forwarded Lipski an email from another Galt SSH referencing the bonus adjustment and attaching spreadsheets detailing the adjustment.

<u>The WP SSHs Shared their Earn-Outs with WP Non-SSH 3 and WP Non-SSH 4</u>

49. On December 26, 2007, a WP SSH responded to a request by CEO and told him that WP planned to share five years of its Earn-Out with WP Non-SSH 3 and WP Non-SSH 4, who were "employees of Wellspring but were not shareholders." On January 8, 2008, CEO forwarded this email to Burge, who forwarded it to Lipski the same day.

50. Lipski concluded, and Burge concurred, that Huron did not have to recognize compensation expense for these contemplated redistributions because WP Non-SSHs 3 and 4 were "Junior Partners." Lipski believed that purchase price accounting remained intact if the SSHs shared Earn-Outs with employees on track to becoming partners as long as the number of junior partners was limited (the "Junior Partner Theory"). He recognized that the facts and circumstances of the particular situation governed whether someone was considered a Junior Partner. Burge agreed that whether a person was a Junior Partner depended on the specific facts, such as the person's status within the firm, how long they had been there, how much revenue they generated, and the duration of their employment.

51. Lipski concluded that WP Non-SSHs 3 and 4 were Junior Partners based on his prior knowledge of their roles, without performing an additional factual analysis or having or requesting any documents to determine why the payments were made. He did not know or ask whether there was a contingency on the Redistributions.

52. In concurring with Lipski's conclusion, Burge did not confirm that Lipski or External Reporting Director performed the necessary factual analysis.

53. Pursuant to the WP Trust Agreement, WP Non-SSHs 3 and 4 received a portion of the WP Earn-Outs: WP Non-SSH 3 received $400,000 for fiscal year 2007, and WP Non-SSH 4 received $1,048,215 for fiscal year 2007 and $1,161,994 for fiscal year 2008. Since these payments were based on their performance, Huron should have recognized non-cash compensation expense for them: $1,448,215 for 2007; and $1,161,994 for 2008.

<u>The Callaway SSHs' Redistribution of Earn-Out Settlement Proceeds to Class B SHs</u>

54. Shortly after the closing of the Callaway acquisition in July 2007, the Callaway SSHs created a Class B membership structure and issued Class B units to fourteen non-SSHs ("Class B SHs"). The written grants stated that the units had no current value and would only gain value if Huron paid Earn-Outs. They further stated that the units were fully vested upon grant, but were subject to repurchase at $1 per unit if the Class B SH ceased to be a Huron employee.

55. In January 2008, Huron and the Callaway SSHs began negotiating an Amendment to Callaway's Asset Purchase Agreement to relieve Huron of its obligation to pay Earn-Outs in exchange for a promissory note payable no later than August 31, 2008 (the "Amendment").

56. On March 21, External Reporting Director, who was reviewing the accounting aspects of the Amendment, emailed a draft Amendment to Engagement Manager, copying Lipski, stating that Huron planned to record the settlement proceeds as additional purchase price. Engagement Manager told External Reporting Director that, to maintain purchase price accounting under EITF 95-8 and SAB Topic 5T, Huron should insert language into the Amendment requiring that Callaway distribute the settlement amount in proportion to the SSHs' ownership interests at the time of the acquisition. External Reporting Director told Lipski about this guidance.

57. When External Reporting Director told the Callaway SSHs' attorney about the required language, the attorney told her it was unacceptable because the Callaway ownership structure had changed a few days after the acquisition's closing with the creation of the Class B membership. He told her that the Class B SHs had rights to the Callaway Earn-Outs proceeds, and thus, the settlement proceeds.

58. On April 3, External Reporting Director emailed the Callaway SSHs' attorney, copying Burge, Lipski, and others at Huron, with suggested language for the Amendment that addressed Engagement Manager's guidance.

59. On April 4, after the Callaway SSHs' attorney revised the suggested language to include a Class A and Class B distinction, Huron and CP4 Warbird Holdings (i.e. the Callaway SSHs) entered into the Amendment. The Amendment specified that the settlement proceeds would only go to Class A and Class B SHs.

60. Huron and Auditor concluded that the portion of the settlement proceeds that would be paid to the Class B SHs would properly be accounted for as additional purchase price under the Junior Partner Theory. Huron and Auditor were not aware of the employment contingency relating to the Class B units. Neither Burge nor Lipski asked whether there was one, or asked for, or saw, the underlying reorganization documents that would have exposed the employment contingencies. Although External Reporting Director asked the Callaway SSHs' attorney for the reorganization documents, she did not receive them.

61. On August 15, pursuant to the Amendment, Huron paid $23,512,158 to CP4 Warbird Holdings. On August 22, CP4 Warbird Holdings distributed a portion of the proceeds to Class B SHs. Because the payments had an employment contingency, Huron should have recognized additional non-cash compensation expense for them: $692,130 for 2007; and $8,305,590 for 2008.

<u>Burge and Lipski Did Not Adequately Analyze Other Redistributions and Redistribution Plans</u>

62. Although Burge and Lipski knew that the Galt SSHs previously paid some of the Galt employees' 2006 bonuses, that the Callaway SSHs had previously redistributed initial cash sales proceeds to non-SSHs, and that the S&W SSHs contemplated redistributing initial sales proceeds, they did not revisit these Redistributions or consider whether SAB Topic 5T applied to them.

63. Burge and Lipski also did not adequately consider or determine whether there were any additional prior Redistributions or contemplated Redistributions. Therefore, they were unaware of, and Huron did not record compensation expense for, several other Redistributions, discussed below – Galt's payments under its Employee Award Program, Galt's 2006 bonus payment to Galt Non-SSH 1, WP's payments to WP Non-SSHs 5 and 6, and the redistributions of sales proceeds among the Galt and WP SSHs.

Galt's Employee Award Program

64. Prior to the Galt acquisition, Galt granted to its employees share units representing a small percentage interest in the firm. The units entitled the employees to a proportional share of proceeds received by Galt from a sale, merger or other liquidity event. To carry out the grants, on March 31, 2006, Galt created an Employee Award Plan "to provide incentive compensation to certain employees . . . who become and remain employed within the Galt group by Huron." Under the plan, the employees' awards vested in 25% increments over a 4-year period (May 2007, 2008, 2009 and 2010), provided the employees remained employed at Huron.

65. Although structured differently, Galt also included another employee, Galt Non-SSH 2, in the award program. Instead of providing a vesting schedule, Galt Non-SSH 2 received a lump award in 2006, but then signed a promissory note promising to repay the same amount as a loan. The note provided that 25% of the loan would be forgiven annually over a 4-year period as long as Galt Non-SSH 2 and at least two of the Galt SSHs remained at Huron.

66. Since the payments had an employment contingency, Huron should have recognized non-cash compensation expense for them: $144,712 for 2006; $399,553 for 2007; $325,522 for 2008; and $78,123 for the first quarter of 2009.

The Galt SSHs' 2006 Bonus to Galt Non-SSH 1

67. In addition to the Galt SSHs payment of 2006 bonuses to employees employed by Galt at the time of the acquisition, the Galt SSHs paid a 2006 bonus of $155,290 to Galt Non-SSH 1, who was hired after the acquisition. At the time of the Restatement, Huron concluded that the bonus was not "clearly for a purpose other than compensation" and therefore, under SAB Topic 5T, it should have recorded this payment as additional non-cash compensation expense in 2006.[4]

The WP SSHs' Redistributions in 2007 and 2008 to WP Non-SSH 5 and WP Non-SSH 6

68. In 2007 and 2008, WP shared portions of its Earn-Out with WP Non-SSH 5 and WP Non-SSH 6. Since WP Non-SSH 5 received $250,000 for both 2007 and 2008 based on her performance as a Huron employee, these payments should have been recognized as non-cash compensation expense. WP Non-SSH 6 received $500,000 of the 2008 Earn-Out for administering the WP trust. At the time of the Restatement, Huron concluded that this payment was not "clearly for a purpose other than compensation" and therefore, under SAB Topic 5T, it should have recognized non-cash compensation expense for it.

[4] As part of its restatement, Huron also accrued an additional $3.1 million of compensation expense for a bonus that the Galt SSHs may pay Galt Non-SSH 1 for his 2008 performance. Whether the Galt SSHs are obligated to pay the bonus is the subject of pending litigation.

Redistributions of Earn-Outs Among SSHs

69. For 2006, 2007 and 2008, the Galt SSHs redistributed Earn-Outs among themselves. Because the redistributions were based upon the SSHs' performance and individual contribution to the Galt practice, Huron should have recognized additional non-cash compensation expense for the amounts subject to redistribution: $85,012 for 2006; $407,117 for 2007; $579,898 for 2008; and $237,600 for the first quarter of 2009.

70. For 2007 and 2008, the WP SSHs redistributed Earn-Outs among themselves. Because the redistributions were based on performance, Huron should have recognized additional non-cash compensation expense for the amounts subject to redistribution: $10,344,897 for 2007; $13,054,731 for 2008; and $2,634,016 for the first quarter of 2009.

Huron's Internal Controls Weaknesses

71. Huron's deficient internal controls contributed to the restatement of its financial statements. As Huron disclosed in its amended Form 10-K for 2008, it did not "maintain effective controls to ensure the appropriate recording and reporting" of certain acquisition sales proceeds. Huron stated that its controls were "not designed to ensure that the redistribution of certain [acquisition sales proceeds] among the selling shareholders and to certain of our employees was correctly recorded in accordance with GAAP, including guidance promulgated by the SEC."

72. After February 2008, Huron did not implement sufficient internal controls to monitor whether the SSHs were sharing Earn-Out proceeds with non-SSHs. Although Huron discussed the issue with SSHs who received Earn-Outs for 2007, no formal process was established for educating SSHs about the accounting implications resulting from sharing Earn-Outs or for obtaining information from SSHs about the distribution of Earn-Outs. Although Huron included language limiting redistributions in the purchase agreements for the two acquisitions that occurred between February 2008 and the restatement, it did not seek to negotiate amendments to the purchase agreements of prior acquisitions.

73. Huron did not take any steps to determine or prevent the sharing of sales proceeds other than Earn-Outs.

74. Burge, as Huron's CFO, and Lipski, as Huron's Controller, were two of the persons responsible for ensuring Huron's books, records and accounts accurately reflected its compensation expense, and for devising and maintaining Huron's internal controls.

Impact of the Redistributions on Huron's Financial Statements

75. As a result of the conduct described above, Huron's financial statements in its annual report on Form 10-K for 2006 through 2008, and in its quarterly report on Form 10-Q for the first quarter of 2009, were materially misstated. On August 17, 2009, Huron filed a Form 10-K/A with restated financial statements.

76. The following table summarizes the additional compensation expense for the Redistributions that were the subject of Huron's restatement, as they impacted direct costs (the income statement line item where compensation expense is recorded) and pre-tax income:

	2006[5]	2007	2008	1Q 2009
Direct Costs				
As Reported	$ 163,569,000	$ 293,387,000	$ 360,404,000	$ 99,131,000
Additional Compensation Expense	$ 3,829,861	$ 17,620,579	$ 30,569,817	$ 3,761,739
As Adjusted	$ 167,398,861	$ 311,007,579	$ 390,973,817	$ 102,892,739
Percentage Understatement	2.29%	5.67%	7.82%	3.66%
Pre-Tax Income				
As Reported	$ 46,822,000	$ 75,497,000	$ 75,140,000	$ 18,638,000
Additional Compensation Expense	$ (3,829,861)	$ (17,620,579)	$ (30,569,817)	$ (3,761,739)
As Adjusted	$ 42,992,139	$ 57,876,421	$ 44,570,183	$ 14,876,261
Percentage Overstatement	8.91%	30.45%	68.59%	25.29%

Burge's and Lipski's Incentive-Based Compensation

77. For his work in 2006, Burge received incentive-based compensation including a cash bonus, a portion of which was based on Huron's performance. On July 7, 2009, pursuant to a 10b5-1 plan, Burge sold shares of Huron stock.

78. For his work in 2006, Lipski received incentive-based compensation including a cash bonus, a portion of which was based on Huron's performance.

VIOLATIONS

79. Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 thereunder require that 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.

80. Section 13(b)(2)(A) of the Exchange Act and Rule 13b2-1 thereunder require 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 prohibit any

[5] Huron's restated 2006 financial statements reflect $1,143,333 of non-cash compensation expense that should have been recognized in 2005.

person from, directly or indirectly, falsifying or causing to be falsified, any book, record or account subject to Section 13(b)(2)(A) of the Exchange Act.

81. Section 13(b)(2)(B) of the Exchange Act requires all reporting companies to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP.

82. As a result of the conduct described above, Huron violated Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 thereunder because it failed to record compensation expense for the Redistributions, and thus filed inaccurate periodic reports with the Commission that materially understated direct costs and overstated pre-tax income.

83. As a result of the conduct described above, Huron violated Section 13(b)(2)(A) of the Exchange Act because it did not keep books, records or accounts that accurately reflected its compensation expense relating to certain redistributions of acquired companies' sales proceeds to non-SSHs and among the SSHs.

84. As a result of the conduct described above, Huron violated Section 13(b)(2)(B) of the Exchange Act because it failed to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that Redistributions were recorded as necessary to permit the preparation of financial statements in conformity with GAAP.

85. As a result of the conduct described above, Burge and Lipski violated Rule 13b2-1 under the Exchange Act and were a cause of Huron's violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 thereunder.

HURON'S REMEDIAL EFFORTS

86. In determining to accept Huron's Offer, the Commission considered remedial acts promptly undertaken by Huron and cooperation afforded by Huron to the Commission staff. Among other things, Huron self-investigated and self-reported the accounting errors, selected new management and implemented various additional controls designed to prevent similar errors going forward.

IV.

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

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act, Huron 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, and 13a-13 thereunder.

B. Pursuant to Section 21C of the Exchange Act, Burge and Lipski 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-13, and 13b2-1 thereunder.

C. Respondent Huron shall, within 10 days of the entry of this Order, pay a civil money penalty in the amount of $1,000,000.00 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Payment must be made in one of the following ways: (A) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request; (B) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm; or (C) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to Enterprise Services Center, Accounts Receivable Branch, HQ Bldg., Room 181, AMZ-341, 6500 South MacArthur Boulevard, Oklahoma City, OK 73169. Payments by check or money order must be accompanied by a cover letter identifying Huron Consulting Group Inc. as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Paul A. Montoya, Assistant Regional Director, U.S. Securities and Exchange Commission, Chicago Regional Office, 175 West Jackson Boulevard, Suite 900, Chicago, Illinois 60604.

D. Respondent Burge shall, within 10 days of the entry of this Order, pay a civil money penalty in the amount of $50,000.00, disgorgement of $147,763.12 and prejudgment interest of $30,338.46 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to Rule 600 of the Commission's Rules of Practice, 17 C.F.R. § 201.600, and 31 U.S.C. 3717. Payment must be made in one of the following ways: (A) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request; (B) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm; or (C) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to Enterprise Services Center, Accounts Receivable Branch, HQ Bldg., Room 181, AMZ-341, 6500 South MacArthur Boulevard, Oklahoma City, OK 73169; and (D) submitted under cover letter that identifies Gary L. Burge 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 Paul A. Montoya, Assistant Regional Director, U.S. Securities and Exchange Commission, Chicago Regional Office, 175 West Jackson Boulevard, Suite 900, Chicago, Illinois 60604.

E. Respondent Lipski shall, within 10 days of the entry of this Order, pay a civil money penalty in the amount of $50,000.00 and disgorgement of $12,750.00 and prejudgment interest of $3,584.94 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to Rule 600 of the Commission's Rules of Practice, 17 C.F.R. § 201.600, and 31 U.S.C. 3717. Payment must be made in one of the following ways: (A) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request; (B) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm; or (C) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to Enterprise Services Center, Accounts Receivable Branch, HQ Bldg., Room 181, AMZ-341, 6500 South MacArthur Boulevard, Oklahoma City, OK 73169; and (D) submitted under cover letter that identifies Wayne E. Lipski 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 Paul A. Montoya, Assistant Regional Director, U.S. Securities and Exchange Commission, Chicago Regional Office, 175 West Jackson Boulevard, Suite 900, Chicago, Illinois 60604.

F. Such disgorgement, interest and civil money penalties may be distributed pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002, as amended, and Section 929B of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Regardless of whether any such distribution is made, amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondents agree that in any Related Investor Action, they shall not argue that they are entitled to, nor shall they benefit by, offset or reduction of any award of compensatory damages by the amount of any part of Respondents' payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Respondents agree that they shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the United States Treasury or to a Fair Fund, as the Commission directs. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against Respondents by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

By the Commission.

Elizabeth M. Murphy
Secretary

Lynn Powalski

By: Lynn M. Powalski
Deputy Secretary

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-67480; File No. S7-24-11)

July 20, 2012

ORDER EXTENDING TEMPORARY CONDITIONAL EXEMPTION IN CONNECTION WITH THE EFFECTIVENESS OF THE DEFINITION OF ELIGIBLE CONTRACT PARTICIPANT

I. Background

Title VII of the Dodd Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")[1] amended the definition of the term "eligible contract participant" in the Commodity Exchange Act ("CEA").[2] This amended definition was incorporated by reference into the Securities Exchange Act of 1934 ("Exchange Act").[3] Section 6(l) of the Exchange Act,[4] which was added by the Dodd-Frank Act,[5] made it unlawful, as of the July 16, 2011 effective date of Title VII (360 days after enactment of the Dodd-Frank Act), for any person to effect a transaction in a security-based swap with or for a person that is not an eligible contract participant, unless such transaction is effected on a national securities exchange registered pursuant to section 6(b) of the Exchange Act.[6]

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

2 Section 721(a) of the Dodd-Frank Act redesignated section 1a(12) of the Commodity Exchange Act, which contained the pre-Dodd-Frank Act definition of eligible contract participant, as section 1a(18), 7 U.S.C. 1a(18), and amended certain provisions of that definition.

3 Exchange Act section 3(a)(65), 15 U.S.C. 78c(a)(65). Section 761(a) of the Dodd-Frank Act added section 3(a)(65) to the Exchange Act.

4 15 U.S.C. 78f(l).

5 Section 761(e) of the Dodd-Frank Act.

6 15 U.S.C. 78f(b).

In June 2011, the Securities and Exchange Commission ("Commission") granted a temporary conditional exemption from section 6(l) of the Exchange Act to certain persons.[7] This temporary conditional exemption allowed those persons that met the definition of eligible contract participant as set forth in section 1a(12) of the Commodity Exchange Act (as in effect on July 20, 2010),[8] but that could potentially be considered non-eligible contract participants under the definition of eligible contract participant as amended by Title VII of the Dodd-Frank Act, to continue to be treated as eligible contract participants until the term eligible contract participant was further defined in final rulemaking. The Commission specified in the Effective Date Relief that the temporary exemption would expire on the effective date for the final rules further defining the term eligible contract participant.

II. Discussion

A. Post-Exemption Developments

Subsequent to the Commission's publication of the Effective Date Relief in June 2011, the Commission adopted, jointly with the Commodity Futures Trading Commission ("CFTC"), rules further defining the term eligible contract participant, which will be effective July 23, 2012.[9] In the Entity Definitions Adopting Release, the Commission reiterated that the temporary conditional exemption from section 6(l) of the Exchange Act would expire upon the effectiveness of the Entity Definitions Adopting Release.[10] The Commission provided further

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7 Order Pursuant to Sections 15F(b)(6) and 36 of the Securities Exchange Act of 1934 Granting Temporary Exemptions and Other Temporary Relief, Together With Information on Compliance Dates for New Provisions of the Securities Exchange Act of 1934 Applicable to Security-Based Swaps, and Request for Comment, 76 FR 36287 (June 22, 2011) ("Effective Date Relief").

8 7 U.S.C. 1a(12) (as in effect on July 20, 2010).

9 See Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant", 77 FR 30596 (May 23, 2012) ("Entity Definitions Adopting Release").

10 See 77 FR at 30700.

notice of the July 23, 2012 expiration of section 6(l) relief in its June 2012 policy statement regarding implementation of the Dodd-Frank Act (the "Implementation Policy Statement").[11]

On July 13, 2012, in response to the request for comment in the Implementation Policy Statement, the Financial Services Roundtable ("Roundtable") submitted a comment letter[12] requesting an extension of this relief until the effective date of the final rules defining the terms "swap" and "security-based swap."[13]

B. Roundtable Request

In support of its request for an extension of section 6(l) relief, the Roundtable stated that the extension is necessary in order to give the industry more time to "review the requirements and implement the systems necessary to conform to the newly finalized definition of [eligible contract participant]."[14] The Roundtable further stated that linking the expiration of the section 6(l) relief to the effective date of the Product Definitions Adopting Release will be more efficient for market participants due to the large number of CFTC Title VII provisions that are already tied to the effectiveness of that release.[15] Finally, the Roundtable stated that the requested extension would result in harmonization with the CFTC.[16]

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11 See Statement of General Policy on the Sequencing of the Compliance Dates for Final Rules Applicable to Security-Based Swaps Adopted Pursuant to the Securities Exchange Act of 1934 and the Dodd-Frank Wall Street Reform and Consumer Protection Act, 77 FR 35625, 35631 (June 14, 2012).

12 Letter from Richard M. Whiting, Executive Director and General Counsel, Financial Services Roundtable, to Elizabeth M. Murphy, Secretary, Commission (July 13, 2012) ("Roundtable Extension Request"), available at: http://www.sec.gov/comments/s7-05-12/s70512-9.pdf.

13 The Commission and the CFTC have approved the final rules ("Product Definitions Adopting Release"). See http://sec.gov/rules/final/2012/33-9338.pdf.

14 Roundtable Extension Request at 2.

15 Id. at 3.

16 Id. The CFTC's existing relief from the CEA analogue to section 6(l) expires on the effective date of the Product Definitions Adopting Release. See Second Amendment to July 14, 2011 Order for Swap Regulation, 77 FR 41260, 41263 n.42 (July 13, 2012).

In light of the concerns expressed by the commenter, the Commission finds that it is necessary or appropriate in the public interest, and is consistent with the protection of investors, to extend the section 6(l) relief provided in the Effective Date Relief for the limited time requested, that is, until the effective date of the Product Definitions Adopting Release. Specifically, pursuant to the Commission's authority under Section 36 of the Exchange Act,[17] the Commission is extending the temporary conditional exemption provided in the Effective Date Relief from section 6(l) of the Exchange Act for persons that meet the definition of eligible contract participant as set forth in section 1a(12) of the CEA (as in effect on July 20, 2010). This temporary conditional exemption will expire on the effective date of the Product Definitions Adopting Release.

III. Conclusion

IT IS HEREBY ORDERED, pursuant to section 36(a) of the Exchange Act, that the temporary conditional exemption from section 6(l) of the Exchange Act provided in the Effective Date Release for persons that meet the definition of eligible contract participant as set forth in section 1a(12) of the Commodity Exchange Act (as in effect on July 20, 2010) is extended until 60 days after publication of the Product Definitions Adopting Release (Rel. No. 33-9338, 34-67453; File No. S7-16-11) in the Federal Register.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

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[17] 15 U.S.C. 78mm. Subject to certain exceptions, section 36 of the Exchange Act authorizes the Commission, by rule, regulation, or order, to conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of the Exchange Act or any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 67479 / July 20, 2012

INVESTMENT ADVISERS ACT OF 1940
Release No. 3436 / July 20, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14641

In the Matter of CHARLES L. RIZZO and GINA M. HORNBOGEN, Respondents.	**ORDER MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS PURSUANT TO SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940 AND SECTION 15(b)(6) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

On November 28, 2011, the Securities and Exchange Commission ("Commission") instituted proceedings pursuant to Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") and Section 15(b)(6) of the Securities Exchange Act of 1934 ("Exchange Act") against Charles L. Rizzo ("Rizzo") and Gina M. Hornbogen ("Hornbogen") (collectively, "Respondents").

II.

Respondents have submitted a joint 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 them and over the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Making Findings and Imposing Remedial Sanctions pursuant to Section 203(f) of the Investment Advisers Act of 1940 and Section 15(b)(6) of the Securities Exchange Act of 1934 ("Order"), as set forth below.

III.

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

A. SUMMARY

This matter concerns the failure of Charles L. Rizzo and Gina M. Hornbogen (collectively, "Respondents") reasonably to supervise Steven Salutric ("Salutric"), who, while acting as an investment advisor, misappropriated $7 million from fifteen clients. Respondents failed to investigate numerous serious red flags indicating misconduct while permitting Salutric's continued access to his victims' accounts. In 2004, Respondents were alerted to numerous suspicious transactions in Salutric client accounts, including a forged client signature. Rizzo had concerns that Salutric might be operating a Ponzi scheme but did nothing to investigate the matter. Moreover, Respondents were advised by the firm's attorney to contact all clients whose accounts contained the suspicious transactions, but this advice was ignored. Respondents did virtually nothing to follow up on these red flags or numerous additional indications of fraud between 2004 and 2009, permitting Salutric's fraud to continue.

B. RESPONDENTS

1. Charles L. Rizzo. Rizzo co-founded Results One Financial, LLC ("Results One"), a registered investment adviser, in 2000 in Elmhurst, Illinois. Rizzo was a director and 35% equity owner of the firm until it dissolved in 2010. Rizzo had supervisory responsibility over Steven Salutric from 2002 through 2009. Rizzo is currently a principal of RH Financial Group, LLC, a registered investment adviser located in Oak Brook, Illinois. Rizzo holds Series 7, 24, and 63 licenses and has been a registered representative of a broker-dealer since 1996. Rizzo, age 61, is a resident of Oak Brook, Illinois.

2. Gina M. Hornbogen. Hornbogen joined Results One in 2000 and served as the firm's chief compliance officer from 2004 until 2010. Hornbogen also became a director and 2.5% equity partner of the firm in 2008. Hornbogen had supervisory responsibility over Steven Salutric from October 2004 through 2009. Hornbogen is currently a principal of RH Financial Group, LLC. Hornbogen holds Series 6, 7, 24, 63, and 66 licenses and has been a registered representative of a broker-dealer since 2001. Hornbogen, age 37, is a resident of Carol Stream, Illinois. Throughout the time of the conduct described herein, Rizzo and Hornbogen were associated with broker-dealers including Waterstone Financial, Inc., Questar Capital Corp., and most recently American Portfolios Financial Services, Inc. Rizzo and Hornbogen are currently associated with a broker-dealer.

C. OTHER RELEVANT ENTITIES AND INDIVIDUALS

3. Results One Financial, LLC. Results One was an Illinois Limited Liability Company located in Elmhurst, Illinois and was registered with the Commission as an investment adviser from 2000 until early 2010. In early 2010, Results One dissolved as a corporate entity. In early 2010, Results One withdrew its registration as an investment adviser. Rizzo and Hornbogen then formed a new firm, RH Financial Group, LLC, a registered investment adviser

that reported in its most recent Form ADV filed with the Commission that it had approximately $150 million in regulatory assets under management.

4. Steven Salutric. Salutric, age 51, is a resident of Carol Stream, Illinois. In 2000, Salutric co-founded Results One along with Rizzo and others. Salutric was a principal of Results One until early 2010. Salutric performed investment advisory services for Results One clients. Salutric was also a certified public accountant and performed accounting and tax services for Results One clients. On January 8, 2010, the Commission filed an emergency ex parte action against Salutric, seeking a temporary restraining order and preliminary and permanent injunctions against Salutric, alleging violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and Sections 206(1) and 206(2) of the Advisers Act. SEC v. Salutric, 10-cv-1115 (N.D. Ill.) (J. Dow). In its complaint, the Commission alleged that Salutric misappropriated millions of dollars from his advisory clients at Results One. On January 8, 2010, the District Court granted the emergency relief sought by the Commission, including a temporary restraining order. On August 5, 2010, the Commission issued an Order Instituting Proceedings, pursuant to Section 203(f) of the Advisers Act, against Salutric based on a July 14, 2010 entry of a permanent injunction against him in the District Court action. On September 10, 2010, Chief Administrative Law Judge Brenda P. Murray entered an order, pursuant to Section 203(f) of the Advisers Act, that Salutric is barred from association with any investment adviser.

D. FACTS

Salutric misappropriated $7 million from his clients.

5. From 2002 through 2009, Salutric misappropriated approximately $7 million from fifteen advisory clients at Results One. About $2.3 million of this amount was misappropriated from 2007 through 2009.

6. Results One client funds and securities were held by Charles Schwab & Co. ("Schwab"), which served as custodian of client funds. Pursuant to investment advisory agreements with clients, Results One personnel had authority to trade in clients' accounts without prior approval.

7. However, Results One personnel did not have authority to withdraw funds from the client accounts. Moreover, Schwab's internal procedures did not permit disbursements of client funds to third parties unless the client signed a wire transfer request.

8. In order to misappropriate client funds, Salutric forged client signatures on wire transfer requests, directing Schwab to wire funds from the clients' accounts to entities linked to Salutric. On occasions when his clients' accounts lacked sufficient funds, Salutric liquidated client securities to generate cash. The clients were not aware of, and did not approve of, Salutric's withdrawals.

9. Salutric transferred stolen client funds to entities under his control, to business ventures with which he was involved, and to some of his accounting clients. A number of these transfers were purportedly loans to the recipients of the funds.

10. Salutric's fraud finally ceased in December 2009, when one of his advisory clients discovered that almost $600,000 was missing from his account. This client's attorney brought this issue to the attention of Schwab and Results One. Shortly thereafter, Salutric admitted to Results One that he had forged this client's signature on wire transfer requests.

11. From at least 2002 until December 2009, Rizzo had supervisory responsibility over Salutric in Salutric's capacity as advisory representative.

12. From at least 2004 until December 2009, Hornbogen had supervisory responsibility over Salutric in Salutric's capacity as advisory representative.

13. From at least 2002 until December 2009, Rizzo and Hornbogen failed reasonably to investigate or otherwise respond to numerous red flags indicating possible violations by Salutric.

From 2002 through early 2004, Rizzo and Hornbogen failed reasonably to respond to suspicious patterns of Salutric client withdrawals.

14. Nearly every business day from late 2002 through December 2009, Results One operations department personnel sent Rizzo and Hornbogen emails listing all "large withdrawals" and "large deposits" in client accounts the previous day.

15. These emails provided notice to Rizzo and Hornbogen of significant client withdrawals, including most, if not all, of the funds Salutric misappropriated from his clients.

16. These emails provided notice to Rizzo and Hornbogen of suspicious amounts and patterns of withdrawals from the accounts of Salutric's clients.

17. For example, during the three months from April 2003 through June 2003, Rizzo and Hornbogen received emails revealing over $1.9 million in withdrawals, most of which were over $100,000. Six hundred thousand dollars of these withdrawals were made from the account of a single client, and another $500,000 in withdrawals was made from the account of one other client.

18. In another instance, Rizzo and Hornbogen received an email showing over $900,000 in deposits into the accounts of four Salutric clients on a single day, June 12, 2003. Then, just four days later, Rizzo and Hornbogen received emails revealing that most of the $900,000 was wired out of the four clients' accounts.

19. On occasion, Rizzo and Hornbogen asked Salutric to explain large withdrawals from his clients' accounts. However, they routinely accepted, without further inquiry, whatever explanation Salutric gave them. At no point did Rizzo and Hornbogen contact Salutric's clients about the suspicious withdrawals.

20. Had Rizzo and Hornbogen contacted Salutric's defrauded clients regarding the suspicious withdrawals, Rizzo and Hornbogen likely would have discovered that these clients were unaware of the transactions and had not authorized them.

Schwab warned Rizzo and Hornbogen that the signature of a Salutric client had been forged.

21. In April 2004, Schwab received a $30,000 wire transfer request for the account of a Salutric client ("Client A"). Schwab personnel noticed that Client A's signature on this request did not match his signature on other documents in Client A's file.

22. Schwab personnel called Jason Helms ("Helms"), the head of operations at Results One. They told Helms they were concerned that Client A's signature was not authentic. Helms relayed the warning on to Hornbogen.

23. In the meantime, Schwab personnel contacted Client A. He informed Schwab that his signature had been forged on the letter of authorization and that he had been unaware of the withdrawal, although he subsequently ratified the transaction. Schwab personnel telephoned Rizzo and alerted him to Client A's statements.

24. Schwab personnel told Rizzo that he needed to investigate this issue to determine who forged Client A's signature.

25. Neither Rizzo nor Hornbogen ever called Client A to ask about the forged signature or the $30,000 transfer.

In June 2004, Schwab informed Rizzo and Hornbogen of $2.5 million in suspicious transactions which indicated possible fraud by Salutric.

26. On June 8, 2004, Rizzo and Salutric spoke by telephone with Schwab personnel regarding $2.5 million in suspicious transfers among the Schwab accounts of Salutric and several of his clients. The suspicious transfers took place between March 2003 and June 2004. Some of the transactions were transfers between Salutric's account and several of his clients' accounts. Others were transfers between accounts of Salutric clients. Rizzo later informed Hornbogen as to the substance of this conversation.

27. Earlier, in April and May 2004, Schwab personnel had discussed some or all of these suspicious transfers with Rizzo in other telephone conversations.

28. During the June 8, 2004 telephone call, Salutric stated that the transfers were loans and that the documentation for the loans was at his home, not in Results One's offices.

29. During the June 8, 2004 call, Salutric stated that the transactions were none of Schwab's business because they were simply loans between clients.

30. Schwab personnel responded by stating that Rizzo and Salutric had a fiduciary duty to all Results One clients and that they had an obligation to act in the best interest of their clients.

31. Schwab insisted that Salutric provide detailed supporting documentation for all of the transactions discussed during this phone call.

32. During this phone call, Rizzo told Schwab personnel that he was considering resigning from Results One because he was worried about these transactions. Schwab personnel responded that Rizzo should be worried about these transactions, as they could indicate fraudulent activity by Salutric.

33. Rizzo took notes during this phone call. On the second page of his notes, Rizzo wrote: "Concerns: (1) Making & receiving loans from clients (PONZI Scheme)."

34. Rizzo did not contact the clients whose accounts were flagged by Schwab regarding the suspicious transfers.

35. In a June 15, 2004 telephone call, Rizzo told Schwab personnel that he was conducting an internal investigation into the transactions flagged by Schwab and that the investigation would include contacting all the clients involved.

36. Rizzo did not conduct an internal investigation into the transactions flagged by Schwab or contact any of the relevant clients.

Schwab demanded that Rizzo and Hornbogen no longer permit Salutric to manage client accounts held by Schwab.

37. On July 19, 2004, Rizzo and Hornbogen participated in a telephone call with Schwab personnel.

38. Schwab personnel told Rizzo and Hornbogen that because of the suspicious transactions involving Salutric, Schwab was no longer comfortable doing business with Salutric.

39. Schwab personnel directed Rizzo and Hornbogen to remove Salutric as an authorized user of Schwab's trading platform.

40. Schwab personnel demanded that Rizzo and Hornbogen ensure Salutric no longer managed client accounts held by Schwab.

41. Schwab personnel added that if they ever found out that Salutric was managing any Schwab clients, the entire relationship between Schwab and Results One would be at risk.

42. Rizzo said that he understood Schwab's instructions and would follow them.

43. Rizzo also said that Results One was considering sending letters to all the clients involved in the suspicious transactions flagged by Schwab.

44. Results One, however, did not send letters to the clients involved in the transactions.

Rizzo deceived Schwab by causing Schwab personnel to believe that Results One was complying with their instructions.

45. Removing Salutric as an authorized user of Schwab's trading platform had little practical effect on his ability to manage client accounts at Schwab.

46. Specifically, Results One's procedures required advisory representatives to submit transaction requests to the operations department, primarily Helms, who would then submit the transactions to Schwab under his name – not the representative's name.

47. Rizzo and Hornbogen were aware of this procedure. Schwab was not.

48. Rizzo submitted Schwab paperwork removing Salutric as an authorized user, knowing that this would have little effect on Salutric's management of Schwab accounts.

49. Despite Rizzo's assurances that Schwab's instructions would be followed, Rizzo and Hornbogen permitted Salutric to continue managing accounts held by Schwab.

50. After July 2004, Rizzo and Hornbogen permitted Salutric to continue routing instructions for his clients' accounts through Results One's operations department.

Rizzo and Hornbogen ignored their attorney's advice to contact all clients whose accounts had been flagged by Schwab.

51. On July 20, 2004, Rizzo and Hornbogen met with the firm's securities counsel ("Attorney A"). Rizzo and Hornbogen had previously sent Attorney A the supporting documentation that Salutric provided to Schwab on June 24, 2004.

52. During this meeting, Attorney A advised Rizzo and Hornbogen that one of the transactions flagged by Schwab "looked like 'borrowing from Peter to pay Paul.'"

53. Attorney A also advised Rizzo and Hornbogen that Results One should not engage in this type of transactions in the future.

54. Attorney A also advised Rizzo and Hornbogen to "send a letter to clients regarding these transactions making sure they agree and understand the transactions and realize that Results One did not play any role in these transactions."

55. Rizzo and Hornbogen never sent any letters to these clients or made any other attempt to verify that the clients agreed with and understood the transactions.

56. Had Rizzo and Hornbogen contacted the clients, they likely would have learned that the clients were unaware of, and had not authorized, the transactions flagged by Schwab.

From October 2004 through 2009, Rizzo and Hornbogen failed to respond to still more suspicious withdrawals from accounts of Salutric clients.

57. From October 2004 through 2009, Rizzo and Hornbogen continued to receive emails notifying them of large, suspicious withdrawals from the accounts of Salutric clients.

58. These emails alerted Rizzo and Hornbogen to virtually all the instances when Salutric misappropriated funds from his clients' accounts between October 2004 and late 2009.

59. For example, between October and December 2004, Rizzo and Hornbogen received emails alerting them to nearly $1.4 million in large withdrawals from the account of a single Salutric client—including withdrawals of $500,000 and $308,000. Despite these warnings, Rizzo and Hornbogen did not contact the client to inquire about the withdrawals. As a result, Rizzo and Hornbogen did not discover that Salutric had misappropriated the funds from the client's account.

From July 2006 through October 2006, Hornbogen failed reasonably to respond to red flags concerning IRA accounts of two Salutric clients.

60. From December 2005 through October 2006, Schwab sent over thirty emails to Results One about two delinquent $100,000 loans previously made from Individual Retirement Accounts ("IRA") of two Salutric advisory clients ("Client B and Client C"). The loans had been made to a real estate company ("Company A"). Company A was one of Salutric's accounting clients. The $100,000 loans had matured the previous year, in July 2004.

61. The loans were required to be repaid into the clients' IRA accounts at Schwab when they matured. Otherwise, the transactions would likely be considered distributions for tax purposes, and the clients would be likely to incur liability for taxes and early withdrawal penalties. Schwab sought answers from Results One as to why these loans had not been repaid.

62. In reality, Salutric had fraudulently diverted the $200,000 to Company A without the knowledge or approval of Client B or Client C. Salutric falsely represented to Company A that his clients had approved the purported loans.

63. Moreover, the $200,000 had already been repaid by Company A; Salutric had diverted the $200,000 paid by Company A to a third party as yet another purported loan.

64. From July 2006 through October 2006, Salutric provided Hornbogen with various incredible excuses and unfulfilled promises that the purported loans would be repaid soon.

65. Hornbogen repeatedly accepted, without further inquiry, Salutric's increasingly incredible excuses as to why the loans had not been repaid, despite mounting indications that he was lying to stall for time.

66. In late August 2006, Salutric provided Hornbogen with a copy of a check dated August 3, 2006 from Company A to Client B. Salutric told Hornbogen that he would mail the original of the check to Schwab.

67. In fact, the copy Salutric gave Hornbogen in August 2006 was a doctored version of a May 2006 check that Company A had written to Client B to repay the purported loan from Client B's IRA account. Company A had given the check to Salutric in May 2006. Instead of forwarding the check to Client B, however, Salutric forged Client B's endorsement on the check and diverted the money to another party.

68. Hornbogen emailed a copy of the check to Schwab, promising that the original of the check would be overnighted to Schwab so it could be deposited into Client B's account.

69. Hornbogen later discovered that Salutric did not send the check to Schwab, but she did nothing to follow up on the issue.

70. Salutric also falsely told Hornbogen that Client B and Client C had both received loan repayment checks directly from Company A and that they had mailed the checks to Results One. Salutric later falsely told Hornbogen that both of these checks had been lost in the mail. Hornbogen did not follow up on this suspicious explanation by Salutric.

71. Had Hornbogen contacted Client B, Client C, or Company A, she likely would have discovered that the $200,000 from Client B and Client C, along with another $1.3 million belonging to seven other Salutric clients, had been fraudulently diverted to Company A.

Hornbogen concealed Salutric's involvement in these transactions.

72. From July 2006 through October 2006, Hornbogen acted as a buffer between Schwab and Salutric when answering Schwab's questions about the purported loans from Client B and Client C to Company A.

73. Whenever Schwab inquired about the purported overdue loans, Hornbogen relayed the question to Salutric and then passed Salutric's response on to Schwab by email.

74. Hornbogen knew that Salutric was the person managing these advisory clients' IRA accounts, and she knew that Company A was Salutric's accounting client.

75. Hornbogen thus knew Salutric was the only person in the office who had communications with the individuals on both sides of the purported loans.

76. Hornbogen also knew that Salutric was not supposed to be managing the accounts of Client B and Client C—Schwab had instructed Rizzo and Hornbogen that Salutric was no longer permitted to manage client accounts held by Schwab back in July 2004.

77. Throughout her email exchanges with Schwab, Hornbogen refrained from using Salutric's name. Instead, she referred only to "the partner in charge of this client" or "the partner in charge at my firm."

78. Through her actions, Hornbogen concealed the fact that Salutric was still managing client accounts held by Schwab.

79. After October 2006, Rizzo and Hornbogen continued to receive emails from the Results One operations department notifying them of large withdrawals from the accounts of Salutric clients.

80. Rizzo and Hornbogen failed reasonably to respond to these emails.

Rizzo and Hornbogen failed reasonably to respond to indications that Salutric had serious financial problems.

81. During a September 2006 meeting, Salutric informed Rizzo that, due to difficulties in distributing a motion picture Salutric co-produced, Salutric and his partners were at risk of defaulting on a $2 million bank loan. During this meeting, Salutric told Rizzo that he might have to declare personal bankruptcy to resolve his debts related to this business venture.

82. In November and December 2006, over $1 million in checks drawn on Salutric's personal Schwab account were returned for insufficient funds. In January and February 2007, a total of $1.7 million in checks drawn on Salutric's Schwab account were returned for insufficient funds. Most of these bounced checks were written to Salutric's clients as personal loans.

83. Rizzo and Hornbogen knew about several of the checks Salutric bounced between November 2006 and February 2007.

84. Nevertheless, Rizzo and Hornbogen did not inquire into the bounced checks.

85. After February 2007, Rizzo and Hornbogen continued to receive emails from the Results One operations department notifying them of large withdrawals from the accounts of Salutric clients.

86. Rizzo and Hornbogen failed reasonably to respond to these emails.

Rizzo failed reasonably to respond to emails raising still more red flags about Salutric.

87. Rizzo failed reasonably to respond to emails indicating that Salutric had facilitated purported loans from his Results One advisory clients to his business partner and had engaged in undisclosed outside business activities and investments.

88. For example, in December 2007, Rizzo reviewed a July 2007 email from Salutric to his business partner in connection with a motion picture ("Partner A") revealing that Salutric had facilitated $640,000 in purported loans from four of his advisory clients to Partner A.

89. Rizzo never took any steps to investigate these transactions. Had Rizzo contacted any of the clients identified in the email, he likely would have learned that they were unaware of the transfers and had not approved the purported loans to Partner A.

90. In December 2008, Rizzo reviewed an email between Salutric and another business partner revealing that Salutric was the managing partner of a company called Celluloid Distribution, and that this entity had an investment in a business venture called The Word of Promise, also with Partner A.

91. This email also revealed that Celluloid Distribution had purportedly borrowed over $900,000 from one of Salutric's advisory clients. In reality, Salutric misappropriated this $900,000 from the client.

92. Salutric never disclosed his interests in Celluloid Distribution and The Word of Promise on his Results One code of ethics forms, as was required.

93. Rizzo took no steps to verify that Salutric's investments in Celluloid Distribution and The Word of Promise had been disclosed on Salutric's Results One code of ethics forms.

94. Rizzo never contacted the client from whom Salutric had misappropriated the $900,000 purportedly loaned to Celluloid Distribution.

95. Despite being made aware of the numerous serious indications of misconduct by Salutric between 2002 and 2009 described above, Rizzo and Hornbogen conducted virtually no investigation into these red flags, thus permitting Salutric's fraud to continue unhindered until December 2009, when he was finally caught. Had Rizzo and Hornbogen conducted a reasonable investigation into any of the red flags described above, they likely would have discovered Salutric's fraud long before December 2009.

E. <u>VIOLATIONS</u>

96. In connection with the conduct described above, Salutric violated Sections 206(1) and 206(2) of the Advisers Act, which prohibit fraudulent conduct by an investment adviser.

97. In connection with the conduct described above, Salutric violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent conduct in connection with any purchase or sale of security.

98. As a result of the conduct described above, Respondents Rizzo and Hornbogen failed reasonably to supervise Salutric, a person subject to their supervision within the meaning of Section 203(e) of the Advisers Act, with a view to preventing and detecting his violations of the federal securities laws.

F. CIVIL PENALTIES

99. Respondent Hornbogen has submitted sworn Statements of Financial Condition dated August 17, 2011 and April 25, 2012 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 actions agreed to in Respondents' Joint Offer.

Accordingly, pursuant to Section 15(b)(6) of the Exchange Act and Section 203(f) of the Advisers Act, it is hereby ORDERED that:

A. Respondents Rizzo and Hornbogen be, and hereby are barred from associating in a supervisory capacity with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization.

Any reapplication for association by any 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.

B. Respondent Rizzo shall, within 15 days of the entry of this Order, shall pay disgorgement of $35,079, prejudgment interest of $7,731, and civil penalties of $130,000, to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600 or 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) if paid by money order or check, such payment shall be hand-delivered or overnight mailed to Enterprise Services Center, HQ Bldg, Room 181, AMZ-341, 6500 South MacArthur Blvd, Oklahoma City, OK 73169; and (D) submitted under cover letter that identifies Charles L. Rizzo 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 Robert J. Burson, Division of Enforcement, Securities and Exchange Commission, 175 W. Jackson Blvd., Suite 900, Chicago, IL, 60604.

C. Respondent Hornbogen shall pay disgorgement of $15,592, prejudgment interest of $3,467, and civil penalties of $25,000 (as well as post-order interest on any amounts not paid within 30 days), to the Securities and Exchange Commission. Payment shall be made in the following installments:

(1) $10,000 within 30 days of the entry of this Order;
(2) $5,676, plus applicable post-order interest, within 180 days of the entry of this Order;
(3) $5,676, plus applicable post-order interest, within 360 days of the entry of this Order;
(4) $5,676, plus applicable post-order interest, within 540 days of the entry of this Order;
(5) $5,676, plus applicable post-order interest, within 720 days of the entry of this Order;
(6) $5,676, plus applicable post-order interest, within 900 days of the entry of this Order; and
(7) $5,679, plus applicable post-order interest, within three years of the entry of this Order.

If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of 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. 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) if paid by money order or check, such payment shall be hand-delivered or overnight mailed to Enterprise Services Center, HQ Bldg, Room 181, AMZ-341, 6500 South MacArthur Blvd, Oklahoma City, OK 73169; and (D) submitted under cover letter that identifies Gina M. Hornbogen 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 Robert J. Burson, Division of Enforcement, Securities and Exchange Commission, 175 W. Jackson Blvd., Suite 900, Chicago, IL, 60604.

D. Based upon Respondent Hornbogen's sworn representations in her Statements of Financial Condition dated August 17, 2011 and April 25, 2012 and other documents submitted to the Commission, the Commission is not imposing a penalty against Respondent Hornbogen greater than $25,000.

E. The Division of Enforcement ("Division") may, at any time following the entry of this Order, petition the Commission to: (1) reopen this matter to consider whether Respondent Hornbogen 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 Hornbogen was fraudulent, misleading, inaccurate, or incomplete in any material respect. Respondent Hornbogen 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.

F. Pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002, as amended, a Fair Fund is created for the disgorgement, interest and/or penalties referenced in paragraphs B and C above. Regardless of whether any such Fair Fund distribution is made, amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondents agree that in any Related Investor Action, they shall not argue that they are entitled to, nor shall they benefit by, offset or reduction of any award of compensatory damages by the amount of any part of Respondents' payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Respondent agrees that they shall, within 30 days after entry of a final order granting the Penalty Offset, notify the

Commission's counsel in this action and pay the amount of the Penalty Offset to the United States Treasury or to a Fair Fund, as the Commission directs. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against Respondents by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

By the Commission.

Elizabeth M. Murphy
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. 67483 / July 20, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-11726

In the Matter of **FREMONT INVESTMENT ADVISORS, INC.** **Respondent.**	**ORDER DIRECTING DISBURSEMENT**

On May 12, 2010, the Commission issued a Notice of Proposed Plan of Distribution and Opportunity for Comment ("Notice") in connection with this proceeding (Exchange Act Release No. 62090) pursuant to Rule 1103 of the Commission's Rules on Fair Fund and Disgorgement Plans, 17 C.F.R. § 201.1103. No comments were received by the Commission in response to the Notice and on June 25, 2010, the Commission approved the proposed plan of distribution ("Plan") (Exchange Act Release No. 62381).

The Plan provides that a Fair Fund consisting of $4,146,000 in disgorgement and a civil penalty, plus any accrued interest, be transferred to U.S. Bank to be distributed by the Fund Administrator to eligible investors according to the methodology set forth in the Plan. The Plan provides that the Commission will arrange for distribution of the Fair Fund when a validated list of payees containing the information required to make the distribution has been received and accepted. A total amount of $4,663,245.18 was disbursed to investors beginning on October 28, 2010.[1]

The Plan further provides that any monies not distributed to investors may be distributed to the Fremont mutual funds harmed by marketing timing and late trading activity in proportion to the portion of overall harm each fund suffered.[2] Because there are

[1] *See* Exchange Act Release No. 63203 (Oct. 28, 2010).

[2] This amount is net of any tax reserve, which will remain in the account pending satisfaction of tax liabilities.

funds already at U.S. Bank from uncashed checks from the prior disbursement, a total of $764.03 should be transferred to U.S. Bank for the residual distribution.

Accordingly, it is ORDERED that the Commission staff shall transfer $764.03 of the Fair Fund to U.S. Bank and the Fund Administrator shall disburse the amount stated in the validated payment file of $688,000.00 as provided for in the Plan.

By the Commission.

Elizabeth M. Murphy
Secretary

Lynn M. Powalski

By: Lynn M. Powalski
Deputy Secretary

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Rel. No. 3438 / July 25, 2012

Admin. Proc. File No. 3-14190

In the Matter of

EVELYN LITWOK

ORDER DISMISSING PROCEEDING

On January 14, 2011, we issued an order instituting administrative proceedings ("OIP") against Evelyn Litwok pursuant to Section 203(f) of the Investment Advisers Act of 1940.[1] On August 4, 2011, an administrative law judge issued an initial decision (the "Initial Decision") in the administrative proceeding granting the Division of Enforcement's motion for summary disposition and barring Litwok from associating with an investment adviser.[2] Both Litwok and the Division petitioned for Commission review of the Initial Decision.

The OIP and the Initial Decision were based on a February 2009 judgment of conviction based on a jury verdict in the United States District Court for the Eastern District of New York finding Litwok guilty of one count of mail fraud and three counts of tax evasion, one each in tax years 1995, 1996, and 1997. Litwok appealed the convictions to the United States Court of Appeals for the Second Circuit. On April 30, 2012, while this administrative appeal was pending, the Second Circuit reversed the tax evasion convictions for tax years 1996 and 1997 and vacated and remanded the mail fraud and 1995 tax evasion convictions.[3] The Division and Litwok have filed motions to dismiss the administrative proceeding.

Advisers Act Section 203(f) authorizes us to determine whether a sanction, including a bar, is in the public interest based on findings that a person associated with an investment adviser has been convicted of certain crimes, including any felony involving mail fraud violations or any

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1 15 U.S.C. § 80b-3(f).

2 Initial Decision Rel. No. 426 (Aug. 4, 2011), 101 SEC Docket 44551.

3 *United States v. Litwok*, 678 F.3d 208 (2d Cir. Apr. 30, 2012).

crime punishable by imprisonment for one or more years.[4] Under Section 202(a)(6), a conviction for purposes of the Advisers Act includes a verdict, judgment, or plea of guilty, or a finding of guilt on a plea of nolo contendere that "has not been reversed, set aside, or withdrawn."[5] Because the Second Circuit reversed or vacated each of the criminal convictions, the convictions may no longer serve as the basis for proceeding against Litwok under Section 203(f). We conclude that there is currently no basis for the proceeding under Advisers Act Section 203(f) and that it is appropriate to dismiss the proceeding.[6]

Accordingly, IT IS ORDERED that this proceeding be, and it hereby is, dismissed.

By the Commission.

Elizabeth M. Murphy
Secretary

Kevin M. O'Neill

By: Kevin M. O'Neill
Deputy Secretary

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4 15 U.S.C. § 80b-3(f), incorporating 15 U.S.C. §§ 80b-3(e)(2)(D) & (e)(3)(A).

5 15 U.S.C. § 80b-2(a)(6).

6 *See Terry Harris*, Investment Advisers Act Rel. No. 2622 (July 26, 2007), 91 SEC Docket 541, 543 (ordering dismissal of administrative proceeding based on finding that "none of the three bases for proceeding under Advisers Action Section 203(f) that were alleged in the OIP remains valid on the record before us on appeal"); *Jimmy Dale Swink, Jr.*, 52 S.E.C. 379, 379 (1995) (vacating findings and administrative bar order when an appellate court reversed the criminal conviction that was the basis for the proceeding).

Commissioner Gallagher not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 67510 / July 26, 2012

INVESTMENT ADVISERS ACT OF 1940
Release No. 3439 / July 26, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14962

In the Matter of Wesley Capital Management, LLC, 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 Wesley Capital Management, LLC ("Wesley" or "Respondent").

II.

In anticipation of the institution of these proceedings, Wesley 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 Wesley and the subject matter of these proceedings, which are admitted, Wesley 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 Wesley'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 Wesley. Wesley was at all relevant times the investment adviser to multiple hedge funds and one managed account. On two occasions in April 2009, Wesley violated Rule 105 of Regulation M by purchasing securities in public offerings by Duke Realty Corporation ("Duke") and Host Hotels & Resorts, Inc. ("Host") after having sold short the securities of both of these issuers during the five business days prior to the pricing of the public offerings. By participating in these offerings, Wesley realized profits of $142,124.

Respondent

2. Wesley is a Delaware limited liability company located in New York, New York. The firm has been registered with the Commission as an investment adviser since March 30, 2009 and managed approximately $253 million in investor assets as of January 31, 2012.

Other Relevant Entities

3. Duke is a publicly traded real estate investment trust headquartered in Indianapolis, Indiana. Duke's stock is registered pursuant to Section 12(b) of the Exchange Act and listed on the New York Stock Exchange.

4. Host is a publicly traded real estate trust investment headquartered in Bethesda, Maryland. Host's stock is registered with the Commission pursuant to Section 12(b) of the Exchange Act and listed on the New York Stock Exchange.

Respondent's Violations of Regulation M

5. Rule 105 of Regulation M of the Exchange Act provides, in pertinent part:

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

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

17 C.F.R. § 242.105(a)(1) and (a)(2) (effective October 9, 2007).

6. Rule 105 of Regulation M is designed to protect the independent pricing mechanism of the securities market shortly before follow-on or secondary offerings. Rule 105 is a prophylactic provision and prohibits the conduct irrespective of the seller's intent. Pursuant to amendments that became effective in October 2007, it is not required that the shares purchased in the offering be used to "cover" the restricted period short sales for there to be a violation of Rule 105. Short Selling in Connection with a Public Offering, Rel. No. 34-56206, 72 Fed. Reg. 45094 (August 10, 2007) (effective October 9, 2007).

7. On Thursday, April 9, 2009, and on Wednesday, April 15, 2009, five of the funds advised by Wesley sold short a total of 460,000 shares of Duke stock at prices ranging from $7.59 to $8.22 per share.

8. On Wednesday, April 15, 2009, Duke stock closed at $8.44. On Thursday, April 16, 2009, before the trading markets opened, Duke priced a follow-on offering of its stock at $7.65 per share. The registered shares were offered to the public through a group of underwriters on a firm-commitment basis. Accordingly, the Rule 105 restricted period ran from Thursday, April 9, 2009 through Wednesday, April 15, 2009.

9. On Thursday, April 16, 2009, the same five funds advised by Wesley that had sold Duke short, purchased 225,000 shares in the follow-on offering at $7.65 per share. Wesley therefore realized an unlawful profit of $82,027 by participating in the Duke offering after having shorted Duke stock during the Rule 105 restricted period.

10. On Thursday, April 23, 2009, five of the funds advised by Wesley sold short a total of 950,000 shares of Host stock at prices ranging from $6.98 to $7.55 per share.

11. On Thursday, April 23, 2009, Host stock closed at $7.10 per share. On Friday, April 24, 2009, before the trading markets opened, Host priced a follow-on offering of its stock at $6.60 per share. The registered shares were offered to the public through a group of underwriters on a firm-commitment basis. Accordingly, the Rule 105 restricted period ran from Friday, April 17, 2009, through Thursday, April 23, 2009.

12. On Friday, April 24, 2009, the same five funds advised by Wesley that had sold Host short, purchased 125,000 shares in the follow-on offering at $6.60 per share. Wesley therefore realized an unlawful profit of $60,097 by participating in the Host offering after having shorted Host stock during the Rule 105 period.

13. After the conduct described above, Wesley developed and implemented policies and procedures pertaining to compliance with Rule 105 of Regulation M.

Violations

14. As a result of the conduct described above, Wesley willfully[1] committed violations of Rule 105 of Regulation M.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Wesley'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 Wesley cease and desist from committing or causing any violations and any future violations of Rule 105 of Regulation M of the Exchange Act.

B. Respondent Wesley is censured.

C. Respondent shall, within 20 days of the entry of this Order, pay disgorgement of $142,124, prejudgment interest of $15,165, and a civil penalty of $75,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600 or pursuant to 31 U.S.C. §3717.

Payment must be made in one of the following ways:

(1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
(2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm; or
(3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

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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)).

Payments by check or money order must be accompanied by a cover letter identifying Wesley as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to George N. Stepaniuk, Assistant Regional Director, Division of Enforcement, Securities and Exchange Commission, 3 World Financial Center, Room 400, New York, NY 10281.

By the Commission.

Elizabeth M. Murphy
Secretary

Lynn M. Powalski

By: Lynn M. Powalski
Deputy Secretary

Commissioner Gallagher
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 67512 / July 26, 2012

INVESTMENT ADVISERS ACT OF 1940
Release No. 3440 / July 26, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14963

In the Matter of

PETER MADOFF,

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 Peter Madoff ("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, Respondent consents to the Commission's jurisdiction over him and the subject matter of these proceedings and 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. Respondent was a long-time employee of Bernard L. Madoff Investment Securities LLC ("BMIS"), and an attorney. After graduating from law school in 1970, Respondent became the firm's chief compliance officer ("CCO") and Senior Managing Director. Respondent was also the lead trader in BMIS's market making and proprietary trading operations for a significant period of time. He has held several securities licenses, including Series 1 (general securities representative), Series 4 (options), and Series 55 (equity trader). Respondent, 66 years old, is a resident of Old Westbury, New York.

2. BMIS registered with the Commission as a broker-dealer in 1960 and as an investment adviser in August 2006, and had its principal place of business in New York, New York. BMIS purportedly engaged in three different operations – investment advisory ("IA") operations, market-making, and proprietary trading. BMIS is currently under the control of a trustee appointed pursuant to the Securities Investor Protection Act of 1970 (15 U.S.C. § 78aaa et seq.).

3. On June 29, 2012, Respondent pleaded guilty to (1) conspiracy to (a) commit securities fraud; (b) falsify records of an investment adviser; (c) falsify records of a broker-dealer; (d) make false filings with the Commission; (e) commit mail fraud; (f) falsify statements in relation to documents required by ERISA; and (g) obstruct and impede the lawful governmental function of the IRS; and (2) falsifying records of an investment adviser, in United States v. Peter Madoff, 10 Cr. 228 (SDNY) (LTS).

4. The information to which Respondent pleaded guilty alleged, *inter alia*, that:

> (a) Bernard L. Madoff, Respondent's brother and the sole owner of BMIS, engaged in a long-standing Ponzi scheme through the firm. While Bernard L. Madoff promised to clients and prospective clients that he would invest their money in shares of common stock, options, and other securities of well-known corporations, he never invested the client funds in the securities as he promised.
>
> (b) Respondent created false and misleading entries in numerous documents at BMIS that were designed to make it appear that Respondent performed various compliance reviews of BMIS's IA operations and that BMIS maintained an effective compliance program. Respondent's false and misleading statements made it appear to regulators and the firm's advisory clients that BMIS actually had a CCO who performed required compliance functions, when in reality Respondent did nothing of the sort;

(c) Respondent also created annual reports in or about 2006 and 2007 pursuant to NASD Rules 3012 and 3013 which falsely stated that he had performed a comprehensive compliance review of all aspects of BMIS's operations, including its IA Operations;

(d) from at least in or about 2006 through 2008, Respondent represented to the firm's investment advisory clients that he was the CCO for the IA operations;

(e) from August 2006 through 2008, Respondent created and caused to be filed with the SEC false and misleading Forms ADV; and

(f) in or about December 2008, after Respondent learned that BMIS could not meet redemption requests, and shortly before BMIS collapsed, Respondent reviewed lists reflecting preferred employees, family members, and certain other IA clients and, with Bernard L. Madoff, decided who should receive BMIS's remaining funds and caused checks to be prepared for these selected clients. The firm collapsed before these checks were mailed.

IV.

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

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

By: Lynn M. Powalski
Deputy Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 67514 / July 26, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-13454

In the Matter of **HENNESSEE GROUP LLC and CHARLES J. GRADANTE,** **Respondents.**	**ORDER DIRECTING DISBURSEMENT OF FAIR FUND**

On February 11, 2011, the Commission published a "Notice of Proposed Plan of Distribution and Opportunity for Comment" ("Notice") in connection with this proceeding pursuant to Rule 1103 of the Commission's Rules on Fair Funds and Disgorgement Plans, 17 C.F.R. § 201.1103 (Exchange Act Rel. No. 63890). The Notice advised parties that they could obtain a copy of the proposed Distribution Plan at www.sec.gov. The Notice also advised that all persons desiring to comment on the Distribution Plan could submit their comments, in writing, no later than 30 days from the date of the Notice. No comments were received by the Commission in response to the Notice. On March 31, 2011, the Commission issued an Order Approving Plan and Appointing a Fund Administrator (Exchange Act Rel. No. 64156).

The Distribution Plan provides that the Commission will arrange for distribution of the Fair Fund through the United States Department of Treasury's Financial Management System when a validated electronic payment file, listing the payees with the identification information required to make the distribution, has been received and accepted by the staff. The validated electronic payment file has been received and accepted for the disbursement of $504,619.82.

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Accordingly, it is ORDERED that the Commission staff shall disburse the Fair Fund in the amount stated in the validated electronic payment file of $504,619.82, as provided for in the Distribution Plan.

By the Commission.

Elizabeth M. Murphy
Secretary

By: Lynn M. Powalski
Deputy Secretary

Commissioner Aguilar,
Commissioner Gallagher
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9343 / July 27, 2012

SECURITIES EXCHANGE ACT OF 1934
Release No. 67526 / July 27, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14863

In the Matter of UBS FINANCIAL SERVICES INC. OF PUERTO RICO Respondent.	ORDER EXTENDING THE TIME BY WHICH UBS PR SHALL SUBMIT TO THE COMMISSION THE FINDINGS OF THE INDEPENDENT CONSULTANT MAKING RECOMMENDATIONS FOR ANY CHANGES IN OR IMPROVEMENTS TO UBS PR'S POLICIES, PROCEDURES, AND PRACTICES, AND A PROCEDURE FOR IMPLEMENTING SUCH RECOMMENDED CHANGES

I.

On May 1, 2012, the Commission issued an Order Instituting Administrative And Cease-And-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 and Sections 15(b) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-And-Desist Order ("Order") against Respondent UBS Financial Services Inc. of Puerto Rico ("UBS PR"), Securities Act Rel. No. 9318, Securities Exchange Act Rel. No. 66893 (May 1, 2012).

Among other things, UBS PR undertook to retain an independent third-party consultant, not unacceptable to the Commission staff, to review UBS PR's closed-end fund disclosures and trading and pricing policies, procedures, and practices for adequacy. And after such review, which UBS PR shall require to be completed within ninety days of the issuance of the Order, UBS PR was ordered to submit to the Commission, the findings of the independent consultant making recommendations for any changes in or improvements to UBS PR's policies, procedures, and practices, and a procedure for implementing such recommended changes.

Additional time is necessary for an independent consultant to conduct its review. UBS PR has consented to submit the findings of the independent consultant within 120 days of UBS PR's retention of the independent consultant.

II.

Accordingly, IT IS ORDERED that:

A. The time for UBS PR to submit to the Commission, the findings of the independent consultant making recommendations for any changes in or improvements to UBS PR's policies, procedures, and practices, and a procedure for implementing such recommended changes independent third-party consultant, has been extended to 120 days after the date of UBS PR's retention of an independent consultant.

B. Upon good cause being shown, the staff of the Commission may grant UBS PR such additional time as the staff deems necessary, not to exceed 90 additional days, for the independent consultant to complete its review or for UBS PR to submit to the Commission the independent consultant's report and recommendations, if any.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Commissioner Walter
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 67524 / July 27, 2012

Administrative Proceeding
File No. 3-13714

In the Matter of Ark Asset Management Co., Inc. Respondent.	ORDER DIRECTING DISBURSEMENT OF DISGORGEMENT FUND

On January 6, 2011, the Commission issued a "Notice of Proposed Plan of Distribution and Opportunity for Comment" ("Notice") in connection with this proceeding pursuant to Rule 1103 of the Commission's Rules on Fair Fund and Disgorgement Plans, 17 C.F.R. §201.1103 (Exchange Act Rel. No. 63666). The Notice advised parties that they could obtain a copy of the proposed Distribution Plan at www.sec.gov. The Notice also advised that all persons desiring to comment on the Distribution Plan could submit their comments, in writing, no later than 30 days from the date of the Notice. No comments were received by the Commission in response to the Notice. On March 1, 2011, the Commission issued an Order Approving Distribution Plan and Appointing a Plan Administrator (Exchange Act Rel. No. 63993).

The Distribution Plan provides that the Commission will arrange for distribution of the Disgorgement Fund through the United States Department of Treasury's Financial Management System when a validated electronic payment file listing the payees with the identification information required to make the distribution has been received from the Plan Administrator and accepted by the staff. The validated electronic payment file has been received and accepted for the disbursement of $740,617.

Accordingly, it is ORDERED that the Commission staff shall disburse the Disgorgement Fund in the amount stated in the validated electronic payment file of $740,617, as provided for in the Distribution Plan.

By the Commission.

Elizabeth M. Murphy
Secretary

Kevin M. O'Neill

By: Kevin M. O'Neill
Deputy Secretary

Commissioner Aguilar, Commissioner Gallagher not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9347 / July 30, 2012

SECURITIES EXCHANGE ACT OF 1934
Release No. 67534 / July 30, 2012

In the Matter of **MIZUHO FINANCIAL GROUP, INC.** **Respondent.**	**ORDER UNDER SECTION 27A(b) OF THE SECURITIES ACT OF 1933 AND SECTION 21E(b) OF THE SECURITIES EXCHANGE ACT OF 1934, GRANTING WAIVERS OF THE DISQUALIFICATION PROVISIONS OF SECTION 27A(b)(1)(A)(ii) OF THE SECURITIES ACT OF 1933 AND SECTION 21E(b)(1)(A)(ii) OF THE SECURITIES EXCHANGE ACT OF 1934 AS TO MIZUHO FINANCIAL GROUP, INC. AND ITS AFFILIATES**

Mizuho Financial Group Inc. ("MHFG") has submitted a letter on behalf of itself and its affiliates, dated July 12, 2012, for a waiver of the disqualification provisions of Section 27A(b)(1)(A)(ii) of the Securities Act of 1933 (the "Securities Act") and Section 21E(b)(1)(A)(ii) of the Securities Exchange Act of 1934 (the "Exchange Act") arising from the settlement of a civil injunctive action brought by the Commission against a subsidiary of MHFG known as Mizuho Securities USA, Inc. ("Mizuho").

On July 18, 2012, the Commission filed civil injunctive action against Mizuho, a registered broker-dealer. In its complaint, the Commission alleged that certain former employees of Mizuho, in connection with the closing of a CDO transaction it arranged known as Delphinus CDO 2007-1 Ltd, obtained ratings for the CDO from Standard & Poor's Ratings Services ("S&P") by misleading S&P. The complaint alleges that Mizuho's employees provided S&P with a false portfolio not reflective of Delphinus's actual closing date portfolio in order to achieve advertised ratings targets. The complaint further alleges that Mizuho misled Delphinus investors by closing the transaction with ratings that were obtained through deception, and that Mizuho employees engaged in deceptive business practices to ensure that S&P would issue an effective date ratings agency confirmation letter to Delphinus. Based on these allegations, the Commission alleged that Mizuho violated Sections 17(a)(2) and 17(a)(3) of the Securities Act. Without admitting or denying the allegations, Mizuho consented to the entry of a final judgment that (i) permanently enjoins Mizuho from violating Sections 17(a)(2) and (a)(3) of the Securities Act, (ii) orders Mizuho to pay disgorgement of $10,000,000 and prejudgment interest of $2,517,330, (iii) orders Mizuho to pay a civil money penalty of $115,000,000 and (iv) pursuant to Section 308 of the Sarbanes-Oxley Act of 2002, orders that the penalty may become part of a disgorgement fund for the benefit of the victims of Mizuho's misconduct (the "Final Judgment"). The Final Judgment was entered on July 26, 2012.

The safe harbor provisions of Section 27(A)(c) of the Securities Act and Section 21E(c) of the Exchange Act are not available for any forward looking statement that is "made with respect to the business or operations of an issuer, if the issuer . . . during the 3-year period preceding the date on which the statement was first made . . . has been made the subject of a judicial or administrative decree or order arising out of a governmental action that (I) prohibits future violations of 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 MHFG's letter, the Commission has determined that, under the circumstances, the request for a waiver of the disqualifications resulting from the entry of the order instituting proceedings 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 Mizuho Financial Group, Inc. and its affiliates resulting from the entry the Final Judgment against Mizuho is hereby granted.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Commissioner Aguilar
Commissioner Gallagher
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9346 / July 30, 2012

In the Matter of **MIZUHO SECURITIES USA, INC.,** **Respondent.**	**ORDER UNDER RULE 602(e) OF THE SECURITIES ACT OF 1933, GRANTING A WAIVER OF THE DISQUALIFICATION PROVISIONS OF RULE 602(b)(4) AND 602(c)(2) AS TO MIZUHO SECURITIES USA, INC.**

Mizuho Securities USA, Inc. ("Mizuho") has submitted a letter, dated July 12, 2012, for a waiver of the disqualification from the exemption under Regulation E arising from its settlement of a civil injunctive proceeding filed against it by the Commission on July 18, 2012. On July 26, 2012, pursuant to an offer of settlement by Mizuho, a Final Judgment was entered against Mizuho in District Court ("Final Judgment"). Under the Final Judgment, Mizuho was enjoined from violating Sections 17(a)(2) and (a)(3) of the Securities Act of 1933 (the "Securities Act").

The Final Judgment (i) permanently enjoined Mizuho from violating Sections 17(a)(2) and (a)(3) of the Securities Act, (ii) ordered Mizuho to pay disgorgement of $10,000,000 and prejudgment interest of $2,517,330, (iii) ordered Mizuho to pay a civil money penalty of $115,000,000, and (iv) established a Fair Fund pursuant to Section 308 of the Sarbanes-Oxley Act of 2002 to distribute the penalty and disgorgement to victims of Mizuho's misconduct.

Rule 602(c)(2) under the Securities Act provides that the Regulation E exemption is not available for the securities of a small business investment company or business development company issuer if any of its principal security holders or any investment adviser or underwriter of the securities to be offered "is temporarily or permanently restrained or enjoined by any court from engaging in or continuing to engage in any conduct or practice in connection with the purchase or sale of any security arising out of such person's conduct as an underwriter, broker, dealer, or investment adviser." Rule 602(b)(4) of the Securities Act provides that the exemptions contained in Regulation E are unavailable if, among other things, the issuer or an affiliate "is subject to any order, judgment, or decree of any court of competent jurisdiction … 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." The Commission may waive these disqualifications upon a showing of good cause. *See* Rule 602(e).

Based on the representations set forth in the request made by Mizuho, the Commission has determined that a showing of good cause has been made pursuant to Rule 602(e) and that the request for a waiver of the disqualification should be granted.

Accordingly, **IT IS ORDERED**, pursuant to Rule 602(e) under the Securities Act, that a waiver from the application of the disqualification provisions of Rule 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 Paredes not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 67530 / July 30, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14858

In the Matter of LocatePlus Holdings Corporation Respondent.	ORDER MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS AND REVOKING REGISTRATION OF SECURITIES PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934

I.

On April 30, 2012, the Securities and Exchange Commission ("Commission") instituted administrative proceedings pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against LocatePlus Holdings Corporation ("LocatePlus" or "Respondent").

II.

In response to these proceedings, Respondent has submitted an Offer of Settlement ("Offer"), which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over 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 Revoking Registration of Securities Pursuant to Section 12(j) of the Securities Exchange Act of 1934 as set forth below.

III.

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

A. RESPONDENT

1. LocatePlus (CIK No. 0001160084) is a Delaware corporation located in Beverly, Massachusetts that provides online access to public record databases for investigative searches. LocatePlus has a class of securities that is registered with the Commission pursuant to Section 12(g) of the Exchange Act and, until trading was suspended on April 30, 2012, was currently quoted under the symbol LPHCQ.PK on OTC Link operated by OTC Markets Group Inc. LocatePlus' fiscal year ends on December 31 and it files as a smaller reporting company. On June 17, 2011, LocatePlus filed a Form 8-K reporting that it and its subsidiaries had filed a voluntary petition under Chapter 11 of the U.S. Bankruptcy Code in the U.S. Bankruptcy Court for the District of Massachusetts.

B. MATERIAL DEFICIENCIES AND DELINQUENT FILINGS

1. Respondent is delinquent in its periodic filings with the Commission. In particular, LocatePlus filed a materially deficient Form 10-K for the 2010 fiscal year, filed a materially deficient Form 8-K on May 3, 2011, and filed a materially deficient Form 10-Q for the first quarter of 2011. In addition, LocatePlus failed to file Forms 10-Q for the second and third quarters of 2011.

2. On April 14, 2011, LocatePlus filed a Form 10-K that contained financial statements for the fiscal year ended December 31, 2010. The financial statements contained in this Form 10-K are unaudited and the filing was materially deficient because Respondent's independent accountant issued a qualified audit opinion on those financial statements.

3. On May 3, 2011, LocatePlus filed a Form 8-K to report a change in its independent accountant. This filing was materially deficient because Respondent failed to address certain items required by Regulation S-K Item 304, which pertains to mandatory disclosures when reporting changes in and disagreements with accountants on accounting and financial disclosure. Specifically, LocatePlus did not provide any information in the Form 8-K concerning whether it had (i) any disagreements with its terminated accountant, (ii) any reportable events that had occurred between the date of its last audited financial statements and the date it terminated its prior accountant, or (iii) any consultations with its new independent accountants about any such disagreements with the prior accountants or any reportable events.

4. On May 6, 2011, LocatePlus filed a Form 10-Q to report its financial results for the first quarter of 2011 (the quarter ended March 31, 2011) that compared current financial results with those from fiscal 2010, which were unaudited. This filing was materially deficient

[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.

because Respondent's independent accountant did not review the filing in conjunction with audited financial statements for the prior fiscal year.

5. To date, the deficiencies in the Form 10-K filed on April 14, 2011, Form 8-K filed on May 3, 2011, and Form 10-Q filed on May 6, 2011 have not been cured.

6. LocatePlus is delinquent in filing its other recent required periodic reports since the Form 10-Q for the quarter ended March 31, 2011.

7. Section 13(a) of the Exchange Act and the rules promulgated thereunder require issuers of securities registered pursuant to Section 12 of the Exchange Act to file with the Commission current and accurate information in periodic reports. Specifically, Rule 13a-1 requires issuers to file annual reports (Forms 10-K or 10-KSB), Rule 13a-11 requires issuers to file current reports (Form 8-K), and Rule 13a-13 requires issuers to file quarterly reports (Forms 10-Q or 10-QSB).

8. Section 13(a)(2) of the Exchange Act requires annual reports to be certified by independent public accountants if required by the rules and regulations of the Commission.

9. Rule 8-02 under Article 8 of Regulation S-X requires smaller reporting companies following the end of their fiscal year to file an audited balance sheet, and statements of income and cash flows.

10. Rule 8-03 under Article 8 of Regulation S-X requires smaller reporting companies to file interim financial statements with a balance sheet as of the end of the issuer's preceding fiscal year.

11. Items 304(a)(1)(iv) and 304(a)(1) (v) of Regulation S-K require a reporting company to disclose, when reporting a change in its independent accountant, whether there were any disagreements or reportable events for the two most recent fiscal years, or any subsequent interim period, before the termination of the prior independent accountant.

12. Item 304(a)(2) of Regulation S-K requires a reporting company to disclose, if it engaged a new independent accountant within the company's two most recent fiscal years, or any subsequent interim period, information about certain consultations with its newly-engaged accountants, including consultations about disagreements with the company's former accountants and reportable events.

13. As a result of its violation of Rules 8-02 and 8-03 of Article 8 of Regulation S-X and Items 304(a)(1)(iv), 304(a)(1)(v) and 304(a)(2) of Regulation S-K, Respondent failed to comply with Section 13(a) of the Exchange Act and Rules 13a-1, 13a-11 and 13a-13 thereunder.

IV.

Section 12(j) of the Exchange Act provides as follows:

The Commission is authorized, by order, as it deems necessary or appropriate for the protection of investors to deny, to suspend the effective date of, to suspend for a period not exceeding twelve months, or to revoke the registration of a security, if the Commission finds, on the record after notice and opportunity for hearing, that the issuer of such security has failed to comply with any provision of this title or the rules and regulations thereunder. No member of a national securities exchange, broker, or dealer shall make use of the mails or any means of instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security the registration of which has been and is suspended or revoked pursuant to the preceding sentence.

In view of the foregoing, the Commission finds that it is necessary and appropriate for the protection of investors to impose the sanction specified in Respondent's Offer.

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

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9344 / July 30, 2012

SECURITIES EXCHANGE ACT OF 1934
Release No. 67531 / July 30, 2012

INVESTMENT COMPANY ACT OF 1940
Release No. 30157 / July 30, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14964

In the Matter of **PETER DONG ZHOU,** **Respondent.**	**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, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), Sections 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 Peter Dong Zhou ("Respondent" or "Zhou").

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, Sections 15(b) and 21C of the Securities Exchange Act of 1934, and Section 9(b) of the Investment Company Act of 1940 ("Order"), as set forth below.

III.

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

Summary

These proceedings arise out of Respondent's conduct surrounding his 2007 to 2009 relationship with China Yingxia International, Inc. ("China Yingxia" or the "Company"), a Chinese reverse merger company, for which Respondent's registered broker-dealer, American Union Securities, Inc. ("American Union"), acted as a placement agent and helped raise over $10 million from American investors, and ultimately Respondent became an insider responsible for the Company's periodic investor communications. Zhou effectively used American Union to assist his unregistered father to conduct offerings for China Yingxia, and engage other unregistered persons to solicit investors. Zhou also participated in the unregistered distribution and sale of restricted securities of China Yingxia, facilitating the Company's payment of so-called consultants. During the course of Zhou's relationship with China Yingxia, he reviewed and filed annual and quarterly reports; reviewed and issued press releases; and helped the Company retain a chief financial officer, directors, legal counsel, auditors, investor relations firms, and various "consultants." All the while, Zhou was privy to China Yingxia's material, non-public information. In early 2009, when Zhou learned that China Yingxia faced serious problems and was essentially near collapse, he used this material, non-public information for his own benefit by depositing China Yingxia shares into his brokerage account and almost immediately selling the securities, all before the stock price ultimately collapsed and the Company ceased operations.

Zhou's conduct violated Sections 5(a), 5(c), and 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. Further, Zhou aided and abetted violations of Section 15(a) of the Exchange Act.

Respondent

1. Zhou, age 30, resides in New York, New York. Zhou was a registered representative and served as president of American Union, formerly a registered broker-dealer based in New York, New York. During the relevant period, Zhou held series 7, 24, 55, and 63 securities 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.

Other Relevant Entities

2. American Union is a New York corporation formerly registered with the Commission as a broker-dealer from approximately June 2004 until November 2010. The firm is no longer in operation. While in existence, the firm provided investment banking and other services to Chinese companies seeking financing from or access to the U.S. capital markets.

3. China Yingxia was a Florida corporation headquartered in Harbin, China with purported operations in China. China Yingxia's stock was quoted on the OTC Link (formerly "Pink Sheets") operated by OTC Markets Group, Inc. under the symbol "CYXI." On February 2, 2012, the Commission instituted administrative proceedings pursuant to Section 12(j) of the Exchange Act against China Yingxia, as the Company had not filed any periodic reports with the Commission since late 2008. By an Order dated March 7, 2012, each class of China Yingxia's registered securities was revoked.

Background

China Yingxia

4. From at least 2007 through 2009, Zhou and his father, who runs a consulting firm specializing in work with Chinese companies ("Consulting Firm"), helped numerous companies become public in the United States through reverse mergers with publicly-traded shell companies.

5. The Consulting Firm had overlapping business with American Union, and nearly always worked with the same Chinese companies, including China Yingxia. Zhou's father, who was the principal of the Consulting Firm, provided startup capital to and shared office space with, and further directed and/or controlled certain activities of, American Union. Zhou's father often presented himself as Chairman of American Union, and held an ownership interest in the firm. Zhou's father was not, however, registered as a broker, nor was he associated with any registered broker-dealer.

6. In mid-2006, with assistance from Zhou and his father, China Yingxia added itself to the long list of companies in recent years that have become public in the United States via reverse merger. China Yingxia purported to be a nutritional food business focusing on products based on cactus, millet, rice, and soybean. China Yingxia's chief executive officer and her family held around 50% of the outstanding shares, and the CEO's son served as a director of the Company.

7. After completion of the reverse merger in May 2006 and until the Company's eventual demise around March 2009, Zhou maintained a prominent role with China Yingxia.

8. Alongside his father, Zhou performed for China Yingxia virtually all tasks required of a public company. In addition to assisting with the reverse merger, Zhou worked with the Company's chief executive officer, oversaw the interviewing and hiring of the Company's CFO (and after his hiring worked closely with him) as well as the appointment of

several new directors who were contacts of Zhou's father. Additionally, Zhou prepared or worked on the Company's filings with the Commission and its press releases; and for the few board meetings that took place, Zhou organized calls, set the agenda, and participated in the meetings. Further, Zhou helped retain U.S. service providers, including an investor relations firm, auditors and lawyers, and managed, if not controlled, those relationships for the Company. Zhou also intimately worked with certain so-called consultants, as described below.

9. Zhou's work with the Company provided him access to material, non-public information concerning the Company and its management and operations.

First China Yingxia Private Placement July 2007

10. By early 2007, China Yingxia sought to raise approximately $6.5 million for working capital and other corporate purposes, including purchasing materials related to a soybean production line.

11. In April 2007, the Company held a road show in New York City, meeting with various fund managers and others that frequently invested in Chinese reverse merger companies. Assisted by one of the Company's service providers, the Company's CEO and Zhou, among others, went on the road show to meet with potential investors, including a well-known fund manager that invested heavily in U.S. listed Chinese companies ("Fund Manager"), and a registered representative of a broker-dealer ("Broker").

12. After the road show, Zhou and his father helped the Company negotiate investment terms with the Fund Manager and one of his associates ("Lead Investors"). The terms included, among other things, the price, investment amounts, closing date, and payment to the Lead Investors for certain services.

13. As negotiations concluded, the Lead Investors entered into consulting agreements to pay them for the due diligence they conducted in conjunction with their investments. The due diligence was later used in efforts to sell China Yingxia to other investors in a subsequent PIPE or private investment in public equity transaction. The Lead Investors invested a total of $2 million in July 2007, marking the close of China Yingxia's first capital raise in the U.S.

Issuance of Shares from CEO's Father

14. In late June and early July 2007, the Lead Investors entered into consulting agreements with an unnamed and, at the time, unknown shareholder of China Yingxia, to compensate for due diligence services supposedly already provided to the Company.

15. The consulting agreements included payment of 250,000 restricted shares of China Yingxia that had been issued in connection with the Company's May 2006 reverse merger. Zhou and his father negotiated and facilitated the execution of the agreements.

16. On August 1, 2007 – almost one month after execution of the agreements – Zhou identified the unnamed shareholder, who was supposedly the counterparty to the agreements. The unnamed shareholder was China Yingxia's CEO's father.

17. Neither of the Lead Investors rendered any services to the CEO's father. As facilitated by Zhou, the CEO's father transferred his restricted shares to the Lead Investors. The CEO's father was a person directly or indirectly controlled by the issuer, China Yingxia. The CEO's father's restricted shares were transferred to the Lead Investors at the apparent direction of the Company. Further, the CEO's father apparently was not reimbursed by the Company for his shares.

18. In the same communication identifying the unnamed shareholder, Zhou provided the Lead Investors with instructions for obtaining an opinion pursuant to Rule 144 under the Securities Act to lift the restrictions on the 250,000 shares, and thus render the shares freely tradeable. While Zhou knew that no services were provided to the CEO's father – as he had only then identified the CEO's father as a party to the agreements – he relayed advice to the Lead Investors that, "if the shares were received as compensation for work done for the Company then [counsel] could not give the 144 legal opinion to lift the restriction, but if the shares were compensatoin [sic] for work done for the shareholder, then this is none [sic] issue."

19. After holding the securities for only a short time, the Lead Investors sold the shares purportedly pursuant to Rule 144 under the Securities Act. At the time, although the shares had been held by the CEO's father for more than one year, they were not eligible for immediate resale. The CEO's father could not legitimately rely on any exemption from registration of such securities given his relationship to the Company. The CEO's father was an "issuer" as that term is defined in the definition of "underwriter" in Section 2(a)(11) of the Securities Act. Those who received shares from the CEO's father, therefore, received restricted shares and were also deemed "underwriters" when they sold such shares. Moreover, the Lead Investors did not meet the requirements for sale under Rule 144, and the transaction to compensate them operated to evade the registration requirements of the Securities Act.

Second China Yingxia Private Placement August 2007 and Illicit Payments to Unregistered Brokers

20. The Company soon embarked on a second capital raise. Although American Union acted as the official placement agent for China Yingxia's second private placement, Zhou's father and three "consultants" provided key introductions and solicited most of the investors. It appears that American Union and Zhou's role in the PIPE was largely limited to certain administrative tasks, leaving the main task of raising money to Zhou's father and the three "consultants."

21. In addition, the "consultants" reviewed and/or circulated deal documents, commented on the terms of the investment, and facilitated the PIPE closing, all in exchange for previously agreed-upon transaction-based compensation stemming from the amount of money China Yingxia raised. One of the "consultants," the Fund Manager, assisted the Company,

including by hosting a meeting with potential investors at a shared conference room in the Fund Manager's office building. The other "consultants," the Broker, whom the Company met on its road show, and one of the Company's service providers, an investor relations firm ("IR Firm"), also assisted with introductions in person or via email. No disclosures were made to any investors concerning any payments to the "consultants."

22. With the exception of the Broker – who conducted his activities away from his firm as it did not have knowledge of or opportunity to supervise his activities – the "consultants" were neither registered as or associated with any broker-dealer.

23. On August 9, 2007, China Yingxia announced the completion of a second round of financing whereby it sold $8,725,130 worth of restricted securities to 20 investors. Virtually all of the 20 investors were contacts of the Fund Manager, Broker, or the IR Firm.

24. Although the offering term sheet, which Zhou circulated to potential investors, provided that American Union, as placement agent, would receive a 13% fee for its services, in fact American Union received no such amount. Contrary to this statement, China Yingxia's agreements with American Union and the Consulting Firm outlined payments each would receive for various services; such agreements nowhere stated that American Union would receive a 13% fee for raising money. Instead, the Consulting Firm's agreement provided that it would receive a 13% PIPE fee. Zhou's father, the principal of the Consulting Firm, doled out money from this fee at his discretion, paying American Union 4%, or $349,005.20, and keeping the larger 9% share, or $785,261.80, for the Consulting Firm. Zhou's father further used this money to pay the three so-called consultants.

25. After the second financing closed in August 2007 and the amount raised became clear, the three "consultants" emailed Zhou and/or his father concerning payment. The Fund Manager emailed several times, stating on one occasion "we are due our share of money from the fund raise." The Broker emailed, "[a]re you going to send me docs to [sic] we can get paid on CYXI?" A principal of the IR Firm emailed, "[w]e are very pleased at ... the finalization of the ... raise. At this time I would like to either meet with you face to face or speak on the phone as to our consulting fee for the investors we introduced to CYXI . . . ."

26. In response to emails from the "consultants," Zhou's father, with Zhou's assistance, executed backdated consulting agreements with the three "consultants." In what appears to be an attempt to conceal the true nature of the services provided, the consulting agreements concerned supposed "strategic consulting services." The agreements stated that the consultants would provide to the Consulting Firm's clients certain services, including "assisting the company in press releases, conference calls, etc.; communicating with investors, accompanying investors to visit the facilities of the [Consulting Firm's] clients; and providing other consulting assistance."

27. Despite that description of the services, the "consultants" received transaction-based compensation for raising money for the Company, not for any consulting services. The Consulting Firm paid the three "consultants" a total of $533,500, and retained for itself almost

$252,000 after distributing those payments. The principal of the Consulting Firm paid with checks drawn from the Consulting Firm's bank account. The money used to pay the so-called consultants is directly traceable to investor money flowing into China Yingxia through the August 2007 private placement. The payments, which were almost exactly 5% of the amounts each "consultant" raised for the Company, were made to: (i) a firm tied to the Fund Manager, for payment of $107,500; (ii) the Broker's employer, a registered broker-dealer, for payment of $226,000; and (iii) the IR Firm, for payment of $200,000.

<u>Insider Trading in China Yingxia Ahead of Press Release</u>

28. Zhou continued to work with the Company well after the financings concluded. He coordinated with the CFO and others on public filings, and also worked with one of the Company's investor relations firms concerning press releases, among other things.

29. In late February 2009, China Yingxia began to experience difficulties relating to allegations of illegal activity involving the CEO. The Company's China-based management was unreachable and fell out of contact with Zhou, his father, and others. Before any news became publicly disseminated by the Company, the CEO sent a letter to the Fund Manager (who maintained a continuing role with the Company and its CEO) detailing serious issues facing China Yingxia, including her fundraising activity and that a factory was shut down as well as other issues affecting workers. The Fund Manager in turn sent the letter to Zhou and his father on February 19, 2009, stating that "[t]his would mean that you knew of all the problems … the closing of the … facility …."

30. Despite Zhou's role with the Company and access to the material, non-public information, on the same day, Zhou opened an individual brokerage account with American Union and deposited 104,514 shares of China Yingxia. Zhou sold his entire position days later on February 26-27, 2009 for approximate profits/loss avoidance of $20,900. Zhou executed no other transactions in the account.

31. On March 6, 2009, the Company issued a press release publicly disclosing problems concerning the CEO and China Yingxia. The press release stated, among other things, that certain disputes involving the CEO "adversely affected the normal operations" of the Company and that they "have caused … [a] shut down" to certain related operations. In response, the stock price declined by close to 70%. After the press release, the Company effectively collapsed. Recent reports indicate that Chinese officials have sentenced China Yingxia's CEO to death for illegal fundraising activities, similar to a Ponzi scheme, involving Chinese citizens.

Violations

32. As a result of the conduct described above, Zhou 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 or sale of securities and in connection with the purchase or sale of securities.

33. As a result of the conduct described above, Zhou willfully violated Sections 5(a) and 5(c) of the Securities Act, which make it unlawful for any person, directly or indirectly, to sell or to offer to sell a security for which a registration statement is not filed or not in effect or there is not an applicable exemption from registration.

34. As a result of the conduct described above, Zhou willfully aided and abetted violations of Section 15(a) of the Exchange Act, which makes it unlawful for any broker or dealer to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security, unless such broker or dealer is registered or associated with a registered 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 Zhou's Offer.

Accordingly, pursuant to Section 8A of the Securities Act, Sections 15(b) and 21C of the Exchange Act, and Section 9(b) of the Investment Company Act, it is hereby ORDERED that:

A. Respondent Zhou cease and desist from committing or causing any violations and any future violations of Sections 5(a), 5(c), and 17(a) of the Securities Act, Sections 10(b) and 15(a) of the Exchange Act, and Rule 10b-5 thereunder.

B. Respondent Zhou 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;
>
> prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter; and
>
> barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or

trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock,

with the right to apply for reentry after three (3) 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, within 30 days of the entry of this Order, pay disgorgement of $20,900, prejudgment interest of $2,463.39 and civil penalties of $50,000 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600 or pursuant to 31 U.S.C. § 3717. Payment must be made in one of the following ways:

(1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
(2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm; or
(3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Peter Dong Zhou as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Andrew M. Calamari, Acting Regional Director, Division of Enforcement, Securities and Exchange Commission, 3 World Financial Center, Suite 400, New York, NY 10281.

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

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9345 / July 30, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14966

In the Matter of JAMES FULD, JR., Respondent.	ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") against James Fuld, Jr. ("Respondent" or "Fuld").

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 8A of the Securities Act of 1933, 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

These proceedings arise out of Respondent's sales of unregistered securities in violation of Section 5 of the Securities Act during the period August 2007 through October 2007.

Respondent

1. Fuld, age 64, currently resides in New York, New York. During the relevant period, Fuld held the title of "President" of James Fuld Jr. Corp.

Other Relevant Entities

2. James Fuld Jr. Corp. ("Fuld Corp.") is a small business Fuld founded in 1979 to sponsor and finance the acquisition of medium-sized consumer product manufacturers and retailers.

3. China Yingxia International, Inc. ("China Yingxia" or the "Company") was a Florida corporation headquartered in Harbin, China with purported operations in China. China Yingxia's stock was quoted on the OTC Link (formerly "Pink Sheets") operated by OTC Markets Group, Inc. under the symbol "CYXI." On February 2, 2012, the Commission instituted administrative proceedings pursuant to Section 12(j) of the Securities Exchange Act of 1934 against China Yingxia, as the Company had not filed any periodic reports with the Commission since late 2008. By an Order dated March 7, 2012, each class of China Yingxia's registered securities was revoked.

Background

4. In or around late April to early May 2007, Fuld sought investment ideas from a well-known fund manager that invested in Chinese companies ("Fund Manager"). Fuld asked the Fund Manager whether he was doing any "PIPE" or private investment in public equity deals in the consumer product or retail industry. Fuld knew the Fund Manager as he had invested in one of the Fund Manager's funds dedicated to U.S. listed Chinese companies.

5. The Fund Manager, in response, introduced Fuld to China Yingxia, a Chinese reverse merger company purportedly involved in the sale of nutraceutical products. China Yingxia's chief executive officer and her family held around 50% of the outstanding shares, and the CEO's son served as a director of the Company. At the time, China Yingxia, through a registered broker-dealer and others, was soliciting investors for participation in a PIPE. The Company was seeking to raise working capital, including for purchasing materials related to a soybean production line.

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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.

6. In anticipation of a possible investment, which would be Fuld's first direct investment in a Chinese company, the Fund Manager and Fuld worked together to evaluate China Yingxia. Fuld and the Fund Manager conducted due diligence on the Company, including review of financial data, and research on franchisees. Additionally, the Fund Manager had communications with contacts in China concerning the Company.

7. After making their determination to invest, Fuld and the Fund Manager negotiated the investment terms with representatives of China Yingxia. In July 2007, Fuld invested $500,000 in his individual capacity, and the Fund Manager invested $1.5 million on behalf of two of his funds.

8. Representatives of China Yingxia negotiated to pay Fuld and the Fund Manager, the lead investors, for the due diligence they conducted in conjunction with their investments. The due diligence was later used by others in efforts to sell China Yingxia to investors in a subsequent PIPE transaction (which closed in August 2007 and raised approximately $8.7 million).

9. On June 29, 2007, Fuld, on behalf of Fuld Corp., entered into a consulting agreement with an unnamed and, at the time, unknown shareholder of China Yingxia, to compensate Fuld for the due diligence he conducted (the "Agreement"). The Fund Manager entered into a substantially identical agreement around the same time concerning the same due diligence. Neither Fuld nor the Fund Manager provided a written report to the Company or others reflecting the due diligence they performed.

10. The Agreement provided for payment to Fuld Corp. of 75,000 restricted shares of China Yingxia that had been issued in connection with the Company's May 2006 reverse merger. Representatives of China Yingxia negotiated and facilitated the execution of the Agreement.

11. On August 1, 2007 – almost one month after execution of the Agreement – China Yingxia representatives identified the unnamed shareholder, who was supposedly the counterparty to the Agreement. The representatives facilitated the transfer of the shareholder's shares to Fuld. Corp. Neither Fuld nor Fuld Corp. rendered any services to the shareholder, who was the CEO's father.

12. The CEO's father was a person directly or indirectly controlled by the issuer, China Yingxia. The CEO's father's restricted shares were transferred to Fuld Corp. at the apparent direction of the Company. Further, the CEO's father apparently was not reimbursed by the Company for his shares.

13. In the same communication identifying the unnamed shareholder, China Yingxia's representatives provided instructions for obtaining an opinion pursuant to Rule 144 under the Securities Act to lift the restrictions on the 75,000 shares, and thus render the shares freely tradeable. Although those Company representatives knew that no services were provided to the shareholder – as they had only then identified the CEO's father as a party to the Agreement – the representatives relayed advice to Fuld and the Fund Manager that, "if the shares were received as compensation for work done for the Company then [counsel] could not give the 144 legal opinion to

lift the restriction, but if the shares were compensatoin [sic] for work done for the shareholder, then this is none [sic] issue."

14. After holding the restricted securities for only a short time, beginning on or around August 13, 2007 and continuing through October 12, 2007, Fuld, on behalf of Fuld Corp., sold the 75,000 restricted shares purportedly pursuant to Rule 144 under the Securities Act, for proceeds of $178,594.85.

15. At the time, although the shares had been held by the CEO's father for more than one year, they were not eligible for immediate resale. The CEO's father could not legitimately rely on any exemption from registration of such securities given his relationship to the Company. The CEO's father was an "issuer" as that term is defined in the definition of "underwriter" in Section 2(a)(11) of the Securities Act. Those who received shares from the CEO's father, therefore, received restricted shares and were also deemed "underwriters" when they sold such shares. Moreover, Fuld Corp. did not meet the requirements for sale under Rule 144, and the transaction to compensate Fuld Corp., as arranged by China Yingxia representatives, operated to evade the registration requirements of the Securities Act.

16. There was no registration statement in effect for the shares that Fuld sold from August 13, 2007 to October 12, 2007.

Violations

17. As a result of the conduct described above, Fuld violated Sections 5(a) and 5(c) of the Securities Act, which make it unlawful for any person, directly or indirectly, to sell or to offer to sell a security for which a registration statement is not filed or not in effect or there is not an applicable exemption from registration.

Cooperation

In determining to accept the Offer, the Commission considered the cooperation afforded the Commission staff by Respondent.

IV.

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

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 8A of the Securities Act, Respondent Fuld cease and desist from committing or causing any violations and any future violations of Sections 5(a) and 5(c) of the Securities Act.

B. Respondent shall, within 30 days of the entry of this Order, pay disgorgement of $178,594.85 and prejudgment interest of $38,096.70 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. Payment must be made in one of the following ways:

(1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
(2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm; or
(3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying James Fuld, Jr. as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Andrew M. Calamari, Acting Regional Director, Division of Enforcement, Securities and Exchange Commission, 3 World Financial Center, Suite 400, New York, NY 10281.

C. Respondent acknowledges that the Commission is not imposing a civil penalty based upon his cooperation in a Commission investigation. If at any time following the entry of the Order, the Division of Enforcement obtains information indicating that Respondent knowingly provided materially false or misleading information or materials to the Commission or in a related proceeding, the Division of Enforcement 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 a civil money 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

Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 67532 / July 30, 2012

INVESTMENT COMPANY ACT OF 1940
Release No. 30158 / July 30, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14965

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

I.

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

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934, and Section 9(b) of the Investment Company Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

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

Summary

These proceedings arise out of Respondent's actions as an unregistered broker selling away on two occasions from the registered broker-dealer with which he was associated. During the relevant period, Respondent received transaction-based compensation in exchange for, among other things, soliciting investors for private offerings involving two separate Chinese reverse merger companies. Respondent ultimately raised over $7 million for the two companies, one of which, China Yingxia International, Inc. ("China Yingxia" or the "Company"), collapsed due to reports of fraud involving its chief executive officer. Respondent's conduct violated Section 15(a) of the Exchange Act.

Respondent

1. Mazur, age 59, is a resident of Hellertown, Pennsylvania. Mazur was formerly a registered representative of a Connecticut-based registered broker-dealer from 2002 to 2008. Mazur holds series 7 and 63 securities licenses.

Other Relevant Entity

2. China Yingxia was a Florida corporation headquartered in Harbin, China with purported operations in China. China Yingxia's stock was quoted on the OTC Link (formerly "Pink Sheets") operated by OTC Markets Group, Inc. under the symbol "CYXI." On February 2, 2012, the Commission instituted administrative proceedings pursuant to Section 12(j) of the Exchange Act against China Yingxia, as the Company had not filed any periodic reports with the Commission since late 2008. By an Order dated March 7, 2012, each class of China Yingxia's registered securities was revoked.

Background

Selling Away in Connection with China Yingxia

3. During the relevant period, Mazur worked as a registered representative with an institutional broker-dealer focused on high-yield, distressed, convertible, and emerging market debt securities and equities.

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

4. In mid-2007, Mazur, who had recently become interested in investing in Chinese reverse merger companies, learned through one of China Yingxia's service providers, an investor relations firm, that the Company was working on a PIPE or private investment in public equity. The investor relations firm ("IR Firm") introduced Mazur to a registered broker-dealer acting as the official placement agent to China Yingxia ("Broker-Dealer"). In due course, Mazur met with, among others, the president of the Broker-Dealer ("Individual A"), and his father ("Individual B"), to receive additional information on the offering. Individual B ran a consulting firm specializing in work with Chinese companies ("Consulting Firm"), and he assisted China Yingxia and the Broker-Dealer with the PIPE. Individual B, however, was not registered as a broker, nor was he associated with any registered broker-dealer.

5. As the deal progressed, Mazur increased his communications with a principal at the IR Firm. He also began communicating with Individual B. Eventually, Mazur asked the principal with the IR firm, "[h]ow can I get paid for bring[ing]" in a certain investor to the deal. Mazur learned from Individual B that "money finder[s]" could earn a certain percentage of investments introduced.

6. Mazur and Individual B, with Individual A's knowledge, reached an oral agreement whereby Mazur would receive transaction-based compensation of 5%, based on the dollar amount of investments he introduced to the Company. While Mazur's broker-dealer had participated in running deals for certain Chinese companies, it was not involved in any way managing or selling the deal for China Yingxia. Mazur's oral agreement and activities were done without his employer's knowledge or opportunity to supervise.

7. Although the Broker-Dealer acted as the official placement agent for the Company, Mazur – and others not formally associated with the official placement agent – solicited virtually all of the investors in exchange for transaction-based compensation. No disclosures were made concerning such payments, rather the term sheet for the deal falsely stated that the Broker-Dealer would receive 13% in fees.

8. Mazur, among other things, circulated confidential offering documents and sent a model that he prepared on the Company to fund managers (including customers of his firm) and several colleagues; reviewed and commented on the terms of the deal and the subscription documents; and facilitated the Company's PIPE closing, including by having documents signed and transmitting such documents to the Broker-Dealer. For some investors, Mazur was the only point of contact. In addition, Mazur worked with China Yingxia representatives and its attorneys to maximize the permissible investment amount for one of the investors Mazur introduced.

9. Further, Mazur kept in close contact with another person, a fund manager who was not associated with a registered broker-dealer but nonetheless solicited investors for the China Yingxia deal ("Fund Manager"). Mazur and the Fund Manager communicated concerning, among other things, the book of investors. Mazur stated that, "[t]he investors I have in the deal [are long-term holders] … I hope your investors are the same …." Mazur also wrote, "I could do much more of this [deal] with good [long-term] investors if necessary." When the

Fund Manager responded to Mazur, "[t]he book is closed[] [d]on't get any more[,]" Mazur stood down and ceased his selling efforts.

10. On August 9, 2007, China Yingxia announced the completion of a PIPE whereby it sold $8,725,130 worth of restricted securities to 20 investors. Virtually all of the 20 investors were contacts of Mazur and others, not the official placement agent. Mazur provided Individual A with a listing of the investors he introduced to the deal along with the amounts each invested. In total, Mazur introduced $4,520,000, more than half of the money invested in the PIPE.

11. After the PIPE closed and the amount raised became clear, Mazur emailed Individuals A and B concerning payment, which totaled $226,000. In response, Individual B and Mazur executed a backdated consulting agreement between the Consulting Firm and Mazur's associated broker-dealer. In an apparent attempt to conceal the true nature of the services provided, the agreement initially concerned supposed "strategic consulting services," and stated that Mazur's employer, a registered broker-dealer, would provide the Consulting Firm with certain services, including "assisting the company in press releases, conference calls, etc.; communicating with investors, accompanying investors to visit the facilities of the [Consulting Firm's] clients; and providing other consulting assistance." The services were not akin to Mazur's role as a registered representative at his broker-dealer.

12. Mazur initially signed the agreement as principal of his broker-dealer, although he was not authorized to do so. Mazur returned the fully executed agreement to Individual A, but a short time later a new and edited agreement was signed by a managing principal at Mazur's firm. Unlike the initial agreement, the edited agreement was not executed by Individual B on behalf of his Consulting Firm.

13. The final form of agreement, edited and executed by a managing principal at Mazur's firm, did not contain any listing of specific services. Instead, the edited agreement generically referred to consulting services provided by Mazur's broker-dealer to the Consulting Firm. The edited agreement further stated that the services had already been provided, and the Consulting Firm was satisfied with such services. Despite Mazur's role as a registered representative, which did not generally include consulting services including the variety listed in the initial agreement, Mazur's activities were conducted under the guise of the consulting agreement.

14. Notwithstanding the references to consulting services in the agreements, Mazur received transaction-based compensation for his selling efforts, not for any consulting services. Mazur received 40% of $226,000, or $90,400, while his associated broker-dealer received the remaining amount under the fiction that Mazur had in fact provided consulting services.

Selling Away in Connection with Company 2

15. In or around early 2008, within months of his improper activity with China Yingxia, a different placement agent approached Mazur to invest in another Chinese reverse merger company ("Company 2").

16. The events surrounding the Company 2 offering appear substantially similar to those concerning China Yingxia. Like China Yingxia, without his broker-dealer's knowledge or opportunity to supervise, Mazur entered into an oral agreement to solicit investors in exchange for transaction-based compensation. The agreement, however, was reached directly with Company 2's placement agent. Mazur then solicited potential investors in the weeks leading up to the PIPE. Mazur contacted many of the same investors he solicited for Company 2, including several of his colleagues. Mazur openly used his work email account to send potential investors term sheets, presentations, or other communications concerning the offering. Again, Mazur's broker-dealer was not involved in any way managing or selling the deal for Company 2.

17. The form of agreement with the broker-dealer for Company 2 appears almost identical to the revised agreement relating to China Yingxia. The Company 2 agreement pertained to undefined "general services" for which Mazur's broker-dealer received $104,000, which was 4% of the $2.6 million in investments Mazur introduced to Company 2. Mazur then received 35% of the payment amount, or $36,400. The agreement was presented to Mazur's broker-dealer after the Company 2 deal closed, and Mazur had already introduced investors to Company 2. Mazur's broker-dealer – specifically, the same managing principal that executed the China Yingxia-related agreement – signed off on the Company 2 related agreement, again apparently under the guise that "consulting" services were provided by one of its registered representatives, Mazur, to another broker-dealer.

18. Mazur's activities, as described herein, exceeded that of any "money finder" and thus required broker-dealer registration. Mazur was involved in the offerings for China Yingxia and Company 2 without his employer broker-dealer's knowledge or opportunity to supervise.

Violations

19. As a result of the conduct described above, Mazur willfully violated Section 15(a) of the Exchange Act, which makes it unlawful for any broker or dealer to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security, unless such broker or dealer is registered or associated with a registered 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 Mazur's Offer.

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

A. Respondent Mazur cease and desist from committing or causing any violations and any future violations of Section 15(a) of the Exchange Act.

B. Respondent Mazur 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;
>
> prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter; and
>
> barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock,

with the right to apply for reentry after two (2) years to the appropriate self-regulatory organization, or if there is none, to the Commission.

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

D. Respondent shall, within 30 days of the entry of this Order, pay disgorgement of $126,800, prejudgment interest of $25,550.01 and civil penalties of $25,000 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600 or pursuant to 31 U.S.C. § 3717. Payment must be made in one of the following ways:

(1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
(2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm; or

(3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Stephen Mazuchowski a/k/a Steve Mazur as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Andrew M. Calamari, Acting Regional Director, Division of Enforcement, Securities and Exchange Commission, 3 World Financial Center, Suite 400, New York, NY 10281.

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

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 67542 / July 30, 2012

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3395 / July 30, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14968

In the Matter of NANCY SHAO WEN CHU Respondent.	**ORDER INSTITUTING PUBLIC ADMINISTRATIVE PROCEEDINGS AND IMPOSING TEMPORARY SUSPENSION PURSUANT TO RULE 102(e)(3) OF THE COMMISSION'S RULES OF PRACTICE**

I.

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

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

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

II.

The Commission finds that:

A. RESPONDENT

1. Nancy Shao Wen Chu, age 54, is a resident of Claremont, California. Chu served as CFO of publicly traded Soyo Group, Inc. ("Soyo") between 2002 and 2009 and she was also effectively the chief executive officer as she ran the day-to-day operations of the company. Chu has never held a Certified Public Accountant license.

B. COURT FINDINGS & INJUNCTION

2. On May 25, 2012, the U.S. District Court for the Central District of California in *SEC v. Chu, et al.*, Case No. CV 11-09859 R(FMOx) (C.D. Cal.) issued a Final Order of Judgment By Default, permanently enjoining Chu from violating, directly or indirectly, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder [15 U.S.C. § 78j(b) and 17 C.F.R. § 240.10b-5] and Section 17(a) of the Securities Act of 1933 [15 U.S.C. § 77q(a)].

3. The Final Order of Judgment by Default was entered after Chu failed to respond to the Commission's complaint, which was properly served on her. That complaint, the allegations of which are deemed true as to Chu by her default, alleged that between January 2007 and November 2008, Soyo, through the actions of Chu and others, misled Soyo's investors, primary lending bank, and auditor by materially overstating Soyo's net revenues and understating its liabilities. According to the complaint, Chu caused Soyo to book over $47 million in fraudulent sales revenues arising from at least 120 fictitious transactions with 21 customers, resulting in Soyo materially overstating its net revenues in its periodic filings by amounts ranging from 14.4 to 76.8 percent. The complaint also alleged that in order to obtain additional bank financing for Soyo and keep its existing line of credit from defaulting, Chu misled Soyo's investors, primary lending bank, and auditor regarding a $6 million debt-for-equity transaction with a Soyo vendor that was never completed.

III.

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

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

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

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

This Order shall be served upon Chu personally or by certified mail at her last known address or as otherwise authorized by the Commission's Rules of Practice.

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. 67550 / July 31, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14969

In the Matter of **Redcell Power Corp.,** **Regency Property Group, Inc. (f/k/a Island Residences Club, Inc.),** **Riddle Records, Inc.,** **Wareforce.com, Inc., and** **Whistler, Inc.,** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents Redcell Power Corp., Regency Property Group, Inc. (f/k/a Island Residences Club, Inc.), Riddle Records, Inc., Wareforce.com, Inc., and Whistler, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Redcell Power Corp. (CIK No. 1079548) is a void Delaware corporation located in Vancouver, British Columbia, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Redcell Power is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q/A for the period ended September 30, 2006, which reported a net loss of over $111,000 for the prior nine months.

2. Regency Property Group, Inc. (f/k/a Island Residences Club, Inc.) (CIK No. 1181277) is a Delaware corporation located in Torrance, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Regency Property Group 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 February 28, 2007, which reported a net loss of over $74,000 for the prior nine months.

3. Riddle Records, Inc. (CIK No. 1271810) is a revoked Nevada corporation located in Beverly Hills, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Riddle Records is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 2006, which reported a net loss of over $90,000 for the prior nine months.

4. Wareforce.com, Inc. (CIK No. 1022901) is a permanently revoked Nevada corporation located in El Segundo, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Wareforce.com is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-K for the period ended December 31, 2000, which reported a net loss of over $7 million for the prior twelve months. As of July 31, 2012, the company's stock (symbol "WFRC") was traded on the over-the-counter markets.

5. Whistler, Inc. (CIK No. 1113580) is a void Delaware corporation located in Lakeside, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Whistler 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, 2002, which reported a net loss of over $1.3 million for the prior twelve months.

B. DELINQUENT PERIODIC FILINGS

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

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

By: Lynn M. Powalski
Deputy Secretary