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 JO WHITE, CHAIR

LUIS A. AGUILAR, COMMISSIONER

DANIEL M. GALLAGHER, COMMISSIONER

KARA M. STEIN, COMMISSIONER

MICHAEL S. PIWOWAR, COMMISSIONER

(68 DOCUMENTS)

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 3729 / December 2, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15630

In the Matter of CHARLES J. DUSHEK, and CHARLES S. DUSHEK, Respondents.	ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 203(F) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Charles J. Dushek ("Dushek Sr.") and Charles S. Dushek ("Dushek Jr.") (collectively, "Respondents" or the "Dusheks")

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement (the "Offers") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings and the findings contained in Section III.3 below, which are admitted, Respondents consent to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

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

1. Dushek Sr., age 69, resides in Warrenville, Illinois. From 2008 through 2013, Dushek Sr. was the president and co-owner of Capital Management Associates, Inc. ("CMA"), an investment adviser registered with the Illinois Securities Department but not the Commission. During that period, Dushek Sr. was registered with the Illinois Securities Department as an investment adviser representative for CMA. Throughout that period, CMA and Dushek Sr. were engaged in the business of advising CMA clients, for compensation, about investments in securities.

2. Dushek Jr., age 37, resides in Illinois. From 2008 through 2013, Dushek Jr. worked at and co-owned CMA. Dushek Jr.'s most recent title at CMA was vice president of administration. Throughout that period, CMA was engaged in the business of advising CMA clients, for compensation, about investments in securities.

3. On October 9, 2013, a judgment was entered by consent against each of the Dusheks, permanently enjoining them from future violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and Sections 206(1) and 206(2) of the Advisers Act, in the civil action entitled Securities and Exchange Commission v. Charles J. Dushek, et al., Civil Action Number 1:13-CV-3669, in the United States District Court for the Northern District of Illinois.

4. The Commission's complaint in the civil action alleges that from 2008 to 2012, the Dusheks participated in a "cherry picking" scheme through CMA. According to the complaint, the Dusheks engaged in cherry picking by assigning profitable trades to themselves, and unprofitable trades to CMA clients. The complaint further alleges that the Dusheks assigned millions of dollars of profits to themselves, and assigned millions of dollars of losses to the clients. Additionally, the complaint alleges that Dushek Sr. and CMA misrepresented CMA's proprietary trading activities in a brochure distributed to clients.

IV.

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

Accordingly, it is hereby ORDERED pursuant to Section 203(f) of the Advisers Act that Respondent Dushek Sr. 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.

Accordingly, it is hereby ORDERED pursuant to Section 203(f) of the Advisers Act that Respondent Dushek Jr. 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 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 Respondents, 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

Kevin M. O'Neill

By: Kevin M. O'Neill
Deputy Secretary

Chair White
Commissioner Gallagher
not participating
Commissioner Piwowar
Disapproved

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9489 / December 3, 2013

In the Matter of **RBS SECURITIES INC.,** **Respondent.**	**ORDER UNDER RULE 602(e) OF THE SECURITIES ACT OF 1933 GRANTING A WAIVER OF THE RULE 602(b)(4) & 602(c)(2) DISQUALIFICATION PROVISIONS**

I.

RBS Securities Inc. ("RBS") has submitted a letter, dated October 24, 2013, requesting a waiver of Rules 602(b)(4) and 602(c)(2) disqualifications from relying on the exemption from registration under Regulation E arising from RBS's settlement of an injunctive action commenced by the Commission.

II.

On November 7, 2013, the Commission filed a civil injunctive action in the U.S. District Court for the District of Connecticut charging RBS with violating Sections 17(a)(2) and (3) of the Securities Act of 1933 ("Securities Act"). In its complaint, the Commission alleged that the violations resulted from certain misstatements and omissions made by RBS to the investing public in 2007 in promoting its $2.2 billion offering of a subprime residential mortgage-backed security. RBS allegedly misled investors about the quality and safety of their investments by claiming that the subprime loans backing the multi-billion dollar offering were "generally" in compliance with the lender's underwriting guidelines when RBS knew or should have known at the time that almost 30% of the loans backing the offering deviated so much from the lender's underwriting guidelines that they should have been kicked out of the offering entirely. On November 25, 2013, pursuant to RBS's consent, the U.S. District Court for the District of Connecticut entered a Final Judgment permanently enjoining RBS from violating Sections 17(a)(2) and (3) of the Securities Act, and requiring RBS to pay disgorgement, prejudgment interest and a civil penalty.

III.

The Regulation E exemption is unavailable for the securities of small business investment company issuers or business development company issuers if the issuer or any of its affiliates is subject to any order, judgment, or decree of a court "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," or if, among other things, any investment adviser or underwriter of the securities to be offered is "temporarily or permanently restrained or enjoined by any court from engaging in or continuing any conduct or practice in connection with the purchase or sale of any security." 17 C.F.R. §§ 230.602 (b)(4) and 230.602(c)(2). Rule 602(e) of the Securities Act provides, however, that the disqualification "shall not apply . . . if the Commission determines, upon a showing of good cause, that it is not necessary under the circumstances that the exemption be denied." 17 C.F.R. § 230.602(e).

IV.

Based upon the representations set forth in RBS's request, the Commission has determined that pursuant to Rule 602(e) under the Securities Act a showing of good cause has been made that it is not necessary under the circumstances that the exemption be denied as a result of the Final Judgment.

Accordingly, **IT IS ORDERED**, pursuant to Rule 602(e) under the Securities Act, that a waiver from the application of the disqualification provisions of Rules 602(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
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 3730 / December 3, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15631

In the Matter of **COREY RIBOTSKY,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS**

I.

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

III.

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

1. Ribotsky, age 42, resides in Glen Head, New York. From November 1999 through the present, Ribotsky has been the managing member and control person of The NIR Group, LLC ("NIR"), an unregistered investment adviser. NIR was briefly registered with the Commission for several months in 2006 but chose to withdraw the firm's registration.

2. On August 17, 2012, the Commission filed an amended complaint ("Complaint") against Ribotsky and NIR in the United States District Court for the Eastern District of New York alleging that they violated antifraud provisions of the federal securities laws, SEC v. The NIR Group, LLC, et al., 11-cv-4723 (JFB)(GRB). The Commission's Complaint alleges, among other things, that from 2007 through 2009 Ribotsky knowingly made material misrepresentations and omissions concerning the liquidity and performance of various hedge funds he managed (the "AJW Funds"). The Complaint also alleges Ribotsky mislead investors when forming the AJW Master Fund in May 2007. The Complaint further alleges that from July 2004 through June 2009, Ribotsky misappropriated for his personal use over $1,000,000 of assets from one of the AJW Funds he managed through NIR.

3. On November 14, 2013, the court entered a final consent judgment against Ribotsky and NIR, *inter alia*, permanently enjoining them from violating Section 17(a) of the Securities Act of 1933, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Sections 206(1), 206(2) and 206(4) of the Investment Advisers Act of 1930 and Rule 206(4)-8 thereunder.

IV.

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 203(f) of the Advisers Act, that Respondent Ribotsky be, and hereby is barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization; with the right to apply for reentry after four 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 ACT OF 1933
Release No. 9490 / December 4, 2013

SECURITIES EXCHANGE ACT OF 1934
Release No. 70983 / December 4, 2013

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3514 / December 4, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15635

In the Matter of **FIFTH THIRD BANCORP and DANIEL POSTON** **Respondents.**	**ORDER INSTITUTING PUBLIC ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933 AND SECTIONS 4C AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934 AND RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND CEASE-AND-DESIST ORDERS AND PENALTIES**

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") and Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against Fifth Third Bancorp ("Fifth Third") and Daniel Poston ("Poston") (collectively, "Respondents"), and that public administrative proceedings be, and hereby are, instituted against Poston pursuant to Section 4C of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 102(e)(1)(iii) of the Commission's Rules of Practice.

II.

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

Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 and Sections 4C and 21C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions and Cease-and-Desist Orders and Penalties ("Order"), as set forth below.

III.

On the basis of this Order and Respondents' Offers, the Commission finds[1] that:

SUMMARY

This proceeding results from Fifth Third's failure to record substantial losses during the financial crisis by not properly accounting for a portion of its commercial real estate loan portfolio. In the third quarter of 2008, Fifth Third decided to sell large pools of non-performing commercial loans. When Fifth Third decided to sell the loans, Generally Accepted Accounting Principles ("GAAP") required the company to reclassify them from "held for investment" to "held for sale," and to carry them at fair value.[2] Because the fair values of these loans were significantly below Fifth Third's carrying values, classifying them as held for sale would have resulted in a $169 million impairment, and increased Fifth Third's pretax loss in the third quarter of 2008 by 132 percent. Fifth Third's Chief Financial Officer Daniel Poston was familiar with the company's loan sale efforts and understood the relevant accounting rules. Nevertheless, he failed to direct that Fifth Third classify the loans as required, and made statements in a Fifth Third management representation letter to Fifth Third's auditors that, in light of the company's loan sale activities, were not true. Fifth Third's and Poston's accounting violations operated to deceive investors during a time of significant upheaval and financial distress for the company.

As the real estate market declined in 2007 and 2008, Fifth Third's non-performing assets ("NPAs") increased substantially. In the third quarter of 2008, it became clear that Fifth Third would no longer be able to rely on its collections and related "work-out" efforts to significantly reduce its NPAs. The only alternative the company meaningfully considered was selling some of its non-performing loans. In July 2008, Poston and the other members of Fifth Third's Corporate Credit Committee authorized the head of Fifth Third's commercial banking division ("the EVP") to determine the likely sales prices for certain pools of non-performing loans. At the time, Fifth Third was carrying these loans at about 75 percent of unpaid balances (as a result of allowances for incurred credit losses and charge-offs taken against the unpaid principal balances). Loan brokers

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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.

2 GAAP prescribes that loans held for sale must be reported at the lower of cost or fair value. Because the fair values of all the loans in this matter were below cost, references herein to such reclassification only refer to fair value. See SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others.*

told Fifth Third that the loans would likely sell, on average, for 30 to 41 percent of unpaid balances.

With Fifth Third's NPAs continuing to increase, the company's senior management decided to pursue a large sale of non-performing commercial loans. In September 2008, Fifth Third executed engagement agreements with two loan brokers to market and sell loans with combined balances of $1.5 billion.[3] Poston was aware that the company's commercial banking division had engaged the loan brokers.

Despite all of the actions that Fifth Third had taken with respect to these loans – including signing engagement agreements with brokers to sell the loans – the company did not classify the loans as held for sale and record them accordingly in its Form 10-Q for the third quarter of 2008. Instead, Fifth Third continued to classify the loans as "held for investment," which incorrectly suggested that the company had not made the decision to sell the loans. Poston certified the accuracy and completeness of Fifth Third's Form 10-Q for the third quarter of 2008 despite his knowledge of the company's loan sales activities and the relevant accounting rules.

In addition, Poston represented to the company's auditors in Fifth Third's November 7, 2008 management representation letter for the third quarter of 2008 that the company had no plans or intentions that may affect the classification of loans, and that the loans Fifth Third had classified as held for investment were those that the company had the intent and ability to hold until maturity or for the foreseeable future. In light of Fifth Third's intent to sell the loans, these representations were not true. Fifth Third began receiving and accepting bids for loans that the brokers marketed about two weeks after Fifth Third's management representation letter was submitted to the company's auditor.

In December 2008, Fifth Third senior management consulted with the company's board of directors about management's decision to sell the non-performing commercial real estate loans discussed above, as well as additional loans that Fifth Third decided in December 2008 to sell. Fifth Third did not disclose the impairments resulting from the reclassification of all the loans until January 22, 2009. The reclassifications resulted in a cumulative $800 million loss. Fifth Third sold most of the loans at issue in December 2008 and in 2009.

RESPONDENTS

1. Fifth Third Bancorp, a diversified financial services company, is an Ohio corporation headquartered in Cincinnati, Ohio. With $121 billion in assets, Fifth Third is the twenty-second largest bank holding company in the United States. Fifth Third's common stock is registered with the Commission pursuant to Exchange Act Section 12(b) and trades on NASDAQ.

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[3] After receiving bids, Fifth Third had the option not to sell any of the loans at issue. Fifth Third began receiving bids on those loans in November 2008.

2. Daniel Poston, 55, is a resident of Cincinnati, Ohio, and was Fifth Third's CFO from 2009 to October 2013. Poston was previously Fifth Third's interim CFO (May 2008 to November 2008), Controller (August 2007 to May 2008 and November 2008 to September 2009), and Director of Audit (October 2001 to August 2007). Before joining Fifth Third, Poston was a partner with a large public accounting firm. Poston was a licensed CPA in Ohio until he left public accounting in September 2001.

FACTS

Fifth Third Considers Loan Sales as NPAs Rise and then Takes Steps to Prepare for a Sale

3. From the third quarter of 2007 through the second quarter of 2008, Fifth Third considered selling pools of non-performing commercial real estate loans.[4] Though it had generally held its commercial loans until maturity, Fifth Third considered selling certain of these loans to deal with a substantial increase in its NPAs.[5] By selling these loans, Fifth Third would save the carrying costs of the loans, such as maintaining the properties and paying property taxes; mitigate the need for additional impairments if workout strategies failed or real estate values continued to decline; avoid the expenses and delays of foreclosure; and allow Fifth Third to report a stronger balance sheet. Fifth Third chose not to sell the loans during this period, however, because it deemed the prices it expected to receive from such sales too low.

4. In the third quarter of 2008, it became clear that Fifth Third's efforts to work out the non-performing loans with the borrowers would not be sufficient to significantly reduce the company's NPAs, and that the company needed to pursue a large loan sale. In July 2008, Poston and the other members of Fifth Third's Corporate Credit Committee authorized the EVP to determine the likely sales prices for four pools of non-performing loans and review the results with the Committee. That day, the EVP instructed his staff to prepare for loan sales. The EVP's direct report and the head of the commercial bank's Special Assets Group ("SAG VP"), then told commercial bank employees, "[o]ur intention is to do a large sale using [loan] brokers …." By the end of July 2008, Fifth Third had decided to use two loan brokers ("Broker A" and "Broker B") to handle a potential sale of loans with combined balances of $700 million.

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4 All of the loans discussed in this matter involved commercial properties in Michigan and Florida. During the relevant period, the value of the collateral securing these loans, which were primarily homebuilder-related properties, was declining at a significant rate.

5 Fifth Third's NPAs were loans on which the ultimate collectability of the full amount of principal and interest was uncertain or that had been renegotiated to provide for a reduction or deferral of interest or principal because of a deterioration in the financial position of the borrower. At year-end 2006, Fifth Third had $271 million in commercial NPAs. By year-end 2007, commercial NPAs had more than doubled to $672 million.

Fifth Third's Interim Controller Informs Poston of Potential Accounting Consequences from Fifth Third's Loan Sale Activities

5. In July and August 2008, Broker A and Broker B both discussed with Fifth Third the potential accounting consequences of the company obtaining "indicative pricing" – i.e. the brokers' expert opinions of what the sales prices were likely to be for the loans. Broker A told the SAG VP that one of Fifth Third's competitors had told Broker A that an audit firm had required the competitor to re-classify loans from held for investment to held for sale when it had obtained indicative pricing from a loan broker, and, consistent with the GAAP requirement to report the loans at fair value, to mark the loans down to the indicative prices it had received from the loan broker, regardless of whether the company sold the loans. After learning of this development, an employee in Fifth Third's risk group sought advice from Fifth Third's interim Controller, noting "[a]s we continue to work on potential commercial loan sales … we want to be sure that if we go out to get indicative prices from brokers that we do not need to mark those loans to market based on those bids."

6. Broker B asked the SAG VP whether Fifth Third "even wanted [indicative] pricing" on the loans it was considering selling. Broker B told the SAG VP that their "early indications are very low" and that Fifth Third's "peers have not wanted this info, because of the accounting rulings." Broker B also asked the SAG VP whether Fifth Third "had the budget set forth for such a large potential [charge-off]."[6] The risk group employee forwarded an email from the SAG VP summarizing this discussion to the interim Controller, and again asked for "confirmation from Accounting before we have the vendor send the pricing information that we will not be forced to take a mark on the loans based on indicative pricing quotes."

7. In the same email chain, the risk group employee expressed his understanding to the interim Controller that Fifth Third should not have to classify these loans as held for sale because the company had not decided to sell them, and would be using the indicative pricing to help it decide whether to proceed with a sale.

8. On August 4, the interim Controller recommended to his colleagues that they "**hold off** on receiving any specific pricing information since it may imply an intent to sell, [and] thereby require us to classify them as [held for sale] and take a mark to adjust the loans to those prices. . . " (emphasis in original). The interim Controller then forwarded the emails to Poston, who was serving as Fifth Third's Chief Financial Officer on an interim basis, and explained that he had "provided verbal/tentative guidance to [the risk group employee] that the receipt of bids on specific loans or pools of loans may be viewed as being inconsistent with the positive intent to hold a loan

[6] The reference to potential charge-off refers to the impairment that Fifth Third would need to recognize to record the loans at fair value upon the reclassification of the loans from held for investment to held for sale.

to maturity and therefore might call into serious question the classification of such loans to the extent they remained [classified as held for investment]."[7]

9. Fifth Third subsequently obtained indicative pricing only *orally* from the two loan brokers. On August 5, Broker A prepared two pricing analyses for Fifth Third: one containing Broker A's most current pricing analysis and a second "that we can send to Fifth Third[]. Pricing information has been removed. . . ." The following day, one of Broker A's principals informed his colleagues that he had given Fifth Third pricing orally, by broad categories. On August 5, Broker B sent the SAG VP a list of loans that Broker B recommended for sale that included the unpaid customer balances for each loan, but no pricing information. In an August 7 email, the SAG VP stated he received "verbal numbers" from Broker B.

10. Poston, who had previously served as Fifth Third's Controller and would return to that role in November 2008, understood the relevant accounting rules.

Fifth Third Retains Loan Brokers to Sell Loans

11. During the August 15 meeting of the Fifth Third Enterprise Committee (which was comprised of Fifth Third's Chief Executive Officer and his direct reports, including Poston and the EVP, but not the interim Controller), the EVP's team presented an analysis of the potential loan sales estimating that, based on the brokers' indicative pricing, selling the $700 million of loans they had identified would result in Fifth Third recording a $272 million impairment. The Enterprise Committee decided to delay a decision on whether to proceed with the contemplated loan sales until the following week's meeting.

12. As it saw its commercial NPAs continuing to increase, Fifth Third began considering an even larger loan sale. Bank executives considered two options: proceeding with the $700 million loan sale they had been contemplating or pursuing a $2 billion loan sale, which would include the $700 million in loans they had already been discussing with the brokers.

13. During the August 22 Enterprise Committee meeting that Poston and other senior executives attended, Fifth Third decided to pursue a larger sale than the company had been discussing with the loan brokers. After identifying additional loans to include in a larger sale, Fifth Third entered into engagement agreements with Broker A and Broker B in September 2008, which evidenced that the company had formed the intent to sell the loans. The agreements provided that

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7 The interim Controller also indicated that he and his team would research the issue and report back. The interim Controller and his team consulted, among other things, Fifth Third's draft policy regarding loan classification, which mirrors the Interagency Guidance on Certain Loans Held for Sale (2001) and a 2007 speech by an SEC accounting fellow on loan classification, which conveys the SEC staff's belief that the classification of loans as held for investment or held for sale is dependent on management intent, and that management should make a positive assertion regarding its ability and intent to hold or sell loans and classify them accordingly. The interim Controller, who believed that the company continued to have the intent to hold the loans until maturity or for the foreseeable future, concluded that a receipt of indicative bids was not, by itself, a bright light indicator that an issuer had decided to sell loans.

the brokers would help Fifth Third market and sell loans totaling about $1.5 billion. Poston was aware that the company's commercial banking division had engaged the loan brokers.[8]

Fifth Third Fails to Reclassify Loans as Required

14. Though Fifth Third had entered into engagement agreements with the brokers to facilitate a sale, which evidenced that the company had formed the intent to sell the loans, the company did not reclassify the loans from held for investment to held for sale prior to the filing of its Form 10-Q for the quarter ended September 30, 2008.

15. During its earnings call in October 2008 and in the Form 10-Q that it filed in November 2008 – which occurred during a time of significant economic upheaval and financial distress for Fifth Third – Fifth Third reported a pretax loss of $128 million for the third quarter of 2008. Had Fifth Third reclassified the loans that were the subject of the engagement agreements as required by GAAP, it would have reported a pretax loss of $297 million.[9] As Fifth Third's Chief Financial Officer, Poston signed the company's Form 10-Q for the quarter ended September 30, 2008 and certified the accuracy and completeness of its contents.

Poston Makes Representations to Fifth Third's Auditors
that, in Light of the Company's Loan Sale Activities, were Not True

16. Though he was familiar with Fifth Third's loan sale activities and understood that another audit firm may have required a competitor to reclassify loans based on having received indicative pricing, neither Poston, nor anyone else at Fifth Third, sought advice from the company's outside auditor, Deloitte & Touche, regarding the appropriate classification of the loans at issue.

17. On November 7, Poston signed Fifth Third's management representation letter to Deloitte, which states, "[t]he Bancorp has no plans or intentions that may affect the carrying value or classification of assets and liabilities" and "[t]he Bancorp has properly classified loans on the condensed consolidated balance sheets as held for sale or held for investment, based on the Bancorp's intent with respect to those loans." In light of Fifth Third's intent to sell the loans, these representations were not true.

18. Fifth Third began receiving and accepting bids for loans that the brokers marketed about two weeks after Fifth Third's management representation letter was submitted to Deloitte. Fifth Third's senior management consulted with the company's board of directors in December

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8 In October 2008, Fifth Third received additional pricing information from the brokers and authorized them to begin marketing the loans and soliciting bids from potential buyers.

9 The impairment from the reclassification was $169 million. This was less than the $272 million expected impairment as of August 15 because Fifth Third increased its partial charge-offs and reserves for the loans at issue between then and September 30.

2008 about its decision to sell the loans discussed above along with additional loans that Fifth Third decided in December 2008 to sell. Fifth Third did not disclose the impairment resulting from the reclassification of all the loans until January 22, 2009, when it released its earnings for the fourth quarter of 2008. Fifth Third sold most of the loans at issue in December 2008 and in 2009.

VIOLATIONS

19. Securities Act Section 17(a)(2) prohibits any person from obtaining money or property in the offer or sale of securities 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.

20. Securities Act Section 17(a)(3) prohibits any person from engaging in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser in the offer or sale of securities.

21. Exchange Act Section 13(a) and Rule 13a-13 thereunder require that every issuer of a security registered pursuant to Exchange Act Section 12 file with the Commission, among other things, quarterly reports as the Commission may require, and, pursuant to Rule 13a-14, mandate, among other things, that an issuer's principal financial officer certify each periodic report.

22. Exchange Act Section 13(b)(2)(A) requires reporting companies to make and keep books, records and accounts which, in reasonable detail, accurately and fairly reflect their transactions and dispositions of their assets.

23. Exchange Act Section 13(b)(2)(B) requires all reporting companies to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP.

24. Exchange Act Rule 13b2-1 prohibits any person from directly or indirectly falsifying or causing to be falsified any book, record or account subject to Exchange Act Section 13(b)(2)(A).

25. Exchange Act Rule 13b2-2 prohibits, among other things, officers of issuers from directly or indirectly making or causing to be made a materially false or misleading statement, or omitting to state any material fact necessary in order to make statements made, in light of the circumstances under which such statements were made, not misleading to an accountant in connection with any quarterly review or the preparation or filing of any document or report required to be filed with the Commission.

26. As a result of the conduct described above, Fifth Third violated Securities Act Sections 17(a)(2) and 17(a)(3), and Exchange Act Sections 13(a) and Rule 13a-13 because its financial statements failed to record its commercial real estate loans appropriately under GAAP.

27. As a result of the conduct described above, Fifth Third violated Exchange Act Sections 13(b)(2)(A) and 13(b)(2)(B) because it failed to make and keep appropriate books and records and devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that it valued its commercial real estate loans in accordance with GAAP.

28. As a result of the conduct described above, Poston willfully violated Securities Act Section 17(a)(3) and Exchange Act Rules 13a-14, 13b2-1, and 13b2-2 and caused and willfully aided and abetted Fifth Third's violations of Securities Act Sections 17(a)(2) and 17(a)(3) and Exchange Act Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) and Rule 13a-13 because he failed to ensure that Fifth Third appropriately recorded its commercial real estate loans; certified that Fifth Third's financial statements were prepared in accordance with GAAP; and made representations in a Fifth Third management representation letter to Fifth Third's auditors regarding the company's classification of commercial loans that, in light of Fifth Third's intent to sell loans, were not true.[10]

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent Fifth Third Bancorp's and Respondent Daniel Poston's Offers.

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

A. Fifth Third Bancorp shall cease and desist from committing or causing any violations and any future violations of Securities Act Sections 17(a)(2) and 17(a)(3) and Exchange Act Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) and Rule 13a-13 thereunder.

B. Daniel Poston shall cease and desist from committing or causing any violations and any future violations of Securities Act Sections 17(a)(2) and 17(a)(3) and Exchange Act Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) and Rules 13a-13, 13a-14, 13b2-1, and 13b2-2 thereunder.

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

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[10] This use of the word "willful" does not reflect a finding that Poston acted with the intention to violate the law or knowledge that he was doing so. As used in the governing provisions of law, "willfully" means only that the actor "intentionally committed the act which constitutes the violation." *Tager v. SEC*, 344 F.2d 5, 8 (2d Cir. 1965); *see also Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000). "There is no requirement that the actor also be aware that he is violating one of the Rules or Acts . . . ." *Tager,* 344 F.2d at 8.

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

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

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

(a) Respondent Poston, or the public accounting firm with which he is associated, is registered with the Public Company Accounting Oversight Board ("Board") in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective;

(b) Respondent Poston, or the registered public accounting firm with which he is associated, has been inspected by the Board and that inspection did not identify any criticisms of or potential defects in the respondent's or the firm's quality control system that would indicate that the respondent will not receive appropriate supervision;

(c) Respondent Poston has resolved all disciplinary issues with the Board, and has complied with all terms and conditions of any sanctions imposed by the Board (other than reinstatement by the Commission); and

(d) Respondent Poston acknowledges his responsibility, as long as Respondent Poston appears or practices before the Commission as an independent accountant, to comply with all requirements of the Commission and the Board, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews and quality control standards.

E. The Commission will consider an application by Respondent Poston to resume appearing or practicing before the Commission provided that his state CPA license is current and he has resolved all other disciplinary issues with the applicable state boards of accountancy. However, if state licensure is dependent on reinstatement by the Commission, the Commission will consider an application on its other merits. The Commission's review may include consideration of, in addition to the matters referenced above, any other matters relating to Respondent Poston's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

F. Respondent Fifth Third shall, within 14 days of the entry of this Order, pay a civil money penalty in the amount of $6,500,000 to the United States Treasury. 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:

(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 Fifth Third 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 Stephen L. Cohen, Esq., Associate Director, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549.

G. Respondent Daniel Poston shall, within 14 days of the entry of this Order, pay a civil money penalty in the amount of $100,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. §3717. 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 Poston 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 Stephen L. Cohen, Esq., Associate Director, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549.

H. Pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002, as amended, the Commission may order that any civil money penalty paid by Fifth Third and Poston be used to create a Fair Fund for the benefit of injured investors. If the Commission does not create a Fair Fund, the Commission will order the transfer of any civil money penalty paid by Respondents to the United States Treasury in accordance with Section 21F(g) of the Securities Exchange Act of 1934 for the Investor Protection Fund. 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 civil penalties in this action ("Penalty Offsets"). If the court in any Related Investor Action grants such Penalty Offsets, Respondents agree that they shall, within 30 days after entry of a final order granting Penalty Offsets, notify the Commission's counsel in this action and pay the amounts of Penalty Offsets to the United States Treasury or as the Commission directs. Such payments shall not be deemed additional civil penalties and shall not be deemed to change the amounts of the civil penalties imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against either Fifth Third or Poston 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 ACT OF 1933
Release No. 9491 / December 4, 2013

SECURITIES EXCHANGE ACT OF 1934
Release No. 70984 / December 4, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15635

In the Matter of **FIFTH THIRD BANCORP** **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**

Fifth Third Bancorp has submitted a letter, dated December 3, 2013, requesting a waiver of the disqualification provisions of Section 27A(b)(1)(A)(ii) of the Securities Act of 1933 ("Securities Act") and Section 21E(b)(1)(A)(ii) of the Securities Exchange Act of 1934 ("Exchange Act") arising from its then-anticipated settlement of an administrative proceeding instituted by the Commission.

On December 4, 2013, pursuant to an Offer of Settlement submitted by Fifth Third, the Commission issued an Order instituting Public Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 and Sections 4C and 21C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions and Cease-and-Desist Orders and Penalties ("Order") against Fifth Third. The Order found that Fifth Third violated Securities Act Sections 17(a)(2) and 17(a)(3), and Exchange Act Sections 13(a) and Rule 13a-13 because its financial statements failed to record its commercial real estate loans appropriately under GAAP; that Fifth Third violated Exchange Act Sections 13(b)(2)(A) and 13(b)(2)(B) because it failed to make and keep appropriate books and records and devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that it valued its commercial real estate loans in accordance with GAAP; it ordered Fifth Third to cease and desist from committing or causing any violations and any future violations of those provisions; and required that Fifth Third pay a penalty.

The safe harbor provisions of Section 27A(c) of the Securities Act and Section 21E(c) of the Exchange Act are not available for any forward looking statement that is "made with respect to the business or operations of the issuer, if the issuer . . . during the 3-year period preceding the date on which the statement was first made . . . has been made the subject of a judicial or administrative decree or order arising out of a governmental action that— (I) prohibits future violations of the antifraud provisions of the securities laws; (II) requires that the issuer cease and desist from violating the antifraud provisions of the securities laws; or (III) determines that the issuer violated the antifraud provisions of the securities laws[.]" Section 27A(b)(1)(A)(ii) of the Securities Act and Section 21E(b)(1)(A)(ii) of the Exchange Act. The disqualifications may be waived "to the extent otherwise specifically provided by rule, regulation, or order of the Commission . . . ." Section 27A(b) of the Securities Act and Section 21E(b) of the Exchange Act.

Based on the representations set forth in Fifth Third's December 3, 2013 waiver request, and on other considerations, the Commission has determined that, under the circumstances, the request for a waiver of the disqualifications resulting from the issuance of the Order is appropriate and should be granted.

Accordingly, IT IS ORDERED, pursuant to Section 27A(b) of the Securities Act and Section 21E(b) of the Exchange Act, that a waiver from the disqualifications under Section 27A(b)(1)(A)(ii) of the Securities Act and Section 21E(b)(1)(A)(ii) of the Exchange Act that would result from the issuance of the Commission's Order against Fifth Third is hereby granted.

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. 70973 / December 4, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15632

In the Matter of **Community Alliance, Inc.,** **Defi Global, Inc.,** **Easy Energy, Inc.,** **Industry Concept Holdings, Inc., and** **Transworld Benefits International, 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 Community Alliance, Inc., Defi Global, Inc., Easy Energy, Inc., Industry Concept Holdings, Inc., and Transworld Benefits International, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Community Alliance, Inc. (CIK No. 1443202) is a defaulted Nevada corporation located in Laguna Beach, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Community Alliance 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 August 31, 2010, which reported a net loss of $6,396 for the prior three months. As of November 26, 2013, the company's stock (symbol "COMA") was quoted on OTC Link (previously, "Pink Sheets") operated

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

2. Defi Global, Inc. (CIK No. 1109219) is a void Delaware corporation located in Scottsdale, Arizona with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Defi Global 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, 2010, which reported a net loss of over $2.3 million for the prior nine months. As of November 26, 2013, the company's stock (symbol "LCHL") 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. Easy Energy, Inc. (CIK No. 1415397) 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). Easy Energy is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 2010, which reported a net loss of $482,087 for the prior nine months. As of November 26, 2013, the company's stock (symbol "ESYE") was quoted on OTC Link, had five market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

4. Industry Concept Holdings, Inc. (CIK No. 1418730) is a delinquent Colorado corporation located in Vernon, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Industry Concept 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, 2010, which reported a deficit of over $1.24 million for the prior three months. As of November 26, 2013, the company's stock (symbol "INHL") was quoted on OTC Link, had five market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

5. Transworld Benefits International, Inc. (CIK No. 1107445) is a suspended California corporation located in Newport Beach, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Transworld is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended December 31, 2007, which reported a net loss of over $2.9 million for the six months ended December 31, 2007. As of November 26, 2013, the company's stock (symbol "TBII") 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

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/or 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 them upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondents personally or by certified, registered, or Express Mail, or by other means 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. 70975 / December 4, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15633

In the Matter of **Catch By Gene, Inc.,** **Four Star Holdings, Inc.,** **Great Spirits, Inc.,** **Solid Management Corp.,** **Shatrusen, Inc., and** **Texas Sweet Crude Oil Corp.,** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents Catch By Gene, Inc., Four Star Holdings, Inc., Great Spirits, Inc., Solid Management Corp., Shatrusen, Inc., and Texas Sweet Crude Oil Corp.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Catch By Gene, Inc. (CIK No. 1497590) is a revoked Nevada corporation located in Gangwon-do, Korea with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Catch By Gene 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, 2010, which reported a net loss of $248,558 for the prior nine months. As of November 26, 2013, the company's stock (symbol "CBYG") was quoted on OTC Link (previously, "Pink Sheets") operated by OTC

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

2. Four Star Holdings, Inc. (CIK No. 1433605) is a dissolved Florida corporation located in Odenville, Alabama with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Four Star 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, 2010, which reported a net loss of $689,214 for the prior nine months. As of November 26, 2013, the company's stock (symbol "FSTH") 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. Great Spirits, Inc. (CIK No. 1407412) is a Colorado corporation located in Granbury, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Great Spirits 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, 2010, which reported a net loss of $315,826 for the prior nine months. As of November 26, 2013, the company's stock (symbol "GSPS") was quoted on OTC Link, had five market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

4. Solid Management Corp. (CIK No. 1088205) is a permanently revoked Nevada corporation located in Vancouver, British Columbia, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Solid Management 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 March 31, 2002, which reported a net loss of $7,843 for the prior twelve months.

5. Shatrusen, Inc. (CIK No. 1425035) is a revoked Nevada corporation located in Ocala, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Shatrusen is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2001, which reported a net loss of $3,851 for the prior nine months.

6. Texas Sweet Crude Oil Corp. (CIK No. 1389871) is a forfeited Delaware corporation located in Melbourne, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Texas Sweet Crude 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, 2010, which reported a net loss of $55,515 for the prior nine months. As of November 26, 2013, the company's stock (symbol "TXSC") 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

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

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

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

9. As a result of the foregoing, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and/or 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 them upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondents personally or by certified, registered, or Express Mail, or by other means 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

December 4, 2013

In the Matter of **Catch By Gene, Inc.,** **Four Star Holdings, Inc.,** **Great Spirits, Inc., and** **Texas Sweet Crude Oil Corp.** **File No. 500-1**	**ORDER OF SUSPENSION OF TRADING**

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Catch By Gene, Inc. because it has not filed any periodic reports since the period ended September 30, 2010.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Four Star Holdings, Inc. because it has not filed any periodic reports since the period ended September 30, 2010.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Great Spirits, Inc. because it has not filed any periodic reports since the period ended September 30, 2010.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Texas Sweet Crude Oil

Corp. because it has not filed any periodic reports since the period ended September 30, 2010.

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. EST on December 4, 2013, through 11:59 p.m. EST on December 17, 2013.

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

December 4, 2013

In the Matter of **Community Alliance, Inc.,** **Defi Global, Inc.,** **Easy Energy, Inc.,** **Industry Concept Holdings, Inc., and** **Transworld Benefits International, 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 Community Alliance, Inc. because it has not filed any periodic reports since the period ended August 31, 2010.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Defi Global, Inc. because it has not filed any periodic reports since the period ended September 30, 2010.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Easy Energy, Inc. because it has not filed any periodic reports since the period ended September 30, 2010.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Industry Concept Holdings, Inc. because it has not filed any periodic reports since the period ended September 30, 2010.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Transworld Benefits International, Inc. because it has not filed any periodic reports since the period ended December 31, 2007.

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

Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed companies is suspended for the period from 9:30 a.m. EST on December 4, 2013, through 11:59 p.m. EST on December 17, 2013.

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. 70980 / December 4, 2013

INVESTMENT ADVISERS ACT OF 1940
Release No. 3731 / December 4, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15634

In the Matter of **Nicholas J. Polito, Jr.,** **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 Nicholas J. Polito, Jr. ("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. Polito, age 66, is a resident of Pennsylvania. From 2005 to August 2010, Polito was an employee of PNC Investments LLC, which is a broker-dealer registered with the Commission and an investment adviser registered with the Commission.

2. On October 17, 2012, Polito pleaded guilty to one count of bank fraud in violation of Title 18 United States Code, Section 1344 before the United States District Court for the Middle District of Pennsylvania, in United States v. Nicholas J. Polito, Jr., Crim. Information No. 3-CR-12-261. On May 6, 2013, a judgment in the criminal case was entered against Polito. He was sentenced to a prison term of 42 months followed by three years of supervised release and ordered to make restitution in the amount of $673,349.44.

3. The count of the criminal information to which Polito pleaded guilty alleged, among other things, that, from 2005 to on or about November 16, 2011, Polito knowingly executed a scheme or artifice to defraud PNC Bank and to fraudulently obtain money from the bank's customer accounts by, among other means, forging investor's names on checks and falsifying investment account statements.

IV.

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

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. 70987 / December 5, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15636

In the Matter of **ICC Worldwide, Inc.,** **Innova Pure Water, Inc.,** **Paladin Holdings, Inc.,** **Performing Brands, Inc.,** **Petrol Oil and Gas, Inc.,** **Platinum Research Organization, Inc.,** **Renew Energy Resources, Inc., and** **Vital Living, 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. ICC Worldwide, Inc. ("ICCW")[1] (CIK No. 1078724) is a void Delaware corporation located in Sarasota, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). ICCW 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, 2009, which reported a net loss of $2,776,688 for the prior nine months. As of December 2, 2013, the common stock of ICCW was quoted on OTC Link (formerly "Pink

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

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

2. Innova Pure Water, Inc. ("IPUR") (CIK No. 791994) is a void Delaware corporation located in North Richland Hills, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). IPUR 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 $219,272 for the prior nine months. As of December 2, 2013, the common stock of IPUR 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. Paladin Holdings, Inc. ("PLHI") (CIK No. 1200268) is a dissolved Florida corporation located in Kingsport, Tennessee with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). PLHI 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 $233,499 for the prior six months. As of December 2, 2013, the common stock of PLHI was quoted on OTC Link, had six market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

4. Performing Brands, Inc. ("PFOB") (CIK No. 1201259) is a void Delaware corporation located in Addison, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). PFOB 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 $5,975,468 for the prior six months. On December 19, 2008, PFOB filed a Chapter 7 petition in the U.S. Bankruptcy Court for the Northern District of Texas, which was closed on June 15, 2012. As of December 2, 2013, the common stock of PFOB was quoted on OTC Link, had five market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

5. Petrol Oil and Gas, Inc. ("POIG") (CIK No. 1109348) is a revoked Nevada corporation located in Overland Park, Kansas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). POIG 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 $1,798,349 for the prior nine months. As of December 2, 2013, the common stock of POIG was quoted on OTC Link, had six market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

6. Platinum Research Organization, Inc. ("PLROQ") (CIK No. 1330340) is a void Delaware corporation located in Dallas, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). PLROQ 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 $3,985,307 for the prior nine months. On February 17, 2009, PLROQ filed a Chapter 7 petition in the U.S. Bankruptcy Court for the Northern District of Texas, which was closed on March 8, 2013. As of December 2, 2013, the common stock of PLROQ was quoted on OTC Link, had five market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

7. Renew Energy Resources, Inc. ("REER") (CIK No. 1137587) is a revoked Nevada corporation located in New Orleans, Louisiana with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). REER 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, 2007, which reported a net decrease in net assets resulting from operations available to common shareholders of $90,576,471 for the prior year. As of December 2, 2013, the common stock of REER was quoted on OTC Link, had five market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

8. Vital Living, Inc. ("VTLV") (CIK No. 1145700) is a revoked Nevada corporation located in Boca Raton, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). VTLV 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 available to common shareholders of $500,528 for the prior six months. As of f, the common stock of VTLV 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

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

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

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

III.

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

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

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

IV.

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

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

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

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

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

December 5, 2013

In the Matter of **ICC Worldwide, Inc.,** **Innova Pure Water, Inc.,** **Paladin Holdings, Inc.,** **Performing Brands, Inc.,** **Petrol Oil and Gas, Inc.,** **Platinum Research Organization, Inc.,** **Renew Energy Resources, Inc., and** **Vital Living, 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 ICC Worldwide, Inc. because it has not filed any periodic reports since the period ended June 30, 2009.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Innova Pure Water, Inc. because it has not filed any periodic reports since the period ended March 31, 2007.

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

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

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Petrol Oil and Gas, 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 Platinum Research Organization, 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 Renew Energy Resources, Inc. because it has not filed any periodic reports since the period ended December 31, 2007.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Vital Living, 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. EST on December 5, 2013, through 11:59 p.m. EST on December 18, 2013.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-71000; File No. SR-NSCC-2013-802)

December 5, 2013

Self-Regulatory Organizations; National Securities Clearing Corporation; Notice of No Objection to Advance Notice Filing, as Modified by Amendment Nos. 1, 2, and 3, to Institute Supplemental Liquidity Deposits to Its Clearing Fund Designed to Increase Liquidity Resources to Meet Its Liquidity Needs

I. Introduction

On March 21, 2013, National Securities Clearing Corporation ("NSCC") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 806(e) of Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"),[1] entitled the Payment, Clearing, and Settlement Supervision Act of 2010 ("Clearing Supervision Act" or "Title VIII") and Rule 19b-4(n) of the Securities Exchange Act of 1934 ("Exchange Act"),[2] advance notice SR-NSCC-2013-802 ("Advance Notice") to institute supplemental liquidity deposits to NSCC's Clearing Fund designed to increase liquidity resources to meet NSCC's liquidity needs ("SLD Proposal").[3]

1 12 U.S.C. 5465(e)(1).

2 17 CFR 240.19b-4.

3 NSCC also filed the SLD Proposal contained in the Advance Notice as proposed rule change SR-NSCC-2013-02 ("Proposed Rule Change"). Release No. 34-69313 (Apr. 4, 2013), 78 FR 21487 (Apr. 10, 2013). On April 19, 2013, NSCC filed with the Commission Amendment No. 1 to the Proposed Rule Change. Release No. 34-69620 (May 22, 2013), 78 FR 32292 (May 29, 2013). On June 11, 2013, NSCC filed with the Commission Amendment No. 2 to the Proposed Rule Change, as previously modified by Amendment No. 1. Release No. 34-69951 (Jul. 9, 2013), 78 FR 42140 (Jul. 15, 2013). On October 7, 2013, NSCC filed Amendment No. 3 to the Proposed Rule Change, as previously modified by Amendment Nos. 1 and 2. Release No. 34-70688 (Oct. 15, 2013), 78 FR 62846 (Oct. 22, 2013). On December 5, 2013, the Commission issued an Order Approving the Proposed Rule Change, as Modified by Amendment Nos. 1, 2, and 3, to Institute Supplemental Liquidity Deposits to Its Clearing Fund Designed to Increase Liquidity Resources to Meet Its Liquidity Needs. Release No. 34-70999.

On April 19, 2013, NSCC filed with the Commission Amendment No. 1 to the Advance Notice.[4] On May 1, 2013, the Commission published notice of the Advance Notice, as modified by Amendment No. 1, for comment in the Federal Register.[5] On May 24, 2013, the Commission published notice of its extension of its review period of the Advance Notice, as modified by Amendment No. 1.[6] The Commission received 12 comment letters, including the NFS Letter, to the SLD Proposal as initially filed and as modified by Amendment No. 1.[7]

On June 11, 2013, NSCC filed with the Commission Amendment No. 2 to the Advance Notice, as previously modified by Amendment No. 1 ("Amended SLD Proposal"), which the

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4 NSCC filed Amendment No. 1 to the Advance Notice and Proposed Rule Change filings to include as Exhibit 2 a comment letter from National Financial Services ("NFS"), a Fidelity Investments ("Fidelity") company, to NSCC, dated March 19, 2013, regarding the SLD Proposal prior to NSCC filing the SLD Proposal with the Commission ("NFS Letter"). See Release No. 34-69451 (Apr. 25, 2013), 78 FR 25496 (May 1, 2013) ("Notice") and see Exhibit 2 to File No. SR-NSCC-2013-802, http://www.sec.gov/rules/sro/nscc/2013/34-69451-ex2.pdf.

5 See Notice, 78 FR 25496.

6 Release No. 34-69605 (May 20, 2013), 78 FR 31616 (May 24, 2013) ("Notice of Amendment No. 1").

7 See NFS Letter. See letters to Elizabeth M. Murphy, Secretary, Commission from: John C. Nagel, Esq., Managing Director and General Counsel, Citadel Securities ("Citadel"), dated April 18, 2013 ("Citadel Letter I") and June 13, 2013 ("Citadel Letter II"); Peter Morgan, Senior Vice President & Deputy General Counsel, Charles Schwab & Co., Inc. ("Charles Schwab"), dated April 22, 2013 ("Charles Schwab Letter I") and May 1, 2013 ("Charles Schwab Letter II"); Thomas Price, Managing Director, Operations, Technology & BCP, Securities Industry and Financial Markets Association ("SIFMA"), dated April 23, 2013 ("SIFMA Letter I"); Julian Rainero, Bracewell & Giuliani LLP, on behalf of Investment Technology Group Inc. ("ITG"), dated April 25, 2013 ("ITG Letter I"); Matthew S. Levine, Managing Director, Co-Chief Compliance Officer, Knight Capital Americas LLC ("Knight Capital"), dated April 25, 2013 ("Knight Capital Letter"); Giovanni Favretti, CFA, Managing Director, Deutsche Bank, dated April 25, 2013 ("Deutsche Bank Letter"); Scott C. Goebel, Senior Vice President, General Counsel, Fidelity, dated April 25, 2013 ("Fidelity Letter I"); and Chief Financial Officer & Executive Managing Director, ConvergEx Execution Solutions LLC ("ConvergEx"), dated May 2, 2013 ("ConvergEx Letter I") and May 22, 2013 ("ConvergEx Letter II").

Commission published for comment in the Federal Register on July 15, 2013.[8] The Commission received nine comment letters to Amendment No. 2.[9]

On October 4, 2013, NSCC filed Amendment No. 3 to the Advance Notice ("Final SLD Proposal"), as previously modified by Amendment Nos. 1 and 2, which the Commission published for comment on October 15, 2013.[10] The Commission received two comment letters to the Final SLD Proposal (i.e., Amendment No. 3).[11]

This publication serves as notice of no objection to the Advance Notice, as modified by Amendment Nos. 1, 2, and 3.

II. Background

A. Purpose of the SLD Proposal

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8 Release No. 34-69954 (Jul. 9, 2013), 78 FR 42127 (Jul. 15, 2013) ("Notice of Amendment No. 2").

9 See letters to Elizabeth M. Murphy, Secretary, Commission from: Thomas Price, Managing Director, Operations, Technology & BCP, SIFMA, dated June 24, 2013 ("SIFMA Letter II") and August 7, 2013 ("SIFMA Letter III"); Scott C. Goebel, Senior Vice President, General Counsel, Fidelity, dated June 26, 2013 ("Fidelity Letter II"); Peter Morgan, Senior Vice President & Deputy General Counsel, Charles Schwab, dated August 5, 2013 ("Charles Schwab Letter III") and September 11, 2013 ("Charles Schwab Letter IV"); Paul T. Clark and Anthony C.J. Nuland, Seward & Kissel, LLP (representing Charles Schwab), dated August 5, 2013 ("Charles Schwab Letter V"); John C. Nagel, Esq., Managing Director and General Counsel, Citadel, dated August 5, 2013 ("Citadel Letter III") and September 5, 2013 ("Citadel Letter IV"); and Mark Solomon, Managing Director and Deputy General Counsel, ITG, dated August 5, 2013 ("ITG Letter II").

10 Release No. 34-70689 (Oct. 15, 2013), 78 FR 62893 (Oct. 22, 2013) ("Notice of Amendment No. 3").

11 See letters to Elizabeth M. Murphy, Secretary, Commission from: Managing Director and Deputy General Counsel, ITG, dated November 1, 2013 ("ITG Letter III"); and Scott C. Goebel, Senior Vice President, General Counsel, Fidelity, dated November 5, 2013 ("Fidelity Letter III").

NSCC filed the SLD Proposal to ensure that it would maintain sufficient liquid financial resources to withstand, at a minimum, a default by its single clearing member or clearing member family ("Clearing Member") to which it has the largest exposure ("Cover One"), in compliance with Commission Rule 17Ad-22(b)(3)[12] and a long-standing NSCC policy.

B. Development of the SLD Proposal

As originally filed, the SLD Proposal would have created two related funding obligations: (1) for the 30 Clearing Members that presented NSCC with the largest peak liquidity requirements on days that did not coincide with quarterly options expiration periods ("Regular Periods"), a liquidity deposit calculated based on the Clearing Member's pro rata portion of NSCC's aggregate liquidity requirements from the 30 Clearing Members during Regular Periods ("Regular SLD"); and (2) for a subset of the 30 Clearing Members that present NSCC with a peak liquidity requirement above NSCC's total liquidity resources on days that coincide with quarterly options expiration periods ("Special Periods"), a liquidity deposit calculated based on each Clearing Members' individual contribution to NSCC's liquidity requirement above its liquidity resources during Special Periods ("Special SLD").[13]

Regular SLD would have been satisfied in cash only; however, a Clearing Member would have received a dollar-for-dollar reduction of its Regular SLD funding obligation to the extent that it contributed to NSCC's line-of-credit ("Credit Facility").[14] Special SLD could only be satisfied with cash.[15]

12 17 CFR 240.17Ad-22(b)(3).

13 See Notice, 78 FR at 25496.

14 Id. at 25498.

15 Id.

On June 11, 2013, in response to comments received, NSCC filed the Amended SLD Proposal so that, in summary: (1) Special Periods were expanded to include monthly options expirations periods along with quarterly options expiration periods; (2) Clearing Members could designate a commercial lender to commit to the Credit Facility on the Clearing Member's behalf, enabling the Clearing Member to receive the dollar-for-dollar reduction of its Regular SLD; (3) any commitments to the Credit Facility made in excess of a Clearing Member's Regular SLD would be allocated ratably among all 30 Clearing Members that would be required to make a Regular SLD funding obligation; and (4) "liquidity exposure reports" would be provided to all NSCC members, so that members, particularly Clearing Members, could better assess their liquidity exposure to NSCC.[16]

On October 4 and 7, 2013, in response to further comments received, NSCC filed the Final SLD Proposal.[17] Among other things, the Final SLD Proposal eliminated the Regular SLD funding obligation.

III. Description of the Final SLD Proposal

The Final SLD Proposal would add Rule 4A to NSCC's Rules and Procedures[18] to establish a supplemental liquidity funding obligation designed to cover the liquidity exposure attributable to those Clearing Members that regularly incur the largest gross settlement debits over a settlement cycle during times of increased trading and settlement activity that arise around Special Periods. More specifically, the obligation applies to a subset of the 30 Clearing

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16 See Notice of Amendment No. 2, 78 FR 42127.

17 NSCC filed the Amendment No. 3 to the Proposed Rule Change on October 7, 2013, three days after the Final Advance Notice.

18 See Exhibit 5 to File No. SR-NSCC-2013-802, http://www.sec.gov/rules/sro/nscc/2013/34-70689-ex5.pdf.

Members that present NSCC with historic peak liquidity needs on days that coincide with Special Periods above NSCC's current total liquidity resources. For this subset, NSCC will require a liquidity deposit based on the proportion of the historic peak liquidity exposure that is presented by each Clearing Member in excess of NSCC's then-available total liquidity resources. NSCC will hold deposits made in satisfaction of a Special SLD funding obligation in its Clearing Fund for a period of seven days after the end of the Special Period.

Additionally, if a Clearing Member believes its current trading activity will present a liquidity need to NSCC above NSCC's total liquidity resources, it may voluntarily deposit funds with NSCC to cover the shortfall ("Prefund Deposit"). NSCC will hold Prefund Deposit funds for a period of seven days after the end of the Special Period. If a Clearing Member presents NSCC with a liquidity need above total liquidity resources that is not funded by a Special SLD funding obligation or a Prefund Deposit, the Final SLD Proposal will empower NSCC to call from that Clearing Member the amount of the shortfall, or that Clearing Member's share if caused by more than one Clearing Member, and hold it for 90 days ("Call Deposit").

IV. Summary of Comments Received and NSCC's Responses

The Commission received 23 comment letters to the SLD Proposal[19] from eight

[19] Since the SLD Proposal was filed as both the Proposed Rule Change and the Advance Notice, the Commission considered all public comments received on the proposal, regardless of whether the comments were submitted to the Proposed Rule Change or the Advance Notice. See NFS Letter, Citadel Letter I, Citadel Letter II, Citadel Letter III, Citadel Letter IV, Charles Schwab Letter I, Charles Schwab Letter II, Charles Schwab Letter III, Charles Schwab Letter IV, Charles Schwab Letter V, SIFMA Letter I, SIFMA Letter II, SIFMA Letter III, ITG Letter I, ITG Letter II, ITG Letter III, Knight Capital Letter, Deutsche Bank Letter, Fidelity Letter I, Fidelity Letter II, Fidelity Letter III, ConvergEx Letter I, and ConvergEx Letter II.

commenters,[20] including the NFS Letter.[21] Commenters include bank affiliated and non-bank affiliated NSCC members, as well as one industry trade group, SIFMA.[22] NSCC also submitted two responses to comment letters received.[23] The Commission has reviewed and taken into full consideration all of the comments received.

All eight commenters express support for NSCC's overall goal of maintaining sufficient financial resources to withstand a default by a Clearing Member (i.e., Cover One).[24] One commenter, who previously supported approval of the Amended SLD Proposal, supports approval of the Final SLD Proposal.[25] The remaining seven commenters oppose the original SLD Proposal and the Amended SLD Proposal, as discussed in more detail below.[26] One of

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20 See Comments to the Advance Notice (File No. SR-NSCC-2013-802), http://sec.gov/comments/sr-nscc-2013-802/nscc2013802.shtml and the Proposed Rule Change (File No. SR-NSCC-2013-02), http://sec.gov/comments/sr-nscc-2013-02/nscc201302.shtml ("Comments Received"). For purposes of discussion, the Commission considers the comment submitted by Seward & Kissel on behalf of Charles Schwab as a Charles Schwab comment, see Charles Schwab Letter V, supra note 9, and the NFS Letter as a Fidelity comment. See NFS Letter.

21 See NFS Letter.

22 See Comments Received, supra note 20.

23 See letters to Elizabeth M. Murphy, Secretary, Commission from Larry E. Thompson, Managing Director and DTCC General Counsel, dated June 10, 2013 ("NSCC Letter I") and August 20, 2013 ("NSCC Letter II").

24 See NFS Letter, Citadel Letter III, Charles Schwab Letter II, Charles Schwab Letter III, Charles Schwab Letter V, SIFMA Letter II, SIFMA Letter III, Knight Capital Letter, Deutsche Bank Letter, Fidelity Letter I, Fidelity Letter II, ConvergEx Letter I, ConvergEx Letter II, ITG Letter II.

25 See Fidelity Letter II, Fidelity Letter III.

26 See NFS Letter, Citadel Letter I, Citadel Letter II, Citadel Letter III, Citadel Letter IV, Charles Schwab Letter I, Charles Schwab Letter II, Charles Schwab Letter III, Charles Schwab Letter IV, Charles Schwab Letter V, SIFMA Letter I, SIFMA Letter II, SIFMA Letter III, ITG Letter I, ITG Letter II, ITG Letter III, Knight Capital Letter, Deutsche Bank Letter, Fidelity Letter I, ConvergEx Letter I, and ConvergEx Letter II.

those seven commenters submitted the sole comment letter in opposition to the Final SLD Proposal.[27]

A. Comments Expressing Support for the Provision of Adequate Liquidity at NSCC

As mentioned above, all eight commenters to the SLD Proposal agreed that NSCC must have access to sufficient liquidity and capital to meet the Cover One standard, and some stated NSCC's critical role as a national clearance and settlement system.[28] For example, one commenter states "that a clearing agency performing central counterparty services is essential to the proper functioning of the capital markets, and that ensuring the clearing agency is well capitalized and financially sound serves to benefit both the clearing agency's members and the capital markets as a whole."[29] The commenter goes on to state that it "appreciates the need for the NSCC, both as a central counterparty and as a financial market utility that has been designated by the Financial Stability Oversight Council as systemically important, to maintain sufficient financial resources to withstand a default by the NSCC member or family of affiliated members to which the NSCC has the largest exposure ... [and] also understands the NSCC's desire to broaden the base of support for its liquidity needs beyond the small group of firms that has historically supported these needs through participation in the NSCC's revolving credit facility, and believes it is important to enable all of the NSCC's members to help the NSCC maintain sufficient financial resources."[30] Another commenter notes that "NSCC should have the resources it needs to be a source of strength for the national clearing and settlement

27 See ITG Letter III.

28 See supra note 24.

29 See SIFMA Letter II.

30 Id.

system. . . ."[31] Additionally, another commenter states that it "appreciates the importance of NSCC's critical role as a [c]entral [c]ounterparty … and supports NSCC's goal in ensuring that it has access to sufficient capital in the event that is largest participant fails."[32]

B. Opposing Comments Received Prior to the Final SLD Proposal

1. Comments Inapplicable to the Final SLD Proposal

The seven commenters opposed to approval of the SLD Proposal objected to the SLD Proposal for various reasons, as discussed below.[33] Additionally, five of the seven commenters that oppose the SLD Proposal, as well as the commenter in support of the Final SLD Proposal, suggested potential alternative mechanisms for NSCC to satisfy its liquidity needs.[34]

Many of the commenters opposed to the original SLD Proposal and Amended SLD Proposal raised concerns with a component of the proposal that NSCC eliminated in the Final SLD Proposal.[35] Those comments included concerns about: (1) the anticipated costs for Clearing

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31 See Charles Schwab Letter III, Charles Schwab Letter V.

32 See ConvergEx Letter II.

33 See Citadel Letter I, Citadel Letter II, Citadel Letter III, Citadel Letter IV, Charles Schwab Letter I, Charles Schwab Letter II, Charles Schwab Letter III, Charles Schwab Letter IV, Charles Schwab Letter V, SIFMA Letter I, SIFMA Letter II, SIFMA Letter III, ITG Letter I, ITG Letter II, ITG Letter III, Knight Capital Letter, Deutsche Bank Letter, ConvergEx Letter I, and ConvergEx Letter II.

34 Alternatives included, but were not limited to: NSCC should issue long-term debt to increase its liquidity resources; NSCC should increase intra-day margin calls; NSCC should increase Clearing Member fees; NSCC should reduce the settlement cycle; NSCC should reduce the volume of unsettled trades; NSCC should establish a bilateral third-party bank committed facility; and NSCC should change its capital structure. See NFS Letter, Citadel Letter II, Citadel Letter III, Charles Schwab Letter II, Charles Schwab Letter III, SIFMA Letter II, SIFMA Letter III, ITG Letter II, Fidelity Letter II, Fidelity Letter III and ConvergEx Letter II. The Commission notes that these comments are beyond the subject of the Final SLD Proposal by NSCC.

35 See Citadel Letter II, Citadel Letter III, Citadel Letter IV, Charles Schwab Letter I, Charles Schwab Letter II, Charles Schwab Letter III, Charles Schwab Letter IV, Charles

Members as a result of implementation of Regular SLD funding obligation, including costs imposed by a quick implementation period;[36] (2) Clearing Members' inability to accurately predict or control their funding obligation and the effects thereof, including broker-dealers' inability to plan for funding and liquidity risks as provided in FINRA Reg. Notice 10-57;[37] (3) distributional effects associated with implementation of the Regular SLD funding obligation, manifested in particular by an anti-competitive and disparate impact on non-bank affiliated Clearing Members compared to bank affiliated Clearing Members with regard to the offsetting commitments to the Credit Facility;[38] and (4) perceived mechanical flaws with the application of the Regular SLD funding obligation.[39]

Since NSCC has eliminated the aspect of the SLD Proposal to which these comments were made, the Commission believes these comments are not relevant for its determination on the Final SLD Proposal.

2. Comments Applicable to the Final SLD Proposal and NSCC's Responses Thereto

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Schwab Letter V, SIFMA Letter I, SIFMA Letter II, SIFMA Letter III, ITG Letter I, ITG Letter II, Knight Capital Letter, Deutsche Bank Letter, ConvergEx Letter I, ConvergEx Letter II.

36 See, e.g., ITG Letter I, ITG Letter II, Citadel Letter III.

37 See Citadel Letter II, Citadel Letter III, Citadel Letter IV, Charles Schwab Letter II, SIFMA Letter I, SIFMA Letter II, ITG Letter II, Knight Capital Letter, Deutsche Bank Letter, ConvergEx Letter II.

38 See Citadel Letter II, Charles Schwab Letter I, Charles Schwab Letter II, Charles Schwab Letter III, Charles Schwab Letter IV, Charles Schwab Letter V, SIFMA Letter II, SIFMA Letter III, ITG Letter I, ITG Letter II, Knight Capital Letter, ConvergEx Letter I, ConvergEx Letter II.

39 See ITG Letter II.

Seven of the eight commenters raised concerns with the SLD Proposal that, while not necessarily directly associated with the Special SLD funding obligation, could apply to elements of the Special SLD funding obligation and thus are relevant for the Commission's consideration of the Final SLD Proposal.[40] Four commenters argued that the SLD Proposal is arbitrary and capricious because it applies to no more than 30 Clearing Members.[41] Six commenters argued that the SLD Proposal would have unintended consequences of forcing a number of Clearing Members to terminate their membership and thereby concentrating the broker clearing business in fewer Clearing Members, potentially increasing systemic risk.[42] One commenter stated that historic peak liquidity needs, which would be used by NSCC to determine the liquidity need presented by each Clearing Member, is not necessarily predictive of future liquidity needs.[43] Three commenters argued that NSCC incorrectly calculates its liquidity needs in the SLD Proposal, either because the liquidity need is calculated using Clearing Member gross settlement

40 See Citadel Letter II, Citadel Letter III, Citadel Letter IV, Charles Schwab Letter I, Charles Schwab Letter II, Charles Schwab Letter III, Charles Schwab Letter IV, Charles Schwab Letter V, SIFMA Letter I, SIFMA Letter II, SIFMA Letter III, ITG Letter I, ITG Letter II, ITG Letter III, Knight Capital Letter, Deutsche Bank Letter, ConvergEx Letter I, ConvergEx Letter II.

41 See Citadel Letter II, ITG Letter I, Charles Schwab Letter IV, Charles Schwab Letter V, SIFMA Letter III, ITG Letter II, ITG Letter III. All four commenters argue that the imposition of a funding obligation to no more than 30 Clearing Members was arbitrary and capricious referred to the Regular SLD funding obligation, in which a Regular SLD funding obligation is satisfied pro rata by 30 Clearing Members irrespective of whether each Clearing Member presented a peak liquidity need above NSCC total available liquidity resources. One of the four commenters claims that the same argument persists for the Special SLD Funding Obligation; as such, the Commission will consider the comment here. See Charles Schwab Letter V.

42 See Citadel Letter II, Charles Schwab Letter II, Charles Schwab Letter III, SIFMA Letter I, SIFMA Letter II, SIFMA Letter III, ITG Letter I, ITG Letter II, Knight Capital Letter, ConvergEx Letter II.

43 See ITG Letter II.

debits instead of net settlement debits or because the settlement debits were aggregated over a four-day cycle.[44] Seven commenters stated that treatment of funds delivered to NSCC to satisfy a funding obligation under the SLD Proposal for Commission Rule 15c3-1 purposes was unclear.[45]

In response to comments that imposition of a funding obligation is arbitrary and capricious, NSCC revised the SLD Proposal to eliminate the Regular SLD funding obligation component,[46] which would have: (i) assigned a funding obligation to the 30 Clearing Members that presented NSCC with the largest peak liquidity needs irrespective of whether the peak liquidity need itself would have surpassed NSCC available liquidity resources, and (ii) allocated a funding obligation to each of those 30 Clearing Members driven substantially by the peak liquidity need presented to NSCC by the largest Clearing Member.[47] In response to comments regarding unintended consequences of the SLD Proposal, such as Clearing Members terminating their membership, NSCC stated that the Clearing Member is in the best position to monitor and manage the liquidity risks presented by its own activity.[48] Similarly, NSCC states that the maintenance of adequate liquidity resources at NSCC is a key element in the reduction of systemic risk at a systemically-important financial market utility and also a key component of

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44 See Citadel Letter III, ITG Letter II, ConvergEx Letter I, ConvergEx Letter II.

45 See 17 CFR 240.15c3-1. See, e.g.,Citadel Letter II, Citadel Letter III, Charles Schwab Letter II, Charles Schwab Letter III, SIFMA Letter II, ITG Letter I, ITG Letter II, ITG Letter III, Knight Capital Letter, ConvergEx Letter II.

46 See Notice of Amendment No. 3, 78 FR at 62894-95.

47 Id. at 62894.

48 NSCC Letter I.

NSCC's ability to prevent the failure of a Clearing Member from having a cascading effect on other Clearing Members.[49]

NSCC agreed that historic peak liquidity needs are not necessarily predictive of future liquidity needs, and as a result NSCC has proposed a mechanism whereby Clearing Members may voluntarily prefund liquidity needs that the Clearing Member anticipates will surpass total liquidity resources available at NSCC through the Prefund Deposit.[50] Furthermore, in the event a Clearing Member does not elect to prefund potential liquidity needs but does present a liquidity need to NSCC above total liquidity resources that is not accounted for by a Special SLD funding obligation, NSCC has proposed a mechanism to require the Clearing Member to fund the liquidity need through the Call Deposit.[51] With respect to comments that NSCC incorrectly calculates its liquidity need by using gross settlement debits instead of net settlement debits, NSCC responded that, as a central counterparty for its members, its risk exposure is reflected by the gross settlement debits presented to it, not net settlement debits, in the event of a Clearing Member default.[52] Furthermore, NSCC stated that calculating liquidity obligations over a four-day settlement cycle is consistent with NSCC's practical liquidity obligation in the event of a Clearing Member default.[53] Finally, in response to comments that the treatment of funds posted in satisfaction of an SLD funding obligation for Rule 15c3-1 purposes is unclear, NSCC stated that it structured the SLD Proposal so that deposits made pursuant to an SLD funding obligation

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49 See NSCC Letter I.

50 See Notice of Amendment No. 3, 78 FR at 62895.

51 See Notice, 78 FR at 25498.

52 See NSCC Letter I.

53 Id.

would constitute Clearing Fund deposits, which have clear regulatory capital treatment under Rule 15c3-1.[54]

Six commenters stated that the SLD Proposal did not provide a sufficient evaluation of its burden on competition and lacked necessary detail so as to elicit meaningful comment.[55] Many of these commenters argued that, while they supported NSCC's need for liquidity resources generally, NSCC did not demonstrate a specific need for additional liquidity in connection with the SLD Proposal.[56] Five commenters argued the SLD Proposal lacked sufficient Clearing Member input prior to submitting the proposal.[57] Three commenters argued that the SLD Proposal did not meet the standard required for an advance notice filing because it did not discuss expected effects on risks to NSCC's Clearing Members or NSCC's management of those risks.[58] Three commenters also argued that the SLD Proposal did not adequately protect investors.[59] One commenter argued that the fact that NSCC submitted the SLD Proposal without Clearing Member input is indicative of a lack of fair representation for Clearing Members in the

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54 Id.

55 See Citadel Letter II, Charles Schwab Letter I, Charles Schwab Letter II, Charles Schwab Letter III, Charles Schwab Letter V, SIFMA Letter II, ITG Letter I, ITG Letter II, Knight Capital Letter, ConvergEx Letter I, ConvergEx Letter II.

56 See Citadel Letter II, Citadel Letter III, SIFMA Letter II, SIFMA Letter III, ITG Letter II, ITG Letter III, ConvergEx Letter II.

57 See Citadel Letter III, Charles Schwab Letter I, ITG Letter I, ITG Letter II, Knight Capital Letter, Deutsche Bank Letter.

58 See Citadel Letter II, Charles Schwab Letter II, Charles Schwab Letter III, ConvergEx Letter II.

59 See Deutsche Bank Letter, Charles Schwab Letter II, Charles Schwab Letter IV, Charles Schwab Letter V, SIFMA Letter II.

governance of NSCC.[60] One commenter stated that NSCC did not take into account the potential impact of other central counterparties instituting similar liquidity provisions.[61] Five commenters argued in opposition of cash being the only source by which a Clearing Member could satisfy a supplemental liquidity deposit.[62]

In response to comments received regarding insufficient detail of the SLD Proposal, NSCC provided detail regarding: the specific need for liquidity resources,[63] implementation timeframes for the SLD Proposal,[64] and a suite of tools, such as monthly and daily reports, to enable Clearing Members to more accurately predict a potential Regular SLD funding obligation.[65] NSCC stated that it would work with Clearing Members to help them understand and develop tools to forecast liquidity exposure and mitigate their peak liquidity exposure.[66] NSCC also stated that it would provide monthly and daily reports to Clearing Members that

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60 See Citadel Letter III.

61 See Charles Schwab Letter II, Charles Schwab Letter III. Additionally, one commenter argued that NSCC attempted to improperly amend the SLD Proposal through a response to comments. See Charles Schwab Letter V. The Commission notes that NSCC filed the Final SLD Proposal subsequent to the Commission's receipt of this comment in accordance with the rule filing process. See Notice of Amendment No. 3, 78 FR 62893.

62 See NFS Letter, Charles Schwab Letter II, Charles Schwab Letter III, Citadel Letter II, Citadel Letter III, SIFMA Letter I, Fidelity Letter II, ITG Letter II.

63 See NSCC Letter II (stating that "NSCC has seen continued increases in potential liquidity needs, driven by consolidation in the industry, developments in trading techniques (including a rise in high frequency trading), and a reduction in volatility from the post-[2008] crisis highs which result in reduced Clearing Fund requirements").

64 See Notice of Amendment No. 3, 78 FR 62893 (stating that the Final SLD Proposal would be implemented on February 1, 2014).

65 See NSCC Letter I, NSCC Letter II, Notice of Amendment No. 2, 78 FR 42127, Notice of Amendment No. 3, 78 FR 62893.

66 See NSCC Letter I.

would show liquidity exposure during relevant periods.[67] NSCC also stated that fluctuating peak activity recently has exceeded NSCC available total liquidity resources.[68] NSCC believes these liquidity needs are largely driven by industry consolidation, developments in trading techniques, including an increased use of high frequency trading, and a reduction in volatility from post-2008 financial crisis levels, generally resulting in a reduction in Clearing Fund requirements.[69] In response to comments received regarding insufficient analysis of the burden on competition that might ensue from implementation of the SLD Proposal, NSCC substantially revised the SLD Proposal twice to expand its analysis of the burden on competition to include, for example, individual subsections specifically addressing competition concerns raised by commenters,[70] and to reduce any disparate impact on Clearing Members stemming from implementation of the SLD Proposal, first to provide a mechanism by which non-bank affiliated Clearing Members could contribute to Credit Facility, and second to eliminate the Regular SLD from the Final SLD Proposal.[71]

In response to comments regarding the lack of Clearing Member input in the SLD Proposal and that the development of the SLD Proposal without Clearing Member input was

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67 See NSCC Letter I, NSCC Letter II.

68 See NSCC Letter II.

69 Id.

70 See Notice of Amendment No. 2, 78 FR 42127. See also NSCC Letter I. NSCC argued that the SLD Proposal would apply fairly across Clearing Members and, while recognizing potential competitive impacts on such members, believed the SLD Proposal addressed important financial resource requirements. NSCC also stated that it was revising the SLD Proposal to address competition concerns.

71 See Notice of Amendment No. 2, 78 FR 42127; Notice of Amendment No. 3, 78 FR 62893. See also NSCC Letter I, NSCC Letter II.

indicative of a lack of fair representation of all Clearing Members at NSCC, NSCC stated that it engaged in discussions with Clearing Members likely to be impacted by the SLD Proposal, including more than 100 meetings with Clearing Members to enhance Clearing Members' understanding of liquidity risks presented to NSCC and the SLD Proposal generally.[72] The Advance Notice and subsequent amendments were published for comment three times, so Clearing Members had an opportunity to comment, and NSCC also substantially revised the SLD Proposal twice as a direct response to comments received on the SLD Proposal.[73] Finally, on September 18, 2013, NSCC announced to its membership that it was forming the Clearing Agency Liquidity Council ("CALC"), an advisory group to continue the dialogue between NSCC and its Clearing Members regarding liquidity issues in a formal setting.[74] According to NSCC, the CALC intends to explore additional liquidity resources in advance of the 2014 renewal of NSCC's Credit Facility, in order to address, for example, NSCC's liquidity needs outside of Special Periods and the refinancing risk associated with the annual renewal of the Credit Facility.[75] According to NSCC, twenty-four Clearing Members joined the CALC, including all eight commenters to the SLD Proposal, which has met on multiple occasions since its inception.

72 See NSCC Letter I.

73 See Notice of Amendment No. 2, 78 FR 42127; Notice of Amendment No. 3, 78 FR 62893. See also NSCC Letter II.

74 DTCC Important Notice a7706, Creation of DTCC Clearing Agency Liquidity Council and Nomination Process (Sep. 18, 2013), http://dtcc.com/downloads/legal/imp_notices/2013/nscc/a7706.pdf.

75 See NSCC Letter II. See also Notice of Amendment No. 2, 78 FR 42127, Notice of Amendment No. 3, 78 FR 62893.

NSCC responded to comments that the SLD Proposal did not contain sufficient information by amending the SLD Proposal twice to further identify the potential impact of the SLD Proposal on Clearing Members and to make substantive revisions to the SLD Proposal to address those concerns.[76] NSCC responded to comments that the SLD Proposal did not protect investors by stating that the maintenance of adequate liquidity resources at NSCC, a designated systemically-important financial market utility[77] that plays a fundamental role in the United States cash equities market,[78] will protect against the transmission of systemic risk among Clearing Members in the event of a failure of one Clearing Member, thereby promoting the prompt and accurate settlement of securities transactions and the protection of investors.[79] NSCC responded to the comment that it did not take into account other central counterparties imposing similar liquidity requirements by stating that such a concern was unlikely given the difference in liquidity risk between cash market central counterparties (i.e., NSCC), where potential liquidity needs typically are orders of magnitude greater than the market risk that their margin collections are designed to cover, and derivatives central counterparties, where liquidity needs generally are more closely aligned to market risk of members' portfolios and the members'

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76 See Notice of Amendment No. 2, 78 FR 42127; Notice of Amendment No. 3, 78 FR 62893. See also NSCC Letter II.

77 Financial Stability Oversight Council ("FSOC") 2012 Annual Report, Appendix A, http://www.treasury.gov/initiatives/fsoc/Documents/2012%20Annual%20Report.pdf ("FSOC Designation").

78 See 12 U.S.C. 5462(9).

79 See NSCC Letter I, NSCC Letter II. Designation as systemically-important by FSOC means that a failure of or disruption to its functioning could create, or increase, the risk of significant credit or liquidity problems spreading among financial institutions or markets, thereby threatening financial stability. See 12 U.S.C. 5462(9). See also FSOC Designation, supra note 77.

margin requirements.[80] In response to comments opposed to cash being the sole funding source by which a Clearing Member could satisfy a supplemental liquidity deposit, NSCC eliminated Regular SLD, thereby eliminating concern relating to disparate treatment that might ensue by requiring Clearing Members that do not make a commitment to lend to NSCC through the Credit Facility to make their Regular SLD funding obligation in cash, and NSCC states that the CALC will evaluate potential alternative collateral approaches that could be used to fund a portion of a Clearing Member's funding obligation.[81]

C. Comments to the Final SLD Proposal

The Commission received two comments on the Final SLD Proposal. Both commenters supported NSCC's decision to eliminate the Regular SLD funding obligation from the SLD Proposal.[82] One commenter argued for approval of the Final SLD Proposal, since the Final SLD Proposal "is a helpful development in the process of determining how best to increase NSCC's liquidity resources to meet its liquidity needs."[83] Moreover, the commenter believes that "NSCC has addressed the area of greatest [m]ember concern in removing provisions of the [SLD] Proposal that collectively deal with the imposition of the Regular [SLD]."[84] One commenter argued for disapproval of the Final SLD Proposal, stating that flawed concepts remain and

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80 See NSCC Letter II.

81 Id. See also discussion below noting that any cash deposit is driven by the Clearing Member's own trading activity.

82 See ITG Letter III, Fidelity Letter III.

83 See Fidelity Letter III.

84 Id.

approval would unnecessarily inhibit the development of ideas from NSCC's CALC.[85] NSCC did not submit a response to comments received after submission of the Final SLD Proposal.

V. Discussion and Commission Findings

Although Title VIII does not specify a standard of review for an advance notice, the purpose of Title VIII is instructive.[86] The stated purpose of Title VIII is to mitigate systemic risk in the financial system and promote financial stability by, among other things, promoting uniform risk management standards for and strengthening the liquidity of systemically-important financial market utilities.[87]

Section 805(a)(2) of the Clearing Supervision Act[88] authorizes the Commission to prescribe risk management standards for the payment, clearing, and settlement activities of designated clearing entities and financial institutions engaged in designated activities for which it is the supervisory agency or the appropriate financial regulator. Section 805(b) of the Clearing Supervision Act[89] states that the objectives and principles for the risk management standards prescribed under Section 805(a) shall be to:

- promote robust risk management;
- promote safety and soundness;
- reduce systemic risks; and
- support the stability of the broader financial system.

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85 See ITG Letter III.

86 12 U.S.C. 5461(b).

87 Id. See also FSOC Designation, supra note 77.

88 12 U.S.C. 5464(a)(2).

89 12 U.S.C. 5464(b).

The Commission adopted risk management standards under Section 805(a)(2) of the Clearing Supervision Act on October 22, 2012, ("Clearing Agency Standards").[90] The Clearing Agency Standards became effective on January 2, 2013, and require clearing agencies that perform central counterparty services to establish, implement, maintain, and enforce written policies and procedures that are reasonably designed to meet certain minimum requirements for their operations and risk management practices on an ongoing basis.[91] As such, it is appropriate for the Commission to review advance notices against these risk management standards that the Commission promulgated under Section 805(a) and the objectives and principles of these risk management standards as described in Section 805(b). Commission Rule 17Ad-22(b)(3), adopted as part of the Clearing Agency Standards, requires a central counterparty to establish, implement, maintain and enforce written policies and procedures reasonably designed to maintain sufficient financial resources to withstand, at a minimum, a default by the participant family to which it has the largest exposure in extreme but plausible market conditions.[92]

After carefully considering the Final SLD Proposal and the comments received[93] on the SLD Proposal and NSCC responses thereto, the Commission finds that NSCC has demonstrated

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90 Release No. 34-68080 (Oct. 22, 2012), 77 FR 66219 (Nov. 2, 2012).

91 The Clearing Agency Standards are substantially similar to the risk management standards established by the Board of Governors governing the operations of systemically-important financial market utilities that are not clearing entities and financial institutions engaged in designated activities for which the Commission or the Commodity Futures Trading Commission is the Supervisory Agency. See Financial Market Utilities, 77 FR 49507 (Aug. 2, 2012).

92 17 CFR 240.17Ad-22(b)(3).

93 In its assessment of this advance notice of the Final SLD Proposal, the Commission assessed whether the issues raised by the commenters relate to the level or nature of risks presented by the Final SLD Proposal. Comments received that relate to issues that do not relate to the Final SLD Proposal's effect on the level or nature of risks presented by

that its Final SLD Proposal is in furtherance of the objectives and principles of Title VIII and the risk management standards prescribed thereunder by the Commission and accordingly it is appropriate for the Commission to issue a no-objection to the Final SLD Proposal.

The Commission recognizes that some commenters did not support certain aspects of the SLD Proposal. However, the Commission believes that the Final SLD Proposal eliminated most of the aspects of the SLD Proposal which concerns were raised, and no comments convinced the Commission that the Final SLD Proposal was not consistent with Title VIII. The Commission believes that, overall, the increased liquidity resources available to NSCC as a result of the Final SLD Proposal: (i) will improve financial safety at NSCC by increasing its ability meet its liquidity needs; (ii) reduce systemic risks and support the stability of the broader financial system; and (iii) accordingly is reasonably designed to ensure NSCC maintains sufficient financial resources to withstand, at a minimum, a default by the participant family to which it has the largest exposure in extreme but plausible market conditions. The Commission's analysis of the comments applicable to the Final SLD Proposal and the Final SLD Proposal's consistency with Title VIII of the Dodd-Frank Act and risk management standards prescribed thereunder by the Commission are discussed below.

As stated above, several commenters argued that the original SLD Proposal suffered from certain defects, such as a failure of NSCC to consult with Clearing Members prior to submitted

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NSCC are not considered within the context of his Notice of No Objection to the Advance Notice under Title VIII; rather, they are considered within an analysis of the Final SLD Proposal's consistency with the Exchange Act and applicable rules and regulations thereunder, which the Commission has done in the Order Approving the Proposed Rule Change, as Modified by Amendment Nos. 1, 2, and 3, to Institute Supplemental Liquidity Deposits to Its Clearing Fund Designed to Increase Liquidity Resources to Meet its Liquidity Needs. See supra note 3.

the SLD Proposal,[94] that the SLD Proposal did not adequately address items required by Title VIII,[95] and that NSCC did not demonstrate a specific need for additional liquidity in connection with the SLD Proposal.[96] The Commission believes that the Final SLD Proposal is consistent with Title VIII. NSCC made substantial revisions to the SLD Proposal directly responsive to comments raised during the comment period, the creation of the CALC to continue the dialogue between NSCC and Clearing Members regarding liquidity generally, and a more robust description of the SLD Proposal and its potential effects on the competition between Clearing Members. The Commission notes the stated intention of the CALC to revisit and further impose NSCC's practices with respect to liquidity risk management as also being relevant in this respect.

The Commission notes that all commenters supported NSCC's objective of maintaining sufficient financial resources to withstand a default by a Clearing Member and acknowledged that NSCC must have sufficient liquidity for these purposes. The Commission agrees with commenters and with NSCC that the maintenance of sufficient liquidity resources at NSCC is of paramount importance to promote safety and soundness and support the broader stability of the financial system. This is underscored by NSCC's designation as a systemically-important financial market utility for which a failure or disruption of its operations would create or increase

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94 See Citadel Letter III, Charles Schwab Letter I, ITG Letter I, ITG Letter II, Knight Capital Letter, Deutsche Bank Letter, Fidelity Letter I.

95 See Citadel Letter II, Charles Schwab Letter II, Charles Schwab Letter III, ConvergEx Letter II.

96 See Citadel Letter II, Citadel Letter III, SIFMA Letter II, SIFMA Letter III, ITG Letter II, ITG Letter III, ConvergEx Letter II. With respect to the comments described above about NSCC requiring cash be deposited as collateral, the Commission believes that NSCC has addressed these comments and has stated that the CALC will evaluate potential alternative collateral approaches.

risk of significant credit or liquidity problems spreading among financial institutions or markets and thereby threaten the stability of the financial system of the U.S.[97]

The Commission also notes that NSCC has stated that fluctuating peak liquidity needs presented to NSCC have exceeded total liquidity resources available to NSCC, emphasizing the need for NSCC to develop a mechanism to help ensure that it maintains adequate liquidity as soon as possible.[98] These liquidity needs are driven by Clearing Members' trading activity, and the Final SLD Proposal is designed as a mechanism to allocate a funding obligation to those Clearing Members with peak liquidity needs that surpass NSCC available liquidity resources.

The Commission takes specific note of comments arguing that implementation of the SLD Proposal could result in an increase of systemic risk by concentrating clearing services into fewer firms if Clearing Members opt to terminate their NSCC membership instead of meeting a Special SLD funding obligation. The Commission has carefully considered those comments, but does not believe a risk of increased concentration is a significant risk under the Final SLD Proposal for several reasons. First, since a Special SLD funding obligation is correlated directly to the liquidity need presented to NSCC as a result of Clearing Members' own[99] trading activity, the Special SLD funding obligation is not an unexpected cost for which the Clearing Member is incapable of controlling. Second, the Special SLD funding obligation applies only in the case where a Clearing Member presents a liquidity need that surpasses the then-current total available liquidity resources, based on a two-year look-back period of the Clearing Member's trading activity. These liquidity resources include the Clearing Fund and the Credit Facility, and

97 See 12 U.S.C. 5462(9).

98 See NSCC Letter II.

99 For these purposes, a Clearing Members' own trading activity includes trading activity from all clients of the Clearing Member.

historically these liquidity resources have provided NSCC with adequate liquidity resources a substantial portion of the time. While the Commission believes the Final SLD Proposal is important for NSCC to ensure that it has a mechanism to maintain adequate liquidity resources at all times, the Commission also expects based on the representations of NSCC that a Special SLD funding obligation will be required in only a small number of cases and from a select few Clearing Members with trading activity that is substantial enough to create a liquidity need above NSCC's total liquidity resources. Finally, the Commission notes that the Final SLD Proposal would enable a Clearing Member to avoid a Special SLD funding obligation by either managing its own trading activity to avoid such an obligation or using the Prefund Deposit, which would likely avoid a Call Deposit that would enable NSCC to hold the deposited funds for 90 days, so that the Clearing Member has options other than termination of membership available to it to manage its potential liquidity funding obligation.

For the reasons stated above, the Commission believes that the Final SLD Proposal is: (i) consistent with Commission regulations and risk management standards in Section 805(b) of the Clearing Supervision Act because it promotes robust risk management and improves safety and soundness at NSCC, while reducing systemic risks to the financial system more generally and (ii) consistent with Rule 17Ad-22 (b)(3) because it provides NSCC with a mechanism to maintain sufficient financial resources to withstand, at a minimum, a default by the Clearing Member to which NSCC has the largest exposure.

VI. Conclusion

IT IS THEREFORE NOTICED, pursuant to Section 806(e)(1)(I) of the Clearing Supervision Act,[100] that the Commission DOES NOT OBJECT to the proposed rule change

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[100] 12 U.S.C. 5465(e)(1)(I).

described in the Advance Notice (File No. SR-NSCC-2013-802) and that NSCC be and hereby is AUTHORIZED to implement the proposed rule change as of the date of this notice or the date of the "Order Approving Proposed Rule Change, as Modified by Amendment Nos. 1, 2, and 3 to Institute Supplemental Liquidity Deposits to [NSCC's] Clearing Fund Designed to Increase Liquidity Resources to Meet Its Liquidity Needs," SR-NSCC-2013-02, whichever is later.

By the Commission.

Kevin M. O'Neill

Kevin M. O'Neill
Deputy Secretary

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-70999; File No. SR-NSCC-2013-02)

December 5, 2013

Self-Regulatory Organizations; National Securities Clearing Corporation; Order Approving Proposed Rule Change, as Modified by Amendment Nos. 1, 2, and 3, to Institute Supplemental Liquidity Deposits to Its Clearing Fund Designed to Increase Liquidity Resources to Meet Its Liquidity Needs

I. Introduction

On March 21, 2013, National Securities Clearing Corporation ("NSCC") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act")[1] and Rule 19b-4 thereunder,[2] proposed rule change SR-NSCC-2013-02 ("Proposed Rule Change") to institute supplemental liquidity deposits to NSCC's Clearing Fund designed to increase liquidity resources to meet NSCC's liquidity needs ("SLD Proposal").[3] On April 10, 2013, the Commission published notice of the

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 NSCC also filed the SLD Proposal contained in the Proposed Rule Change as advance notice SR-NSCC-2013-802 ("Advance Notice"), as modified by Amendment No. 1, pursuant to Section 806(e)(1) of the Payment, Clearing, and Settlement Supervision Act of 2010 and Rule 19b-4(n)(1)(i) thereunder. See Release No. 34-69451 (Apr. 25, 2013), 78 FR 25496 (May 1, 2013). On May 20, 2013, the Commission extended the period of review of the Advance Notice, as modified by Amendment No. 1. Release No. 34-69605 (May 20, 2013), 78 FR 31616 (May 24, 2013). On June 11, 2013, NSCC filed Amendment No. 2 to the Advance Notice, as previously modified by Amendment No.1. Release No. 34-69954 (Jul. 9, 2013), 78 FR 42127 (Jul. 15, 2013). On October 4, 2013, NSCC filed Amendment No. 3 to the Advance Notice, as previously modified by Amendment Nos.1 and 2. Release No. 34-70689 (Oct. 15, 2013) 78 FR 62893 (Oct. 22, 2013). On December 5, 2013, the Commission issued a Notice of No Objection to the Advance Notice, as modified by Amendment Nos. 1, 2, and 3, to Institute Supplemental Liquidity Deposits to Its Clearing Fund Designed to Increase Liquidity Resources to Meet Its Liquidity Needs. Release No. 34-71000.

Proposed Rule Change for comment in the Federal Register.[4] On April 19, 2013, NSCC filed with the Commission Amendment No. 1 to the Proposed Rule Change,[5] which the Commission published for comment in the Federal Register on May 29, 2013 and designated a longer period for Commission action on the Proposed Rule Change, as amended.[6] The Commission received 12 comment letters, including the NFS Letter, to the SLD Proposal as initially filed and as modified by Amendment No. 1.[7]

On June 11, 2013, NSCC filed with the Commission Amendment No. 2 to the Proposed Rule Change, as previously modified by Amendment No. 1 ("Amended SLD Proposal"), which

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4 Release No. 34-69313 (Apr. 4, 2013), 78 FR 21487 (Apr. 10, 2013) ("Notice").

5 NSCC filed Amendment No. 1 to the Proposed Rule Change and Advance Notice filings to include as Exhibit 2 a comment letter from National Financial Services ("NFS"), a Fidelity Investments ("Fidelity") company, to NSCC, dated March 19, 2013, regarding the SLD Proposal prior to NSCC filing the SLD Proposal with the Commission ("NFS Letter"). See Release No. 34-69620 (May 22, 2013), 78 FR 32292 (May 29, 2013) ("Notice of Amendment No. 1") and see Exhibit 2 to File No. SR-NSCC-2013-02 (http://www.sec.gov/rules/sro/nscc/2013/34-69620-ex2.pdf).

6 Notice of Amendment No. 1, 78 FR 32292.

7 See NFS Letter. See letters to Elizabeth M. Murphy, Secretary, Commission from: John C. Nagel, Esq., Managing Director and General Counsel, Citadel Securities ("Citadel"), dated April 18, 2013 ("Citadel Letter I") and June 13, 2013 ("Citadel Letter II"); Peter Morgan, Senior Vice President & Deputy General Counsel, Charles Schwab & Co., Inc., ("Charles Schwab") dated April 22, 2013 ("Charles Schwab Letter I") and May 1, 2013 ("Charles Schwab Letter II"); Thomas Price, Managing Director, Operations, Technology & BCP, Securities Industry and Financial Markets Association ("SIFMA"), dated April 23, 2013 ("SIFMA Letter I"); Julian Rainero, Bracewell & Giuliani LLP, on behalf of Investment Technology Group, Inc. ("ITG"), dated April 25, 2013 ("ITG Letter I"); Matthew S. Levine, Managing Director, Co-Chief Compliance Officer, Knight Capital Americas LLC ("Knight Capital"), dated April 25, 2013 ("Knight Capital Letter"); Giovanni Favretti, CFA, Managing Director, Deutsche Bank, dated April 25, 2013 ("Deutsche Bank Letter"); Scott C. Goebel, Senior Vice President, General Counsel, Fidelity, dated April 25, 2013 ("Fidelity Letter I"); and Chief Financial Officer & Executive Managing Director, ConvergEx Execution Solutions LLC ("ConvergEx"), dated May 2, 2013 ("ConvergEx Letter I") and May 22, 2013 ("ConvergEx Letter II").

the Commission published for comment in the Federal Register on July 15, 2013, with an order instituting proceedings to determine whether to approve or disapprove the Proposed Rule Change ("Order Instituting Proceedings").[8] The Commission received nine comment letters to Amendment No. 2 and the Order Instituting Proceedings.[9] On September 25, 2013, the Commission designated a longer period of review for Commission action on the Order Instituting Proceedings.[10] On October 7, 2013, NSCC filed Amendment No. 3 to the Proposed Rule Change ("Final SLD Proposal"), as previously modified by Amendment Nos. 1 and 2, which the Commission published for comment on October 15, 2013.[11] The Commission received two comment letters to the Final SLD Proposal (i.e., Amendment No. 3).[12]

By this order, the Commission approves the Final Proposed Rule Change.

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8 Release No. 34-69951 (Jul. 9, 2013), 78 FR 42140 (Jul. 15, 2013) ("Notice of Amendment No. 2").

9 See letters to Elizabeth M. Murphy, Secretary, Commission from: Thomas Price, Managing Director, Operations, Technology & BCP, SIFMA, dated June 24, 2013 ("SIFMA Letter II") and August 7, 2013 ("SIFMA Letter III"); Scott C. Goebel, Senior Vice President, General Counsel, Fidelity, dated June 26, 2013 ("Fidelity Letter II"); Peter Morgan, Senior Vice President & Deputy General Counsel, Charles Schwab, dated August 5, 2013 ("Charles Schwab Letter III") and September 11, 2013 ("Charles Schwab Letter IV"); Paul T. Clark and Anthony C.J. Nuland, Seward & Kissel, LLP (representing Charles Schwab), dated August 5, 2013 ("Charles Schwab Letter V"); John C. Nagel, Esq., Managing Director and General Counsel, Citadel, dated August 5, 2013 ("Citadel Letter III") and September 5, 2013 ("Citadel Letter IV"); and Mark Solomon, Managing Director and Deputy General Counsel, ITG, dated August 5, 2013 ("ITG Letter II").

10 Release No. 34-70501 (Sep. 25, 2013), 78 FR 60347 (Oct. 1, 2013).

11 Release No. 34-70688 (Oct. 15, 2013), 78 FR 62846 (Oct. 22, 2013) ("Notice of Amendment No. 3").

12 See letters to Elizabeth M. Murphy, Secretary, Commission from: Managing Director and Deputy General Counsel, ITG, dated November 1, 2013 ("ITG Letter III"); and Scott C. Goebel, Senior Vice President, General Counsel, Fidelity, dated November 5, 2013 ("Fidelity Letter III").

II. Background

A. Purpose of the SLD Proposal

NSCC filed the SLD Proposal to ensure that it would maintain sufficient liquid financial resources to withstand, at a minimum, a default by its single clearing member or clearing member family ("Clearing Member") to which it has the largest exposure ("Cover One"), in compliance with Commission Rule 17Ad-22(b)(3)[13] and a long-standing NSCC policy.

B. Development of the SLD Proposal

As originally filed, the SLD Proposal would have created two related funding obligations: (1) for the 30 Clearing Members that presented NSCC with the largest peak liquidity requirements on days that did not coincide with quarterly options expiration periods ("Regular Periods"), a liquidity deposit calculated based on the Clearing Member's pro rata portion of NSCC's aggregate liquidity requirements from the 30 Clearing Members during Regular Periods ("Regular SLD"); and (2) for a subset of the 30 Clearing Members that present NSCC with a peak liquidity requirement above NSCC's total liquidity resources on days that coincide with quarterly options expiration periods ("Special Periods"), a liquidity deposit calculated based on each Clearing Members' individual contribution to NSCC's liquidity requirement above its liquidity resources during Special Periods ("Special SLD").[14]

Regular SLD would have been satisfied in cash only; however, a Clearing Member would have received a dollar-for-dollar reduction of its Regular SLD funding obligation to the extent

13 17 CFR 240.17Ad-22(b)(3).

14 See Notice, 78 FR at 21487-88.

that it contributed to NSCC's line-of-credit ("Credit Facility").[15] Special SLD could only be satisfied with cash.[16]

On June 11, 2013, in response to comments received, NSCC filed the Amended SLD Proposal so that, in summary: (1) Special Periods were expanded to include monthly options expirations periods along with quarterly options expiration periods; (2) Clearing Members could designate a commercial lender to commit to the Credit Facility on the Clearing Member's behalf, enabling the Clearing Member to receive the dollar-for-dollar reduction of its Regular SLD; (3) any commitments to the Credit Facility made in excess of a Clearing Member's Regular SLD would be allocated ratably among all 30 Clearing Members that would be required to make a Regular SLD funding obligation; and (4) "liquidity exposure reports" would be provided to all NSCC members, so that members, particularly Clearing Members, could better assess their liquidity exposure to NSCC.[17]

On October 4 and 7, 2013, in response to further comments received, NSCC filed the Final SLD Proposal.[18] Among other things, the Final SLD Proposal eliminated the Regular SLD funding obligation.

III. Description of the Final SLD Proposal

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15 Id. at 21489.

16 Id.

17 See Notice of Amendment No. 2, 78 FR at 42127.

18 NSCC filed the Final Proposed Rule Change on October 7, 2013, three days after NSCC filed Amendment No. 3 to the Advance Notice.

The Final SLD Proposal would add Rule 4A to NSCC's Rules and Procedures[19] to establish a supplemental liquidity funding obligation designed to cover the liquidity exposure attributable to those Clearing Members that regularly incur the largest gross settlement debits over a settlement cycle during times of increased trading and settlement activity that arise around Special Periods. More specifically, the obligation applies to a subset of the 30 Clearing Members that present NSCC with historic peak liquidity needs on days that coincide with Special Periods above NSCC's current total liquidity resources. For this subset, NSCC will require a liquidity deposit based on the proportion of the historic peak liquidity exposure that is presented by each Clearing Member in excess of NSCC's then-available total liquidity resources. NSCC will hold deposits made in satisfaction of a Special SLD funding obligation in its Clearing Fund for a period of seven days after the end of the Special Period.

Additionally, if a Clearing Member believes its current trading activity will present a liquidity need to NSCC above NSCC's total liquidity resources, it may voluntarily deposit funds with NSCC to cover the shortfall ("Prefund Deposit"). NSCC will hold Prefund Deposit funds for a period of seven days after the end of the Special Period. If a Clearing Member presents NSCC with a liquidity need above total liquidity resources that is not funded by a Special SLD funding obligation or a Prefund Deposit the Final SLD Proposal will empower NSCC to call from that Clearing Member the amount of the shortfall, or that Clearing Member's share if caused by more than one Clearing Member, and hold it for 90 days ("Call Deposit").

IV. Summary of Comments Received and NSCC's Responses

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19 See Exhibit 5 to File No. SR-NSCC-2013-02, http://www.sec.gov/rules/sro/nscc/2013/34-70688-ex5.pdf.

The Commission received 23 comment letters to the SLD Proposal[20] from eight commenters,[21] including the NFS Letter.[22] Commenters include bank affiliated and non-bank affiliated NSCC members, as well as one industry trade group, SIFMA.[23] NSCC also submitted two responses to comment letters received.[24] The Commission has reviewed and taken into full consideration all of the comments received.

All eight commenters express support for NSCC's overall goal of maintaining sufficient financial resources to withstand a default by a Clearing Member (i.e., Cover One).[25] One commenter, who previously supported approval of the Amended SLD Proposal, supports

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20 Since the SLD Proposal was filed as both the Proposed Rule Change and the Advance Notice, the Commission considered all comments received on the proposal, regardless of whether the comments were submitted to the Proposed Rule Change or the Advance Notice. See NFS Letter, Citadel Letter I, Citadel Letter II, Citadel Letter III, Citadel Letter IV, Charles Schwab Letter I, Charles Schwab Letter II, Charles Schwab Letter III, Charles Schwab Letter IV, Charles Schwab Letter V, SIFMA Letter I, SIFMA Letter II, SIFMA Letter III, ITG Letter I, ITG Letter II, ITG Letter III, Knight Capital Letter, Deutsche Bank Letter, Fidelity Letter I, Fidelity Letter II, Fidelity Letter III, ConvergEx Letter I, and ConvergEx Letter II.

21 See Comments to the Proposed Rule Change (File No. SR-NSCC-2013-02), http://sec.gov/comments/sr-nscc-2013-02/nscc201302.shtml, and the Advance Notice (File No. SR-NSCC-2013-802) (http://sec.gov/comments/sr-nscc-2013-802/nscc2013802.shtml ("Comments Received"). For purposes of discussion, the Commission considers the comment submitted by Seward & Kissel on behalf of Charles Schwab as a Charles Schwab comment, see Charles Schwab Letter V, supra note 9, and the NFS Letter as a Fidelity comment. See NFS Letter.

22 See NFS Letter.

23 See Comments Received, supra note 21.

24 See letters to Elizabeth M. Murphy, Secretary, Commission from Larry E. Thompson, Managing Director and DTCC General Counsel, dated June 10, 2013 ("NSCC Letter I") and August 20, 2013 ("NSCC Letter II").

25 See NFS Letter, Citadel Letter III, Charles Schwab Letter II, Charles Schwab Letter III, Charles Schwab Letter V, SIFMA Letter II, SIFMA Letter III, Knight Capital Letter, Deutsche Bank Letter, Fidelity Letter I, Fidelity Letter II, ConvergEx Letter I, ConvergEx Letter II, ITG Letter II.

approval of the Final SLD Proposal.[26] The remaining seven commenters oppose the original SLD Proposal and the Amended SLD Proposal, as discussed in more detail below.[27] One of those seven commenters submitted the sole comment letter in opposition to the Final SLD Proposal.[28]

A. Comments Expressing Support for the Provision of Adequate Liquidity at NSCC

As mentioned above, all eight commenters to the SLD Proposal agreed that NSCC must have access to sufficient liquidity and capital to meet the Cover One standard, and some stated NSCC's critical role as a national clearance and settlement system.[29] For example, one commenter states "that a clearing agency performing central counterparty services is essential to the proper functioning of the capital markets, and that ensuring the clearing agency is well capitalized and financially sound serves to benefit both the clearing agency's members and the capital markets as a whole."[30] The commenter goes on to state that it "appreciates the need for the NSCC, both as a central counterparty and as a financial market utility that has been designated by the Financial Stability Oversight Council as systemically important, to maintain sufficient financial resources to withstand a default by the NSCC member or family of affiliated members to which the NSCC has the largest exposure … [and] also understands the NSCC's

26 See Fidelity Letter II, Fidelity Letter III.

27 See NFS Letter, Citadel Letter I, Citadel Letter II, Citadel Letter III, Citadel Letter IV, Charles Schwab Letter I, Charles Schwab Letter II, Charles Schwab Letter III, Charles Schwab Letter IV, Charles Schwab Letter V, SIFMA Letter I, SIFMA Letter II, SIFMA Letter III, ITG Letter I, ITG Letter II, ITG Letter III, Knight Capital Letter, Deutsche Bank Letter, Fidelity Letter I, ConvergEx Letter I, and ConvergEx Letter II.

28 See ITG Letter III.

29 See supra note 25.

30 See SIFMA Letter II.

desire to broaden the base of support for its liquidity needs beyond the small group of firms that has historically supported these needs through participation in the NSCC's revolving credit facility, and believes it is important to enable all of the NSCC's members to help the NSCC maintain sufficient financial resources."[31] Another commenter notes that "NSCC should have the resources it needs to be a source of strength for the national clearing and settlement system …."[32] Additionally, another commenter states that it "appreciates the importance of NSCC's critical role as a [c]entral [c]ounterparty … and supports NSCC's goal in ensuring that it has access to sufficient capital in the event that is largest participant fails."[33]

B. Opposing Comments Received Prior to the Final SLD Proposal

1. Comments Inapplicable to the Final SLD Proposal

The seven commenters opposed to approval of the SLD Proposal objected to the SLD Proposal for various reasons, as discussed below.[34] Additionally, five of the seven commenters that oppose the SLD Proposal, as well as the commenter in support of the Final SLD Proposal, suggested potential alternative mechanisms for NSCC to satisfy its liquidity needs.[35]

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31 Id.

32 See Charles Schwab Letter III, Charles Schwab Letter V.

33 See ConvergEx Letter II.

34 See Citadel Letter I, Citadel Letter II, Citadel Letter III, Citadel Letter IV, Charles Schwab Letter I, Charles Schwab Letter II, Charles Schwab Letter III, Charles Schwab Letter IV, Charles Schwab Letter V, SIFMA Letter I, SIFMA Letter II, SIFMA Letter III, ITG Letter I, ITG Letter II, ITG Letter III, Knight Capital Letter, Deutsche Bank Letter, ConvergEx Letter I, and ConvergEx Letter II.

35 Alternatives included, but were not limited to: NSCC should issue long-term debt to increase its liquidity resources; NSCC should increase intra-day margin calls; NSCC should increase Clearing Member fees; NSCC should reduce the settlement cycle; NSCC should reduce the volume of unsettled trades; NSCC should establish a bilateral third-party bank committed facility; and NSCC should change its capital structure. See NFS

Many of the commenters opposed to the original SLD Proposal and Amended SLD Proposal raised concerns with a component of the proposal that NSCC eliminated in the Final SLD Proposal.[36] Those comments included concerns about: (1) the anticipated costs for Clearing Members as a result of implementation of Regular SLD funding obligation, including costs imposed by a quick implementation period;[37] (2) Clearing Members' inability to accurately predict or control their funding obligation and the effects thereof, including broker-dealers' inability to plan for funding and liquidity risks as provided in FINRA Reg. Notice 10-57;[38] (3) distributional effects associated with implementation of the Regular SLD funding obligation, manifested in particular by an anti-competitive and disparate impact on non-bank affiliated Clearing Members compared to bank affiliated Clearing Members with regard to the offsetting

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Letter, Citadel Letter II, Citadel Letter III, Charles Schwab Letter II, Charles Schwab Letter III, SIFMA Letter II, SIFMA Letter III, ITG Letter II, Fidelity Letter II, Fidelity Letter III and ConvergEx Letter II. The Commission notes that these comments are beyond the subject of the Final SLD Proposal by NSCC that is before the Commission for approval under Section 19(b) of the Act (which provides that the Commission shall approve a proposed rule change if it finds that such proposed rule change is consistent with the requirements of this title and the applicable rules and regulations issued thereunder).

36 See Citadel Letter II, Citadel Letter III, Citadel Letter IV, Charles Schwab Letter I, Charles Schwab Letter II, Charles Schwab Letter III, Charles Schwab Letter IV, Charles Schwab Letter V, SIFMA Letter I, SIFMA Letter II, SIFMA Letter III, ITG Letter I, ITG Letter II, Knight Capital Letter, Deutsche Bank Letter, ConvergEx Letter I, ConvergEx Letter II.

37 See, e.g., ITG Letter I, ITG Letter II, Citadel Letter III.

38 See Citadel Letter II, Citadel Letter III, Citadel Letter IV, Charles Schwab Letter II, SIFMA Letter I, SIFMA Letter II, ITG Letter II, Knight Capital Letter, Deutsche Bank Letter, ConvergEx Letter II.

commitments to the Credit Facility;[39] and (4) perceived mechanical flaws with the application of the Regular SLD funding obligation.[40]

Since NSCC has eliminated the aspect of the SLD Proposal to which these comments were made, the Commission believes these comments are not relevant for its determination on the Final SLD Proposal.

2. Comments Applicable to the Final SLD Proposal and NSCC's Responses Thereto

Seven of the eight commenters raised concerns with the SLD Proposal that, while not necessarily directly associated with the Special SLD funding obligation, could apply to elements of the Special SLD funding obligation and thus are relevant for the Commission's consideration of the Final SLD Proposal.[41] Four commenters argued that the SLD Proposal is arbitrary and capricious because it applies to no more than 30 Clearing Members.[42] Six commenters argued

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39 See Citadel Letter II, Charles Schwab Letter I, Charles Schwab Letter II, Charles Schwab Letter III, Charles Schwab Letter IV, Charles Schwab Letter V, SIFMA Letter II, SIFMA Letter III, ITG Letter I, ITG Letter II, Knight Capital Letter, ConvergEx Letter I, ConvergEx Letter II.

40 See ITG Letter II.

41 See Citadel Letter II, Citadel Letter III, Citadel Letter IV, Charles Schwab Letter I, Charles Schwab Letter II, Charles Schwab Letter III, Charles Schwab Letter IV, Charles Schwab Letter V, SIFMA Letter I, SIFMA Letter II, SIFMA Letter III, ITG Letter I, ITG Letter II, ITG Letter III, Knight Capital Letter, Deutsche Bank Letter, ConvergEx Letter I, ConvergEx Letter II.

42 See Citadel Letter II, ITG Letter I, Charles Schwab Letter IV, Charles Schwab Letter V, SIFMA Letter III, ITG Letter II, ITG Letter III. All four commenters argue that the imposition of a funding obligation to no more than 30 Clearing Members was arbitrary and capricious referred to the Regular SLD funding obligation, in which a Regular SLD funding obligation is satisfied pro rata by 30 Clearing Members irrespective of whether each Clearing Member presented a peak liquidity need above NSCC total available liquidity resources. One of the four commenters claims that the same argument persists for the Special SLD Funding Obligation; as such, the Commission will consider the comment here. See Charles Schwab Letter V.

that the SLD Proposal would have unintended consequences of forcing a number of Clearing Members to terminate their membership and thereby concentrating the broker clearing business in fewer Clearing Members, potentially increasing systemic risk.[43] One commenter stated that historic peak liquidity needs, which would be used by NSCC to determine the liquidity need presented by each Clearing Member, is not necessarily predictive of future liquidity needs.[44] Three commenters argued that NSCC incorrectly calculates its liquidity needs in the SLD Proposal, either because the liquidity need is calculated using Clearing Member gross settlement debits instead of net settlement debits or because the settlement debits were aggregated over a four-day cycle.[45] Seven commenters stated that treatment of funds delivered to NSCC to satisfy a funding obligation under the SLD Proposal for Commission Rule 15c3-1 purposes was unclear.[46]

In response to comments that imposition of a funding obligation is arbitrary and capricious, NSCC revised the SLD Proposal to eliminate the Regular SLD funding obligation component,[47] which would have: (i) assigned a funding obligation to the 30 Clearing Members that presented NSCC with the largest peak liquidity needs irrespective of whether the peak

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43 See Citadel Letter II, Charles Schwab Letter II, Charles Schwab Letter III, SIFMA Letter I, SIFMA Letter II, SIFMA Letter III, ITG Letter I, ITG Letter II, Knight Capital Letter, ConvergEx Letter II.

44 See ITG Letter II.

45 See Citadel Letter III, ITG Letter II, ConvergEx Letter I, ConvergEx Letter II.

46 See 17 CFR 240.15c3-1. See, e.g., Citadel Letter II, Citadel Letter III, Charles Schwab Letter II, Charles Schwab Letter III, SIFMA Letter II, ITG Letter I, ITG Letter II, ITG Letter III, Knight Capital Letter, ConvergEx Letter II.

47 See Notice of Amendment No. 3, 78 FR at 62847.

liquidity need itself would have surpassed NSCC available liquidity resources, and (ii) allocated a funding obligation to each of those 30 Clearing Members driven substantially by the peak liquidity need presented to NSCC by the largest Clearing Member.[48] In response to comments regarding unintended consequences of the SLD Proposal, such as Clearing Members terminating their membership, NSCC stated that the Clearing Member is in the best position to monitor and manage the liquidity risks presented by its own activity.[49] Similarly, NSCC states that the maintenance of adequate liquidity resources at NSCC is a key element in the reduction of systemic risk at a systemically-important financial market utility and also a key component of NSCC's ability to prevent the failure of a Clearing Member from having a cascading effect on other Clearing Members.[50]

NSCC agreed that historic peak liquidity needs are not necessarily predictive of future liquidity needs, and as a result NSCC has proposed a mechanism whereby Clearing Members may voluntarily prefund liquidity needs that the Clearing Member anticipates will surpass total liquidity resources available at NSCC through the Prefund Deposit.[51] Furthermore, in the event a Clearing Member does not elect to prefund potential liquidity needs but does present a liquidity need to NSCC above total liquidity resources that is not accounted for by a Special SLD funding obligation, NSCC has proposed a mechanism to require the Clearing Member to fund the liquidity need through the Call Deposit.[52] With respect to comments that NSCC incorrectly

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48 Id. at 62846-47.

49 NSCC Letter I.

50 See NSCC Letter I, NSCC Letter II.

51 See Notice of Amendment No. 3, 78 FR at 62847.

52 See Notice, 78 FR at 21489.

calculates its liquidity need by using gross settlement debits instead of net settlement debits, NSCC responded that, as a central counterparty for its members, its risk-exposure is reflected by the gross settlement debits presented to it, not net settlement debits, in the event of a Clearing Member default.[53] Furthermore, NSCC stated that calculating liquidity obligations over a four-day settlement cycle is consistent with NSCC's practical liquidity obligation in the event of a Clearing Member default.[54] Finally, in response to comments that the treatment of funds posted in satisfaction of an SLD funding obligation for Rule 15c3-1 purposes is unclear, NSCC stated that it structured the SLD Proposal so that deposits made pursuant to an SLD funding obligation would constitute Clearing Fund deposits, which have clear regulatory capital treatment under Rule 15c3-1.[55]

Six commenters stated that the SLD Proposal did not provide a sufficient evaluation of its burden on competition and lacked necessary detail so as to elicit meaningful comment.[56] Many of these commenters argued that, while they supported NSCC's need for liquidity resources generally, NSCC did not demonstrate a specific need for additional liquidity in connection with the SLD Proposal.[57] Five commenters argued the SLD Proposal lacked sufficient Clearing

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53 See NSCC Letter I.

54 Id.

55 Id.

56 See Citadel Letter II, Charles Schwab Letter I, Charles Schwab Letter II, Charles Schwab Letter III, Charles Schwab Letter V, SIFMA Letter II, ITG Letter I, ITG Letter II, Knight Capital Letter, ConvergEx Letter I, ConvergEx Letter II.

57 See Citadel Letter II, Citadel Letter III, SIFMA Letter II, SIFMA Letter III, ITG Letter II, ITG Letter III, ConvergEx Letter II.

Member input prior to submitting the proposal.[58] Three commenters also argued that the SLD Proposal did not adequately protect investors.[59] One commenter argued that the fact that NSCC submitted the SLD Proposal without Clearing Member input is indicative of a lack of fair representation for Clearing Members in the governance of NSCC.[60] One commenter stated that NSCC did not take into account the potential impact of other central counterparties instituting similar liquidity provisions.[61] Five commenters argued in opposition of cash being the only source by which a Clearing Member could satisfy a supplemental liquidity deposit.[62]

In response to comments received regarding insufficient detail of the SLD Proposal, NSCC provided detail regarding: the specific need for liquidity resources,[63] implementation timeframes for the SLD Proposal,[64] and a suite of tools, such as monthly and daily reports, to

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58 See Citadel Letter III, Charles Schwab Letter I, ITG Letter I, ITG Letter II, Knight Capital Letter, Deutsche Bank Letter.

59 See Deutsche Bank Letter, Charles Schwab Letter II, Charles Schwab IV, Charles Schwab Letter V, SIFMA Letter II.

60 See Citadel Letter III.

61 See Charles Schwab Letter II, Charles Schwab Letter III. Additionally, one commenter argued that NSCC attempted to improperly amend the SLD Proposal through a response to comments. See Charles Schwab Letter V. The Commission notes that NSCC filed the Final SLD Proposal subsequent to the Commission's receipt of this comment in accordance with the rule filing process. See Notice of Amendment No. 3, 78 FR 62846.

62 See NFS Letter, Charles Schwab Letter II, Charles Schwab Letter III, Citadel Letter II, Citadel Letter III, SIFMA Letter I, Fidelity Letter II, ITG Letter II.

63 See NSCC Letter II (stating that "NSCC has seen continued increases in potential liquidity needs, driven by consolidation in the industry, developments in trading techniques (including a rise in high frequency trading), and a reduction in volatility from the post-[2008] crisis highs which result in reduced Clearing Fund requirements").

64 See Notice of Amendment No. 3, 78 FR 62846 (stating that the Final SLD Proposal would be implemented on February 1, 2014).

enable Clearing Members to more accurately predict a potential Regular SLD funding obligation.[65] NSCC stated that it would work with Clearing Members to help them understand and develop tools to forecast liquidity exposure and mitigate their peak liquidity exposure.[66] NSCC also stated that it would provide monthly and daily reports to Clearing Members that would show liquidity exposure during relevant periods.[67] NSCC also stated that fluctuating peak activity recently has exceeded NSCC available total liquidity resources.[68] NSCC believes these liquidity needs are largely driven by industry consolidation, developments in trading techniques, including an increased use of high frequency trading, and a reduction in volatility from post-2008 financial crisis levels, generally resulting in a reduction in Clearing Fund requirements.[69] In response to comments received regarding insufficient analysis of the burden on competition that might ensue from implementation of the SLD Proposal, NSCC substantially revised the SLD Proposal twice to expand its analysis of the burden on competition to include, for example, individual subsections specifically addressing competition concerns raised by commenters,[70] and to reduce any disparate impact on Clearing Members stemming from implementation of the SLD

65 See NSCC Letter I, NSCC Letter II, Notice of Amendment No. 2, 78 FR 42140, Notice of Amendment No. 3, 78 FR 62846.

66 See NSCC Letter I.

67 See NSCC Letter I, NSCC Letter II.

68 See NSCC Letter II.

69 Id.

70 See Notice of Amendment No. 2, 78 FR 42140. See also NSCC Letter I. NSCC argued that the SLD Proposal would apply fairly across Clearing Members and, while recognizing potential competitive impacts on such members, believed the SLD Proposal addressed important financial resource requirements. NSCC also stated that it was revising the SLD Proposal to address competition concerns.

Proposal, first to provide a mechanism by which non-bank affiliated Clearing Members could contribute to Credit Facility, and second to eliminate the Regular SLD from the Final SLD Proposal.[71]

In response to comments regarding the lack of Clearing Member input in the SLD Proposal and that the development of the SLD Proposal without Clearing Member input was indicative of a lack of fair representation of all Clearing Members at NSCC, NSCC stated that it engaged in discussions with Clearing Members likely to be impacted by the SLD Proposal, including more than 100 meetings with Clearing Members to enhance Clearing Members' understanding of liquidity risks presented to NSCC and the SLD Proposal generally.[72] The Proposed Rule Change and subsequent amendments were published for comment four times, so Clearing Members had an opportunity to comment, and NSCC also substantially revised the SLD Proposal twice as a direct response to comments received on the SLD Proposal.[73] Finally, on September 18, 2013, NSCC announced to its membership that it was forming the Clearing Agency Liquidity Council ("CALC"), an advisory group to continue the dialogue between NSCC and its Clearing Members regarding liquidity issues in a formal setting.[74] According to NSCC, the CALC intends to explore additional liquidity resources in advance of the 2014 renewal of NSCC's Credit Facility, in order to address, for example, NSCC's liquidity needs

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71 See Notice of Amendment No. 3, 78 FR 62846. See also NSCC Letter II.

72 See NSCC Letter I.

73 See Notice of Amendment No. 2, 78 FR 42140, Notice of Amendment No. 3, 78 FR 62846. See also NSCC Letter II.

74 DTCC Important Notice a7706, Creation of DTCC Clearing Agency Liquidity Council and Nomination Process (Sep. 18, 2013), http://dtcc.com/downloads/legal/imp_notices/2013/nscc/a7706.pdf.

outside of Special Periods and the refinancing risk associated with the annual renewal of the Credit Facility.[75] According to NSCC, twenty-four Clearing Members joined the CALC, including all eight commenters to the SLD Proposal, which has met on multiple occasions since its inception.

NSCC responded to comments that the SLD Proposal did not contain sufficient information by amending the SLD Proposal twice to further identify the potential impact of the SLD Proposal on Clearing Members and to make substantive revisions to the SLD Proposal to address those concerns.[76] NSCC responded to comments that the SLD Proposal did not protect investors by stating that the maintenance of adequate liquidity resources at NSCC, a designated systemically-important financial market utility[77] that plays a fundamental role in the United States cash equities market, will protect against the transmission of systemic risk among Clearing Members in the event of a failure of one Clearing Member, thereby promoting the prompt and accurate settlement of securities transactions and the protection of investors.[78] NSCC responded to the comment that it did not take into account other central counterparties imposing similar liquidity requirements by stating that such a concern was unlikely given the difference in

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75 See NSCC Letter II. See also Notice of Amendment No. 2, 78 FR 42140, Notice of Amendment No. 3, 78 FR 62846.

76 See Notice of Amendment No. 2, 78 FR 42140, Notice of Amendment No. 3, 78 FR 62846. See also NSCC Letter II.

77 Financial Stability Oversight Council ("FSOC") 2012 Annual Report, Appendix A, http://www.treasury.gov/initiatives/fsoc/Documents/2012%20Annual%20Report.pdf ("FSOC Designation").

78 See NSCC Letter I, NSCC Letter II. Designation as systemically-important by FSOC means that a failure of or disruption to its functioning could create, or increase, the risk of significant credit or liquidity problems spreading among financial institutions or markets, thereby threatening financial stability. See 12 U.S.C. 5462(9). See also FSOC Designation, supra note 77.

liquidity risk between cash market central counterparties (i.e., NSCC), where potential liquidity needs typically are orders of magnitude greater than the market risk that their margin collections are designed to cover, and derivatives central counterparties, where liquidity needs generally are more closely aligned to market risk of members' portfolios and the members' margin requirements.[79] In response to comments opposed to cash being the sole funding source by which a Clearing Member could satisfy a supplemental liquidity deposit, NSCC eliminated Regular SLD, thereby eliminating concern relating to disparate treatment that might ensue by requiring Clearing Members that do not make a commitment to lend to NSCC through the Credit Facility to make their Regular SLD funding obligation in cash, and NSCC states that the CALC will evaluate potential alternative collateral approaches that could be used to fund a portion of a Clearing Member's funding obligation.[80]

C. Comments to the Final SLD Proposal

The Commission received two comments on the Final SLD Proposal. Both commenters supported NSCC's decision to eliminate the Regular SLD funding obligation from the SLD Proposal.[81] One commenter argued for approval of the Final SLD Proposal, since the Final SLD Proposal "is a helpful development in the process of determining how best to increase NSCC's liquidity resources to meet its liquidity needs."[82] Moreover, the commenter believes that "NSCC has addressed the area of greatest [m]ember concern in removing provisions of the [SLD]

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79 See NSCC Letter II.

80 Id. See also discussion below noting that any cash deposit is driven by the Clearing Member's own trading activity.

81 See ITG Letter III, Fidelity Letter III.

82 See Fidelity Letter III.

Proposal that collectively deal with the imposition of the Regular [SLD]."[83] One commenter argued for disapproval of the Final SLD Proposal, stating that flawed concepts remain and approval would unnecessarily inhibit the development of ideas from NSCC's CALC.[84] NSCC did not submit a response to comments received after submission of the Final SLD Proposal.

V. Discussion and Commission Findings

After careful review, the Commission finds that the Final SLD Proposal is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a registered clearing agency.[85] In particular, the Commission finds that the Final SLD Proposal is consistent with the following provisions of the Act: (i) Section 17A(b)(3)(A),[86] which requires that a clearing agency "is so organized and has the capacity to be able to facilitate the prompt and accurate clearance and settlement of securities transactions ... to safeguard securities and funds in its custody and control and for which it is responsible ... and to enforce ... compliance by its participants with the rules of the clearing agency;" (ii) Section 17A(b)(3)(F),[87] which requires that: the rules of a clearing agency not be designed to permit unfair discrimination among participants in the use of the clearing agency; and the rules of a clearing agency promote the prompt and accurate clearance and settlement of securities

83 Id.

84 See ITG Letter III.

85 In approving the Proposed Rule Change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f). Comments about the potential competitive impact of the Proposed Rule Change are addressed above and below.

86 15 U.S.C. 78q-1(b)(3)(A).

87 15 U.S.C. 78q-1(b)(3)(F).

transactions and protect investors and the public interest; (iii) Section 17A(b)(3)(D),[88] which requires that the rules of a clearing agency provide for the equitable allocation of reasonable dues, fees, and other changes among its participants; and (iv) Section 17A(b)(3)(I),[89] which requires the rules of a clearing agency not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

The Commission's Order Instituting Proceedings solicited comment on a number of issues. After carefully considering the Final SLD Proposal and the comments received on the SLD Proposal and NSCC responses thereto, the Commission finds that the Final SLD Proposal is consistent with the Exchange Act and therefore must be approved.

The Commission recognizes that some commenters did not support certain aspects of the SLD Proposal. The Commission, however, must approve a proposed rule change if it finds that the proposed rule change is consistent with the requirements of the Exchange Act and the applicable rules and regulations thereunder. No comments convinced the Commission that the Final SLD Proposal was not consistent with the Exchange Act and the applicable rules and regulations thereunder. The Commission believes that, overall, the Final SLD Proposal: (i) will improve financial safety at NSCC by increasing its ability to meet its liquidity needs; (ii) provides for the equitable allocation of reasonable expenses; and (iii) does not permit unfair discrimination among Clearing Members in the use of NSCC or impose an unnecessary burden on competition. The Commission's analysis of the comments applicable to the Final SLD Proposal and the Final SLD Proposal's consistency with the Exchange Act are discussed below.

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88 15 U.S.C. 78q-1(b)(3)(D).

89 15 U.S.C. 78q-1(b)(3)(I).

As stated above, several commenters argued that the original SLD Proposal suffered from certain defects, such as a failure of NSCC to consult with Clearing Members prior to submitting the SLD Proposal,[90] that the SLD Proposal contained an insufficient evaluation of the burden on competition, and an insufficient description of the SLD Proposal,[91] and that NSCC did not demonstrate a specific need for additional liquidity in connection with the SLD Proposal.[92]

The Commission believes that the Final SLD Proposal is consistent with the Exchange Act and the applicable rules and regulations thereunder. NSCC made substantial revisions to the SLD Proposal directly responsive to comments raised during the comment period, created the CALC to continue the dialogue between NSCC and Clearing Members regarding liquidity generally, and provided a more robust description of the SLD Proposal and its potential effects on the competition between Clearing Members,[93] in particular describing how the Final SLD Proposal addresses those potential effects.[94]

As stated above, all commenters expressed support for the notion that NSCC must have access to sufficient liquidity.[95] One commenter stated that "NSCC's critical role as a national clearance and settlement system" made it so that adequate liquidity resources at NSCC was of

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90 See supra note 58.

91 See supra note 56.

92 See supra note 57.

93 See Notice of Amendment No. 2, 78 FR 42140, Notice of Amendment No. 3, 78 FR 62846, NSCC Letter I, NSCC Letter II.

94 See Notice of Amendment No. 3, 78 FR 62846, NSCC Letter II.

95 See supra note 25.

paramount importance.[96] The Commission believes that NSCC's maintenance of adequate Cover One liquidity resources helps ensure that orderly settlement can be completed notwithstanding the failure of its largest Clearing Member. The Commission further believes approval of the Final SLD Proposal is necessary to improve the overall financial safety of NSCC and its ability to complete settlement.

The Commission also notes that NSCC has stated that fluctuating peak liquidity needs presented to NSCC have exceeded total liquidity resources available to NSCC, emphasizing the need for NSCC to develop a mechanism to help ensure that it maintains adequate liquidity as soon as possible.[97] These liquidity needs are driven by Clearing Members' trading activity, and the Final SLD Proposal is designed as a mechanism to allocate a funding obligation to those Clearing Members with peak liquidity needs that surpass NSCC available liquidity resources.

The Commission also believes that the Final SLD Proposal provides a mechanism to help ensure that NSCC maintains sufficient liquidity prospectively. The Commission agrees with commenters that have suggested that historic peak liquidity is not necessarily predictive of future liquidity needs. To this point, the Final SLD Proposal permits Clearing Members to use a Prefund Deposit in cases where a Clearing Member anticipates that its current trading activity will surpass total liquidity resources at NSCC. Furthermore, in the event that a Clearing Member does not elect to make a Prefund Deposit but does present a liquidity need to NSCC above total liquidity resources that is not accounted for by a Special SLD funding obligation, NSCC may require the Clearing Members to fund the liquidity need by making a Call Deposit. The Commission believes that these tools provide NSCC with the means to access sufficient liquidity

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96 See ConvergEx Letter II.

97 See NSCC Letter II.

prospectively. For the above reasons, the Commission believes the SLD Proposal is consistent with the requirements of Exchange Act Sections 17A(b)(3)(A) and (F) regarding the prompt and accurate settlement of securities transactions.

The Commission takes specific note of comments arguing that the costs of the Final SLD Proposal would have the unintended consequence of causing many Clearing Members to terminate their membership with NSCC and thereby concentrating the brokerage clearing business in fewer Clearing Members, potentially leading to an increase of systemic risk. The Commission recognizes that there are costs of the Final SLD Proposal for Clearing Members for which the Special SLD funding obligation applies. Clearing Members would be required to meet the Special SLD funding obligation in cash, which would be maintained by NSCC for a period of seven business days following the end of the Special Period.[98] Furthermore, funds delivered to NSCC pursuant to a Call Deposit will be maintained by NSCC for a period of 90 days.[99]

Under the Final SLD Proposal, Clearing Members would only be required to provide funding to the extent that the Clearing Member's trading activity during a two-year look-back period of correlated Special Period dates would have resulted in NSCC having insufficient liquidity resources to cover the default of that Clearing Member after taking into account all of NSCC's available liquidity resources at the time of default.[100] The Special SLD funding obligation provides for an allocation formula that ratably applies to a subset of the 30 Clearing Members that present largest peak liquidity needs to NSCC above NSCC's total liquidity

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98 See Notice, 78 FR at 21490.

99 See Exhibit 5 to File No. SR-NSCC-2013-02, http://www.sec.gov/rules/sro/nscc/2013/34-70688-ex5.pdf.

100 Id. See also Notice, 78 FR at 21489.

resources during Special Periods.[101] By allocating the funding obligation to those Clearing Members that directly create the liquidity need, the Final SLD Proposal helps to ensure that those Clearing Members who impose equivalent liquidity burdens on NSCC bear equivalent financial costs and allows each Clearing Member to exercise a degree of control over the funding obligation it bears. Accordingly, and notwithstanding the views expressed by commenters, the Commission believes that applying a liquidity obligation only to those Clearing Members that present a liquidity need to NSCC based on a historical look-back period above the total liquidity resources available to NSCC is an equitable allocation of expenses as required by Exchange Act Section 17A(b)(3)(D).

NSCC's application of the Special SLD funding obligation to no more than the 30 Clearing Members that present the highest peak liquidity exposures over a two-year look-back period during Special Periods[102] prima facie has the effect of limiting that obligation to a subset of Clearing Members. However, a Special SLD funding obligation will not be imposed on a Clearing Member, irrespective of the rank of that Clearing Member's peak liquidity need vis-à-vis other Clearing Members, unless that Clearing Member's peak liquidity need surpassed NSCC's total liquidity resources.[103]

Since whether an individual Clearing Member will have a Special SLD funding obligation is dependent solely upon the liquidity needs presented by that Clearing Member during the look-back period in excess of NSCC's then-available total liquidity resources, the

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[101] See Notice of Amendment No. 3, 78 FR at 62847.

[102] Id. See also Exhibit 5 to File No. SR-NSCC-2013-02, http://www.sec.gov/rules/sro/nscc/2013/34-70688-ex5.pdf.

[103] See Notice of Amendment No. 3, 78 FR at 62847.

Commission believes that expanding the Special SLD funding obligation to all Clearing Members is not necessary given the practical application of the rule to a subset of the 30 Clearing Members. Accordingly, despite the views expressed by some commenters, the Commission believes that limiting application of the Special SLD requirement to no more than 30 Clearing Members is consistent with the requirement of Exchange Act Section 17A(b)(3)(D) that expenses be equitably allocated among Clearing Members.

As stated above, the Commission recognizes that costs will be imposed through the Final SLD Proposal on Clearing Members for which the Special SLD funding obligation applies. The Commission also recognizes that some Clearing Members may make an economic decision to terminate their NSCC membership to avoid these costs. The Commission believes, however, that the Final SLD Proposal is a reasonable measure of the associated liquidity expenses experienced by NSCC and that the associated costs are necessary and appropriate for NSCC to ensure that it has the liquidity resources required to continue to operate in a safe and sound manner.

Under the Final SLD Proposal, a funding obligation is generated when a Clearing Member's trading activity during a historic Special Period would have resulted in NSCC having insufficient liquidity resources to cover the default of that Clearing Member after taking into account all of NSCC's available liquidity resources at that time. As a result, a Special SLD funding obligation is the amount of the difference between a demonstrated peak total liquidity need created and current total liquidity resources available, which difference NSCC would be unable to account for through other liquidity resources.

As for the unintended consequences associated with the Final SLD Proposal, the Commission agrees with NSCC that the maintenance of adequate liquidity at NSCC is a fundamental element in addressing the goal of reducing the potential systemic risk posed by a systemically-important financial market utility[104] and also a key component of NSCC's ability to prevent the failure of a Clearing Member from having a cascading effect on other Clearing Members. The Commission also believes that since Clearing Members exercise a degree of control over whether they will face an SLD funding obligation, they could explore alternatives to termination of membership to avoid incurring a Special SLD funding obligation, including changes to trading behavior so that their trading activity does not present a liquidity need to NSCC above NSCC's total available liquidity resources, as informed by the daily and monthly "liquidity transaction" reports to be provided by NSCC as part of the Final SLD Proposal.[105] Accordingly, the Commission believes the expenses charged by NSCC through imposition of the Special SLD funding obligation are reasonable as required by Exchange Act Section 17A(b)(3)(D).

For these reasons stated above, the Commission believes that the Final Proposed Rule Change containing the Final SLD Proposal meets the Section 17A(b)(3)(D) Exchange Act standard of equitable allocation of reasonable dues, fees, and other charges among its participants. The Commission finds it equitable that Clearing Members address the liquidity exposure that they actually present to NSCC during Special Periods and that such liquidity exposure is not borne by Clearing Members whose trading activity does not generate the liquidity need. Similarly, the Commission finds the Final SLD Proposal equitable in that two

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104 See NSCC Letter I.

105 See Notice of Amendment No. 2, 78 FR 42140, Notice of Amendment No. 3, 78 FR 62846, NSCC Letter II. With respect to the comments described above about NSCC requiring cash be deposited as collateral, the Commission believes that NSCC has addressed these comments and has stated that the CALC will evaluate potential alternative collateral approaches.

Clearing Members that produce the same liquidity need in excess of NSCC's total liquidity resources will be assessed the same Special SLD funding obligation. Furthermore, the Final SLD Proposal is equitable because it allows Clearing Members to anticipate and manage their own liquidity exposure to the clearing agency by changing their trading behavior. Finally, the Commission believes that the limitation in NSCC's rules to apply the Special SLD funding obligation to not more than 30 Clearing Members is not arbitrary or capricious because a Clearing Member's Special SLD funding obligation will depend solely upon its trading activity in relation to NSCC's total liquidity resources.

Several commenters raised concerns regarding the perceived burdens on competition and asserted that there are unfair and discriminatory impacts of the SLD Proposal, in particular with respect to an aspect of the eliminated Regular SLD funding obligation.[106] However, no commenters argued that the Final SLD Proposal discriminated among Clearing Members in the use of the clearing agency or imposed an unnecessary or inappropriate burden on competition. Because a Special SLD funding obligation will be imposed only to the extent that an individual Clearing Member's trading activity over a two-year historical look-back period on corresponding days surpasses the total liquidity resources available to NSCC, only a small number of Clearing Members likely will incur a Special SLD funding obligation. While the Special SLD funding obligation will very likely only be met by a small number of Clearing Members, NSCC (i) will provide all members with a daily report regarding the liquidity exposure presented by such member, (ii) will provide similar monthly reports specifically to Clearing Members to help

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106 See Citadel Letter II, Charles Schwab Letter I, Charles Schwab Letter II, Charles Schwab Letter III, Charles Schwab Letter IV, Charles Schwab Letter V, SIFMA Letter I, SIFMA Letter II, ITG Letter I, ITG Letter II, Knight Capital Letter, ConvergEx Letter I, ConvergEx Letter II.

Clearing Members determine whether they should make Prefund Deposits or otherwise manage their liquidity exposure,[107] and (iii) has created the CALC to ensure that the Special SLD funding obligation will continue to only reasonably and fairly impose a requirement on those Clearing Members that can foresee the liquidity exposure that they may present to NSCC during Special Periods.[108]

As a result, the Commission believes that the Final SLD Proposal meets the requirements of Sections 17A(b)(3)(F) and (I) of the Exchange Act. To the extent the imposition of the Special SLD funding obligation results in a burden on competition because it levies a funding obligation on some Clearing Members but not others, such burden is necessary or appropriate for NSCC to ensure that it has the liquidity resources required to continue to operate in a safe and sound manner. Furthermore, the Special SLD funding obligation does not amount to unfair discrimination among Clearing Members in the use of the clearing agency because the funding requirement is correlated directly with trading activity that creates the actual liquidity need.

VI. Conclusion

On the basis of the foregoing, the Commission finds that the proposal is consistent with the requirements of the Act and in particular with the requirements of Section 17A of the Act and the rules and regulations thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[109] that the proposed rule change SR-NSCC-2013-02, as modified by Amendment Nos. 1, 2, and 3, be and hereby is APPROVED, as of the date of this order or the date of the "Notice of No Objection to

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107 See Notice of Amendment No. 2, 78 FR 42140, Notice of Amendment No. 3, 78 FR 62846, NSCC Letter II.

108 See NSCC Letter I, NSCC Letter II.

109 15 U.S.C. 78s(b)(2).

Advance Notice Filing, as Modified by Amendment Nos. 1, 2, and 3, to Institute Supplemental Liquidity Deposits to [NSCC's] Clearing Fund Designed to Increase Liquidity Resources to Meet Its Liquidity Needs," SR-NSCC-2012-802, whichever is later.

By the Commission.

Kevin M. O'Neill

Kevin M. O'Neill
Deputy Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 70989 / December 5, 2013

INVESTMENT ADVISERS ACT OF 1940
Release No. 3732 / December 5, 2013

INVESTMENT COMPANY ACT OF 1940
Release No. 30818 / December 5, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15255

In the Matter of

JOHN THOMAS CAPITAL MANAGEMENT GROUP LLC, d/b/a PATRIOT28 LLC,

GEORGE R. JARKESY JR.,

JOHN THOMAS FINANCIAL, INC. and

ANASTASIOS "TOMMY" BELESIS,

Respondents.

ORDER MAKING FINDINGS, IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER, PURSUANT TO SECTIONS 21C, 15(b)(4) AND 15(b)(6) OF THE SECURITIES EXCHANGE ACT OF 1934, SECTION 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940 AS TO JOHN THOMAS FINANCIAL, INC. AND ANASTASIOS "TOMMY" BELESIS

I.

On March 22, 2013, the Securities and Exchange Commission ("Commission") instituted public administrative and cease-and-desist proceedings pursuant to Sections 15(b)(4) and 15(b)(6) of the Securities Exchange Act of 1934 ("Exchange Act"), Section 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 John Thomas Financial, Inc. ("JTF") and Anastasios "Tommy" Belesis ("Belesis") (collectively the "Respondents").

II.

Respondents have submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Making Findings, Imposing Remedial Sanctions and a Cease-and-Desist Order, Pursuant to Sections 21C, 15(b)(4) and 15(b)(6) of the Securities Exchange Act of 1934, Section 203(k) of the Investment Advisers Act of 1940, and Section 9(b) of the Investment Company Act of 1940 as to John Thomas Financial, Inc. and Anastasios "Tommy" Belesis ("Order"), as set forth below.

III.

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

Summary

This case concerns fraudulent conduct by the manager (the "Manager") of two hedge funds known as the John Thomas Bridge and Opportunity Fund LP I and the John Thomas Bridge and Opportunity Fund LP II (together, the "Funds"),[2] and the Funds' adviser (the "Adviser"). Respondent Belesis' broker-dealer, Respondent JTF, placed customers in the Funds, provided various services to a number of the companies in which the Funds invested, and provided execution services with respect to many of the Funds' securities transactions. The Manager and the Adviser elevated the interests of Respondents over those of the Funds by paying or causing to be paid excessive monies to JTF that should have remained with the Funds. Through Belesis' influence over the Manager and the Adviser, Respondents aided, abetted and caused the Manager's and Adviser's breaches of their fiduciary duties to the Funds.

Although JTF and the Funds shared the "John Thomas" brand name, the Adviser purported to be wholly independent of JTF. Likewise, the Manager represented that he was "responsible for all of the investment decisions" of the Funds. However, the Manager and the Adviser on occasion acquiesced to Respondent Belesis' demands regarding certain investment decisions. The independence of the Adviser and JTF was untrue.

In addition, the Manager and the Adviser used the Funds' assets to pay the Respondents significant amounts for providing services that had little or no direct value to the Funds. As one

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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.

[2] The Funds currently are known as Patriot Bridge and Opportunity Fund LP I and Patriot Bridge and Opportunity Fund LP II.

example, in connection with certain bridge loans made by Fund I, Respondents received hundreds of thousands of dollars in "fees" for providing little or no services.

Respondents

1. JTF was a broker-dealer located in New York, New York from 2007 until September 2013. At all times relevant to the conduct described herein, the firm was registered with the Commission and a member of the Financial Industry Regulatory Authority ("FINRA"). At all times relevant to the conduct described herein, JTF was controlled and indirectly owned by Belesis. At all relevant times, JTF offered brokerage and investment services, investment banking services and private wealth management.

2. Belesis, age 38, of New York, New York, was the founder and chief executive officer of JTF. Until late 2011, Belesis' firm was the primary placement agent for the Funds, and was one of several broker-dealers that executed equity trade orders for the Funds. Belesis and the Manager became acquainted in 2003.

Other Relevant Entities

3. The Adviser is an unregistered investment adviser that serves as the general partner of two hedge funds, Fund I and Fund II.

4. The Manager manages the Adviser. In that capacity, the Manager purportedly controlled all operations and activities of the Adviser and the Funds.

Background

5. The Manager established the Adviser in 2007 as an unregistered investment adviser to serve as the adviser to Fund I. The venture grew from the Manager's prior successes with bridge loan financings.

6. In 2009, the Manager and the Adviser formed a twin fund: Fund II. With the termination of Fund I scheduled for 2012, Fund II was formed in order to hold certain longer-term investments, including life settlement policies that had not matured. Initially, Fund II was structured to solicit foreign investors but when none bought shares of the fund, the Adviser opened Fund II to domestic investors.

7. The Manager and the Adviser purported to invest the Funds in three asset classes: (i) equity investments, including shares of stock, options and warrants, mostly in speculative microcap companies that were either not traded publicly or thinly-traded over the counter; (ii) bridge loans to public and non-public growth-stage companies; and (iii) life settlement policies. Although only Fund I was invested in life settlement policies, Fund II was invested in Fund I.

8. Each Fund has a lock-up period. Fund I's lock-up period was five years and was scheduled to expire in September 2012, when the Fund was to terminate. At that time, the Manager and the Adviser were expected to distribute its assets in cash and/or in kind, although distribution was incomplete by the end of September 2013. Fund II's lock-up period is four years and Fund II is scheduled to terminate no later than 2019. With the Manager's consent and at his discretion, and provided they pay a penalty fee, investors can redeem their shares before the respective lock-up periods expire.

9. Respondent JTF had several roles relating to the Funds. JTF served as the primary placement agent for solicitation of investments in the Funds and it acted as the broker for many of the Funds' equity trades. Separately, it also served as the investment bank for some of the companies that received bridge loans from the Funds. JTF has received nearly $4 million in fees and commissions directly and indirectly from the Funds.

10. At the end of 2011, the Manager valued Fund I at approximately $18 million to $20 million and Fund II at approximately $10 million. The Funds' auditor reported Fund I's "total return since inception" was twenty-four percent. Together the Funds have approximately 120 investors with just a few of them invested in both Funds.

<u>The Undisclosed Role of the Respondents in Fund Operations</u>

11. The Adviser disclosed JTF's role as placement agent and potential executing broker-dealer for the Funds' equity transactions. The Adviser made no disclosure that Respondents would become involved in the Adviser's investment activities. To the contrary, the Adviser – acting through the Manager – represented that it was solely responsible for managing the Funds and independent from Respondent JTF.

12. To underscore the independence of the Adviser and JTF, the Adviser's web site included a disclaimer indicating that other than using JTF as a placement agent, the Adviser had no business relationship with JTF.

13. Respondent Belesis was aware of the disclaimer distancing the Adviser from JTF.

14. Respondents involved themselves in directing how the Funds' money flowed to at least two companies to which the Funds loaned money, Company A and Company B.

15. Company A was formed in April 2010 when Company C, in which the Funds had invested, merged with a third company. Respondents JTF and Belesis had a long-standing relationship with Company C; JTF had raised substantial amounts of capital for Company C through numerous private placements, and JTF itself had substantial holdings in Company C's stock.

16. The Manager and the Adviser first invested the Funds' assets in Company C in 2009, when Fund I extended a bridge loan to the company. That loan was repaid, and another one was made at the end of the year. From that point on, neither of the Funds' loans to Company C was repaid; instead, the Funds received allotments of penalty shares of Company C and then Company A after the merger. In 2010, the Funds' positions in Company A had grown disproportionately to their other holdings due to the penalty shares, so that nearly a third of each Fund's assets were invested in Company A.

17. By late 2010, the Company A position grew to a paper value of more than $8 million in Fund I, and more than $2 million in Fund II, or nearly a third of each Fund's values.

18. Respondent Belesis – sometimes, but not always, in collaboration with the Manager – became involved in how the Funds' money would be invested in Company A. Company A's chief executive officer requested money from Belesis for operating costs, including rent, payroll and payments to Company A's service providers. The Funds' bank records show debits to pay certain Company A expenses.

19. In at least one instance, Belesis' decision regarding how the Funds' money would be spent at Company A, one of the Funds' largest holdings, prevailed over the wishes of Company A's corporate officers, who urged him to handle company affairs differently. However, Company A's officers had no choice but to accept Respondent Belesis' decisions because of Belesis' influence over whether and when money would flow to Company A from the Funds, the company's main source of capital.

20. Separately, in late 2009, the Manager and the Adviser invested approximately $200,000 of the Funds' money in a publicly traded shell company, and the Funds became the shell company's controlling shareholders. The shell merged with a small, private company in the summer of 2010 to form Company B. The Funds owned approximately twenty-five percent of Company B's unrestricted stock after the merger, which traded publicly on the OTC Bulletin Board.

21. Respondent Belesis exercised undisclosed influence over the Adviser in connection with certain of the Funds' investments in Company B. When the Funds extended a bridge loan to Company B and the proceeds were delayed in arriving at the company, the company president and chief executive officer addressed Belesis – not the Manager, the supposed exclusive manager of the Funds – about the delay. Belesis in turn reassured him that the Funds would provide the loan.

22. The Manager frequently deferred to Respondent Belesis and sought to placate him by delivering improper benefits relating to the Funds' investment activities to Respondent JTF, including cash, fees and securities.

<u>The Undisclosed Business Relationship between the Adviser and JTF</u>

23. In addition to the undisclosed role the Respondents had with regard to the Funds' investment activities, the Adviser and the Manager – who purported to be independent from the Respondents – also did not disclose that they were engaged in actively referring business to the Respondents.

24. This undisclosed arrangement was described in a March 2009 email from an employee of the Adviser to Belesis:

> [The Manager] and I have worked hard over the past month creating a backlog of potential clients for JTF and [the Adviser]. We now have two or three that could be JTF clients in a matter of weeks with tens of thousands of dollars in monthly fees not to mention [another business transaction] already in the bag....
>
> The failure of your staff to execute payment on our contract has put a stop to our progress. . . . I still have high hopes for the potential of this liaison between JTF, [the Adviser] and myself. Based upon your email below I estimate that you feel same. [The Manager], I know is optimistic of the potential that this relationship holds . . . .

25. In March 2009, the director of a company that the Adviser and the Manager had steered to JTF asked to meet with Belesis before paying for JTF's services. In response, Belesis angrily erupted at the Manager. The Manager's reply indicates his allegiance to Belesis: "*I just told him to send the stock and money, sign the document or get lost,*" he wrote. "*I think this will get done today. Nobody gets access to Tommy until they make us money!!!!!*"

<u>The Manager and the Adviser Diverted the Funds' Money to Enrich the Respondents</u>

26. In breach of his fiduciary duty to the Funds, the Manager, through his role at the Adviser, actively negotiated fees on behalf of Respondent JTF in connection with the Funds' activities, to the detriment of the Funds.

27. The Manager used his role as manager of the Funds to enrich the Respondents, and kept an appreciative Belesis apprised of his efforts. For example, the Manager giddily wrote to Belesis in March 2010: "*[W]e are all going to make so much f[...]ing money this year, the clients of John Thomas are going to have a banner year .... Write yourself a check and get ready to cash it $45 million.*"

28. On another occasion, after Respondent Belesis opined to the Manager about the lack of fees he was securing for JTF in February 2009, the Manager responded that "*we will always try to get you as much as possible, Everytime [sic] without exception!*"

29. Overall, the Manager's allegiance to the Respondents deprived the Funds of a material amount of money, directly or indirectly, for placement fees, loans to small companies that then used the money to pay fees to JTF, and for unearned bridge loan fees JTF received for performing little or no services.

Fund Money Was Routed to JTF for Unearned Bridge Loan Fees

30. The Funds extended short-term bridge loans to small, usually private companies. In exchange for the loans, the Funds received interest on the amount of the loan and what the Manager called an "equity kicker" of stock, options or warrants in the company.

31. The Respondents occasionally introduced the Manager and the Adviser to candidates for bridge loans. For its involvement, JTF earned a fee of approximately ten percent of each bridge loan the Funds made, plus a three percent non-accountable business expense. The Manager and the Adviser made no effort to negotiate a lower fee for JTF.

32. The Funds typically extended bridge loans to struggling, cash-poor ventures. Every dollar provided in the loan was essential to the borrowers' future prospects and, therefore, the Funds' investment in the borrowing companies and chances of ultimately being repaid.

33. The Manager abandoned his fiduciary duties to the Funds and negotiated arrangements whereby the borrowing companies – in which the Funds were invested and from which the Funds sought repayment – would pay unwarranted finder fees to Respondent JTF out of the proceeds received from the Funds. Thus, the Manager of the Funds, when negotiating bridge loans between the Funds and the borrowing companies, placed the interests of Respondents above the interests of the Adviser's clients, the Funds, and assumed responsibility for negotiating on behalf of JTF. As examples:

a. In March 2009, the Manager offered the Respondents increasingly favorable fees on a bridge loan the Funds were extending to Company A, and also offered commissions and warrants without Respondents requesting such benefits.

b. In February 2010, the Manager drafted a $130,000 commission for Respondent JTF in a term sheet for a $1 million bridge loan to a company that expressly informed the Manager that it did not want to commit to long-term financing with JTF.

c. In May 2009, the Manager structured a transaction between the Funds and Company D specifically so that Respondents JTF and Belesis could be "the hero," as the Manager wrote in an email, and earn commissions and fees.

34. Respondents were willing recipients of the Funds' generosity provided by the Manager and the Adviser, but it was the Manager who was responsible for negotiating their fees from the Funds' bridge loans.

35. In some instances, the Manager negotiated and procured a fee for the Respondents even though they had not referred the borrower to the Funds for financing and had done, at most, minimal work relating to the loan. For example:

a. The Manager was a director of Company D and introduced the company to the Funds for a bridge loan and to Respondent JTF for long-term financing. When the Funds extended a bridge loan in October 2008, JTF received a full fee for having done merely negligible work relating to the loan.

b. The Manager was a director of Company B and brought the company to Respondent JTF for investment banking work in the summer of 2010. When the Funds extended a bridge loan to Company B, JTF received a fee on the loan despite having done only minor work on the loan.

36. Between 2008 and 2010, JTF was paid a total of $488,750 in fees from four bridge loans, including at least two for which it did inconsequential work. JTF's fees came from the borrowing company, which paid the fees upon receipt of the bridge loan money from the Funds, thereby immediately diminishing the loans the Funds made by the amount of the fees the Manager arranged for Respondent JTF.

37. In addition to the bridge loan fees, the Manager and the Adviser paid JTF more than $741,000 in brokerage commissions from the Funds' securities trades, nearly $2.5 million in placement fees for selling shares of the Funds, and more than $4 million in consulting fees for investment banking work.

38. Respondents took improper action, thereby enabling the Manager and the Adviser to misuse the Funds' assets and misrepresent the Manager's exclusive role in making investment decisions for the Funds.

39. As a result of the conduct described above, Respondents JTF and Belesis willfully[3] aided and abetted and caused the Adviser's and the Manager' violations of Section 206(2) of the Advisers Act.

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[3] A willful violation of the securities laws means "that the person charged with the duty knows what he is doing." Wonsover v. SEC, 205 F.3d 408, 411 (D.C. Cir. 2000) (quoting Hughes v. SEC, 174 F.2d 969, 977 (D.C. Cir. 1949)).

IV.

In view of the foregoing, the Commission deems it appropriate, in the public interest, and for the protection of investors to impose the sanctions agreed to in Respondents' Offer.

Accordingly, pursuant to Sections 15(b)(4) and 15(b)(6) of the Exchange Act, Section 203(k) of the Advisers Act, and Section 9(b) of the Investment Company Act, it is hereby ORDERED that:

A. Respondents shall cease and desist from committing or causing any violations and any future violations of Section 206(2) of the Advisers Act.

B. Respondents are censured.

C. Respondent Belesis 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 one (1) year to the appropriate self-regulatory organization, or if there is none, to the Commission.

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

E. Respondent Belesis shall, within fifteen (15) days of the entry of this Order, pay disgorgement of $311,948, prejudgment interest of $88,052, and a civil money penalty in the amount of $100,000 to the Securities and Exchange Commission. 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. 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;[4]
(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 John Thomas Financial, Inc. and Anastasios "Tommy" Belesis as Respondents 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, Division of Enforcement, Securities and Exchange Commission, 200 Vesey Street, 4th Floor, New York, NY 10281-1022.

F. Respondent JTF shall pay civil penalties of $500,000 to the Securities and Exchange Commission. Payment shall be made in the following installments:

a. $125,000 plus interest pursuant to 31 U.S.C. § 3717, due 90 days from the entry of this Order;
b. $125,000 plus interest pursuant to 31 U.S.C. § 3717, due 180 days from the entry of this Order;
c. $125,000 plus interest pursuant to 31 U.S.C. § 3717, due 270 days from the entry of this Order; and
d. Any outstanding balance plus interest pursuant to 31 U.S.C. § 3717, due 360 days from the entry of this Order.

If any payment is not made by the date the payment is required by this Order, the entire outstanding balance the civil penalties, plus any additional interest accrued pursuant to 31 U.S.C.

[4] The minimum threshold for transmission of payment electronically is $1,000,000. For amounts below the threshold, respondents must make payments pursuant to option (2) or (3) above.

3717, shall be due and payable immediately, without further application. 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;[5]
(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 John Thomas Financial, Inc. and Anastasios "Tommy" Belesis as Respondents 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, Division of Enforcement, Securities and Exchange Commission, 200 Vesey Street, 4th Floor, New York, NY 10281-1022.

G. 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, 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

[5] See note 4 above.

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

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-71018)

Order Granting a Temporary Exemption Pursuant to Section 36(a)(1) of the Securities Exchange Act of 1934 from the Filing Deadline Specified in Rule 613(a)(1) of the Exchange Act

December 6, 2013

Rule 613(a)(1) of the Securities Exchange Act of 1934 ("Exchange Act")[1] requires the Financial Industry Regulatory Authority, Inc. ("FINRA") and the eighteen registered national securities exchanges (collectively, the "SROs") to "jointly file on or before 270 days from the date of publication of the Adopting Release [for Rule 613 of the Exchange Act[2]] 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 [the rule]." The Adopting Release for Rule 613 was published in the Federal Register on August 1, 2012,[3] thus requiring the national market system plan ("NMS plan") to be filed on or before April 28, 2013.[4] On March 7, 2013, the Securities and Exchange Commission ("Commission") granted a request from the SROs for a temporary exemption from this deadline until December 6, 2013.[5] On November 8, 2013, the SROs filed an application, pursuant to Rule 0-12 under the Exchange

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1 17 CFR 242.613(a)(1).

2 17 CFR 242.613.

3 Securities Exchange Act Release No. 67457 (July 18, 2012), 77 FR 45722 (August 1, 2012) ("Adopting Release").

4 April 28, 2013, was a Sunday. Therefore, in accordance with Rule 160(a) of the Commission Rules of Practice, the deadline for filing the NMS plan was Monday, April 29, 2013.

5 See Securities Exchange Act Release No. 69060, 78 FR 15771 (March 12, 2013); and letter from Robert L.D. Colby, Executive Vice President and Chief Legal Officer, FINRA, to Elizabeth M. Murphy, Secretary, Commission, dated February 7, 2013 ("February 7, 2013 Letter").

Act,[6] to request the Commission to grant a temporary exemption under Section 36 of the Exchange Act,[7] from the deadline specified in Rule 613(a)(1) of the Exchange Act[8] for submitting the NMS plan to the Commission until September 30, 2014.[9]

In their Current Request Letter, the SROs explain that on February 26, 2013, they published a Request for Proposal ("RFP") to solicit bids from which they will select an entity to serve as the consolidated audit trail ("CAT") plan processor to build, operate, administer, and maintain the CAT.[10] Thirty-one firms, including four distinct SRO groups, initially indicated that they planned to submit bids on the RFP.[11] The SROs further state in the Current Request Letter that following the publication of the RFP, potential bidders and members of the public, including broker-dealer members of the SROs, expressed interest in the process by which the SROs will review and evaluate bids, narrow down the list of bids, use those bids in formulating the CAT NMS Plan, and, ultimately, select the CAT plan processor.

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6 17 CFR 240.0-12.

7 15 U.S.C. 78mm.

8 17 CFR 242.613(a)(1).

9 See Letter from Robert L.D. Colby, Executive Vice President and Chief Legal Officer, FINRA, to Elizabeth M. Murphy, Secretary, Commission, dated November 7, 2013 (the "Current Request Letter").

10 In the February 7, 2013 Letter, the SROs stated that an RFP process was necessary prior to filing an NMS plan pursuant to Rule 613 ("CAT NMS Plan"). The SROs explained their belief that such a process would ensure that potential alternative solutions for creating the consolidated audit trail could be presented to the SROs for their consideration, and would provide the SROs with information necessary to prepare a detailed cost/benefit analysis as required by Rule 613. See February 7, 2013 Letter, supra note 5.

11 According to the SROs, since that time, seven firms have formally notified the SROs of their intent to withdraw as primary bidders. See Current Request Letter, supra note 9. Of the seven firms that formally notified the SROs of their intent to withdraw as primary bidders, two are SRO groups. See http://catnmsplan.com/web/groups/catnms/@catnms/documents/appsupportdocs/p217583.pdf (last visited November 19, 2013).

The SROs state in the Current Request Letter that they solicited views from potential bidders regarding whether they preferred to know the process the SROs will follow to review, evaluate, and select a bidder in advance of submitting their bids and whether that process could influence either a decision regarding whether to submit a bid or the contents of a bid. The SROs represent that many potential bidders indicated that knowing the process by which the SROs will choose the plan processor is important to finalizing their bids. According to the SROs, the potential bidders also generally expressed the view that providing bidders with four weeks between approval of a selection process and the submission deadline for the bids would be an appropriate timeframe to allow bidders to make any changes to their bids in light of the approved evaluation and selection process. Based on this feedback, the SROs filed with the Commission an NMS plan to govern the SROs' process for the selection of a CAT plan processor, and for mitigating conflicts of interest that might arise in the process (the "Selection NMS Plan").[12]

In the Current Request Letter, the SROs state that a temporary exemption is necessary and appropriate regardless of whether the Commission approves the Selection NMS Plan. Specifically, the SROs note that if the Selection NMS Plan is approved, they believe it will take "approximately seven months from the receipt of the bids to review and evaluate the bids, perform the in-depth and thorough analysis . . . required by Rule 613, and draft the CAT NMS plan for submission to the SEC."[13] The SROs further state that "[b]ecause the content of the bids is critical to the analysis needed to draft the CAT NMS Plan, the SROs estimate that seven months following the receipt of bids is necessary to ensure that they can fully address the considerations enumerated in Rule 613, including a discussion of the costs and benefits of not

12 The Commission published the Selection NMS Plan for notice and comment. See Securities Exchange Act Release No. 70892 (November 15, 2013), 78 FR 66910 (November 21, 2013).

13 See Current Request Letter, supra note 9.

only the proposed solution(s) but also of the alternative solutions considered but not proposed as the solution in the CAT NMS Plan, so that the Commission and the public have sufficiently detailed information to carefully consider all aspects of the CAT NMS Plan ultimately submitted by the SROs."[14] If the Selection NMS Plan is not approved, the SROs explain that they will need the temporary exemption to allow bidders additional time to finalize their bids, and allow the SROs additional time to develop an alternative process for evaluating the bids, developing the CAT NMS Plan, and selecting the CAT plan processor.[15]

Section 36 of the Exchange Act[16] authorizes the Commission, by rule, regulation, or order, to exempt, either conditionally or unconditionally, 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.

The Commission finds that it is appropriate in the public interest, and is consistent with the protection of investors, to grant the SROs a temporary exemption from the deadline for filing the CAT NMS Plan contained in Rule 613(a)(1) until September 30, 2014. The Commission believes that granting the exemption is appropriate in light of the need for the SROs to establish a deadline for finalizing and submitting bids in response to the RFP; to evaluate the bids submitted and select the CAT Plan Processor under the Selection NMS Plan, if the Selection NMS Plan is approved by the Commission, or an alternative process if the Selection NMS Plan is not approved by the Commission; and to draft the CAT NMS Plan.

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14 Id.

15 Id.

16 15 U.S.C. 78mm.

Accordingly, IT IS HEREBY ORDERED, pursuant to Section 36 of the Exchange Act,[17] that the SROs are temporarily exempted from the deadline for submitting the NMS plan to govern the creation, implementation, and maintenance of a consolidated audit trail and central repository contained in Rule 613(a)(1)[18] until September 30, 2014.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

[17] 15 U.S.C. 78mm.

[18] 17 CFR 242.613(a)(1).

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

December 6, 2013

In The Matter Of	:	
	:	
Guar Global Ltd.	:	**ORDER OF SUSPENSION OF TRADING**
	:	
File No. 500-1	:	

It appears to the Securities and Exchange Commission that the public interest and the protection of investors require a suspension of trading in the securities of Guar Global Ltd. ("Guar Global") because of concerns regarding the accuracy and adequacy of information in the marketplace and potentially manipulative transactions in Guar Global's common stock. Guar Global is a Nevada corporation based in McKinney, Texas. It is quoted on OTC Link under the symbol GGBL.

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

Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed company is suspended for the period from 9:30 a.m. EST on December 6, 2013 through 11:59 p.m. EST on December 19, 2013.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

December 6, 2013

In the Matter of **Aden Solutions, 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 Aden Solutions, Inc. The company has not filed any periodic reports since the period ended September 30, 2011 and there are questions regarding the accuracy of publicly available information about the company.

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

THEREFORE, IT IS ORDERED, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed company is suspended for the period from 9:30 a.m. EST on December 6, 2013, through 11:59 p.m. EST on December 19, 2013.

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. 71012 / December 6, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15637

In the Matter of MICHAEL ANTHONY GONZALEZ, Respondent.	ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act) against Michael Anthony Gonzalez ("Gonzalez" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, 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. Gonzalez operated a purported bond portfolio management business out of his home using two different business names, Michael Gonzalez INV and Michael Gonzalez Investments. In 1994, Gonzalez obtained his Series 7 Securities license. From 1994 to 2001, Gonzalez was a registered representative associated with broker-dealers registered with the Commission. In 2003, both the NASD (now FINRA) and the NYSE barred Gonzalez from associating with their member firms for misuse of client funds. Gonzalez, 48 years old, is a resident of Pasadena, California.

2. On November 13, 2013, a final judgment was entered by consent against Gonzalez, permanently enjoining him from future violations of Section 17(a) of the Securities Act of 1933, and Sections 10(b) and 15(a) of the Exchange Act and Rule 10b-5 thereunder in the civil action entitled *Securities and Exchange Commission v. Michael Anthony Gonzalez*, Case No. CV 12-03319 FMO in the United States District Court for the Central District of California.

3. Gonzalez held himself out as a bond portfolio manager through solicitations in a local magazine and directly to friends and acquaintances. Between February 2010 and April 17, 2012, when the Commission filed an emergency action against him, Gonzalez raised at least $1 million from approximately twenty investors, by falsely claiming to purchase specific California municipal bonds on behalf of those investors. In fact, Gonzalez did not purchase the bonds; instead he concealed his securities fraud with fake confirmations and receipts. Gonzalez also lured investors by touting his prior association with well-known broker-dealers while omitting to disclose that he had been barred by both NASD and the NYSE from associating with their member brokerage firms. Gonzalez also lied to investors claiming he was currently associated with a New York based registered broker-dealer which provided investor protection through the Securities Investor Protection Corporation when he was not. In fact, Gonzalez was operating a Ponzi scheme, and failed to repay investors as the bonds he sold them reached their purported maturity dates.

IV.

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

Accordingly, it is hereby ORDERED pursuant to Section 15(b)(6) of the Exchange Act that Respondent Gonzalez 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; 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
Commissioner Gallagher? not participating

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 71031 / December 11, 2013

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3515 / December 11, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15638

In the Matter of **Craig Toll, CPA,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted against Craig Toll ("Respondent" or "Toll") 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.

20 of 68

II.

In anticipation of the institution of these proceedings, Toll 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, Toll 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 Toll's Offer, the Commission finds that:

1. Toll, 64, has been a certified public accountant licensed to practice in the State of Florida since 1980. He served as Chief Financial Officer of InnoVida Holdings, LLC from approximately December 2007 until March 2011. From 1994 until 1999, he was Chief Financial Officer of CHS Electronics, Inc., a publicly traded company.

2. On December 7, 2012, the Commission filed a complaint against Toll and others in the United States District Court for the Southern District of Florida, styled *SEC v. Craig Toll, et al.,* Case No. 12-CV-24326. On November 26, 2013, the District Court entered an order permanently enjoining Toll, by consent, from future violations of Sections 17(a) of the Securities Act of 1933 ("Securities Act"), and Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 ("Exchange Act"). The Court also barred Toll from serving as an officer or director of a publicly traded company.

3. Among other things, the Commission's complaint alleged that Toll, while CFO of InnoVida Holdings, made misrepresentations and omissions to investors and prospective investors in InnoVida Holdings by creating financial statements falsely inflating InnoVida Holdings' cash and valuation, which he and InnoVida's CEO used to attract investors to the company.

IV.

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

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

Toll is suspended from appearing or practicing before the Commission as an accountant.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Aguilar
Commissioner Piwowar
not participating

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 71043 / December 11, 2013

INVESTMENT ADVISERS ACT OF 1940
Release No. 3734 / December 11, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15639

In the Matter of

MATTHEW K. LAZAR,

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 Matthew K. Lazar ("Lazar" or "Respondent").

II.

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

III.

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

1. From September 2008 through January 2009, Lazar was employed as an investment adviser representative in the Columbus, Ohio branch office of Envit Capital Private Wealth Management, LLC, an unregistered investment adviser. Lazar holds Series 7 and Series 66 securities licenses. Lazar, 33 years old, is a resident of Rochester, New York.

2. On November 27, 2013, a final judgment was entered by consent against Lazar, permanently enjoining him from future violations of Section 17(a) of the Securities Act of 1933; Sections 10(b) and 15(a)(1) of the Exchange Act and Rule 10b-5 thereunder; and Sections 206(1) and 206(2) of the Advisers Act, in the civil action entitled Securities and Exchange Commission v. Edward M. Laborio, et al., Civil Action Number 1:12-cv-11489-MBB, in the United States District Court for the District of Massachusetts. Lazar was also barred for a period of three years from participating in an offering of penny stock, including engaging in activities with a broker, dealer, or issuer for purposes of issuing, trading, or inducing or attempting to induce the purchase or sale of any penny stock.

3. The Commission's Complaint alleged that from October through December 2008, Lazar raised $585,000 from 10 investors through the sale of a PIPE (private investment in a public equity) in Envit Capital Group, Inc. Lazar allegedly misrepresented the nature of the PIPE, most notably that it guaranteed a return of 8.5% annually and that it was safe, like a fixed annuity or a certificate of deposit, despite the fact that the PIPE offering materials stated that "no assurance can be made that [the dividend] will take place." The Complaint further alleged that Lazar admitted that he did not read the PIPE offering documents when he received them, but instead first read them in approximately January 2009, after one of his investors pointed out that the PIPE offering memorandum did not guarantee a dividend. The Complaint also alleged that Lazar induced the purchase of securities without being registered in violation of Section 15(a) of the Exchange Act.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Lazar'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 Lazar be, and hereby is:

> barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization, with the right to apply for reentry after three years to the appropriate self-regulatory organization, or if there is none, to the Commission.

Any application 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 Stein
Commissioner Piwowar
Not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 71049 / December 11, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15640

In the Matter of: A.L. Waters Capital, LLC, 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 A.L. Waters Capital, LLC ("Waters Capital" 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, Respondent consents to the Commission's jurisdiction over it 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, 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. A.L. Waters Capital, LLC was, at all relevant times, a Massachusetts limited liability company based in Braintree, Massachusetts. It was registered with the Commission as a broker-dealer beginning in 2005. It was formed as a limited liability company in 2005.

2. Arnett L. Waters, age 63, was a resident of Milton, Massachusetts. At all relevant times, he was the president and chief executive officer of Waters Capital. Arnett Waters was a registered representative with Waters Capital from April 2005 through March 9, 2012, when he was permanently barred from association with any FINRA member for failing to provide testimony requested in FINRA's investigation. In 1993, Waters was censured and barred for two years by the New York Stock Exchange for forging a document to secure a bank loan and refusing to comply with the Exchange's requests for information and testimony. On December 12, 2012, Waters was barred by the Commission pursuant to Section 15(b) of the Exchange Act and Section 203(f) of the Advisers Act, based his criminal conviction for criminal contempt of the asset freeze order entered in a civil injunctive action brought by the Commission on May 1, 2012, against him, Waters Capital, and a second entity operated by Waters.

3. On December 4, 2013, a final judgment was entered by consent against Waters Capital, permanently enjoining it from future violations of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, in the civil action entitled Securities and Exchange Commission v. A.L. Waters Capital, LLC, et al., Civil Action Number 12-CV-10783, in the United States District Court for the District of Massachusetts.

4. The Commission's complaint alleged the following facts: From at least 2009 through at least April 2012, Defendant Arnett Waters engaged in a scheme to misappropriate at least $780,000 from at least 9 investors by falsely representing that he would invest their funds in securities through Defendant Waters Capital, a Massachusetts-based limited liability company formed by Waters. Waters and Waters Capital purported to create various private investment "funds" and offered them to potential investors, creating marketing materials and agreements related to these purported funds and distributing them to investors. All of these materials indicated that individuals who bought interests in these funds would be invested in business partnerships holding portfolios of securities and other investment products. Defendants accepted investors' money under the pretense that their money would be invested in the portfolios described in the fund documents. Instead, investors' money was spent on the Waters' personal expenses. Waters, and through him, Waters Capital, made multiple misrepresentations to investors, and to Financial Industry Regulatory Authority and Commission staff, to conceal the fact that investor money had been misappropriated in a fraudulent scheme.

IV.

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

Accordingly, it is hereby ORDERED pursuant to Section 15(b)(6) of the Exchange that Respondent A.L. Waters Capital, LLC, 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

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. 71050 / December 12, 2013

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3516 / December 12, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15641

In the Matter of

GLG PARTNERS, INC. and
GLG PARTNERS, L.P.,

Respondents.

ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission" or "SEC") 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 GLG Partners, Inc. ("GPI") and GLG Partners, L.P. ("GLG") (collectively, "Respondents").

II.

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

III.

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

Respondents

1. GPI is a Delaware corporation with its principal offices in New York, NY. During the time period relevant to this proceeding, GPI was listed on the NYSE. GPI served as the holding company for U.K. investment adviser GLG, which was GPI's then-primary subsidiary, as well as various GLG affiliates. During this time period, GLG shared senior management with GPI. GPI's common stock and warrants to purchase the common stock were securities registered pursuant to Section 12(g) of the Exchange Act. On October 14, 2010, GPI was acquired by a U.K.-listed issuer. GPI's stock and warrants are no longer listed.

2. GLG is a U.K. investment adviser structured as an English limited partnership, with its headquarters in London, England. It has operated in the U.S. directly and through affiliates. GLG is not registered with the Commission but is authorized and regulated by the U.K. Financial Conduct Authority. GLG is the investment manager for the GLG Emerging Markets Fund ("EM Fund") and was the investment manager for the EM Fund's side-pocket fund, GLG Emerging Markets (Special Assets) Fund ("EMSA1 Fund"), prior to the EMSA1 Fund's dissolution. The EM and EMSA1 Funds were hedge funds, formed as Cayman Islands limited liability companies, which had U.S. investors. GLG is not currently a subsidiary of GPI but remains its affiliate.

Summary

3. This matter involves investment adviser GLG's failure to maintain sufficient controls relating to the valuation of fund assets. Under GLG's asset valuation policies, assets which were not quoted in the market and whose value could not readily be determined through outside data sources ("Level 3 assets") were to be priced monthly by an independent pricing committee ("IPC"). However, GLG had established inadequate controls to ensure information relevant to Level 3 asset valuations was provided to the IPC, and, on various occasions, GLG failed to provide material information to the IPC. In addition, GLG had established no mechanism for ensuring that the IPC had sufficient time to review pricing recommendations, and, in certain instances, GLG failed to provide the IPC with enough time to review recommendations. GLG also generally kept no record of the IPC's basis for monthly decisions to keep Level 3 asset valuations unchanged, which violated GLG's Pricing Policy directive that "comprehensive documentation" be maintained "to ensure the rationale supporting any judgments made is recorded and available for future reference."

4. As a result of these controls failures, GLG overvalued a 25% private equity stake in an emerging market coal-mining company ("Coal Co.") from November 2008 through November

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

2010. This Level 3 asset had been purchased in March 2008 by the EM Fund and transferred in June 2008 to the EMSA1 Fund. The Coal Co. asset was overvalued by roughly $160 million for 25 months, resulting in inflated fee revenue of $7,766,667 for GLG and its parent GPI, then a U.S.-listed issuer. The overvaluation of the asset led to misstatements in GPI's filings with the SEC relating to the period from 2008 through the second quarter of 2010.

5. By their actions, GPI violated Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Exchange Act Rules 13a-1, 13a-11, 13a-13, and 12b-20, and GLG was a cause of these violations.

Background

GLG's Valuation Policies and Practices

6. Each GLG fund's asset valuation policies were set forth in the fund's prospectus as well as the Pricing and Valuation Policy for GLG Funds ("Pricing Policy"). The EM Fund prospectus provided that a Level 3 asset would be valued as determined by the fund's directors, in good faith and with care, in consultation with GLG and the fund's administrator. The summary of terms for the EMSA1 Fund stated that the EMSA1 Fund was adopting the same valuation principles described in the EM Fund prospectus. GLG's use of the term "Level 3" was not equivalent, and did not purport to be equivalent, to the concept of Level 3 inputs contained in U.S. Generally Accepted Accounting Principles or International Financial Reporting Standards.

7. The Pricing Policy set forth the "framework and methodology for determination, validation, approval, regular monitoring and review of pricing across the GLG Funds." Pursuant to the Pricing Policy, each fund's directors delegated the responsibility for approving prices and pricing mechanisms to GLG's IPC. Furthermore, the Pricing Policy stated that documents supporting valuations should be made and kept.

8. Pursuant to the Pricing Policy, the IPC met on a monthly basis, but GLG or the fund administrator could call additional meetings "on an *ad hoc* basis on short notice to approve a price of an asset, and/or provide additional information." The IPC did not have a fixed membership but required a "quorum" of participants from four separate groups for its meetings. The quorum for an IPC meeting consisted of:

> 1. any one Director of the relevant fund; 2. a representative of the Fund Administrator; 3. a representative from senior management of [GLG]; 4. a representative from the risk management team of [GLG].

Although not expressly stated in the Pricing Policy, only participants falling into the four categories of quorum members could vote to approve prices, and all votes were required to be unanimous. A senior member of GLG's middle-office accounting staff acted as a non-voting "chair" for the meetings, which were typically held by teleconference.

9. Under the Pricing Policy, "All assets priced using Level 3 prices should be referred to the IPC on a monthly basis for ratification and approval by the IPC."

10. GLG's middle-office accounting department did not have a systematic, monthly practice for asking GLG fund managers whether changes to the values of Level 3 assets were warranted for any assets held in their funds' portfolios. Instead, the middle-office accounting staff sporadically collected some changes in Level 3 pricing recommendations and other updates from the various GLG fund managers, then set the monthly meeting agenda and circulated the available information to an e-mail list of potential IPC participants in advance of monthly meetings.

11. Beginning in 2009, an undocumented supplemental practice developed for conducting "semi-annual private-equity reviews" in January and July, at which all of the GLG funds' Level 3 assets were reviewed by the IPC. Commentaries and documentation relevant to each position's mark were prepared by the GLG fund teams, collected by middle-office accounting staff, and then distributed by middle-office accounting staff to the potential IPC participants in advance of these semi-annual meetings. The lack of an established practice for monthly reviews created confusion within GLG as to whether relevant information and changes in pricing recommendations should be transmitted to the IPC on an ongoing, monthly basis or whether transmittal could be delayed until the next semi-annual review.

Purchase and Initial Marking of Coal Co. Stake

12. In December 2007, GLG agreed to buy a 25% stake in Coal Co. for $210 million. It was the EM Fund's objective to sell the stake in a potential near-term IPO. The EM Fund closed the Coal Co. purchase on March 20, 2008. On March 31, 2008, the IPC approved an initial valuation or "mark" of $425 million for the position. GLG based its recommendation for the $425-million mark on an internal valuation report prepared by an EM Fund analyst. This internal report employed a discounted-cash-flow ("DCF") analysis as well as a review of comparable public equities. The report took note of a large increase in coking coal prices that had occurred in late 2007 and early 2008 as the primary justification for the mark-up over the EM Fund's purchase price. Furthermore, the report projected that Coal Co. would be able to quadruple its coal production over the next four or five years, pursuant to its management's aggressive expansion plans. Three months later, the Coal Co. position was transferred to the EMSA1 Fund.

13. The manager of the EM and EMSA1 Funds resigned from GLG on October 31, 2008, along with the analyst who had prepared GLG's internal valuation report on Coal Co. and who was responsible for ongoing updates of GLG's DCF model for the position. Until June 2011, the Coal Co. stake remained in the EMSA1 Fund, which did not accept additional investment during that period.

GLG's Policies and Procedures Failed to Ensure Timely Transmittal of Relevant Information to IPC, Resulting in Overvaluation of Coal Co. Position

14. On a number of occasions between November 2008 and December 2010, GLG employees received information calling into question the $425-million valuation for the Coal Co. position, but there were inadequate policies and procedures to ensure that relevant information such as this was timely provided to the IPC or that recommendations to lower the mark were

forwarded to the IPC expediently. Additionally, there was confusion among GLG's fund managers, middle-office accounting personnel, and senior management as to whose role it was to determine that valuation issues should be elevated to the IPC.

15. GLG also failed to implement policies and procedures to ensure that the IPC participants were provided with sufficient time to thoroughly review pricing recommendations and supporting documentation forwarded to the IPC. This failure occurred despite prior guidance from the GLG funds' independent auditor, in early 2008, that the IPC should be given adequate time before making determinations in order to make sure that sufficient rigor was exercised with respect to valuations. As a result of these failures, the Coal Co. position remained overvalued during the entire period from November 1, 2008 through November 30, 2010.

2008 – 2009

16. By the time that the Coal Co. mark for the month of November 2008 was ratified by the IPC, several of the key bases for the initial mark of $425 million no longer held true. Coal Co. and GLG were no longer pursuing an IPO in the near to mid-term, there had been a significant decline in emerging equity markets and in the stock prices of comparable coal miners, and coking coal prices had begun a steep decline. GLG failed to provide current information on these factors to the IPC at that time. Additionally, GLG failed to inform the IPC that Coal Co. had experienced significant shortfalls in its projected output, GLG's prior DCF model for Coal Co. was no longer being updated, and internal doubts had arisen among GLG's analysts regarding the continued validity of the Coal Co. mark. During this same time period, GLG and GPI employees with responsibility for the EMSA1 Fund discussed in e-mails their intention to obtain a third-party valuation of Coal Co. and to reexamine the position's mark on the basis of the third-party valuation. However, there was no established procedure for obtaining third-party valuations and the third-party valuation was not obtained until January 2010.

17. During the first half of 2009, GLG's policies and procedures failed to ensure transmittal of additional relevant, valuation-related information to the IPC. For example, the IPC was not informed of a continued drop in Coal Co.'s output and in the price of coking coal. Moreover, the IPC was not informed that GLG's analysts were reaching lower valuations for the Coal Co. position. During the second half of 2009, the IPC received no updates on the Coal Co. position prior to the year-end semi-annual private-equity review.

First Half of 2010

18. GLG obtained a third-party valuation of Coal Co. in January 2010. The EM Fund co-manager's primary objective in obtaining the third-party valuation report was to assist in GLG's private-market attempts to sell the EMSA1 Fund's stake in Coal Co. rather than as a pricing document to be submitted to the IPC. He obtained a brief, free valuation report from one of EM Fund's brokers, as a client accommodation. When he later forwarded the report to the middle-office accounting staff, the middle-office accounting staff, who lacked expertise in valuing assets, assumed that the report was sufficient for the IPC to base pricing decisions upon. In actuality, the report was based on limited sources of information, and the third-party firm had made no attempt

to contact Coal Co. directly in order to obtain or verify information contained in the report. Nevertheless, the third-party report reflected a valuation for the EMSA1 Fund's Coal Co. stake of $350 million, which was $75 million less than the EMSA1 Fund's $425-million mark.

19. After receiving the report from the fund manager, GLG's middle-office accounting staff failed to forward it to the list of potential IPC participants until after business hours on the night before the January 2010 semi-annual private-equity review meeting. The report was provided to the participants as part of an extensive production of data and recommendations for all 37 private-equity positions held by GLG firm-wide. GLG thus did not provide sufficient time for the IPC participants to review the report in depth prior to the IPC meeting, which was held at 12:30 PM. The IPC approved maintaining the existing mark of $425 million based on a $200 million range of values that only appeared on the report's cover page rather than the actual valuation of $350 million set forth in the body of the report. Despite guidance from its funds' auditor in early 2008 that the IPC would benefit from technical assistance when considering valuations, GLG did not obtain such assistance for the IPC in evaluating the third-party report on Coal Co. or at any point during the relevant period.

<u>Second Half of 2010 – January 2011</u>

20. In mid-June 2010, GLG concluded that its efforts to find a private-market buyer for the Coal Co. position had failed and that a near-term IPO was still unlikely. In order to present the EMSA1 Fund investors with an alternative exit opportunity, GLG decided to hire a global financial services firm to conduct an auction of the EMSA1 Fund shares, the value of which, by that time, was almost entirely in the Coal Co. stake. The high bidder in the auction would be permitted to make a tender offer to many of the EMSA1 Fund shareholders[2] and, in June 2011, this bidder and all non-tendering shareholders would automatically be subscribed into a successor special-assets fund. The auction plan included preparation and issuance of a detailed Coal Co. valuation report by the financial services firm.

21. Although the EM Fund co-manager received the financial services firm's draft report and final valuation figures in September 2010, GLG lacked policies and procedures to ensure that the conclusions of the financial services firm were timely forwarded to and considered by the IPC. The draft report provided a preliminary valuation range of $221-259 million and a stated midpoint of $240 million. The final report provided a final valuation range of $246-284 million and a stated midpoint of $265 million, which was $160 million less than GLG's $425 million mark. However, a recommendation to lower the Coal Co. mark to the financial services firm's final valuation of $265 million was not presented to the IPC in connection with the IPC's monthly meetings for September, October or November 2010. Instead, the recommendation was put forward in January 2011 in connection with the IPC's semi-annual private equity review, to be effective December 1, 2010. At that time, however, the financial services firm's report was not shared with the IPC, based on confidentiality concerns associated with the auction process. In

[2] "U.S. persons," as well as Canadian, Australian, Japanese, and South African shareholders, among others, were to be excluded from the offer.

addition, the IPC was not provided with any valuation recommendation for the Coal Co. position or other related materials in advance of the January 2011 meeting.

Failure to Document IPC's Basis for Monthly Decisions to Keep Level 3 Asset Valuations Unchanged

22. The Pricing Policy directed that Level 3 prices be "ratifi[ed] and approv[ed]" monthly and that "comprehensive documentation" be maintained "to ensure the rationale supporting any judgments made is recorded and available for future reference." However, for 21 of 25 months from November 2008 through November 2010, GLG failed to document the basis for the IPC's monthly ratification and approval of the EMSA1 Fund's $425-million Coal Co. mark.

Inflated Fee Revenue to GLG and GPI

23. The EMSA1 Fund's summary of terms provided that the EMSA1 Fund would charge a 2% annual management fee and a 0.5% annual administration fee – identical to fee percentages charged by the EM Fund. Both the management fee and the administration fee were calculated on the basis of the EMSA1 Fund's monthly net asset value ("NAV"). Contractually, the EMSA1 Fund remitted the 2% management fee to GLG and remitted 2/3 of the 0.5% administration fee, *i.e.*, 0.33%, to a GPI subsidiary. Accordingly, a total of 2.33% in annual fees was remitted to GPI, calculated on the full amount of the Coal Co. position's valuation, which was by far the largest component of the EMSA1 Fund's NAV.

24. As a result of GLG's deficient valuation policies and procedures, the monthly valuation for the EMSA1 Fund's Coal Co. position was overstated by approximately $160 million during the period from November 1, 2008 through November 30, 2010. This led to inflated or excess management and administration fees remitted to GLG and/or GPI totaling approximately $7,766,667.

Misstatements in GPI's Filings

25. GPI's SEC filings contained a number of misstatements related to AUM which resulted from the $160-million overvaluation of the Coal Co. position from November 2008 through November 2010. AUM was a key metric for GPI because the issuer's revenues were largely a function of various types of fee revenues calculated as percentages of AUM. Information regarding AUM was thus necessary to an understanding of the results of GPI's operations. Beginning in the second quarter of 2009, GPI's filings frequently highlighted GLG's "long-short fund" and "alternative strategy" AUM, which included the EMSA1 Fund's AUM, as preferential to its "long-only fund" AUM because the former categories typically had a higher fee structure. Some of GPI's misstatements were made in quarterly or annual reports, while others appeared in press releases and/or investor presentations filed as exhibits to Forms 8-K.

26. In all, at least 14 of GPI's filings, filed with the Commission from March 2009 through August 2010, contained the following types of misstatements: (1) overstatements of AUM of the EMSA1 Fund; (2) overstatements of combined AUM of GLG special assets funds;

and (3) overstatements of AUM of GLG "mixed asset" long-short funds as a percentage of alternative-strategy AUM. These overstatements ranged in magnitude from 8.9% to 36.4%. For example, GLG's $160 million overvaluation of the EMSA1 Fund's Coal Co. position resulted in GPI's overstatement of the EMSA1 Fund's AUM by about 33.3% in its 2008 annual report and by 36.4% in its 2009 annual report. In addition, the combined AUM of GLG special assets funds was overstated by between 14% and 18% from the fourth quarter of 2008 through the second quarter of 2010.

Violations of the Exchange Act

27. Section 13(b)(2)(B) of the Exchange Act requires public companies to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles and to maintain accountability for assets. Section 13(b)(2)(A) of the Exchange Act requires public companies to make and keep books, records and accounts which, in reasonable detail, accurately and fairly reflect the company's transactions and dispositions of its assets. No showing of *scienter* is required to establish a violation of Sections 13(b)(2)(A) and (B). *SEC v. World-Wide Coin Investments, Ltd.*, 567 F.Supp. 724, 751 (N.D. Ga. 1983).

28. As set forth above, GPI and its wholly-owned subsidiary, GLG, failed to design and maintain adequate internal controls related to the valuation of fund assets, on the basis of which fee revenues were calculated and recorded. GLG had inadequate policies and procedures to ensure that information relevant to valuations was provided to the IPC when it became available, and, in various instances, GLG failed to provide necessary information to the IPC due to confusion within GLG regarding whose role it was to elevate such information to the IPC. GLG had no policies or procedures to ensure that the IPC had sufficient time to review valuation recommendations, and, in various instances, GLG failed to provide the IPC with sufficient time to review such recommendations. In addition, GLG generally kept no record of the IPC's basis for monthly decisions to keep individual Level 3 fund asset valuations unchanged. As a result of these failures, the books and records of GPI and GLG were inaccurate because the EMSA1 Fund's Coal Co. position was overvalued from November 2008 through November 2010. GPI thus violated Sections 13(b)(2)(B) and 13(b)(2)(A) of the Exchange Act, and GLG was a cause of these violations.

29. Section 13(a) of the Exchange Act and Rules 13a-1, 13a-11 and 13a-13 thereunder require issuers of registered securities to file factually accurate annual, quarterly, and current reports with the SEC. No showing of *scienter* is required to establish a violation of Section 13(a). *SEC v. Savoy Indus., Inc.*, 587 F.2d 1149, 1167 (D.C. Cir. 1978), cert denied, 440 U.S. 913 (1979). Exchange Act Rule 12b-20 requires the addition to such reports of further material information as necessary to make the required report statements not misleading.

30. As set forth above, GPI filed numerous reports with the SEC covering the period 2008 through June 30, 2010 that contained inaccuracies related to overstated AUM, which were

material. GPI thus violated the aforementioned reporting provisions, and GLG, through its valuation-related controls failures, was a cause of these violations.

Undertakings

GPI and GLG have undertaken to:

31. Retain, within 30 days from the date of entry of the Order, the services of an Independent Consultant, who is not unacceptable to the Commission's staff. Respondents shall require the Independent Consultant to perform all of the services and tasks described below. Respondents shall exclusively bear all costs, including compensation and expenses, associated with the retention and performance of the Independent Consultant.

32. Respondents shall require the Independent Consultant to conduct a comprehensive review and prepare a written report ("Initial Report") regarding GLG's policies, procedures and practices for the valuation of Level 3 assets. Respondents shall require the Independent Consultant to issue and deliver to GLG and the Commission's staff the Initial Report within 180 days from the date of entry of the Order. The Initial Report must include a description of the review performed, the conclusions reached, and the Independent Consultant's recommendations as to how GLG should improve, modify or supplement its policies, procedures and practices for the valuation of Level 3 assets.

33. GLG shall adopt all recommendations in the Initial Report, provided, however, that within 30 days after the Independent Consultant delivers the Initial Report, GLG shall in writing advise the Independent Consultant and the Commission's staff of any recommendations that it considers unduly burdensome, impractical or costly. GLG need not adopt such recommendations at that time but shall propose in writing an alternative policy or procedure designed to achieve the same objective or purpose. As to any recommendations on which GLG and the Independent Consultant do not agree, such parties shall attempt in good faith to reach an agreement within 30 days after GLG delivers the written advice. In the event that GLG and the Independent Consultant are unable to agree on an alternative proposal, GLG shall abide by the determination of the Independent Consultant.

34. GLG shall, within three months after the issuance of the Independent Consultant's Initial Report, certify, in writing, compliance with the undertakings set forth above. The certification shall identify the undertakings, provide written evidence of compliance in the form of a narrative, and be supported by exhibits sufficient to demonstrate compliance. The Commission staff may make reasonable requests for further evidence of compliance, and Respondents agree to provide such evidence. The certification and supporting material shall be submitted to Lisa W. Deitch, Assistant Director, with a copy to the Office of Chief Counsel of the Enforcement Division.

35. Respondents shall, one year after GLG's implementation of the recommendations, require the Independent Consultant to review and test GLG's policies, procedures and practices for the valuation of Level 3 assets and deliver to GLG and the Commission's staff a final written report ("Final Report") analyzing GLG's adoption, implementation, maintenance and

enforcement of the policies, procedures and practices contained in the Initial Report and the effectiveness of those policies, procedures, and practices during the prior year. Respondents shall require the Independent Consultant to issue and deliver to GLG and the Commission's staff the Final Report within 90 days from the date of the first-year implementation anniversary. The Final Report must include a description of the review and testing performed, the conclusions reached, and any additional recommendations by the Independent Consultant as to how GLG should further improve, modify or supplement its policies, procedures and practices for the valuation of Level 3 assets.

36. GLG shall adopt all additional recommendations in the Final Report, provided, however, that within 30 days after the Independent Consultant delivers the Final Report, GLG shall in writing advise the Independent Consultant and the Commission's staff of any recommendations that it considers unduly burdensome, impractical or costly. GLG need not adopt such additional recommendations at that time but shall propose in writing an alternative policy or procedure designed to achieve the same objective or purpose. As to any recommendations on which GLG and the Independent Consultant do not agree, such parties shall attempt in good faith to reach an agreement within 30 days after GLG delivers the written advice. In the event that GLG and the Independent Consultant are unable to agree on an alternative proposal, GLG shall abide by the determination of the Independent Consultant.

37. GLG shall, within three months after the issuance of the Independent Consultant's Final Report, certify, in writing, adoption of the Independent Consultant's additional recommendations. The certification shall identify the recommendations, provide written evidence of compliance in the form of a narrative, and be supported by exhibits sufficient to demonstrate compliance. The Commission staff may make reasonable requests for further evidence of compliance, and Respondents agree to provide such evidence. The certification and supporting material shall be submitted to Lisa W. Deitch, Assistant Director, with a copy to the Office of Chief Counsel of the Enforcement Division.

38. Respondents: (i) shall not have the authority to terminate the Independent Consultant, without the prior written approval of the Commission's staff; (ii) shall compensate the Independent Consultant, and persons engaged to assist the Independent Consultant, for services rendered pursuant to the Order at their reasonable and customary rates; and (iii) shall not be in and shall not have an attorney-client relationship with the Independent Consultant and shall not seek to invoke the attorney-client or any other doctrine or privilege to prevent the Independent Consultant from transmitting any information, reports or documents to the Commission or the Commission's staff.

39. Respondents shall require the Independent Consultant to enter into an agreement that provides that for the period of engagement and for a period of two years from completion of the engagement, the Independent Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with Respondents, or any of their present or former affiliates, directors, officers, employees, or agents acting in their capacity. The agreement will also provide that the Independent Consultant will require that any firm with which he/she is affiliated or of which he/she is a member, and any person engaged to assist the

Independent Consultant in performance of his/her duties under this Order shall not, without prior written consent of the Commission's staff, enter into any employment, consultant, attorney-client, auditing or other professional relationship with Respondents, or any of their present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement.

IV.

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

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act, Respondents GPI and GLG cease and desist from committing or causing any violations and any future violations of Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act, and Rules 12b-20, 13a-1, 13a-11, and 13a-13 thereunder.

B. Respondents GPI and GLG shall comply with the undertakings enumerated in Section III above.

C. Respondents GPI and GLG shall, within 14 days of the entry of this Order, pay disgorgement of $7,766,667, representing their management and administrative fee overcharges for the period November 1, 2008 through November 30, 2010, and prejudgment interest of $437,679, 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) Respondents may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
(2) Respondents 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) Respondents 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 GPI and GLG as Respondents 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 Antonia Chion, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549.

D. Within 14 days of the entry of this Order, Respondent GPI shall pay a civil money penalty in the amount of $375,000 to the Securities and Exchange Commission, and Respondent GLG shall pay a civil money penalty in the amount of $375,000 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Payment must be made in one of the following ways:

(1) Respondents may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
(2) Respondents 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) Respondents 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 GPI and GLG as Respondents 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 Antonia Chion, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, 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 disgorgement, interest and/or penalties referenced in paragraphs C-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, 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 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

Chair White
Commissioner Gallagher
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9493 / December 12, 2013

SECURITIES EXCHANGE ACT OF 1934
Release No. 71051 / December 12, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15642

In the Matter of **MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933 AND SECTIONS 15(b)(4) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate 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 15(b)(4) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Merrill Lynch, Pierce, Fenner & Smith Incorporated ("MLPFS" or "Respondent," and together with affiliates, "Merrill").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 and Sections 15(b)(4) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

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

A. Summary

1. MLPFS violated the federal securities laws in connection with its structuring and marketing of a series of collateralized debt obligation transactions ("CDOs") in 2006 and 2007.

2. In a CDO, a special purpose vehicle (an "Issuer") issues tranches of securities backed by a portfolio of assets – the collateral – owned by the Issuer. CDOs commonly have collateral managers responsible for the selection, acquisition, and monitoring of this portfolio. This Order concerns CDO Issuers named Octans I CDO Ltd. ("Octans I"), Norma CDO I Ltd. ("Norma"), and Auriga CDO Ltd. ("Auriga"). The collateral for all three CDOs consisted primarily of credit default swaps ("CDS") referencing subprime Residential Mortgage Backed Securities ("RMBS").[2]

3. MLPFS failed to inform investors in Octans I and Norma that an undisclosed third party named Magnetar Capital LLC (together with affiliates, "Magnetar") – a hedge fund firm that bought the equity in the transactions but whose interests were not necessarily the same as those of the CDOs' other investors – had rights relating to, and exercised significant influence over, the selection of the CDOs' collateral.

4. In particular, with Octans I, a $1.5 billion CDO that closed September 26, 2006, Magnetar had a contractual right to object to the inclusion of collateral selected by the collateral manager during the so-called "warehouse" phase that precedes closing. Yet the disclosure that MLPFS provided to investors stated that the collateral acquired by Octans I on closing was "selected by [the collateral manager] and held by [Merrill] pursuant to warehousing agreements between [Merrill] and [the collateral manager]." This was a material misstatement in that it made no mention of Magnetar's rights.

5. With Norma, a $1.5 billion CDO that closed March 1, 2007, a third of the assets for the portfolio were acquired during the warehouse phase by Magnetar rather than by the designated collateral manager. The collateral manager for Norma initially did not know about Magnetar's purchases but then eventually accepted them. Magnetar also exercised the equivalent of a veto over the collateral manager's selection of certain other assets for Norma. Yet with

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

[2] Residential Mortgage Backed Securities are bonds backed by pools of residential mortgage loans, in this case subprime loans. CDS are explained below.

Norma, too, the disclosure that MLPFS provided to investors stated that the collateral on closing would consist of a portfolio "selected by the Collateral Manager." This was a material misstatement because it made no mention of Magnetar's involvement in collateral selection. MLPFS also failed to disclose in the offering circulars and pitchbook used to market the Norma transaction that Magnetar received a $35.5 million discount on its equity investment in Norma and a separate $4.5 million payment that Magnetar referred to as a "sourcing fee."

6. Finally, MLPFS violated books-and-records requirements of the Exchange Act in connection with Auriga, a $1.5 billion CDO that closed December 20, 2006 and, unlike the other CDOs, was managed by an affiliate of MLPFS. Merrill had agreed (as with the other CDOs discussed in this Order) to pay "carry" from the Auriga warehouse (essentially, interest or returns that accumulated on the warehoused assets) to Magnetar. To benefit itself, however, MLPFS improperly avoided recording many of the warehoused trades at the time they occurred, which was in September and October 2006. Seeking to avoid having to pay Magnetar and having to trade out of the positions in the event that Auriga did not close or that these trades were excluded from its portfolio, MLPFS delayed recording these trades until after Auriga priced on November 22, 2006, when it became reasonably clear that Auriga would close and that the September and October 2006 trades would be included in its portfolio.

B. <u>Respondent and Other Relevant Entities</u>

7. **Merrill Lynch, Pierce, Fenner & Smith Incorporated**, a registered broker-dealer and investment adviser based in New York, at all relevant times was Merrill Lynch & Co., Inc's. ("ML & Co.") principal U.S. broker-dealer subsidiary. ML & Co., formerly one of the world's leading investment banks, was acquired by Bank of America Corporation on January 1, 2009.

8. **Merrill Lynch International** ("MLI"), a MLPFS affiliate incorporated under the laws of England, was the warehouse provider in connection with the CDO transactions at issue in this Order.

9. **Harding Advisory LLC** (together with its predecessor, "Harding") is a registered investment adviser based in Morristown, New Jersey. Harding served as collateral manager for Octans I.

10. **NIR Capital Management, LLC** ("NIR") was an unregistered investment adviser based in Charlotte, North Carolina. NIR was an affiliate of The NIR Group, LLC, which was formerly an investment management firm based in Roslyn, New York. NIR served as collateral manager for Norma.

11. **250 Capital LLC** ("250 Capital"), a MLPFS affiliate until February 2010 (when it was acquired by a third party), was an unregistered New York-based investment adviser that served as collateral manager for Auriga.

12. **Magnetar Capital LLC** is a hedge fund manager headquartered in Evanston, Illinois. During 2006 and 2007 Magnetar was involved in creating a series of CDOs with Merrill

and other arranging banks. These CDOs were typically named after astronomical constellations, and so are sometimes known as "Constellation CDOs." Octans I, Norma, and Auriga were Constellation CDOs. Magnetar purchased the equity piece of each of these transactions.

13. **Octans I CDO Ltd.**, **Norma CDO I Ltd.**, and **Auriga CDO Ltd.** were special-purpose vehicles incorporated in the Cayman Islands.

C. Facts

Background on CDOs and CDS

14. A CDO is a special purpose vehicle that issues debt to investors and uses the proceeds to invest in fixed income securities or loans. The CDO's debt is issued in different tranches that feature varying levels of risk and reward. The senior tranche is the highest rated, is first in the priority of repayment through what is called the CDO's waterfall and has the lowest risk of default. Because of the lower risk of default and the priority of repayment in the CDO's waterfall, the holders of the senior tranche have lower rates of return. The inverse is true for the lowest-rated tranche in the CDO. Typically, that tranche (usually referred to as "equity") is unrated, has the highest rate of return, is last in terms of the priority of repayment through the CDO's "waterfall" and has the highest risk of default.

15. A CDS is a type of derivative through which two parties transfer the risk of ownership of a particular reference obligation. The protection buyer ("short") of a CDS pays to purchase protection in the event of, *e.g.*, default, failure to pay interest, writedowns or substantial credit ratings downgrade of the reference obligation (collectively, "Credit Events"). The protection seller ("long") sells that protection and assumes the risk of a Credit Event on the reference obligation. In 2006, the protection buyer normally paid the protection seller a premium or spread as part of the CDS.[3] There are different types of reference obligations; the ones relevant here were RMBS or CDOs comprised of RMBS. In many respects, a CDS mimics the performance of the referenced asset. Thus, an investor can gain exposure to an asset by entering into a CDS that references the asset, instead of by purchasing the asset itself.

16. A CDO can be backed by bonds or by CDS (a "synthetic CDO"). A CDO backed by both bonds and CDS is called a "hybrid CDO." Octans I, Norma, and Auriga were hybrid CDOs with a very high percentage of synthetic assets (approximately 90%).

17. Typically, if a CDO has a collateral manager, it is the collateral manager that independently directs the selection and purchase of assets warehoused at the arranging bank. At closing, this collateral is then acquired by and transferred to the CDO issuer. The arranging bank normally executes a warehouse agreement with the collateral manager governing the acquisition

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[3] For example, a protection buyer may agree to pay a protection seller 150 basis points to purchase protection against default on a $10 million of a designated reference obligation, or $150,000 per annum, paid periodically.

of collateral, as well as the allocation of risk (losses) and carry (gains) while assets are being warehoused and also in the event the CDO fails to close.

Overview of the Merrill-Magnetar Relationship

18. In the spring of 2006, Magnetar approached MLPFS to arrange a series of CDO transactions.

19. In May 2006, a Magnetar representative ("Magnetar Representative") met with the co-heads of MLPFS's CDO structuring group ("Co-Head One" and "Co-Head Two," or the "CDO Co-Heads"), the head of MLPFS's CDO syndicate group ("Syndicate Head"), and the MLPFS salesperson covering Magnetar ("Salesperson") to discuss working together on CDOs backed by synthetic mezzanine RMBS.[4] As the Salesperson later put it in an email, the meeting participants discussed an arrangement "whereby we pick mutually agreeable [collateral] managers to work with, Magnetar plays a significant role in the structure and composition of the portfolio . . . and in return [Magnetar] retain[s] the equity class and we distribute the debt. We agreed in principle to do a series of mezz[anine] abs[5] deals . . . with largely synthetic collateral. . . . We have agreed to a short list of [collateral] managers."

20. The equity piece of a CDO transaction was typically the hardest to sell and therefore the greatest impediment to closing a CDO. Magnetar's willingness to buy the equity in a series of CDOs therefore gave it substantial leverage in the assembly of these transactions, including influence over portfolio composition.

21. Officials at MLPFS, including the CDO Co-Heads, understood that Magnetar sought to use the returns on its equity investments to fund protection premiums for short positions on the junior (mezzanine) tranches of the same or similar CDOs. Officials at MLPFS also understood that Magnetar sometimes entered into CDS in which it was the short party facing a CDO in which Magnetar also had an equity position – that is, Magnetar sometimes "shorted into" the CDOs it helped create.[6]

[4] RMBS were commonly issued in tranches of increasing risk and potential reward, all backed by a given pool of loans. As relevant to this matter, "mezzanine" refers to tranches that are below the "senior" (i.e., safest) tranches and are rated BBB and BBB-. Mezzanine tranches are riskier than senior tranches but offer a higher potential return.

[5] "ABS" refers to asset-backed securities. The term includes, but was sometimes used interchangeably with, RMBS.

[6] For example, in a July 2006 email Co-Head Two wrote to Co-Head One: "[l]et's propose to Magnetar that they do the same strategy in CLOs [i.e. collateralized loan obligations] that they r doing in ABS CDOs . . . They take the equity, we work for less, we get mgrs [i.e. collateral managers] who they select to work for less and they can short BBB rated CLOs into the deal." That same month, Co-Head Two noted in an email to Co-Head One that Magnetar was "[b]asically putting on no trigger equity – only to get positive carry to use versus their shorts (including BBB rated ABS CDOs)."

22. MLPFS accordingly should have understood that Magnetar's interests were not necessarily the same as those of potential investors in the debt tranches of the CDOs, whose investments depended solely on the CDO and its collateral performing well.

23. On July 13, 2006, the MLPFS Salesperson wrote to a Magnetar principal ("Magnetar Principal"): "Extremely important to us that you know this partnership is the top priority of the cdo group (top to bottom) . . . . They are def approaching as a partnership with you and want you to feel that way. They view you as an issurer [sic] rather than a cpty. Their ultimate goal is to maximize your return with the best structure possible."

24. Similarly, on August 18, 2006, Co-Head Two wrote to the Magnetar Principal and Representative on behalf of himself and Co-Head One, copying the Salesperson and a group of senior Merrill executives going up three levels of supervision from the CDO Co-Heads: "We view our relationship as a partnership and will do whatever it takes to make this [i.e. Octans I] (/future) transaction(s) successful and are committed to helping your platform in every way possible."

25. Merrill and Magnetar ultimately collaborated on four CDOs, including the three discussed in this Order. MLPFS's CDO structuring group received approximately $40 million in gross fees from the Constellation CDOs. In addition, Merrill received millions of dollars more in intermediation fees and warehouse carry relating to the Constellation CDOs.

<u>Octans I</u>

26. Octans I was the first CDO that MLPFS and Magnetar worked on together. MLPFS and Magnetar agreed on Harding as the collateral manager for Octans I.

27. On or about May 26, 2006, MLPFS, Harding, and Magnetar entered into an Engagement Letter that set forth broad parameters for the Octans I transaction and assigned the parties roles in it. The agreement contemplated that Magnetar would purchase the equity in Octans I.

28. After Octans I closed on September 26, 2006, Merrill assisted Magnetar in taking short positions via CDS on Octans I's mezzanine tranches.[7] That is, Magnetar "shorted" the very CDO it helped to create and in which it held equity.

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[7] On August 22, 2006, after MLPFS had priced Octans I, the Magnetar Representative emailed Co-Head One, a CDO banker, and the Salesperson: "Now that we are priced, if you can find anyone who wants to take exposure synthetically, we would like to buy protection on any of the [Octans I] tranches." Through Merrill, Magnetar shorted $10 million worth of Octans I's notes. Through other firms, Magnetar took much larger short positions on Octans I's notes. Magnetar's long equity exposure to Octans I at closing was $94 million, although months later Magnetar sold $64 million of its equity interest into a different CDO. Magnetar had informed the CDO banker in July 2006 that it would seek to "repack" the equity stake, which would diminish Magnetar's long exposure to Octans I . The CDO Co-Heads, too, were aware of Magnetar's interest in diminishing its equity stake and had approved of structural features in Octans I to make that possible.

Magnetar's Warehouse Rights and Influence on Collateral Selection

29. On or about May 26, 2006, MLI, Harding, and Magnetar also entered into a warehouse agreement approved by MLPFS's CDO Co-Heads. This agreement was a departure from Merrill's usual practice in that it gave Magnetar the dominant stake in the warehouse carry, as well as substantive rights relating to the selection and acquisition of collateral for the Octans I investment portfolio. Specifically, the warehouse agreement gave Magnetar the right to receive 85% of the warehouse carry in exchange for taking 85% of the risk.

30. The warehouse agreement, which was sent to the outside law firm that represented Merrill and Octans I in the transaction, also gave Magnetar rights relating to collateral selection, including (i) the right to object to the inclusion of collateral selected by Harding prior to purchase for the warehouse; and (ii) the right to veto any decision by MLI to trade out of collateral because Harding or MLI has determined that the collateral no longer meets criteria for inclusion in the CDO.

31. Consistent with the warehouse agreement and Magnetar's status as the anticipated equity investor, Merrill and Harding consulted with Magnetar throughout the process of acquiring assets for the portfolio.

32. For example, MLPFS sought Magnetar's approval for the composition of the so-called "CDO bucket," which was a segment of the Octans I portfolio reserved for CDO securities (as opposed to RMBS). On June 1, 2006, the MLPFS banker immediately responsible for the Octans I transaction ("CDO Banker") asked the Magnetar Representative:

> [Harding's President] and I were just talking and we thought it might be beneficial to utilize the 10% CDO bucket for cash CDO trades . . . . So if you add in the 5% BB bucket, that makes it an 85% synthetic/15% cash deal. Does that work for you?
>
> On[e] other thought was to include a 5% limit for CDOs managed by [Harding] within the collateral portfolio. Are you okay with that?

The Magnetar Representative responded: "Rather not have [Harding] cdo's in deal, just seems off. No problem w cash cdo's, although I may want to buy protection," i.e. short the CDOs separately.

33. A particularly pronounced example of Magnetar's influence on the selection of collateral for Octans I relates to an investment product known as the ABX Index.[8] Magnetar was

[8] Launched in January 2006, the ABX Index was a standardized CDS referencing a benchmark basket of 20 RMBS. The ABX Index was available at various levels of credit rating. New ABX Indices became available twice per year, and in each case referenced RMBS issued in the preceding six months. Thus, for example, ABX 2006-1 BBB referenced "BBB" rated tranches of 20 RMBS issued in the second half of 2005.

seeking, for reasons related to its own investment strategy, to have its CDOs acquire exposure to the RMBS bonds referenced in the ABX Index.

34. In May 2006, Magnetar initiated discussions with Merrill about having Octans I acquire exposure to the ABX Index. On or about May 23, 2006, the Magnetar Representative explained in a telephone conversation with the CDO Banker and MLPFS's head of ABS trading ("Head Trader") Magnetar's view of the mechanism by which the trade could be accomplished. Later that day the Magnetar Representative emailed his Salesperson at MLPFS: "Let's buy some index!" The next morning, the Magnetar Representative again emailed the Salesperson: "ABX opening weaker, lets do call, BUY!!!" The Salesperson replied: "hunting [the CDO Banker] down."

35. On or about May 30, 2006, the Magnetar Representative again reviewed the mechanics of buying the index in a telephone call that included at least the MLPFS Salesperson and Head Trader. The participants conferenced in a representative of Harding to find out if there were any index bonds to which Harding did *not* want Octans I to be exposed (so these could be "shorted" or neutralized from the portfolio's block index exposure).

36. Soon after the call, the Salesperson wrote to the Magnetar Representative (emphasis added): "We'll push to get [index] names they [i.e. Harding] have issue with [i.e. want excluded from the index exposure] tomorrow am. . . . [The Head Trader] is on board with *what you need done as far as the index goes*."

37. From June 1 to June 8, Merrill, Magnetar, and Harding worked together to acquire approximately $300 million worth of block exposure to the ABX Index at the BBB and BBB- levels. After excluding twelve bonds (out of 40 in the index at the two rating levels) that Harding said it disfavored, the Octans I portfolio had net exposure to approximately $220 million worth of ABX Index bonds, representing nearly 15% of the Octans I portfolio.

Misrepresentations and Omissions

38. Outside investors in Octans I were not informed of Magnetar's warehouse rights and role in collateral selection. This information would have been important to investors; they would have wanted to know that someone other than the collateral manager, and in particular an equity investor with interests not necessarily the same as their own, had played a significant role in selecting collateral for the portfolio.

39. MLPFS provided to investors offering circulars for Octans I. These disclosure documents stated that collateral to be acquired by the Issuer at closing was "selected by the Collateral Manager" pursuant to "warehousing agreements between MLI and the Collateral Manager." This was a misstatement: omitted entirely were Magnetar's rights under the agreement and role in selecting assets for Octans I.

40. The section of the offering circulars concerning the collateral manager also stated that the "Collateral Manager will undertake to select all Collateral Debt Securities" employing a

process that "depends heavily on the skills of the Collateral Manager in analyzing and selecting the" collateral. These too were misstatements in that no mention was made of Magnetar's rights and involvement throughout the warehousing process.

41. MLPFS also created and distributed "pitchbooks" for Octans I to potential investors. The pitchbooks, like the offering circulars, described the warehouse agreement as between Merrill and Harding, without disclosing that Magnetar was a party to, and had rights under, the agreement. The pitchbooks also referred to Harding's experience as a collateral manager "in analyzing and selecting the collateral debt securities," but were silent as to Magnetar's role in the selection of collateral. Again, these were misstatements.

42. In July 2006, Co-Head One reviewed a pitchbook that the CDO Banker had prepared. Having identified oversights in disclosure related to other risk factors, Co-Head One chided the CDO Banker in an email:

> Looks very sloppy. You and whoever speaks to investors need to be up to speed on this. Please pay attention to these details – this deal is different from our standard deal. We cannot afford to make mistakes – will get back to [the Magnetar Representative]. When I met with him today he talked about wanting to do 5 deals with us. I am depending on you to be the last line of defence when on this deal . . .

Co-Head One said nothing about the omission from the pitchbook of Magnetar's rights regarding, and involvement in, collateral selection.

<u>Norma</u>

Magnetar Reaffirms Its Interest in Portfolio Selection, in the ABX Index, and in Shorting Against Its CDOs As Well As on Them

43. MLPFS introduced NIR to Magnetar as the potential collateral manager for what became the Norma transaction. On July 1, 2006, after performing due diligence on NIR, the Magnetar Representative wrote to the MLPFS Salesperson that he would accept NIR as manager (emphasis added): "I like NIR, experienced guys, smart, quantitative approach. Negative is that they are newbies, have one h[igh] g[rade] deal, haven't even really thought about a mezz[anine] deal yet, ... A bit risky, I'll do it because I like their approach, *but will want to be very involved.*"

44. The Magnetar Representative added:

> The big issue for us is hedging. To proceed with [a transaction managed by] NIR, we would like [Merrill] to commit to selling us a certain amount of protection on the A and BBB tranches of each deal we've done with you. That way we know our equity allocation isn't getting ahead of our hedges.
>
> For example, [Merrill] would agree to sell us an amount of CDS and CDO protection equal to our equity investment on the A and BBB tra[nc]hes of [the transactions managed

by] Harding, [another manager], and NIR no worse than 20bp back of where cash is placed.

45. On July 9, 2006, the Magnetar Representative wrote to Co-Head One and the Salesperson (emphasis added): "Going fwd, we would like to be in loop on trading approval emails for our deals . . . . *For cdo's we want to buy protection from the deal*" – i.e. take a short position opposite the CDO through Merrill – "on most or all of the cdo allocation," i.e. the assets selected for the "CDO buckets" within the CDO portfolios.

46. This turned out to be the case for Norma. Magnetar, through Merrill, shorted approximately $89 million of CDO securities in Norma's portfolio of collateral.[9] (At closing the figure was $80 million.) By comparison, Magnetar's total long exposure to Norma was approximately $39 million.

47. Magnetar also sought to have the Norma portfolio acquire exposure to the ABX Index, which by July 2006 was available in the 2006-1 and 2006-2 versions. On July 31, 2006, the Magnetar Representative wrote to Co-Head One, the CDO Banker, and the Salesperson (emphasis added): "Need to be aggressive in doing the index arb[itrage] trades on ABX 1 and 2 right out of the gate. *Have to push the managers to use as many bonds as possible out of the indices*."

48. The Magnetar Representative attached to the email a draft of an engagement letter (that was never finalized) among MLPFS, Magnetar, and NIR with language that would have obligated MLPFS to "facilitate the execution of pass through trades on the ABX indices by purchasing each of the ABX.1 and ABX.2 indexes and, in respect of index securities acceptable to the [Collateral] Manager, simultaneously buying protection in the form of single-name ABS CDS from the Issuer."

49. On August 11, 2006, Magnetar sent to the Salesperson, who forwarded it to Co-Head One and the CDO Banker, a draft of an equity purchase agreement between Magnetar and Merrill. The draft, which also was never finalized, repeated Magnetar's interest in having Norma acquire exposure to the ABX index: "To facilitate the ramping of warehouse, [Merrill] will . . . assist the [Collateral] Manager to, immediately upon opening of the warehouse, sell CDS on all Manager approved names in the ABX 06-1 and 06-2 indices[.]"

Magnetar Pushes Merrill To Open the Norma Warehouse

50. On or about August 11, 2006, the Salesperson assured the Magnetar Principal: "[The CDO Co-Heads] want to get to a place where they have earned place to be one of your short-list of go-to dealers. Our job [is] to get us there by performing."

[9] Magnetar also took a short position on approximately $5 million of securities issued by Norma.

51. By mid-August 2006, Magnetar was urging Merrill to open the warehouse and begin acquiring collateral for Norma and another CDO. On August 16, 2006, the Magnetar Principal emailed the Salesperson: "I was straightforward asking to have two more warehouses open and having managers in place to opportunistically buy paper. Why is there a hold up . . .?"

52. The next day, the Salesperson wrote to the Magnetar Representative: "for index trades we need to know what names are good in both 06-1 & 06-2 yes? and do you want to execute both Baa2 & Baa3 [i.e. acquire the index at both the BBB and BBB- levels]?"

53. That evening, the Salesperson wrote to Co-Head One: "I know the warehouse committee meeting is tomorrow am . . . we have promised [the Magnetar Representative and Magnetar Principal] once that meeting is over, warehouses will be open for [Norma and another CDO]. . . . I cannot go back again and tell them they can't get going tomorrow . . . will they be able to start buying tomorrow after this meeting?"

54. On August 21, 2006, the Salesperson wrote to Co-Head One and the CDO Banker: "I told [Magnetar] the [Norma] warehouse is open tomorrow. . . .Their biggest sensitivity is timing and meeting deadlines when we say we will. . . . [The Magnetar Principal] is all over me. He will get p_ssed very quickly if things not moving forward. . . . he will want to ramp [Norma] tomorrow . . . . We can't afford to turn [him] off."

Merrill Allows Magnetar To Trade for the Norma Portfolio

55. Within two days Merrill and Magnetar started buying the ABX Index as collateral for the Norma portfolio. They did so without NIR's involvement. This was a departure from normal practice: generally the collateral manager, not an investor, works together with the arranging bank to acquire assets for a CDO.

56. MLPFS's CDO structuring group understood that it was the collateral manager's responsibility to select assets for a CDO portfolio. For example, in April 2006, Co-Head One had written to MLPFS's CDO structuring group, copying Co-Head Two: "Please note that all assumptions relating to collateral that form the basis for showing analyses to investors require collateral manager sign off. NO EXCEPTIONS."

57. On the morning of August 22, 2006, the Salesperson advised the Magnetar Representative that Co-Head One and the CDO Banker were "talking to nir about buying" and "coordinating index with [the Head Trader]."

58. The Salesperson also asked: "How much of the index are you looking to do?" The Magnetar Representative replied: "We should do $300MM each of ABX 1 and 2, should discuss with [the Head Trader] whether Baa2 or Baa3 makes more sense, inclined to stick with Baa2 . . . . Lets do a call." NIR was not included in this email communication.

59. That afternoon the CDO Banker, Head Trader, and Salesperson convened a telephone call with the Magnetar Representative to discuss the index trade for Norma. NIR was not included in this telephone call.

60. After the call, the Magnetar Representative sent the CDO Banker and Salesperson a chart, titled "Ranking of Baa2 ABX.HE Bonds," that NIR had prepared and given to the Magnetar Representative. The Salesperson forwarded the chart to the Head Trader. The chart divided the 40 bonds in the 2006-1 and 2006-2 ABX Indices at the Baa2 (BBB) level into three categories: "Top Rated" (containing 20 bonds), "Middle" (10 bonds), and "Bottom" (10 bonds).[10]

61. Beginning the next day, Magnetar acquired nearly $600 million in long synthetic block index purchases for the Norma portfolio. These purchases, done in a series of trades from August 23 to September 5, 2006, referenced the ABX 2006-1 and 2006-2 Indices at the BBB (Baa2) level. This block exposure consisted of $15 million worth of exposure to each of the 40 bonds on the indices. Each time Magnetar made a purchase for the portfolio, the Magnetar Representative emailed the Salesperson, CDO Banker, and Head Trader, but did not copy NIR.

62. On August 24, 2006, the CDO Banker left a voice message for NIR advising NIR that, as the NIR principal who received the message ("NIR Principal One") wrote in an email to the other NIR principal ("NIR Principal Two"), "the [Norma] warehouse is open" and [the Magnetar Representative] has done some index trades." NIR appears not to have contacted Merrill about the voice message.

63. In September 2006, shortly after finishing with the nearly $600 million in purchases of the ABX Indices, Magnetar and Merrill sought to eliminate or reduce exposure to the $150 million of exposure to ten bonds that NIR had classified in the "Bottom" category. Specifically, they sought to execute short trades that would offset, or net out, the long exposure to those bonds caused by the block index exposure. The Magnetar Representative and MLPFS's Head Trader did this, too, independently of NIR. NIR (along with MLPFS's Salesperson and CDO Banker) was copied on emails between the Head Trader and the Magnetar Representative concerning the short trades, but was not consulted in advance by Merrill in connection with the short trades. Ultimately, Magnetar and Merrill offset only $127.5 million out of $150 million of exposure, leaving $22.5 million in exposure to four bonds that NIR had classified as "Bottom."

64. NIR was apparently unaware that Magnetar and Merrill were trading ABX Index for the Norma portfolio. Indeed, beginning in August 2006, NIR had been independently

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[10] NIR had advised the Magnetar Representative in an email six days earlier that: (i) NIR "would choose to stay away from" the "Bottom" category, "assuming that the market premium does not compensate for the heightened risk of default"; (ii) the 10 bonds in the "Middle" category "are characterized by some weakness that would not disqualify them from purchase, but would require some degree of enhanced premium for inclusion"; and (iii) the 20 "Top Rated" bonds had "the most appealing characteristics, and [NIR] would look to aggressively add these to the portfolio assuming acceptable relative value. We would expect the premiums to be tight on the majority of these bonds, and will need to evaluate how much we can fill once we study the final transaction model in greater detail."

acquiring assets for the Norma warehouse. For example, on September 19, 2006, the Head Trader sent an electronic message to NIR Principal Two: "do you have a record of the trades that Magnetar has done on the index and single names." NIR Principal Two responded: "not on index. When you say single names, do you mean the trades we've [i.e. NIR has] done for the warehouse or something else? We obviously have the trades we've done for warehouse, but not aware of any other trades Magnetar has done."

65. Similarly, on October 11, 2006, a Merrill employee, having noticed discrepancies between Merrill's and NIR's records for the Norma portfolio, asked an NIR employee: "the first big difference I found was that we [i.e. Merrill] have a set of index trades in the warehouse. . . . Are you familiar with any of these index trades? Do they belong in Norma?" NIR Principal Two advised his employee: "Per our conversations with [the CDO Banker], none of these trades go in our warehouse."

NIR Accepts Magnetar's Index Trades

66. On or about November 9, 2006, the Salesperson, CDO Co-Heads, and CDO Banker became aware that NIR did not know about the index-related trades Magnetar had executed for the Norma portfolio. With both Magnetar and NIR having acquired assets for the portfolio, the total collateral exceeded the $1.5 billion limit on the portfolio size.

67. In November and December 2006, Merrill and NIR (with Magnetar) were involved in reconciling their records. Merrill and NIR decided that the excess collateral – this turned out to be approximately $260 million in assets that NIR had independently sourced – could be securitized in a new CDO, eventually named Fourth Street Funding, Ltd. ("Fourth Street").

68. During the reconciliation process, NIR advised Merrill of its interest in "shorting out" – i.e. reducing or eliminating exposure to – some of the RMBS bonds to which Magnetar's index trades exposed the Norma portfolio. For example, on November 13, 2006, NIR Principal Two sent the CDO Banker a portfolio list identifying $82.5 million in collateral for shorting that was attributable to the Magnetar index trades but that nonetheless ended up in Norma's closing portfolio. The $82.5 million included the $22.5 million in remaining exposure to four index bonds in what NIR had called the "Bottom" category.

69. On November 27 and 28, Merrill representatives (including the CDO Banker and Salesperson), the Magnetar Representative, and NIR held telephone calls to discuss the Norma warehouse.

70. On November 29, 2006, NIR Principal One emailed the CDO Banker and others on MLPFS's CDO desk: "attached is the latest portfolio . . . . The portfolio has been updated to reflect the ABX adjustments that we discussed." The attached portfolio included all of Magnetar's index purchases, including assets that NIR had expressed a desire to short in communications with Merrill.

71. In December 2006, NIR and MLI entered into a warehouse agreement for Fourth Street. In January 2007, Merrill and NIR moved approximately $260 million of collateral from the Norma warehouse into the warehouse for the Fourth Street transaction.

72. Leading up to Norma's close on March 1, 2007, NIR repeatedly sought to have Merrill reduce the portfolio's exposure to the $22.5 million in remaining exposure to the "Bottom" of the index. NIR made one final effort on February 23, 2007, advising the CDO Banker and other Merrill employees in an email from NIR Principal Two: "we'd prefer not to add the longs that correspond to the pending shorts until we've finalized our trading strategy, which should be shortly after closing. In the event we're unable to execute shorts and stay in compliance with [a rating agency hedge test], we don't want to be long these bonds." In response, the Head Trader emailed a subordinate trader and other Merrill employees, stating: "This is NOT to change in any way. The portfolio has been agreed upon."

73. The Norma portfolio ultimately included all of Magnetar's index-related trades.

Magnetar's Control Over Norma's CDO Bucket

74. As discussed above, the "CDO Bucket" was a segment of the portfolio reserved for securities issued in other CDO transactions. Magnetar insisted that it approve – and in most cases short – the positions in Norma's $150 million CDO bucket.

75. On November 27, 2006, the Magnetar Representative wrote to the NIR Principals and the MLPFS Salesperson, both CDO Co-Heads, the CDO Banker, and the Head Trader:

> First of all, I'm starting to feel like I'm not seeing any of the trade approval requests. I should be on the regular distribution list for those, resi [i.e. RMBS], CDO or anything else (especially anything else!), as I'm sure has been discussed.
>
> Second, I definitely want to approve any CDO's that go in the deal, don't recall approving any, so I assume 'Approved' [in a list NIR had sent] means only that NIR has internally approved the credit.
>
> For [three specified cash CDO securities], I only want them in the deal if I'm buying the protection [i.e. if the warehouse acquires them in synthetic form], absolutely do NOT want any of those three bonds in the deal as cash bonds.

76. That night, the Magnetar Representative wrote to the Salesperson: "After all of our painful discussions on communications, . . . I can't begin to understand how someone approved 11 CDO's into Norma without me knowing about them."

77. The next morning, the Salesperson reassured the Magnetar Representative: "I hear you. . . . [I] spoke to [the CDO Banker] this am. . . . [The CDO Banker] has to make sure that the [collateral] manager sends list of prospective collateral [to you] to check if any issues 'prior' to sending requests [to the Head Trader for the warehouse]."

78. Merrill and NIR complied with the Magnetar Representative's demands – NIR removed the three cash CDO positions to which he had objected (and changed two of those CDO positions from cash to synthetic).

79. Through emails variously sent to, among others, the CDO Banker, Syndicate Head, Head Trader, Salesperson, and NIR Principals, Magnetar also selected or approved three more CDO positions subsequently added to Norma's portfolio.[11] And in many cases Magnetar, through Merrill, took the short side opposite Norma's long synthetic exposure (dictating the spread levels at which it would do so). Magnetar ultimately was the short counterparty on all but one of Norma's eight synthetic positions (seven of them at closing), meaning that it was short into Norma approximately $89 million ($80 million at closing), with an additional $5 million short on debt tranches of Norma.

Misrepresentations and Omissions

80. Outside investors in Norma were not informed of Magnetar's involvement in collateral selection. This information would have been important to investors; they would have wanted to know that someone other than the collateral manager, and in particular an equity investor with interests not necessarily the same as their own, had played a significant role in selecting collateral for the portfolio.

81. MLPFS provided to investors offering circulars for Norma. These disclosure documents stated that collateral to be acquired by the Issuer at closing was "selected by the Collateral Manager," with no mention of Magnetar's role in collateral selection.

82. The offering circulars also stated that the "Collateral Manager will perform certain investment management functions, including directing and supervising the investment by the Issuer in [its collateral]," employing a process whose success "depends heavily on the skills of the Collateral Manager in analyzing and selecting the" collateral. Again, no mention was made of Magnetar's involvement throughout the warehouse phase.

83. The offering circular for Norma contained the following disclosure:

> Initial Preference Shareholder may Enter Into Credit Derivative Transactions Relating to [Collateral] in the Issuer's Portfolio. On or after the Closing Date, the Initial Preference Shareholder [i.e. the equity investor – Magnetar] may enter into credit derivative transactions relating to [collateral] included in the Issuer's portfolio under which it takes a short position (for example, by buying protection under a credit default swap relating to such obligation or security) or otherwise

[11] In one instance, the Syndicate Head wrote to the Magnetar Representative and NIR Principal One, copying the CDO Banker, to ask them to consider a non-Constellation CDO for inclusion in the Norma portfolio as a favor to Harding. Harding, the Syndicate Head wrote, had been a big buyer of other Constellation CDOs and "very likely the Norma deal."

> hedges certain of the risks to which the Issuer is exposed. The Issuer and Noteholders will not receive the benefit of these transactions by the Initial Preference Shareholder and, as a result of these transactions, the interests of the Initial Preference Shareholder may not be consistent with those of Noteholders.

84. This disclosure advised debt investors in Norma that the unnamed equity investor (Magnetar) might have a short position on assets as to which the Issuer was long, or might otherwise hedge certain of the risks to which the Issuer was exposed. This disclosure, however, did not apprise investors that Magnetar, through Merrill, was taking short positions opposite the Issuer on assets that Magnetar helped *select for the Issuer* in the warehouse phase. The conflict of interest, in other words, was substantially greater than what was disclosed, rendering the disclosure materially misleading.

85. MLPFS also created and distributed "pitchbooks" for Norma to potential investors. The pitchbooks, like the offering circulars, discussed only NIR's experience as a collateral manager and approach to the selection of collateral, and were silent as to Magnetar's role in the selection of collateral. The pitchbooks were therefore misleading.

86. MLPFS structured Norma so that the CDO would provide Magnetar with a $35.5 million discount on its equity investment and with a $4.5 million payment at closing that Magnetar referred to as a "sourcing fee." The offering circular for Norma failed to disclose that the CDO subsidized Magnetar's investment with a discount and therefore the gross proceeds in the offering circular were overstated by the $35.5 million amount. As a result, investors were told that Norma had more cash flowing into the deal at closing than it actually did, and were never informed that the CDO was financing a large discount. In addition, the offering circular and pitchbook for Norma failed to disclose Magnetar's receipt of the $4.5 million fee even though the MLPFS CDO structuring group's protocol (as reflected in draft written procedures) at the time was to disclose the receipt of fees by third parties. In an October 2006 email concerning a different Constellation CDO, the Salesperson had noted in an email to the Magnetar Representative (following a conversation that included both of them as well as the CDO Banker and Syndicate Head) that debt investors would view the $4.5 million fee as "excess cash coming out of the deal" and so were not possible in the Constellation CDO under discussion, but "in the upcoming deals" – i.e., future transactions, including Norma, whose closing at the time of this email was still months away – such a fee was a possibility because it "can [be disclosed] in the marketing materials" for those transactions.

<u>Auriga</u>

Overview

87. The collateral manager for Auriga was MLPFS affiliate 250 Capital. Auriga's warehouse phase lasted from September 2006 to December 20, 2006, when the transaction closed.

88. Auriga's portfolio at closing consisted of 121 CDS in which Auriga sold protection to certain counterparties on various RMBS. Thus, Auriga was "long," and the ultimate counterparties were "short," those assets.

89. For 79 of those 121 CDS, the ultimate counterparty was MLI, which shared a system of records with MLPFS.[12] Thus, when collateral was being assembled for Auriga during its warehouse phase, a MLPFS affiliate effectively bought protection on 79 assets from another MLPFS affiliate, 250 Capital, which was acting on behalf of the Auriga warehouse.

90. MLPFS had agreed to pay most of the "carry" on Auriga's warehouse to Magnetar. Magnetar and 250 Capital in turn agreed to share the carry, so that Magnetar would receive 75%, and 250 Capital 25%, of the carry. Thus, Magnetar was entitled to most of the premiums that short counterparties paid to the warehouse for protection under the CDS

91. The 79 trades took place in September and October 2006 (the "September and October Trades"). In order to benefit Merrill, however, MLPFS's ABS trading desk ("Desk") did not record 68 of the September and October Trades in the MLPFS books and records where its CDS trades were regularly recorded at the time they occurred. Rather, to avoid paying carry to Magnetar in the event that any of the trades was excluded from Auriga's portfolio before the deal closed, the Desk delayed recording those 68 trades until after Auriga priced on November 22, 2006, when it became reasonably clear that each of those CDS would ultimately be included in Auriga's portfolio. That date was as much as two months after the September and October Trades occurred.

92. The Desk also delayed entering those 68 September and October Trades in MLPFS's books and records in the belief that it would avoid the necessity of having to trade out of those CDS in the event that they were not ultimately included in Auriga's portfolio. If any of the long positions that 250 Capital acquired for Auriga were not transferred from the warehouse to the CDO, the Desk believed that they would remain on MLPFS's books, potentially requiring Merrill to unwind them. The Desk believed that it could avoid this problem by delaying the recording of the trades.

93. When the Desk entered those 68 trades in MLPFS's books and records after Auriga priced on November 22, 2006, the Desk inaccurately recorded the trade date as November 22, 2006, rather than the September and October 2006 dates when the trades actually took place.

[12] As was typical of CDOs at the time, for the CDS in Auriga's portfolio, MLI served as the initial counterparty. In the initial counterparty role, MLI directly faced Auriga as the short on the CDS in the portfolio, and then acted as an intermediary by entering into an offsetting long position with an "ultimate" short counterparty, such as another dealer, on the same reference RMBS, leaving MLI with no net exposure. For 83 of the CDS acquired for Auriga's portfolio during the warehouse period and after closing, however, MLI did not enter into such offsetting trades, and thus, MLI itself was also the ultimate counterparty with short exposure on those trades.

MLPFS's Failure To Properly Record the September and October Trades

94. 250 Capital (on behalf of the Auriga warehouse) and the Desk (on behalf of MLI) agreed to the following CDS trades on or about the respective dates and at the notional values below:

Trade Date	Notional Value	Number of Trades
09/19/2006	$132,000,000	19
09/20/2006	$90,000,000	7
09/21/2006	$47,000,000	7
10/02/2006	$85,000,000	10
10/06/2006	$120,000,000	15
10/10/2006	$90,000,000	6
10/13/2006	$40,000,000	4

95. Together, the 68 CDS trades above had a notional value of $604 million, representing approximately 40 percent of the total notional value of Auriga's fully-ramped portfolio, and 75 percent of the notional value of the total number of CDS trades between 250 Capital (on behalf of Auriga) and MLI before and after closing.

96. At the time of each of the September and October Trades, 250 Capital and the Desk agreed upon the reference RMBS asset on which Auriga was to sell protection as well as the spread payable to Auriga.

97. Although MLPFS did not generate confirmations for the September and October Trades, both 250 Capital and the Desk understood that they were bound to execute the CDS, and that the trades occurred, when they agreed upon the RMBS reference assets and spreads on the respective September and October dates above.

98. In contemporaneous emails, both 250 Capital and the Desk referred to trades as having been "locked" once they agreed upon spreads. For example, in an email to 250 Capital dated October 6, 2006 – one of the trade dates set forth above – referring to an asset on which 250 Capital had agreed to sell protection, a trader on the Desk ("Trader") wrote: "spreads are locked effective now. Cool?" Similarly, an October 11, 2006 spreadsheet that 250 Capital sent to the Desk records the October 6 Trades as "locked."

99. The Desk's informal platform for retaining information from prior trades, known as "Xlint," further reflected the Desk's understanding that the September and October Trades took place on the September and October dates set forth above, in that the Desk's entries for 14 of the Auriga CDS trades in Xlint show dates in September or October.

100. MLPFS's "US Based Credit Derivative Business Compliance Supervision Manual," which applied to the Desk in 2006, required, *inter alia*, that "[a]ll business transactions must be properly recorded on the Firm's 'Books and Records' in a prompt and timely manner (processed the same day as the transaction is executed)[.]"

101. Despite the parties' understanding that the September and October Trades were effective in September and October, and MLPFS's policy that trades were to be recorded "in a prompt and timely manner," the Desk delayed recording 68 of those trades in MLPFS's database for synthetic trades, known as "Aurora." The Desk did so in order to benefit Merrill by avoiding the need to pay carry to Magnetar on any of the September and October Trades that might be excluded from Auriga's portfolio prior to closing.

102. Ordinarily, to compensate Merrill for the risk it assumed in keeping the CDS in Auriga's warehouse on its books during the ramping period, Merrill would have kept for itself the warehouse carry, including CDS spread, paid to the warehouse prior to closing. However, in exchange for Magnetar's agreement to purchase the equity in Auriga, MLPFS agreed to pay the carry to Magnetar, which subsequently agreed to pay 25% of the carry it received to 250 Capital, but MLPFS did not promptly record that liability. The Desk therefore deferred recording the trades in Aurora until after Auriga priced on November 22, 2006, when it became reasonably certain that each of the September and October Trades would be transferred from the warehouse into Auriga's portfolio.

103. In a November 15, 2006 email to the Head Trader, the Trader, who had executed the September and October Trades, wrote: "Most single name trades [facing the Desk] are not done as I didn't want to give [Magnetar] carry if the bond was thrown out of the vehicle."

104. Similarly, in a December 20, 2006 email to the Head Trader under the subject heading "CDS for auriga", 250 Capital's Managing Director wrote: "[The Trader] mentioned a concern about the cds names and the way we booked them. I was insistant [*sic*] that we lag the trade, but lock the spreads. the negative carry ml would have on that for the warehouse was about 750k /month given Magnetar's warehouse carry arrangement. There was no reason to start paying a derivative early."

105. Moreover, the Desk postponed the entry of the September and October trades in Aurora because it believed that doing so might avoid a need for Merrill to trade out of the CDS if they were not ultimately included in Auriga's portfolio. If the CDS trades were not transferred from the warehouse to the CDO, the long positions that 250 Capital acquired on behalf of Auriga would have remained on MLPFS's books, potentially requiring that the Desk unwind them. In the Desk's view, it could obviate any need to do so by delaying the recording of the September and October Trades.

106. As the Trader explained to the Head Trader in a November 27, 2006 email: "[250 Capital] and I discussed the option of booking the trades and we mutually decided not to. I saw no reason to pay carry … and I thought I was giving us/[250 Capital] more flexibility if names were kicked out of the deal (i.e. if the trade doesn't exist there's nothing to liquidate)."

107. Accordingly, Merrill did not record 68 of the September and October Trades in its systems until after Auriga priced on November 22, 2006, when it became reasonably certain that the September and October Trades would be included in Auriga's portfolio.

108. Moreover, Merrill inaccurately recorded the date for the September and October Trades in Aurora as November 22, 2006, rather than the September and October dates on which the trades actually occurred. Thus, MLPFS's books and records showed a trade date for the September and October 2006 Trades that was as much as two months later than the actual trade dates.

D. Violations

109. As a result of the conduct described above, MLPFS willfully[13] violated Sections 17(a)(2) and 17(a)(3) of the Securities Act, which prohibit, in the offer or sale or securities, respectively "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," and "engag[ing] in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

110. As a result of the conduct described above, MLPFS willfully[14] violated Section 17(a)(1) of the Exchange Act and Rule 17a-3(a)(2) thereunder, which require every registered broker or dealer to make and keep current ledgers or other records reflecting, among other things, all assets and liabilities.

[13] 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)).

[14] *See supra* note 13.

IV.

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

Accordingly, pursuant to Section 8A of the Securities Act and Sections 15(b)(4) and 21C of the Exchange Act, it is hereby ORDERED that:

A. Respondent MLPFS cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act and Section 17(a)(1) of the Exchange Act and Rule 17a-3(a)(2) thereunder.

B. Respondent MLPFS is censured.

C. Respondent shall, within ten (10) business days of the entry of this Order, pay disgorgement of $56,286,000 and prejudgment interest of $19,228,027 and a civil money penalty in the amount of $56,286,000 (for a total payment of $131,800,027) to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600 and 31 U.S.C. § 3717. Payment 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 MLPFS 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, Director, New York Regional Office, Securities and Exchange Commission, 3 World Financial Center Suite 400, New York, NY 10281.

By the Commission.

Elizabeth M. Murphy
Secretary

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

Chair White, Commissioner Gallagher not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9494 / December 12, 2013

SECURITIES EXCHANGE ACT OF 1934
Release No. 71052 / December 12, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15642

In the Matter of **MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED,** **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 BANK OF AMERICA CORPORATION AND ITS AFFILIATES**

Bank of America Corporation ("Bank of America") has submitted a letter on behalf of itself and its affiliates, dated October 21, 2013, 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 Merrill Lynch, Pierce, Fenner & Smith Incorporated's ("MLPFS's")[1] public settlement of public administrative and cease-and-desist proceedings instituted by the Commission. On December 12, 2013, the Commission instituted an Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act and Sections 15(b)(4) and 21C of the Exchange Act, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order") against MLPFS.

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[1] Bank of America acquired MLPFS in January 2009.

Under the Order, the Commission found that MLPFS, a registered broker-dealer and investment adviser, willfully violated Sections 17(a)(2) and 17(a)(3) of the Securities Act in connection with its structuring and marketing of two collateralized debt obligations ("CDOs") in 2006 and 2007. The Order concerned CDO issuers named, *inter alia*, Octans I CDO Ltd. ("Octans I") and Norma CDO I Ltd. ("Norma"). MLPFS failed to inform investors in Octans I (a $1.5 billion CDO that closed on September 26, 2006) and Norma (a $1.5 billion CDO that closed on March 1, 2007) that an undisclosed third party—a hedge fund firm that bought the equity in the transactions but whose interests were not necessarily the same as those of the CDOs' other investors—had rights relating to, and exercised significant influence over, the selection and assembly of the CDOs' collateral.

Without admitting or denying the findings in the Order, except as to the Commission's jurisdiction over it and the subject matter of the proceedings, MLPFS consented to the Order. In the Order, the Commission ordered that MLPFS, *inter alia*, be censured, cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act, and pay disgorgement of $56,286,000, prejudgment interest of $19,228,027, and a civil money penalty of $56,286,000 to the United States Treasury.

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 representations set forth in Bank of America'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 (as defined above) 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 Bank of America and its affiliates resulting from the Commission's Order (as defined above) is hereby granted.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Chair White
Commissioner Gallagher
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 3735 / December 12, 2013

INVESTMENT COMPANY ACT OF 1940
Release No. 30828 / December 12, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15643

In the Matter of JOSEPH G. PARISH III and SCOTT H. SHANNON, Respondents.	ORDER INSTITUTING PUBLIC ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTIONS 203(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940 AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") and Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act"), against Joseph G. Parish III ("Parish") and Scott H. Shannon ("Shannon," and together with Parish, "Respondents").

II.

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

III.

On the basis of this Order and Respondents' Offers, the Commission finds[1] that:

A. Summary

1. This matter involves violations of the federal securities laws by Shannon and Parish in their role as investment managers for a collateralized debt obligation transaction ("CDO"). Shannon and Parish were the principals of NIR Capital Management, LLC ("NIR"), which, as the collateral manager of the CDO, was responsible for the independent selection, acquisition and monitoring of a portfolio of assets – the collateral – backing a series of securities issued to investors by a special-purpose vehicle (the "Issuer") named Norma CDO I Ltd. ("Norma").

2. Respondents nevertheless allowed the equity investor in Norma, a hedge fund firm consisting of Magnetar Capital LLC and its affiliates (together, "Magnetar"), to influence the selection of Norma's portfolio of collateral. Respondents knew that Magnetar sought to take short positions on CDO debt, in addition to its long investment in CDO equity. Respondents, therefore, should have realized that Magnetar's interests were not necessarily the same as those of potential investors in the debt tranches of Norma, whose investments depended solely on the CDO and its collateral performing well.

3. The Norma transaction was a $1.5 billion CDO that closed on March 1, 2007. The collateral for the transaction consisted of approximately 90% credit default swaps ("CDS") referencing residential mortgage backed securities ("RMBS").[2] Approximately 10% of the portfolio – the so-called "CDO bucket" – consisted of securities issued in other CDO transactions. The transaction was structured and marketed by subsidiaries of Merrill Lynch & Co., Inc. (collectively "Merrill"), which also lent their balance sheet to store, or "warehouse," collateral acquired for the CDO in the months leading up to the closing of the transaction.

4. As a result of Magnetar's influence, NIR ultimately incorporated into the portfolio collateral that Shannon sought to exclude, including significant exposure to RMBS that Magnetar and Merrill, not Respondents, had initially acquired and selected. Parish allowed

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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.

[2] RMBS are bonds backed by pools of residential mortgage loans, in this case subprime loans.

Magnetar to influence the form of exposure to, or selection of, a substantial amount of CDO assets that ended up in Norma's portfolio and should have known that Shannon sought to exclude significant RMBS exposure.

5. In a Collateral Management Agreement with the Norma Issuer (NIR's client), NIR represented that, in performing its duties, it would:

> act in good faith and exercise reasonable care, using a degree of skill and attention no less than that which [NIR] exercises with respect to comparable assets that it manages for itself and . . . in a commercially reasonable manner consistent with accepted practices and procedures applied by reasonable and prudent institutional managers of national standing in connection with the management of assets [comparable to Norma's collateral].

6. NIR also represented that it would "follow its customary standards, policies and procedures in performing its duties" as collateral manager for Norma.

7. These representations were misleading because they did not disclose Magnetar's role in the process of collateral selection and because Respondents departed from the represented standard of care.

8. Merrill had arranged the Norma transaction at the impetus and behest of Magnetar, and Respondents knew that Magnetar picked NIR as the manager after Merrill proposed it for consideration. Both Merrill and Magnetar therefore were in a position to send NIR additional CDO business.

9. By March 2008 (a year after its closing), Norma had collapsed. Although Norma's investors lost more than $515 million, NIR received approximately $2 million in management fees, a portion of which flowed to Shannon and Parish individually.

B. <u>Respondents</u>

10. **Scott H. Shannon**, 50 and a resident of Charlotte, North Carolina, was one of NIR's two Managing Partners. By 2007, Shannon had 20 years of experience in structured and corporate finance. Shannon and his staff were primarily responsible for choosing Norma's RMBS assets.

11. **Joseph G. Parish III**, 57 and a resident of North Carolina, was NIR's other Managing Partner. By 2007, Parish had 28 years of experience in structured and corporate finance. Parish and his staff were primarily responsible for choosing Norma's CDO assets.

C. <u>Other Relevant Entities</u>

12. **NIR Capital Management, LLC** was an unregistered investment adviser based in Charlotte, North Carolina. During 2006 and 2007, NIR was the collateral manager for five

CDOs (totaling approximately $7.5 billion in assets under management), all arranged by Merrill. NIR was an affiliate of The NIR Group, LLC ("NIR Group"), which was formerly an investment management firm based in Roslyn, New York. Shannon and Parish ran all of NIR's day-to-day activities, including its investment-advisory function. Respondents were not involved in the activities of NIR Group other than their management of the assets of the CDOs.

13. **Merrill Lynch, Pierce, Fenner & Smith Incorporated**, the principal U.S. broker-dealer subsidiary of Merrill Lynch & Co., Inc., has been registered with the Commission since March 12, 1959. Merrill structured and marketed the Norma CDO and was one of the leading arrangers of CDOs between 2005 and 2008. On January 1, 2009, Merrill was acquired by Bank of America Corporation.

14. **Merrill Lynch International**, a Merrill affiliate incorporated under the laws of England, was the warehouse provider for Norma.

15. **Magnetar Capital LLC** is an asset manager headquartered in Evanston, Illinois. During 2006-2007 Magnetar was involved in creating a series of CDOs with various arranging banks and collateral managers. These CDOs were typically named after astronomical constellations, and so are sometimes known as "Constellation CDOs." At the time the RMBS and CDO assets were purchased, Magnetar had committed to purchasing $90 million worth of Norma's equity tranche. NIR was aware that Magnetar took $60 million in short positions on CDO assets into Norma's portfolio among the final pre-closing trades.[3] After the pre-close ramp was completed and without NIR's involvement, Merrill reduced the net cost of Magnetar's equity investment in Norma from $90 million to $39 million. Unknown to Respondents, Magnetar took an additional $20 million in short positions on CDO assets through Merrill into Norma's portfolio during the warehouse phase, and also took a short position on $5 million of securities issued by Norma itself.

16. **Norma CDO I Ltd.** was a special purpose vehicle incorporated in the Cayman Islands on December 7, 2006.

D. <u>Facts</u>

<u>Background On CDOs and CDS</u>

17. A CDO is a special purpose vehicle that issues debt to investors and uses the proceeds to invest in fixed income securities or loans. The CDO's debt is issued in different tranches that feature varying levels of risks and returns. The senior tranche is the highest rated, is first in the priority of repayment through what is called the CDO's waterfall and has the lowest risk of default. Because of the lower risk of default and the priority of repayment in the CDO's waterfall, the holders of the senior tranche have lower rates of return. The inverse is true for the lowest-rated tranche in the CDO. Typically, that tranche (usually referred to as "equity") is

[3] After Norma closed, Parish also allowed Magnetar to take an additional $8.9 million short position on a CDO that went into Norma's portfolio.

unrated, has the highest rate of return, is last in terms of the priority of repayment through the CDO's "waterfall" and has the highest risk of default.

18. A CDS is a type of derivative through which two parties transfer the risk of ownership of a particular reference obligation. The protection buyer ("short") of a CDS pays to purchase protection in the event of, *e.g.*, default, failure to pay interest, writedowns or substantial credit ratings downgrade of the reference obligation (collectively, "Credit Events"). The protection seller ("long") sells that protection and assumes the risk of a Credit Event on the reference obligation. In 2006, the protection buyer normally paid the protection seller a premium or spread as part of the CDS.[4] There are different types of reference obligations; the ones relevant here were RMBS or CDOs comprised of RMBS. In many respects, a CDS mimics the performance of the referenced asset. Thus, an investor can gain exposure to an asset by purchasing CDS that references the asset, instead of by purchasing the asset itself.

19. A CDO can be backed by bonds (a "cash CDO") or by CDS (a "synthetic CDO"). A CDO backed by both bonds and CDS is called a "hybrid CDO." Norma was a hybrid CDO. When fully ramped, Norma was comprised of approximately 95% synthetic assets.

20. Typically, a collateral manager would acquire synthetic collateral by sending out BWICs (or, bids wanted in competition) or responding to OWICs (or, offers wanted in competition) or broker/dealer axe sheets from the market ("axe" refers to a credit a broker/dealer has a particular interest in purchasing or selling). The winners of a BWIC process would be those counterparties who offered to pay the highest premiums to the CDO going long the asset. The inverse is true for an OWIC. The winner is the counterparty that agrees to accept the lowest premium for going long the referenced asset.

21. Because the acquisition of the collateral for a CDO takes time, a warehouse facility is normally opened at the arranging bank (here Merrill) for the benefit of the yet-to-be created CDO. A warehouse essentially is a designated account through which the bank finances the acquisition of collateral before the transaction closes. The bank purchases collateral upon the instruction of the collateral manager; the collateral is then placed in the warehouse facility for the benefit of the yet-to-be created CDO.

Roles Of NIR And Merrill

22. As collateral manager, NIR was the investment adviser for the Issuer, both selecting and managing a portfolio pursuant to a collateral management agreement with the Issuer.

23. In general, the collateral manager for a CDO determines which assets are appropriate for inclusion in a CDO's portfolio. A CDO transaction may or may not have a collateral manager. However, when a CDO is managed, the manager's independent selection of

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[4] For example, a protection buyer may agree to pay a protection seller 150 basis points to purchase protection against default on a $10 million of a designated reference obligation, or $150,000 per annum, paid periodically.

assets is an important selling point to potential investors, and information about the collateral manager's selection process is included in marketing materials and the offering circulars by which the CDO's debt is sold.

24. Norma was structured and marketed by Merrill, which (as discussed) also acted as their warehouse lender.

Origin Of Norma

25. Norma came about because Magnetar, a prospective equity purchaser, approached Merrill in the spring of 2006 about arranging a series of CDOs that would meet certain of Magnetar's specifications so that Magnetar could purchase the equity in the resulting CDO. In industry parlance, this was a so-called "reverse inquiry" deal because it came about at the behest of an investor rather than an arranging bank or collateral manager. Magnetar approved NIR as the collateral manager for the Norma CDO after Merrill introduced NIR to Magnetar.

26. The equity piece of a CDO transaction was typically the hardest to sell and therefore the greatest impediment to closing a CDO. This was especially true by mid-2006 for CDOs linked to RMBS. Magnetar's willingness to buy the equity in a series of CDOs, including Norma, therefore gave it substantial leverage in these transactions.

27. Shannon and Parish understood that Magnetar was interested in "hedging" its investments in CDO equity with short positions on CDO debt. Respondents, therefore, should have realized that Magnetar's interests were not necessarily the same as those of potential investors in the debt tranches of Norma, whose investments depended solely on the CDO and its collateral performing well.

28. On or about August 17, 2006, NIR and Merrill entered into a warehouse agreement that, as is common with CDO warehouse agreements, gave NIR the responsibility to select and acquire collateral that, with Merrill's approval, would be warehoused at Merrill and ultimately included in the Issuer's portfolio at closing.

Assembly Of Norma's RMBS Portfolio

Magnetar And NIR Each Sourced Assets

29. During the summer of 2006, a representative of Magnetar ("Magnetar Representative") discussed with Respondents an investment product known as the ABX Index.[5]

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[5] The ABX.HE was an index of RMBS names constructed by Markit Group Limited. The first ABX.HE Index was launched in January 2006. Dealers of subprime RMBS would select 20 different RMBS issued six months prior to the launch date with a new version of the index issued every six months. ABX.HE 2006-1 launched in January 2006 referencing 20 selected subprime RMBS issued in the second half of 2005. Each ABX.HE was actually five separate indices based on a tranche from each of the 20 subprime RMBS transactions related to the rating level of the tranche and then equally weighted in the index (*e.g.*, ABX.HE 2006-1 BBB contained the 20 "BBB" rated tranches from each of the selected subprime transactions).

The Magnetar Representative eventually asked that Respondents provide Magnetar a ranking of RMBS contained in the BBB rated ABX.HE 2006-1 and 2006-2 Indices (which will be referred to as the "2006 ABX Indices").

30. On August 16, 2006, Shannon, copying Parish, sent the Magnetar Representative an email attaching a "ranking" that divided the combined 40 bonds in the 2006 ABX Indices into what Shannon called "3 buckets based on our analysis of collateral, structure, performance, and issue/servicer."

31. In this email, Shannon described the buckets as follows (emphasis added):

> A) <u>Top half</u>: *these are the 20 bonds with the most appealing characteristics, and we would look to aggressively add these to the portfolio* assuming acceptable relative value. . . .
>
> B) <u>Next 25%</u>: *these 10 bonds are characterized by some weakness that would not disqualify them from purchase*, but would require some degree of enhanced premium for inclusion.
>
> C) <u>Bottom 25%</u>: *we would choose to stay away from these 10 bonds*, assuming that the market premium does not compensate for the heightened risk of default.

Respondents provided this analysis to the Magnetar Representative for informational purposes, not as a trading authorization.

32. On August 24, 2006, however, Parish emailed Shannon to say that a Merrill employee in the CDO group "left a voice message that the warehouse is open; she also noted that [Magnetar Representative] has done some index trades. Not sure what that means. . . . maybe he will ramp the deal for us." This last comment was a joke; as Parish (and Shannon) well knew, it was NIR's, not Magnetar's, job to "ramp" Norma, *i.e.*, to select and acquire collateral for the Norma warehouse.

33. However, as it turned out, in late August and early September 2006, the Magnetar Representative used the groupings in Shannon's "buckets" email to purchase $600 million worth of 2006 ABX Indices intended for Norma, which in effect caused Norma to take a long position on all 40 bonds on the 2006 ABX Indices at the BBB credit level. The Magnetar Representative subsequently caused Merrill to enter into separate CDS contracts by which Merrill took off-setting short positions on most or all of the 10 bonds that Shannon had put in the "bottom 25%" bucket.

34. The result intended by Magnetar and Merrill was for Norma to be long the 30 bonds in NIR's "top half" and "next 25%" groupings, and to have no net exposure to NIR's

"bottom 25%."[6] In total, Magnetar's purchases resulted in $472.5 million in long exposure (net the off-setting shorts) to the names on the 2006 ABX Indices, all intended for Norma.

35. Merrill never sent Respondents trade confirmations for the $600 million in long trades that the Magnetar Representative made, as required under the warehouse agreement. Thus Respondents, despite being the investment managers for Norma, were unaware of those trades. Consequently, beginning on August 17, 2006, Respondents set about independently assembling a portfolio for Norma.

36. As part of this process, among other things, Shannon and his team conducted credit analysis of potential collateral (over 2000 RMBS bonds), memorializing their results in continually updated lists of "acceptable" or "approved" RMBS bonds. Shannon primarily looked to and relied on the senior RMBS credit analyst at NIR ("Credit Analyst") to create the approved lists.

37. Using the approved lists, Shannon acquired assets in the marketplace. By November 9, 2006, NIR had caused the Norma warehouse to acquire $1.081 billion worth of synthetic RMBS collateral independently selected by Shannon and his team. $275 million of the synthetic RMBS collateral referenced 19 of the top 30 ABX names sent to Magnetar on August 16, 2006. Of that amount, only $150 million referenced bonds in the 2006 ABX Indices at the BBB credit level (and an additional $125 million referenced bonds in the 2006 ABX Indices at the BBB- credit level). This is in part because Shannon and his team did not find a number of bonds on the 2006 ABX Indices acceptable for purchase.

Shannon Accepted Magnetar's Purchases Despite Negative Credit Views

38. On or about November 9, 2006, Shannon and Parish learned from Merrill that Magnetar's trades were intended for Norma. Shannon and Parish were confused that a third party had purchased collateral for the portfolio.

39. As Norma's portfolio size was capped, it could not accommodate all of NIR's and Magnetar's trades.[7] Shannon attempted to determine which of the component parts of the Magnetar-acquired indices (meaning the individual names included in the 2006 ABX Indices) should stay in the portfolio and which should be eliminated by "shorting out" (*i.e.*, entering into offsetting trades on) the unwanted assets.

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6 Magnetar did not fully offset all of the long exposure to the 10 bonds in the "bottom 25%," leaving $22.5 million in long exposure to four of the bonds. As discussed below, when Norma closed, this $22.5 million of exposure remained.

7 Respondents and Merrill eventually came up with the solution to create a new CDO – known as Fourth Street Funding, Ltd. ("Fourth Street") – to house the excess collateral. To "accommodate" Magnetar's purchases, Respondents and Merrill moved $260 million in RMBS collateral that NIR actually selected for Norma from that warehouse into a later-created Fourth Street warehouse.

40. Starting on November 13, 2006, Shannon categorized (in a spreadsheet that Parish sent to Merrill, copying Shannon, on that same day) $82.5 million of Magnetar's index purchases as "short." On that same day, Shannon wrote to the Credit Analyst:

> This is a long story which I'll fill you in on later, but I need to get your confirmation that the "Long" index names [*i.e.*, bonds] I listed below are OK for us to invest, while the "Short" are deals we want to stay away from . . . . The short story is that we have the opportunity to pull in names from the index to fill out our ramp (part of Magnetar hedging strategy), and I created the list below based on what we had already invested in, plus names on the Approved List that we didn't hit due to tight spread levels. Concentrations are not an issue, at least in this preliminary view. Please let me know if you would change any of these. Pretty timely.

41. On November 16, 2006, Shannon wrote Parish, "Do you want to give [Merrill] an indication of which names we would want to short?", to which Parish responded, "[Merrill] told [u]s to work it through [Magnetar]. We should compile a list of required short positions . . . ." On November 17, 2006, Shannon wrote to the Credit Analyst, "I created the attached based on what you gave me last night. Just would like you to confirm this is accurate prior to forwarding to Merrill." In the attached spreadsheet, Shannon now identified $127.5 million in Magnetar's index purchases (including the $82.5 million from the November 13 list) as "short." Later that day, Shannon sent the same spreadsheet to Parish: "See attached for listing of long, shorts."

42. On November 21, 2006, Shannon, copying Parish, sent Merrill a "portfolio report . . . to reconcile the long/short Index positions." The report classified the forty RMBS underlying Magnetar's ABX purchases as either "long," "fence," or "nuetral" [sic]. The "neutral" [sic] category consisted of $67.5 million of exposure (including the $22.5 million discussed in paragraph 48 below) that Shannon wanted to neutralize by shorting. The "fence" category consisted of an additional $90 million of exposure that Shannon was on the fence about ($60 million of which Shannon previously marked as "short" on November 17).

43. By late November 2006, Shannon accepted the collateral Magnetar had selected. On November 28, 2006, Shannon, without copying Parish, wrote to the Credit Analyst (emphasis added): "Long story short, it looks like the plan had always been to include the 30 names in the index that we said were acceptable, and not include the bottom 10. *This will pick up some bonds that we would not otherwise have bought based on recent performance, but they will be in the portfolio*."

44. Shannon continued:

> Magnetar bought all the names in the index, so we have excess concentrations in a number of names that would either stay in the

> deal, or seed a new mez[zanine] deal[8] . . . . Communication between us, Magnetar, and Merrill [has] not been very effective . . . .

45. Shannon followed up in a December 3, 2006 email, again without copying Parish, to the Credit Analyst (emphasis added):

> Perhaps you could . . . *let me know the deals [i.e., RMBS bonds] in norma that we should be prepared to defend based on recent performance* . . . .
>
> As I believe I mentioned last week, the final portfolio includes a number of index trades we did not execute, as we are long the 30 names we initially indicated to Magnetar were acceptable. *This leaves us with several names we probably would not want* such as rasc deal and mabs deal, but we also picked up a number of good ones such as ramp EFc and ffml.

46. In total, in November 2006 NIR ultimately incorporated into the portfolio at least $67.5 million, and as much as $157.5 million, in collateral that Shannon had sought to exclude.

47. In December 2006, NIR and Merrill entered into a warehouse agreement for Fourth Street, the new CDO that would house the excess collateral resulting from Magnetar's competing purchases. In January 2007, Respondents and Merrill moved $260 million worth of synthetic RMBS assets and $28 million of CDO assets that Respondents had independently selected for Norma months earlier from the Norma warehouse into the Fourth Street warehouse.

Norma Closed With RMBS Assets Shannon Did Not Want

48. As the March 1, 2007 closing date for Norma approached, Shannon continued to try to exclude certain bonds from the portfolio, including the $22.5 million in long exposure that Magnetar did not fully short out from the August 2006 "bottom 25%" bucket. For example, on February 23, 2007, Shannon, copying Parish, sent an email to Merrill employees with the subject heading "Non-inclusion of several bonds into Norma." Seeking to have Merrill at least eliminate Norma's remaining $22.5 million exposure to four bonds that NIR initially ranked at the bottom, Shannon noted in pertinent part: "we don't want to be long these bonds."

49. After Merrill relayed Shannon's concerns to Magnetar, the Magnetar Representative responded to both Merrill and Parish, "As we discussed, think we should close the deal [with the $22.5 million], then see what combo of stuff we can trade . . . and those names we need to hedge. Some of those will be super difficult to trade right now."[9] The $22.5 million

8 The new transaction was Fourth Street. *See* footnote 7 above.

9 A day later, Shannon noted in an email to the Credit Analyst: "We really don't want to be long those 22.5mm bonds, but if we short now without corresponding purchase of additional bonds at wider spreads, we would

– along with the other Magnetar purchases that Shannon had sought to short out – was in Norma's closing portfolio.

Assembly Of Norma's CDO Bucket

50. Parish allowed Magnetar to be involved in the form and selection of CDO assets acquired for Norma. As a result, Parish knew that Magnetar was the short counterparty for much of Norma's synthetic exposure to CDO securities (and, unknown to Respondents, Magnetar was the short counterparty on nearly all of that synthetic exposure through Merrill).

51. Parish began work on Norma's $150 million "CDO bucket" in mid-September 2006. Before purchasing any CDO securities, Parish reached out to the Magnetar Representative on September 18, 2006: "not sure if you consider exposure to your CDOs [i.e. Constellation CDOs] to be redundant or not. Let me know either way." The Magnetar Representative responded: "I actually prefer to have my CDOs in the portfolio. Whether or not you buy the cash, I will do CDS [that is, be the short counterparty] with you in whatever size you need."

52. On November 27, 2006, Parish, copying Shannon, sent the Magnetar Representative a summary of securities acquired or pending for Norma's CDO bucket (totaling $118 million). The Magnetar Representative responded to Parish and Shannon, copying several Merrill employees:

> First of all, I'm starting to feel like I'm not seeing any of the trade approval requests. I should be on the regular distribution list for those, resi [RMBS], CDO or anything else (especially anything else!), as I'm sure has been discussed.
>
> Second, I definitely want to approve any CDO's that go in the deal, don't recall approving any, so I assume "Approved" means only that NIR has internally approved the credit.
>
> For [the three *non*-Constellation CDOs that NIR had acquired in cash form], I only want them in the deal if I'm buying the protection [*i.e.*, if Magnetar can short them synthetically], absolutely do NOT want any of those three bonds in the deal as cash bonds.

53. In a further email to Parish, the Magnetar Representative continued to assert his "rights": "just wanted to put my foot down with ML on stuff going in warehouse without my approval. Technically, I have approval rights on resi [RMBS], but on CDO's it has always been very clear that I want to be involved from the beginning." Parish and the Magnetar

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be in violation of [a] test [referring to a credit rating agency-imposed hedge test]." Shannon also referred to one of these RMBS bonds as a "real stinker."

Representative agreed to a telephone call, with Parish noting: "We can review the portfolio and get clear on any mixed signals."

54. After this, Parish accommodated Magnetar's preferences. In particular, in November 2006, Parish and Magnetar jointly worked with Merrill on the CDO bucket and made the following changes:

- removed one $7.5 million non-Constellation CDO that NIR had acquired in cash form;
- changed the form of two non-Constellation CDOs from cash to synthetic form (with Magnetar as the short counterparty),[10] which increased the size of the CDO bucket by $9.5 million; and
- cancelled an order for a cash Constellation CDO and replaced it with a new order for the same CDO in synthetic form (with Magnetar as the short counterparty) for the same amount.

55. In December 2006, NIR acquired exposure to two additional CDOs. One was a Constellation CDO in synthetic form (again, with Magnetar as the short counterparty) and one was a non-Constellation cash CDO that the Magnetar Representative approved for consideration.

56. When fully ramped prior to closing, Norma had six cash CDO positions totaling $57.5 million (five of which were bonds from other Constellation CDOs), and seven synthetic CDO positions totaling $85 million (five of which were on other Constellation CDOs). Known to Parish, Magnetar was the short counterparty on four of the synthetic positions, meaning that Magnetar had a $60 million short position opposite Norma's CDO assets. (Unknown to Respondents, Magnetar took an additional $20 million in short positions on CDO assets through Merrill into Norma's portfolio.) After Norma closed, Parish also allowed Magnetar to take an additional $8.9 million short position on a CDO that went into Norma's portfolio.

57. Magnetar's undisclosed involvement in the assembly of the CDO bucket disadvantaged Norma and its investors. The synthetic CDO securities that Magnetar demanded in place of cash CDO securities had an "implied writedown" feature that obligated Norma, as the long counterparty, to pay the short counterparty when certain contractually specified events short of default occurred. This feature caused Norma to suffer losses more quickly than it would have if it owned the CDO securities in cash form.

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[10] Parish at one point asked the Magnetar Representative if he would be "opposed" to NIR bringing back a cash component to one of the CDO securities and the Magnetar Representative responded, "Afraid so, [that CDO] in particular I don't want the cash in there."

Shannon And Parish Misled Their Advisory Client, The Issuer

58. Shannon and Parish each received $116,553 out of NIR's $2.2 million management fee for Norma. NIR's client, the Issuer, however, knew nothing about Magnetar's involvement in collateral selection or about Respondents' compromised decision-making.

59. In the Collateral Management Agreement for Norma (which Shannon signed on behalf of NIR), NIR represented to the Issuer that all collateral purchased for the Issuer on or before the closing date "satisf[ied] all of the terms and conditions applicable to such purchases as set forth" in the Collateral Management Agreement. And in the Collateral Management Agreement, NIR undertook to:

> act in good faith and exercise reasonable care, using a degree of skill and attention no less than that which [NIR] exercises with respect to comparable assets that it manages for itself and, without limiting the foregoing, in a commercially reasonable manner consistent with accepted practices and procedures applied by reasonable and prudent institutional managers of national standing in connection with the management of assets of the nature and character of [Norma's collateral] . . . . To the extent not inconsistent with the foregoing, [NIR] shall follow its customary standards, policies and procedures in performing its duties [as Collateral Manager].

60. These representations were materially false or misleading in that Respondents departed from the required level of care and from NIR's customary standards, policies and procedures when Respondents allowed Norma to acquire assets that Magnetar, not NIR, had initially chosen and that Shannon would have preferred to exclude from the portfolio.

E. Violations

61. As a result of the negligent conduct described above, Respondent Parish willfully[11] violated Section 206(2) of the Advisers Act, which prohibits "engag[ing] in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client."[12]

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11 A willful violation of the securities laws means merely "'that the person charged with the duty knows what he is doing. It does not mean that, in addition, he must suppose that he is breaking the law.'" *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)).

12 Unlike Section 206(1) of the Advisers Act which requires proof of scienter, Section 206(2) of the Advisers Act may rest on a finding of simple negligence. *SEC v. Steadman*, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992) (citing *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194-95 (1963).) *See also SEC v. Wash. Inv. Network*, 475 F.2d 392, 396 (D.C. Cir. 2007).

62. As a result of the conduct described above (which at a minimum was reckless), Respondent Shannon willfully violated Sections 206(1) and 206(2) of the Advisers Act. Section 206(1) of the Advisers Act prohibits "employ[ing] any device, scheme, or artifice to defraud any client or prospective client."

F. Undertakings

63. Respondents have undertaken to dissolve NIR Capital Management, LLC within seventy-five (75) days upon the issuance of this Order. Within ten (10) days of such action, Respondents shall certify to the staff that NIR Capital Management, LLC has been dissolved.

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

IV.

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

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

A. Respondent Shannon cease and desist from committing or causing any violations and any future violations of Sections 206(1) and (2) of the Advisers Act, and Respondent Parish cease and desist from committing or causing any violations and future violations of Section 206(2) of the Advisers Act.

B. Respondent Shannon 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 two (2) years to the appropriate self-regulatory organization, or if there is none, to the Commission.

C. Any reapplication for association by Respondent Shannon will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against Respondent Shannon, 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 Parish be, and hereby is:

suspended from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization for a period of 12 months, effective on January 1, 2014; 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 for a period of 12 months, effective on January 1, 2014.

E. Respondent Shannon shall, within ten (10) business days of the entry of this Order, pay disgorgement of $116,553 and prejudgment interest of $24,109 and a civil money penalty in the amount of $116,553 (for a total payment of $257,215) to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600 and 31 U.S.C. § 3717.

Respondent Parish shall, within ten (10) business days of the entry of this Order, pay disgorgement of $116,553 and prejudgment interest of $24,109 and a civil money penalty in the amount of $75,000 (for a total payment of $215,662) to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600 and 31 U.S.C. § 3717.

Payment must be made in one of the following ways:

(1) 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

(2) 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 Shannon and Parish as Respondents 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, Director, New York Regional Office, Securities and Exchange Commission, 3 World Financial Center Suite 400, New York, NY 10281.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 71065 / December 12, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15438

In the Matter of DARLENE A. BISHOP, Respondent.	ORDER MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934

I.

In these proceedings, instituted on August 23, 2013 pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act"), respondent Darlene A. Bishop ("Respondent" or "Bishop") has submitted an Offer of Settlement ("Offer") which the Securities and Exchange Commission ("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, Respondent consents to the Commission's jurisdiction over her and the subject matter of these proceedings and to the entry of this Order Making Findings and Imposing Remedial Sanctions Pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Order"), as set forth below.

III.

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

1. From at least June 2010 to February 2011, Bishop was a principal of JonDar Enterprises, LLC, a Texas limited liability company, through which she received compensation for marketing and selling securities offered by Dresdner Financial. Bishop never was registered as a broker or was associated with a registered broker-dealer. Bishop, 41 years old, is a resident of Odessa, Texas.

2. On August 1, 2013, a judgment was entered by consent against Bishop, permanently enjoining her from future violations of Sections 5(a), 5(c), and 17(a) of the Securities Act of 1933 ("Securities Act") and Sections 10(b) and 15(a) of the Exchange Act and Rule 10b-5 thereunder in the civil action entitled Securities and Exchange Commission v. Geoffrey Lunn, et al., Civil Action Number 12-cv-02767, in the United States District Court for the District of Colorado.

3. The Commission's complaint alleged that between June 2010 and February 2011 Bishop marketed fraudulent securities offered by a fictitious business called Dresdner Financial directly to investors through emails, phone calls and other means. The complaint further alleged that Bishop sold fraudulent, unregistered securities to at least 21 investors for a total of at least $1,452,000 and was paid at least $253,000 from the investors' funds as a commission. The complaint also alleged that Bishop made numerous false statements to the investors regarding the securities and the reasons for which the investors had not received their promised returns.

4. On August 6, 2013, Bishop pled guilty to one count of aiding and abetting wire fraud in violation of Title 18 United States Code, Section 1343 before the United States District Court for the Western District of Texas, in United States v. Darlene Bishop, Case No. 13-cr-00239.

IV.

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

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

For a period of five years from the date of this Order, Respondent shall not engage in or participate in any unregistered offering of securities conducted in reliance on Rule 506 of Regulation D (17 C.F.R. § 230.506), including by occupying any position with, ownership of, or relationship to the issuer enumerated in 17 C.F.R. § 230.506(d)(1) (adopted by the Commission in Release No. 33-9414).

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Gallagher
Commissioner Piwowar
not participating

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 71068 / December 12, 2013

INVESTMENT ADVISERS ACT OF 1940
Rel. No. 3736 / December 12, 2013

Admin. Proc. File No. 3-15057

In the Matter of

PETER SIRIS
c/o M. William Munno
Seward & Kissel LLP
One Battery Park Plaza
New York, NY 10004

OPINION OF THE COMMISSION

EXCHANGE ACT PROCEEDING

INVESTMENT ADVISER PROCEEDING

Grounds for Remedial Action

Injunction

Respondent was permanently enjoined from violations of the federal securities laws. *Held*, it is in the public interest to bar respondent from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization, and from participating in an offering of penny stock.

APPEARANCES:

M. William Munno and *Kimberly E. White*, of Seward & Kissel LLP, for Peter Siris.

Paul Gizzi and *Osman Nawaz*, for the Division of Enforcement.

Appeal filed: January 22, 2013
Last brief received: May 8, 2013

I.

Peter Siris appeals from the decision of an administrative law judge barring him from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization and from participating in an offering of penny stock, based on his having been enjoined from violating various provisions of the federal securities laws. We base our findings on an independent review of the record, except with respect to those findings not challenged on appeal.

II.

Siris is the founder and managing director of Guerilla Capital Management, LLC, which is an investment adviser to two funds that invest in Chinese reverse merger companies.[1] Siris is also the managing director of Hua Mei 21st Century, LLC, a consulting firm that provides services to Chinese reverse merger companies.[2] In 2012, Siris, Guerilla Capital and Hua Mei agreed, without admitting or denying allegations, to be enjoined from violating Sections 5(a), 5(c), and 17(a) of the Securities Act of 1933;[3] Sections 10(b) and 15(a) of the Securities Exchange Act of 1934,[4] and Rule 10b-5[5] and Rule 105 of Regulation M[6] thereunder; and Section 206(4) of the Investment Advisers Act of 1940,[7] and Rule 206(4)-8[8] thereunder.[9] In addition to

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1 A "reverse merger" is a "method for a private company to become public without fulfilling the ordinary disclosure and registration obligations of a newly public company. The private company arranges to be acquired by a public company with minimal assets (*i.e.*, a shell company) and transfers the private company's assets to the new, publicly-traded owner in exchange for the shell company's equity, and the private company's former management then runs the original company under the corporate identity of the acquiring public company." *SEC v. Cavanagh*, 445 F.3d 105, 108 n.4 (2d Cir. 2006); *see also* SEC, *Investor Bulletin: Reverse Mergers* (June 2011), *available at* http://www.sec.gov/investor/alerts/reversemergers.pdf.

2 Through his funds—Guerilla Capital LP and Hua Mei 21st Century LP—and consulting firm, Siris was a significant investor and consultant in the area of Chinese reverse merger companies. Siris also has written several books on investing and previously wrote an investment column for the New York Daily News, in which he would often discuss the companies in which his funds invested.

3 15 U.S.C. §§ 77e(a), 77e(c), & 77q(a).

4 15 U.S.C. §§ 78j(b) & 78*o*(a).

5 17 C.F.R. § 240.10b-5.

6 17 C.F.R. § 242.105.

7 15 U.S.C. § 80b-6(4).

8 17 C.F.R. § 275.206(4)-8

9 *SEC v. Siris*, No. 12 Civ. 5810 (S.D.N.Y. Sept. 18, 2012).

entering the injunction, the district court ordered the defendants, jointly and severally, to pay $592,942.39 in disgorgement, plus prejudgment interest of $70,488.83, and ordered Siris personally to pay a civil penalty of $464,011.93. The complaint in this civil action (the "Complaint") alleged a variety of illegal conduct in connection with trading by Siris and affiliates in multiple Chinese companies. The Complaint alleged "wide-ranging misconduct from 2007 to 2010, including improper sales of unregistered securities, unregistered broker-dealer activity, illegal insider trading, material misrepresentations and omissions, and trading in violation of certain short-selling restrictions." Because these allegations are central to our determination of sanctions and to our consideration of Siris's arguments on appeal, we summarize them below.[10]

A. Siris engaged in misconduct related to China Yingxia.

Many of the Complaint's allegations involved the defendants' relationship with China Yingxia, a purported nutritional health food company with operations in Harbin, China.[11] China Yingxia entered the U.S. capital markets through a reverse merger in May 2006. Early in 2007, China Yingxia sought to raise capital in the United States through meetings with potential investors. In April 2007, China Yingxia representatives met in New York City with various fund managers, including Siris, and in July 2007, Siris on behalf of his two funds invested $1.5 million in the company through a private investment in public equity ("PIPE") transaction.[12]

According to the Complaint, after investing in China Yingxia through this PIPE transaction, Siris sold unregistered shares of China Yingxia stock in violation of Sections 5(a) and 5(c) of the Securities Act.[13] Siris acquired the China Yingxia shares through a sham

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10 Consistent with our precedent, we "rely on the factual allegations of the injunctive complaint in determining the appropriate remedial action in the public interest." *Marshall E. Melton*, 56 S.E.C. 695, 711 (2003).

11 The registration of China Yingxia's securities was eventually revoked pursuant to Exchange Act Section 12(j) based on its failure to file periodic reports after late 2008. *China Yingxia International, Inc.*, Securities Exchange Act Rel. No. 66523 (March 7, 2012), 2012 WL 1028984.

12 "PIPEs are unregistered securities issued by companies whose stock is already publicly traded. Because PIPEs are unregistered, they cannot be offered to the market generally, and once issued, they cannot be resold or traded for a set period of time, usually 60-120 days. Issuers, through placement agents, target qualified potential investors who are offered PIPEs at a significant discount from the common stock's market price as compensation for the temporary illiquidity." *SEC v. Lyon*, 605 F. Supp. 2d 531, 536 (S.D.N.Y. 2009).

13 Section 5(a) provides that "[u]nless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly . . . to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such a security through the use or medium of any prospectus or otherwise." 15 U.S.C. § 77e(a). And Section 5(c) provides that "[i]t shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate

(continued...)

agreement arranged by representatives of China Yingxia. To compensate Siris for due diligence conducted prior to the PIPE transaction (which China Yingxia used to promote itself to other potential investors in subsequent PIPE transactions), 175,000 shares of China Yingxia stock were transferred from an unidentified shareholder to Siris's consulting firm, Hua Mei, allegedly to reimburse Hua Mei for services performed for the shareholder. If China Yingxia had issued the shares directly to Hua Mei, the shares would not have been freely tradable because Hua Mei would have been an underwriter under the Securities Act.[14] China Yingxia representatives therefore structured the agreement to provide Hua Mei with shares that were ostensibly eligible for immediate resale because they were acquired from a shareholder and not the issuer itself.[15] But the shareholder that was the counterparty to the agreement with Hua Mei was later identified as the father of China Yingxia's CEO and, as "a person directly or indirectly controlled by the issuer," he qualified as an "issuer" under Section 2(a)(11) of the Securities Act.[16] Moreover, Hua Mei never performed any services for the CEO's father; the services performed by Hua Mei—due diligence that the company later used to promote itself—were rendered directly to China

(...continued)
commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security." 15 U.S.C. § 77e(c). Thus, absent an available exception, it is unlawful for any person, directly or indirectly to use the mails or other means of interstate commerce to sell or offer to sell a security for which a registration statement is not filed or not in effect.

Between August 14, 2007 and November 15, 2007, Siris on behalf of Hua Mei sold 8,600 shares of China Yingxia stock for proceeds of approximately $24,600. But these shares were not eligible for resale at this time: there was no registration statement in effect at the time for the sale of these shares, and Hua Mei was not entitled to any exemption from registration when selling the unregistered shares during this time period. Thus, the Complaint alleges that Siris's sale of China Yingxia stock on behalf of Hua Mei violated the registration requirements of Section 5 of the Securities Act.

14 Section 4(1) of the Securities Act exempts from registration "transactions by any person other than an issuer, underwriter, or dealer." 15 U.S.C. § 77d(1). And Section 2(a)(11) of the Act defines "underwriter" as "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates . . . in any such undertaking." 15 U.S.C. § 77b(a)(11).

15 Through the sham agreement, China Yingxia representatives and Siris sought to take advantage of a "safe harbor" exemption in Rule 144 of the Securities Act. Rule 144 permits the public resale of restricted or control securities under certain conditions. *See* 17 C.F.R. § 230.144. In order to obtain a favorable opinion under Rule 144 permitting Hua Mei to freely trade the shares, Siris falsely stated in an e-mail to China Yingxia's counsel that he "received these shares from [the CEO's father] in exchange for consulting services rendered to [the CEO's father] in China," he was "informed [the CEO's father] is not an affiliate of the company," and "[t]he services we provided were to [the CEO's father] and not to the company." In light of the true facts surrounding Hua Mei's acquisition of the shares, the transaction did not meet the requirements for a sale under Rule 144.

16 15 U.S.C. § 77b(a)(11).

Yingxia. Thus, the agreement between Hua Mei and the CEO's father was simply a sham designed "as an end-run around the registration provisions of the federal securities laws."[17]

The Complaint further alleged that Siris acted as a unregistered broker in violation of Section 15(a)(1) of the Exchange Act[18] by "raising over $2 million worth of investments in exchange for transaction-based compensation." In a second PIPE transaction completed in August 2007, Siris actively participated in soliciting investors for China Yingxia, even telling others that "[t]his is my deal." Once the deal was complete, Siris e-mailed a China Yingxia representative about receiving his "share of money from the fund raise." To facilitate the payment, the China Yingxia representative and Siris executed a backdated consulting agreement between a consulting firm controlled by the China Yingxia representative and Hua Mei for supposed "strategic consulting services." But "[d]espite the stated services in the consulting agreement, Siris, through Hua Mei, in fact received transaction-based fees for raising money for China Yingxia and not for providing consulting services."[19] The compensation Siris obtained through the consulting agreement was for "inducing or attempting to induce the purchase" of China Yingxia securities, and because Siris was not registered as a broker or dealer, and was not associated with any registered broker-dealer, he acted in violation of Section 15(a) of the Exchange Act.[20]

After the August 2007 PIPE transaction, Siris continued to work closely with China Yingxia. Siris's activities on behalf of China Yingxia included reviewing "Commission filings, including its quarterly financial statements on Forms 10-Q" and providing "guidance to the Company on key hiring and other business decisions." For example, "Siris recommended and facilitated the hiring of the Company's CFO in June 2008" and "made recommendations for director positions." Siris also communicated regularly with China Yingxia's CEO to, among other things, "provid[e] advice on how the Company should best present itself to the public."

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17 The "safe harbor" provided by Rule 144 "is not available to any person with respect to any transaction or series of transactions that, although in technical compliance with Rule 144, is part of a plan or scheme to evade the registration requirements of the Act." 17 C.F.R. § 230.144.

18 15 U.S.C. § 78*o*(a).

19 According to the Complaint,

> In total, Siris introduced seven investors and $2,150,000 worth of investments to China Yingxia through the August 2007 PIPE. In return, Hua Mei received payment of $107,500, which equaled exactly 5% of the amount of investments Siris introduced to China Yingxia. The Consulting Firm [controlled by the China Yingxia representative] paid Hua Mei by check with a memo line stating "CYXI finance commission" with funds from the August 2007 PIPE.

20 15 U.S.C. § 78*o*(a) (providing that it is unlawful "to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security" unless one is a registered broker or dealer or associated with a registered broker or dealer).

The Complaint alleged that in February and March 2009 Siris engaged in insider trading in China Yingxia stock, in violation of Exchange Act Section 10(b) and Rule 10b-5 thereunder. According to the Complaint, because of his consulting relationship and course of dealings with China Yingxia, Siris both "owed a fiduciary duty to China Yingxia and its shareholders" and "had access to China Yingxia's material, non-public information, such as the Company's financial picture, key hiring decisions, and operation matters." The Complaint alleged that "[i]n violation of this duty, Siris repeatedly traded the securities of China Yingxia while in possession of material, non-public information." The Complaint specifically detailed two episodes of Siris's trading of China Yingxia stock after receiving material, non-public information.

The first occurred after Siris received a letter from China Yingxia's CEO, dated February 17, 2009. Early in 2009, concerns about suspected illegal fundraising activity by the CEO had resurfaced,[21] and the CEO had reportedly gone into hiding as Chinese nationals who had made "loans" to China Yingxia began to demand repayment. In the February 17, 2009 letter, the CEO "disclosed to Siris the illegal fundraising, and 'some drastic behavior' by Chinese nationals that caused business disruptions, preventing employees from going to work." According to the Complaint, "[f]rom the CEO's letter, Siris had possession of material, non-public information directly from the CEO confirming her illegal activities and the status of the Company's operations." Shortly after receipt of the CEO's letter, Siris began selling shares of China Yingxia—between February 19, 2007 and March 2, 2009, Siris sold 628,660 shares.

The second episode of insider trading occurred after Siris received additional material, non-public information on March 3, 2009. Late that afternoon, Siris received a draft press release from China Yingxia's CFO that disclosed "problems at the Company affecting its ability to continue operations." According to the Complaint, "[b]efore this time, China Yingxia [had] remained quiet, without issuing any release about the events surrounding the CEO's activities or closure of a Company-owned facility." The day after receiving the draft press release, Siris increased the size of his orders to sell China Yingxia stock, and between receipt of the draft press release and the public issuance of the press release on March 6, 2009, Siris sold an additional 515,000 shares. After the issuance of the press release, China Yingxia's stock price decreased dramatically, going from $0.08 on March 6 to $0.025 on March 9 (the first trading day after the press release was issued).[22]

The Complaint further alleged that Siris made misrepresentations and omitted material information in communications with his funds' investors concerning China Yingxia, in violation of Adviser Act Section 206(4) and Rule 206(4)-8 thereunder. On March 3, 2009, Siris wrote in his monthly newsletter to investors about some concerns he had with China Yingxia, including discussing in general terms the CEO's illegal fundraising. Siris added that "[w]e are in the process of taking legal action against the company, its management, its Directors, the investment bankers, the lawyer, and auditors." The newsletter specifically stated that "[w]e believe the

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21 Siris had been aware of allegations of illegal fundraising by the CEO as early as July 2008.

22 The Complaint alleged that Siris had ill-gotten gains from these illegal trades of China Yingxia stock of approximately $172,000.

bankers have significant liability," noting that "the investment bankers continued to handle the SEC filings, hired the CFO, and selected directors." Similarly, in an e-mail to select investors in China Yingxia on March 4, 2009, Siris mentioned possible legal action against China Yingxia, the investment bankers, the auditors, and "anyone else we can find," noting that "[t]he investment bankers are in a particularly vulnerable position" because "after raising money, they continued to work with the company . . . actually wrote and filed the financial documents . . . [and] hired the CFO and the consultant." The Complaint alleged that these communications to investors included material misrepresentations and omissions because they made no mention of Siris's own "role with the now-failed Company and gave the false and misleading impression that others should be sued for the very conduct in which Siris himself engaged."

B. Siris engaged in misconduct in connection with ten confidential offerings.

In addition to insider trading involving China Yingxia stock, the Complaint alleged that between July 2009 and December 2010 Siris engaged in extensive insider trading in connection with ten confidential securities offerings by selling or selling short the issuers' securities prior to the public announcement of the offerings.[23] The Complaint alleged that in advance of each offering Siris or his firm, Guerrilla Capital, was confidentially solicited by a broker-dealer and brought "over the wall," meaning that Siris was "given access to material, non-public confidential information on a securities offering after agreeing not to trade while in possession of the information." As the Complaint explained,

> In general, Siris agreed not to share the information he received with anyone nor trade on the information from the time of going "over-the-wall" until the public announcement of the offering or deal. After going "over-the-wall," Siris and his funds were generally privy to information such as the name of the issuer doing the deal, anticipated and actual timing for closing, the book or list of investors involved in the offering, anticipated and actual pricing, and updates on other particulars of the deals.

For each of the ten offerings, the Complaint detailed how Siris, after being brought over the wall, traded in the securities of the issuer prior to public announcement of the offering, violating Securities Act Section 17(a)(1), Exchange Act Section 10(b), and Rule 10b-5 thereunder, and reaping ill-gotten gains totaling approximately $161,000.[24]

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23 The issuers involved in the ten confidential offerings were China Green Agriculture, Inc., Harbin Electric, Inc., Yongye International, Inc., Sutor Technology Group, Ltd., Gulf Resources, Inc., Universal Travel Group, Inc., Puda Coal, Inc., China Agritech, Inc., and HQS Sustainable Maritime Industries, Inc.

24 The Complaint further alleged that, with regard to one of the ten offerings, Siris made a materially false representation in a 2009 securities purchase agreement. In that agreement, Siris represented that he had "not engaged in any purchases or sales of the securities of" Universal Travel (including any short sales) after being first contacted by the placement agent on December 7, 2009, and promised that he would "not engage in any purchases or sales of the securities" of Universal Travel prior to the public disclosure of the offering. Despite these

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Finally, the Complaint alleged that Siris violated Rule 105 of Regulation M by directing short sales during the five business days before pricing in two follow-on securities offerings in which he participated.[25]

III.

A. The Exchange Act and Advisers Act authorize sanctions based on an injunction.

Section 15(b)(6) of the Exchange Act authorizes us to bar a person from association with a broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization[26] or from participating in an offering of penny stock if the person has been, among other things, enjoined from any conduct or practice in connection with the purchase or sale of a security and if, at the time of the alleged misconduct, the person was participating in an offering of any penny stock.[27] Section 203(f) of the Advisers Act authorizes us to impose an industry-wide associational bar if the person has been, among other things, enjoined from any conduct or practice in connection with the purchase

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representations, Siris had directed short sales of 7,000 shares of Universal Travel stock on December 9 (after being brought over the wall but before signing the agreement), and directed sales of 300 shares of Universal Travel stock on December 10, 2009 (after signing the agreement but before the offering was publicly disclosed).

[25] Since October 2007, Rule 105 has prohibited any person who makes a short sale during the restricted period—generally the five business days before pricing of a securities offering—from purchasing any securities of that issuer in a follow-on offering done on a firm commitment basis. *See* 17 C.F.R. § 242.105(a). On September 18, 2009, Siris, for his funds, purchased 50,000 shares of Smartheat, Inc. at $9.00 per share in a publicly marketed firm commitment follow-on offering. During the five business days before pricing of this offering, Siris's funds sold short 25,000 shares of Smartheat at prices between $9.91 and $10 per share, making his subsequent purchases a violation of Rule 105. A similar violation occurred when, on February 12, 2010, Siris purchased 180,000 shares of Puda Coal, Inc. at $4.75 per share in a confidentially marketed firm commitment follow-on offering. During the five business day before pricing of this offering, Siris's funds sold short 3,600 shares of Puda Coal at $5.68 per share. The Complaint alleged ill-gotten gains from these violations of Rule 105 of approximately $127,000.

[26] The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010), which was signed into law July 21, 2010, expanded the categories of associational bars authorized by Exchange Act Section 15(b)(6) and Advisers Act Section 203(f), allowing the Commission to impose, in addition to direct associational bars, a broad collateral bar on participation throughout the securities industry. There is no dispute in this proceeding that the conduct alleged in the Complaint continued until after Dodd-Frank became law. In any event, under our decision in *John W. Lawton*, Investment Advisers Act Rel. No. 3513 (Dec. 13, 2012), 2012 WL 6208750, at *10, imposition of a collateral bar based on a present assessment of a person's potential harm to the public is not impermissibly retroactive, even if informed in part by pre-Dodd-Frank conduct.

[27] 15 U.S.C. § 78*o*(b)(6).

or sale of a security and if, at the time of the alleged misconduct, the person was associated with an investment adviser.[28] It is undisputed that Siris was enjoined from conduct in connection with the purchase or sale of securities. Likewise, it is undisputed that, at the time of the alleged misconduct, Siris was participating in an offering of penny stock (China Yingxia)[29] and was associated with an investment adviser (Guerilla Capital).[30] Accordingly, we find that the threshold statutory requirements for the imposition of sanctions have been satisfied.

B. The public interest requires that Siris be barred.

We next turn to whether, and to what extent, sanctions are in the public interest.[31] In analyzing the public interest we consider, among other things: the egregiousness of the respondent's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the respondent's assurances against future violations, the respondent's recognition of the wrongful nature of his or her conduct, and the likelihood that the respondent's occupation will present opportunities for future violations.[32] Our "inquiry into . . . the public interest is a flexible one, and no one factor is dispositive."[33] And our "determination that a remedial, disciplinary sanction is in the public interest is based on the particular circumstances

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28 15 U.S.C. § 80b-3(f).

29 China Yingxia, a security priced at less than five dollars per share, qualifies as a penny stock. *See* 15 U.S.C. § 78c(a)(51)(A); 17 C.F.R. § 240.3a51-1 (defining "penny stock" to include "any equity security other than a security . . . that has a price of five dollars or more"). And Siris's activities related to the offering of China Yingxia bring him within the statute's definition of a person participating in an offering of a penny stock. *See* 15 U.S.C. § 78*o*(b)(6)(C) ("[T]he term 'person participating in an offering of penny stock' includes any person acting as any promoter, finder, consultant, agent, or other person who engages in activities with a broker, dealer, or issuer for purposes of the issuance or trading.").

30 Although not registered with the Commission, Guerilla Capital Management, LLC is an investment adviser and Siris an associated person within the meaning of the Advisers Act. *See* 15 U.S.C. § 80b-2(a)(11) ("'Investment adviser' means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities."); 15 U.S.C. § 80b-2(a)(17) ("The term 'person associated with an investment adviser' means any partner, officer, or director of such investment adviser (or any person performing similar functions), or any person directly or indirectly controlling or controlled by such investment adviser . . . .").

31 15 U.S.C. § 78*o*(b)(6)(A); 15 U.S.C. § 80b-3(f).

32 *Vladimir Boris Bugarski*, Exchange Act Release No. 66842 (Apr. 20, 2012), 2012 WL 1377357, at *4 (citing *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981)).

33 *David Henry Disraeli*, Exchange Act Rel. No. 57027 (Dec. 21, 2007), 2007 WL 4481515, at *15, *petition denied*, 33 F. App'x 334 (D.C. Cir. 2008) (per curiam).

and entire record of the case."[34] Based upon these factors, we find that an industry-wide bar is in the public interest here.

Siris's conduct was egregious and recurrent and amply justifies his being barred from the industry. He was enjoined based on alleged conduct that included numerous instances of insider trading over the course of almost two years and that resulted in ill-gotten gains of over half-a-million dollars. In addition to recurrent insider trading, the Complaint further alleged that Siris committed securities fraud through material misrepresentations in connection with a securities purchase agreement and misrepresentations and omissions to investors in his funds.[35] We have repeatedly held that "'conduct that violates the antifraud provisions of the securities laws is especially serious and subject to the severest of sanctions under the securities laws.'"[36]

Siris's conduct involved scienter. The multiple, repeated instances of insider trading alleged in the Complaint support the conclusion that Siris acted intentionally, or at a minimum, with severe recklessness.[37] This is particularly true given Siris's long experience in the industry and admitted knowledge that he could not trade while in possession of material, non-public information. Moreover, in addition to fraud-based claims, the Complaint alleged deceptive conduct in connection with a violation of Section 5 of the Securities Act. The sale of China Yingxia stock that forms the basis of the Section 5 charge was facilitated by Siris's making a knowingly false representation that the stock he received was for services rendered to the shareholder and not the company.[38] According to the Complaint, despite knowing of its falsity, Siris made this representation to evade the registration requirements of Section 5 so he could freely trade China Yingxia stock.[39] Giving "considerable weight to the injunctive allegations" of

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34 *Melton*, 56 S.E.C. at 698.

35 As noted, the Complaint also alleged that Siris violated the registration requirements of Section 5 of the Securities Act, acted as an unregistered broker in violation of Section 15(a) of the Exchange Act, and violated the short selling requirements of Rule 105 of Regulation M. *See supra* at 4-6, 10.

36 *Bugarski*, 2012 WL 1377357, at *5 (quoting *Melton*, 56 S.E.C. at 713).

37 "Scienter is a mental state consisting of an intent to deceive, manipulate, or defraud, and includes recklessness, commonly defined as 'an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the [respondent] or so obvious that the [respondent] must have been aware of it.'" *Johnny Clifton*, Exchange Act Rel. No. 69982 (July 12, 2013), 2013 WL 3487076, *10 n.67 (quoting *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 513 F.3d 702, 704 (7th Cir. 2008)).

38 Although Siris attempts in his reply brief to address the Division's arguments regarding the consulting agreement (claiming that he did not know the CEO's father was an affiliate and that China Yingxia's counsel provided an opinion that the shares were freely tradable), he does not dispute that he made a knowingly false representation concerning the recipient of the consulting services.

39 The Exchange Act Section 15(a) charge also involved deception. Siris and a China Yingxia representative entered into a back-dated agreement allegedly for "strategic consulting

(continued...)

the Complaint,[40] we find based on our review of the entire record that Siris's conduct involved scienter, which supports a bar.[41]

Siris insists that he has taken "corrective efforts" to avoid future misconduct, such as ceasing to participate in offerings, eliminating consulting services, establishing trading compliance protocols, appointing a chief compliance officer, maintaining a restricted list, and establishing an e-mail backup system.[42] While we acknowledge the steps Siris has taken, we find that such voluntary measures do not ensure, as he suggests, that "there is no realistic prospect for future violations."[43] And accepting the sincerity of Siris's assurances against future misconduct does not mean that "there can be no risk of future misconduct warranting a bar."[44] As we have held "such assurances are not an absolute guarantee against misconduct in the future"; we weigh them against the other *Steadman* factors in assessing the public interest.[45]

If permitted, Siris intends to remain in the securities industry, which we have recognized "presents continual opportunities for dishonesty and abuse and depends heavily on the integrity of its participants and on investors' confidence."[46] And although Siris represents that he intends

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services," when in fact the agreement was to pay Siris "transaction-based fees for raising money for China Yingxia and not for providing consulting services."

40 *Schield Mgmt. Co.*, 58 S.E.C. 1197, 1212-13 (2006); *see also Melton*, 56 S.E.C. at 698-700 ("[A]s we have stated in a number of decisions, we have adopted the policy in administrative proceedings based on consent injunctions that the injunctive allegations may be given considerable weight in assessing the public interest.").

41 Siris quotes *Steadman* for the proposition that "[i]t would be a gross abuse of discretion to bar an investment adviser from the industry on the basis of isolated negligent violations." 603 F.2d at 1140-41. As discussed, we reject Siris's contention that his conduct was isolated and merely negligent.

42 Siris also represents that he is in the process of liquidating and winding up his funds.

43 As an alternative to a bar, Siris proposes that he is willing to continue the "corrective efforts" he has already taken (not participating in offerings and not accepting consulting assignments) as well as not purchasing penny stocks. In addition to the "practical difficulties in enforcing compliance with such a proposal," *James C. Dawson*, Advisers Act Rel. No. 3057 (July 23, 2010), 2010 WL 2886183, at *6, we reject Siris's proposed sanctions short of a full industry-wide bar because—given the nature of the misconduct and the opportunity that continued participation in the industry would present for future violations—we do not believe Siris's proposal provides sufficient protection for investors in the public interest, *see id.*

44 *Gary M. Kornman*, Exchange Act Rel. No. 59403 (Feb. 13, 2009), 2009 WL 367635, at *11. (holding that respondent's assurances against future misconduct, even if accepted as "sincerely given," did not prevent a finding that a bar was in the public interest, when considered in conjunction with the other *Steadman* factors).

45 *Id.*

46 *Id.* at *7.

to work as a securities analyst and is prepared to agree "not to serve as a portfolio manager or investment adviser to a managed account," we agree with the Division that Siris's agreeing not to serve in those capacities "does not ensure the protection of investors," because the allegations supporting the injunction involve a broad array of misconduct not unique to service as a portfolio manager or investment adviser. Indeed, Siris's "repeated and egregious misconduct evidences an unfitness to participate in the securities industry that goes beyond just the professional capacity in which [he] was acting when he engaged in the misconduct underlying these proceedings."[47]

We also find that Siris has not meaningfully recognized the wrongful nature of his conduct. Although Siris insists that he has "acknowledged his conduct" and "accepted responsibility for it," he continues to maintain, as discussed more fully below, that his conduct did not in fact amount to violations of the securities laws as alleged in the Complaint. Denying that there is a factual basis for most of the securities law violations in the Complaint (something Siris agreed not to do) does not amount to a meaningful recognition of his misconduct.[48]

Indeed, although Siris agreed that he would not contest the factual allegations of the Complaint in this proceeding, he has failed to abide by this agreement and has repeatedly disputed the Complaint's factual allegations.[49] The flagrant manner in which Siris has violated the terms of his consent also gives us pause about relying upon his assurances against future misconduct, even accepting them as sincere. Weighing the relevant factors, we conclude that, "notwithstanding the sincerity of his present assurances that he will not commit such misconduct again, the risk that he would not be able to fulfill his commitment is sufficiently great that permanent associational bars are required to protect the public interest."[50]

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47 *Alfred Clay Ludlum, III*, Advisers Act Rel. No. 3628 (July 11, 2013), 2013 WL 3479060, at *5. As we recognized in *Ludlum*, "'[b]rokers, dealers, municipal securities dealers, and transfer agents routinely gain access to sensitive financial and investment information of investors and other market participants, and persons associated with municipal advisors and [nationally recognized statistical rating organizations] routinely learn confidential and potentially market-moving information about securities, issuers, and potential transactions'" and "'securities professionals must take on heightened responsibilities to safeguard that information and to avoid temptations to fraudulently misuse their access for inappropriate—but potentially lucrative or self-serving—ends.'" *Id.* (quoting *Lawton*, 2012 WL 6208750, at *11). Thus, Siris's repeated insider trading is exactly the type of egregious behavior that supports a collateral bar.

48 *Cf. Michael T. Studer*, 57 S.E.C. 890, 898 (2004) (finding that respondent did not recognize the wrongful nature of his misconduct when he admitted "mistakes in judgment" but denied scienter that was established in the underlying proceeding).

49 See *infra* at 19-21.

50 *Kornman*, 2009 WL 367635, at *11; *see also Gibson*, 2008 WL 294717, at*6 ("We have accepted Gibson's assertions, but nevertheless have determined that they do not outweigh the other *Steadman* factors that weigh in favor of barring Gibson from continuing in the industry.").

IV.

Siris does not dispute the basis for these proceedings—that he was enjoined from conduct in connection with the purchase or sale of securities and that he was associated with an investment adviser and participating in an offering of penny stock—and he acknowledges that the trading and other violative conduct alleged in the Complaint took place. He claims, however, that his misconduct was not egregious and does not warrant a bar. According to Siris, the Division has failed to show that he acted with "a high degree of scienter, as it asserts." To the contrary, he argues, "the facts show negligence, not purposeful or reckless misconduct requiring a bar." Siris asserts that, if the Commission considers his conduct in the context of the surrounding facts and circumstances, it will find that a lesser sanction will serve the public interest. In addition, Siris challenges the initial decision on procedural grounds, arguing that summary disposition was inappropriate. As discussed below, we find Siris's arguments unpersuasive and agree with the law judge's determination to impose an industry-wide bar.

A. Siris's arguments against the imposition of a bar are unpersuasive.

It is well-established, as Siris contends, "that a respondent in a 'follow-on' proceeding may introduce evidence regarding the 'circumstances surrounding' the conduct that forms the basis of the underlying proceeding as a means of addressing 'whether sanctions should be imposed in the public interest.'"[51] Relying on this precedent, Siris's principal argument in this proceeding is that a bar is not required in the public interest because his conduct was neither egregious nor undertaken with scienter. With regard to China Yingxia, Siris insists that his trading was the result of legitimate research and investigation by his consulting firm and not based on material, non-public information. Similarly, with regard to the ten confidential offerings, Siris maintains that he never intentionally traded based on confidential information. But this line of argument represents a misapplication of the relevant precedent. Although Siris may put forward mitigating evidence concerning the circumstances surrounding his underlying misconduct, he is not permitted to contest the allegations in the Complaint.[52] We have repeatedly held that "where, as here, respondents consent to an injunction, 'they may not dispute the factual allegations of the injunctive complaint in [a subsequent] administrative proceeding.'"[53]

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51 *Schield Mgmt. Co.*, 58 S.E.C. at 1213 (quoting *Blinder, Robinson & Co. v. SEC*, 837 F.2d 1099, 1109 (D.C. Cir. 1988)).

52 *See id.* (rejecting attempts by the respondent to put forward assertions that were "in conflict with the allegations in the Complaint and therefore not consistent with relevant precedent").

53 *Id.* (quoting *Melton*, 56 S.E.C. at 712); *Lawton*, 2012 WL 6208750, at *5 ("Having consented to the entry of an injunction on the basis of the Complaint's allegations, Lawton may not use this proceeding to collaterally attack the allegations."); *Bugarski*, 2012 WL 1377357, at *5 ("[W]hen an injunction has been entered by consent, it is appropriate to prohibit Respondents from contesting the factual allegations of the Complaint."); *Martin A. Armstrong*, Advisers Act Rel. No. 2926 (Sept. 17, 2009), 2009 WL 2972498, at *3 ("We have repeatedly held that a party may not collaterally attack the factual allegations in an injunctive complaint brought by the

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In consenting to the entry of an injunction against him in district court, Siris acknowledged that the "entry of a permanent injunction may have collateral consequences," and he expressly agreed that "in any disciplinary proceeding before the Commission based on the entry of the injunction in this action, [he] understand[s] that [he] shall not be permitted to contest the factual allegations of the complaint in this action." Siris further agreed "not to take any action or make or permit to be made any public statement denying, directly or indirectly, any allegation in the complaint or create the impression that the complaint is without factual basis." Despite these express representations, the vast majority of Siris's arguments in this proceeding—both before the law judge and before us on appeal—consist of his contesting the factual allegations of the Complaint.[54]

For example, Siris repeatedly suggests or directly avers that his conduct was not "undertaken with scienter." But the Complaint expressly alleged that Siris acted "with scienter." And we have held, in the context of a consent injunction, that when the injunctive complaint contains allegations that a respondent "engaged in scienter-based offenses" the respondent is precluded from arguing in a follow-on proceeding "that he had no scienter."[55] Thus, Siris is precluded from arguing that there was no scienter in his conduct related to the allegations of scienter-based fraud (including insider trading and material misrepresentation) in the Complaint.[56]

Siris also repeatedly argues in connection with the insider trading allegations that he was not in possession of material, non-public information. In the context of his trading of China Yingxia stock, Siris argues that he "did not understand that anything in [the CEO's] letter . . . contained material nonpublic information" and "it is far from evident that it did." He further argues that he "did not know whether [the draft press release] contained material nonpublic information" and "[i]ndeed, it did not." But the Complaint alleged that "[f]rom the CEO's letter,

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Commission when, as is the case here, the party has consented to the entry of an injunction on the basis of such allegations.").

54 If Siris had legitimate factual challenges to the validity of the Complaint's allegations, his opportunity to bring them was in the district court proceeding. But having consented to the entry of the injunction against him—expressly agreeing to waive findings of fact and not contest the factual allegations of the Complaint—Siris is not permitted to dispute the Complaint's allegations in this proceeding.

Quoting our decision in *Dawson*, Siris notes that "[p]arties settle injunctive actions for a variety of reasons, not all of them evincing a consciousness of misconduct." 2010 WL 2886183, at *5. This is no doubt true, but it does not mean that Siris, after consenting to an injunction in the district court (whatever his reasons), may then violate the terms of his consent by contesting the factual allegations of the injunctive complaint before the Commission.

55 *Dawson*, 2010 WL 2886183, at *5.

56 As noted, the Complaint alleged that Siris violated Exchange Act Section 10(b), Rule 10b-5 thereunder, and Securities Act Section 17(a)(1), violations that require scienter. *See Aaron v. SEC*, 446 U.S. 680, 695-97 (1980).

Siris had possession of material, non-public information directly from the CEO confirming her illegal activities and the status of the Company's operations" and that when Siris was sent the draft press release he "received new material, non-public information." Siris may not challenge those allegations in this proceeding.

In the context of the ten confidential offerings, with the exception of three instances where he admits "mistakes" for which "[h]e has no satisfactory explanation,"[57] Siris argues that at the time of his trading he had not been brought over the wall and was thus not in possession of material, non-public information. But the Complaint alleged that Siris traded in the issuers' securities "while in possession of material, non-public information concerning the [ten] offerings." And the Complaint specifically alleged that Siris had been brought over the wall—*i.e.*, received "access to material, non-public confidential information on a securities offering after agreeing not to trade while in possession of the information"—for each offering at the time he directed trades in advance of the offering's public announcement.[58] Given the Complaint's allegations concerning the offerings, Siris is precluded from arguing that he was not in possession of material non-public information at the time of his trading.[59]

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57 Siris concedes that he or his firm was in possession of material, non-public information when he traded ahead of the public announcement of the offerings for Harbin Electric in July 2009, HQ Sustainable Maritime Industries in August 2010, and Puda Coal in December 2010, but he characterizes his illegal trading each time as merely a "mistake" that "should not have occurred."

58 Siris's claims that he did not trade ahead of the public announcement of the offerings while in possession of material non-public information are directly contrary to specific allegations in the Complaint for each offering. For example, in his opening brief Siris contends that he did not go over the wall with regard to a Universal Travel Group offering until "[a]fter the close" of the market on December 9, 2009, but the Complaint specifically alleged that "[o]n December 7, 2009, Broker-Dealer B confidentially solicited Siris and brought him 'over-the-wall' concerning a registered direct or confidentially marketed public offering for Universal Travel Group, Inc." Similarly, Siris claims that he "declined to go over the wall until" the afternoon of February 11, 2010, for a Puda Coal offering announced February 12, 2010, but the Complaint alleged that "[o]n February *1*, 2010, Broker-Dealer B confidentially solicited Siris and brought him 'over-the-wall' concerning a registered direct or confidentially marketed public offering for Puda Coal, Inc."

59 There are several other instances where Siris, directly or indirectly, contests the factual allegations in the Complaint. For example, Siris disputes his status as a fiduciary of China Yingxia, relevant time periods and dates contained in the Complaint, and that his disclosures to investors concerning China Yingxia were deficient under Advisers Act Rule 206(4)-8. In insisting that he made adequate disclosures to his investors about China Yingxia, however, Siris does not even address the Complaint's allegation that he failed to reveal his own role in China Yingxia and "gave the false and misleading impression that others should be sued for the very conduct in which Siris himself engaged."

Siris insists that he is not contesting the factual allegations of the Complaint or violating the terms of his consent but merely "informing the Commission of the facts and circumstances surrounding [his] conduct." We reject this contention. By arguing with respect to the Complaint's allegations of insider trading that there was no scienter and that he was not in possession of material, non-public information, Siris is plainly violating his consent by "denying, directly or indirectly, [the] allegation[s] in the complaint" and "creat[ing] the impression that the complaint is without factual basis." Without scienter or the possession of material, non-public information there can be no illegal insider trading. Far from merely providing mitigating evidence relating to the "circumstances surrounding" the alleged violations, Siris is impermissibly collaterally attacking the basis for the underlying injunctive action in the district court.[60]

Siris further argues that the Division has failed to "specify any *facts* or offer any concrete evidence" but instead "merely offers conclusory allegations." But under our precedent, the Division is not required "to prove the allegations of an injunctive complaint in a follow-on administrative proceeding before any disciplinary action can be taken."[61] As we have explained,

> We do not believe that Congress, having made an injunction a ground for commencing the proceeding, intended for the parties to conduct the proceeding as if the injunction had never been entered, disregarding the allegations underlying the injunction. . . .

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60 *See supra* note 53; *see also Kornman v. SEC*, 592 F.3d 173, 134 (D.C. Cir. 2010) (approving of the Commission's decision to estop respondent from making mitigation arguments that were "essentially collateral attacks" on the district court's judgment); *Blinder, Robinson & Co.*, 837 F.2d at 1109-10 (recognizing that a respondent in a follow-on proceeding may not "relitigate the factual question[s]" going to the respondent's liability).

Even if Siris's factual arguments were properly before us, the record evidence that Siris points to in support of his arguments consists largely of uncorroborated, self-serving assertions from his own investigation testimony, his Answer and supporting affidavit submitted in this proceeding, and a "white paper" submitted by his counsel to the Division in advance of these proceedings. Additionally, in more than one instance, the underlying materials cited by Siris do not actually support the factual assertions he has made before the Commission in this proceeding. For example, in both his Answer and his opening brief in this appeal, Siris cites his investigation testimony for the proposition that he did not review the China Yingxia draft press release when he received it. But the excerpt of the transcript upon which he relies says nothing about whether he read or reviewed the draft press release. Moreover, in his briefs before us, Siris makes several factual assertions without any reference to record evidence. For example, Siris claims that, when a broker-dealer representative contacted him about an offering of Sutor Technologies, the representative did not disclose any price terms. But he points to no record evidence to support this bald assertion (and even his affidavit, which discusses the telephone call with the representative, does not include this factual assertion).

61 *Melton*, 56 S.E.C. at 710.

> [I]t would be illogical and a waste of resources for us not to rely on the factual allegation of the injunctive complaint in a civil action settled by consent in determining the appropriate remedial action in the public interest.[62]

Thus, for purposes of a follow-on administrative proceeding, the allegations in an injunctive complaint are established, and we rely upon them in determining the appropriate sanction in the public interest.[63] Siris's insistence to the contrary notwithstanding, the Division is not required in this proceeding to put forward record evidence to prove the factual allegations in the Complaint.[64]

Siris also argues that his conduct did not "remotely resemble insider trading that merits a bar" in part because it "primarily involved Offerings and not daily trading activities." We disagree. First, this argument ignores the repeated instances of fraudulent conduct involving China Yingxia that did not involve offerings, including insider trading and providing materially misleading information to investors. More importantly, Siris's trading ahead of the public announcement of the offerings is not less worthy of sanctions than other forms of insider trading. Even if it can be said that Siris did not actively seek out insider information, he took unfair advantage of his role as a leading investor in Chinese reverse merger companies, knowing that he frequently would be contacted about participating in offerings and likely would become privy to confidential information about the offerings. The Complaint avers that after receiving material, non-public information about offerings from placement agents and expressly agreeing not to trade on the information, Siris repeatedly abused his position of trust by trading in the issuers' securities ahead of the public announcement—sometimes within minutes of his being provided the confidential information. We find such behavior—which he engaged in repeatedly—egregious and deserving of the severest sanctions.[65]

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62 *Id.* at 711-12.

63 *See supra* note 10.

64 Moreover, because the parties agreed to settle the matter well in advance of trial, the Division's record is necessarily not as developed as it would be had the matter been tried in the district court.

65 Siris also argues that this case is "dramatically unlike" other cases in which respondents were barred in follow-on proceedings. We have consistently recognized, however, that the appropriate sanction "depends on the facts and circumstances of each and cannot be precisely determined by comparison with action taken in other proceedings." *Kornman*, 2009 WL 367635, at *9. Moreover, precedent does not support Siris's contention that his conduct, which involved many instances of insider trading and multiple other securities law violations, was significantly less egregious than that in other cases in which respondents have been barred.

B. Summary disposition was appropriate.

Siris argues that he raised genuine issues of material fact that precluded the law judge from granting the Division's motion for summary disposition.[66] But the purported genuine issues of material fact identified by Siris—whether there was material, non-public information and whether his insider trading was knowing and intentional (*i.e.*, involved scienter)—are not in dispute given the allegations in the Complaint, which Siris agreed he would not contest in this proceeding.[67] As we recently held in the context of an administrative proceeding following entry of a consent injunction, "[f]ollow-on proceedings are not an appropriate forum to 'revisit the factual basis for,' or legal challenges to, an order issued by a federal court, and challenges to such orders do not present genuine issues of material fact in our follow-on proceedings."[68] Because Siris has not identified any "genuine factual issue with respect to sanctions or any other material issue in the case," the law judge did not err in resolving the case by summary disposition.[69]

* * * *

As we have repeatedly recognized, "[a]ntifraud injunctions have especially serious implications for the public interest."[70] "Based on our experience enforcing the federal securities laws, we believe that ordinarily, and in the absence of evidence to the contrary, it will be in the public interest to . . . suspend or bar from participation in the securities industry, or prohibit from participation in an offering of penny stock, a respondent who is enjoined from violating the antifraud provisions."[71] In our consideration of the *Steadman* factors in this case, we have

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66 Commission Rule of Practice 250 provides for summary disposition "if there is no genuine issue with regard to any material fact and the party making the motion is entitled to summary disposition as a matter of law." 17 C.F.R. § 201.250.

67 *See Gibson v. SEC*, 561 F.3d 548, 553 (6th Cir. 2009) (noting, in the context of a follow-on disciplinary proceeding, that "Gibson agreed not to dispute the facts alleged in the original district court Complaint," and that, "[w]hen the facts underlying Gibson's relevant misconduct are undisputed, it stands to reason that there is no genuine issue of fact").

68 *Lawton*, 2012 WL 6208750, at *5 (quoting *Jose P. Zollino*, Exchange Act Rel. No. 55107 (Jan. 16, 2007), 2007 WL 98919, at *4); *see also Kornman*, 592 F.3d at 183 (recognizing that a "summary proceeding was appropriate" in a follow-on proceeding when the respondent's criminal case "disposed of the central issue regarding the nature of his 'alleged misconduct' for administrative enforcement purposes"); *Jeffrey L. Gibson*, Exchange Act Rel. No. 57266 (Feb. 4, 2008), 2008 WL 294717, at*5 ("Use of the summary disposition procedure has been repeatedly upheld in cases such as this one where the respondent has been enjoined or convicted, and the sole determination concerns the appropriate sanction.").

69 *Gibson*, 2008 WL 294717, at*6. In determining whether to grant summary disposition, the law judge accepted the sincerity of Siris's assurances against future misconduct. *See Peter Siris*, Initial Decision Rel. No. 477 (Dec. 31, 2012), 2012 WL 6738469, at *1-2.

70 *Gibson*, 2008 WL 294717, at *7.

rejected the arguments that Siris is precluded from making based upon his consent to the entry of the injunction against him, which amount to the bulk of Siris's arguments before us.

Based upon our weighing of the relevant factors and the parties' arguments that are properly before us, we conclude that it is in the public interest to bar Siris from the securities industry.[72] Siris was enjoined based on egregious and recurrent conduct involving fraud and deception, which he has failed to meaningfully acknowledge. Although he has taken some ameliorative steps and has promised to avoid future misconduct, we conclude that the weight of the relevant factors supports an industry-wide bar. Accordingly, we will bar Siris from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization and from participating in an offering of penny stock.

(...continued)

71 *Melton*, 56 S.E.C. at 713. Contrary to Siris's suggestion, it is not our view that his consenting to an antifraud injunction in the district court "automatically means a bar is appropriate" without regard for the *Steadman* factors. But because "'[f]idelity to the public interest' requires a severe sanction when a respondent's misconduct involves fraud," *Gibson*, 2008 WL 294717, at *7 (quoting *Richard C. Spangler, Inc.*, 46 S.E.C. 238, 252 (1976)), in most fraud cases the *Steadman* factors, such as egregiousness, scienter, and opportunity for future misconduct, will weigh in favor of a bar.

We likewise reject Siris's contention that, "[a]ccording to the law judge, because follow-on cases involving anti-fraud injunctions have resulted in bars, there was no need to examine the entire record in considering the *Steadman* factors." This is not an accurate characterization of the law judge's decision. In the context of Siris's argument that his conduct was not as bad as that in other cases in which a bar was imposed, the law judge simply pointed out that there have been no administrative proceedings following the entry of an antifraud injunction in which the respondent was not barred. *Siris*, 2012 WL 6738469, at *5. But there is no indication that the law judge automatically imposed a bar; instead, the initial decision shows that she recognized and appropriately applied the *Steadman* factors. *Id.* at *4-5. And in any event, our de novo review would cure any error in this regard. *See Kornman*, 2009 WL 367635, at *9 n.44 (noting that de novo review by the Commission cures an alleged failure by the law judge to properly apply *Steadman*).

72 We have also considered the deterrent effect of imposing an industry-wide bar on Siris as a factor in our analysis. *See Schield Mgmt. Co.*, 58 S.E.C. at 1217-18 ("We also consider the extent to which the sanction will have a deterrent effect."); *see also Steadman v. SEC*, 603 F.2d 1126, 1142 (5th Cir. 1979) ("[T]he Commission also may consider the likely deterrent effect its sanctions will have on others in the industry."); *PAZ Sec., Inc. v. SEC*, 494 F.3d 1059, 1066 (D.C. Cir. 2007) (noting that although "'general deterrence is not, by itself, sufficient justification for expulsion or suspension . . . it may be considered as part of the overall remedial inquiry'" (quoting *McCarthy v. SEC*, 406 F.3d 179, 189 (2d Cir. 2005)).

An appropriate order will issue.[73]

By the Commission (Chair WHITE and Commissioners AGUILAR and STEIN; Commissioners GALLAGHER and PIWOWAR not participating).

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

[73] We have considered all of the parties' contentions. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 71068 / December 12, 2013

INVESTMENT ADVISERS ACT OF 1940
Rel. No. 3736 / December 12, 2013

Admin. Proc. File No. 3-15057

In the Matter of PETER SIRIS c/o M. William Munno Seward & Kissel LLP One Battery Park Plaza New York, NY 10004

ORDER IMPOSING REMEDIAL SANCTIONS

On the basis of the Commission's opinion issued this day, it is

ORDERED that Peter Siris be barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization, and from participating in an offering of penny stock.

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. 71070 / December 12, 2013

INVESTMENT ADVISERS ACT OF 1940
Release No. 3738 / December 12, 2013

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3518 / December 12, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15645

In the Matter of **Rodney A. Smith,** **Michael Santicchia, CPA, and** **Stephen D. Cheaney, CPA,** **Respondents.**	**ORDER INSTITUTING PUBLIC ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, SECTION 4C OF THE SECURITIES EXCHANGE ACT OF 1934, AND RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that public administrative and cease-and-desist proceedings be, and hereby are, instituted against Rodney A. Smith, Michael Santicchia, CPA, and Stephen D. Cheaney, CPA (collectively "Respondents") pursuant to Section 203(k) of the Investment Advisers Act of 1940 ("Advisers Act"), Section 4C[1] of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 102(e)(1)(ii) and 102(e)(1)(iii) of the Commission's Rules of Practice.[2]

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[1] Section 4C provides, in relevant part, that:
The Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found . . (2) to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations thereunder.

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

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement (the "Offers") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Public Administrative and Cease-and-Desist Proceedings Pursuant to Section 203(k) of the Investment Advisers Act of 1940, Section 4C of the Securities Exchange Act of 1934, and Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds[3] that

Summary

1. This matter involves misconduct by Respondents in completing surprise exams pursuant to Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder (the "Custody Rule").[4] Freedom One Investment Advisors, Inc. ("Freedom One"), a formerly registered investment adviser, had custody of client assets held in two omnibus accounts and was required by the Custody Rule to have an independent public accountant conduct annual surprise exams to verify those assets. For 2006 and 2008, Freedom One engaged UHY LLP ("Accounting Firm") to perform the surprise exams. By failing to complete the surprise exams (i.e. conduct fieldwork, prepare and issue a surprise exam report, and file Forms ADV-E), Respondents, three accountants at Accounting Firm caused Freedom One to violate the Custody Rule. In addition, Smith willfully aided and abetted Freedom One's 2006 violations of the Custody Rule, and Santicchia and Cheaney engaged in improper professional conduct within the meaning of Section 4C of the Exchange Act and Rule 102(e)(1)(ii) of the Commission's Rules of Practice.

Rule 102(e)(1)(iii) provides, in pertinent part, that:
The Commission may . . . deny, temporarily or permanently, the privilege of appearing or practicing before it . . . to any person who is found...to have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws or the rules and regulations thereunder.

[3] 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.

[4] On December 31, 2009, the Commission revised Rule 206(4)-2. Freedom One's conduct for 2006 through 2008 was governed by the Custody Rule in effect before the December 31, 2009 amendments (the "Prior Custody Rule"). See *Custody of Funds or Securities of Clients by Investment Advisers*, Release No. IA-2176 (Sept. 25, 2003).

Respondents

2. **Rodney A. Smith**, age 63, of Ann Arbor, Michigan, was an Accounting Firm principal from 2005 through 2008. He was a member of the engagement teams for both of Accounting Firm's surprise exams. Accounting Firm terminated his employment on November 21, 2008. Smith received his Bachelor of Science in Accounting and Corporate Finance from Penn State University. He is not and has never been a CPA.

3. **Michael Santicchia**, age 53, of Dearborn, Michigan, has been a partner with Accounting Firm or its predecessor since approximately 1994. While holding the position of Accounting Firm's Michigan Regional Attest Leader, he was a member of the engagement team, and the only partner thereon, for both of Accounting Firm's surprise exams. Santicchia has been a licensed Certified Public Accountant ("CPA") in Michigan since 1984, Pennsylvania since 1999, Oklahoma and New York since 2000, Indiana since 2002, and Massachusetts since 2010.

4. **Stephen D. Cheaney**, age 58, of Northville, Michigan, has been employed by Accounting Firm, or its predecessor, since 1983, and has been an Accounting Firm principal for approximately the last 15 years. After Smith left Accounting Firm, Santicchia assigned Cheaney to replace Smith on the 2008 surprise exam. Cheaney has been a licensed CPA in Michigan since 1985.

Other Relevant Entities

5. **Freedom One Investment Advisors, Inc.**, was a privately-held Michigan corporation headquartered in Clarkston, Michigan and registered with the Commission as an investment adviser from December 1995 until April 2, 2013, when it filed a Form ADV-W to withdraw its registration with the Commission.

6. **Freedom One Retirement Services, LLC ("FORS")**, is a Michigan and North Carolina limited liability company headquartered in Clarkston, Michigan. FORS provided retirement plan services, including record keeping services, to Freedom One. FORS was an affiliate of Freedom One.

7. **Freedom One Financial Group, LLC ("FOFG")** was the 66% owner of Freedom One and FORS until December 31, 2012, when it was acquired by a dually-registered broker-dealer and investment adviser.

Background

8. From 2006 through 2008, Freedom One offered four different types of discretionary and non-discretionary investment management services, including to individuals with IRA accounts ("IRA Accounts"); and to individuals with personal taxable accounts ("Managed Accounts"). During the relevant period, Freedom One managed approximately $625 million in assets, approximately $69 million of which were held in the IRA Accounts and Managed Accounts.

9. The Custody Rule requires registered investment advisers with custody of client funds or securities to implement certain controls designed to protect those client assets from loss, misappropriation, misuse, or the adviser's insolvency. Before the December 31, 2009 amendment of the Custody Rule, Rule 206(4)-2(a)(3) required these advisers to have a reasonable basis for believing that a "qualified custodian," such as a bank or broker-dealer, was sending quarterly account statements to each of the clients for which they maintained funds or securities, or to send the quarterly account statements themselves and obtain an annual surprise examination by an independent public accountant to verify all of the client funds and securities.

10. From 2006 through 2008, Freedom One held funds and securities for the IRA Accounts and Managed Accounts in an omnibus account at a broker-dealer registered with the Commission ("Custodian 1"). A third-party custodian and trustee ("Custodian 2") instructed Custodian 1 as to which trades to execute, based on instructions it received from Freedom One. Custodian 2 maintained two separate omnibus accounts – one for the IRA Accounts and one for the Managed Accounts.

11. From 2006 through 2008, FORS maintained the records for Custodian 2's omnibus accounts on a participant level (i.e. keeping track of how the assets in the IRA and Managed Accounts broke down by client) and directed Custodian 2 to make distributions. Since FORS' responsibilities gave it the authority to obtain possession of clients' funds and securities held in Custodian 2's omnibus accounts, and FORS was an affiliate of Freedom One, Freedom One was deemed to have custody of the assets contained in Custodian 2's omnibus accounts.

12. From 2006 through 2008, because FORS was not a qualified custodian and it sent quarterly account statements to Freedom One's clients with IRA Accounts and Managed Accounts, the Prior Custody Rule required Freedom One to have a surprise exam for each of those years.

<u>FOFG Engaged Accounting Firm to Complete Freedom One's 2006 and 2008 Surprise Exams</u>

13. FOFG engaged Accounting Firm to complete Freedom One's surprise exams for 2006 and 2008. FOFG executed two engagement letters with Accounting Firm, dated December 18, 2006 and November 5, 2007. According to each engagement letter, Accounting Firm was to perform an "annual surprise audit" of a "previously tested product that [Freedom One has] developed [i.e. the IRA Accounts]..." Neither of the engagement letters stated what year the surprise exams were for.

14. Although neither of the letters referred to the Custody Rule itself, they each provide surprise exam guidance directly from it, stating:

> "An independent public accountant verifies all of those funds and securities by actual examination at least once during each calendar year…and files a certificate on Form ADV-E (17 CFR 279.8) with the Commission within 30 days after the completion of the

examination, stating that it has examined the funds and securities and describing the nature and extent of the examination."

15. Both engagement letters also reference a November 2006 email from Freedom One's chief compliance officer ("CCO"), to Smith, which states "The following is some of the regulatory language spelling our [sic] the requirement...**§ 275.206(4)-2 Custody of funds or securities of clients by investment advisers.**" The email also includes the entire text of the Prior Custody Rule. Smith drafted both engagement letters and Santicchia reviewed them.

Respondents Conducted Some Field Work for the 2006 and 2008 Surprise Exams

16. During 2006 and 2007, the Accounting Firm engagement team conducted some field work for the first surprise exam, with a surprise exam date of December 31, 2006 (the "2006 exam"). Similarly, during 2008, the engagement team conducted some field work for the second surprise exam, with a surprise exam date of August 31, 2008 (the "2008 exam").

17. Smith was a member of both surprise exam engagement teams until he left Accounting Firm at the end of November 2008. He was responsible for staffing the engagements, planning the exam procedures, reviewing the workpapers, preparing the report to be issued (the "surprise exam report"), and preparing the Form ADV-E. When Smith left Accounting Firm, a manager at Accounting Firm who performed some of the 2006 exam fieldwork and all of the 2008 exam fieldwork ("Accounting Firm Manager") had already started performing the 2008 exam procedures, but his 2008 surprise exam work had not yet been reviewed.

18. Santicchia was a member of, and sole partner on, both surprise exam engagement teams. Santicchia was responsible for assigning Smith and Cheaney to the engagements, participating in some planning procedures, reviewing the workpapers, issuing the surprise exam report, and ensuring that the Form ADV-E was filed. Santicchia never performed this work on either exam and no report was ever issued.

19. On or about December 5, 2008, after Smith left Accounting Firm, Santicchia assigned Cheaney, who like Smith was a principal but not a partner, to replace Smith on the 2008 exam, and asked him to review Accounting Firm Manager's work on that exam.

20. On December 8, 2008, Cheaney reviewed the workpapers, and prepared comments and questions for Accounting Firm Manager, which he memorialized in Accounting Firm's electronic workpaper filing system (the "Notes"). Cheaney commented in the Notes that "some [exam] steps [had] not [been] completed." In the Notes, he also questioned "where is [client] independence [affirmation] and engagement continuance forms?"

21. In the Notes, he also questioned whether "the work that is done accomplish[es] the audit objective that all of the assets reported are there on an unannounced day." Finally, Cheaney commented that he "briefly looked at the 2006 [workpaper] file," and found that "[i]t

appears that the job was not completed, no evidence that there is any report even drafted and never filed....the [workpapers] were not even reviewed. my [sic] guess is that nothing was ever filed with SEC."

22. Cheaney then told Santicchia that he had completed his review and that the 2008 exam was incomplete. Santicchia also reviewed the Notes, and therefore knew Cheaney's conclusions regarding the 2006 exam.

23. Santicchia never followed up with Cheaney and neither Santicchia nor Cheaney followed up with Accounting Firm Manager to determine whether he addressed the issues identified in the Notes, or took any other action to address the incomplete exams.

24. At the time, Accounting Firm did not tell Freedom One that it had not completed the exams. At the end of March 2009, Accounting Firm Manager left Accounting Firm. By the end of July 2010, Freedom One learned that no report had ever been issued for the 2008 exam. By mid-April 2011, Freedom One learned that Accounting Firm did not complete either exam, did not issue a report for either exam, and did not file the Forms ADV-E. On May 5, 2011, Accounting Firm refunded the fees Freedom One paid for both exams, totaling $19,000.

Respondents Failed to Complete the 2006 and 2008 Surprise Exams in Accordance with Applicable Standards

25. Respondents failed to complete the 2006 and 2008 surprise exams. That is, they failed to conduct fieldwork, prepare and issue surprise exam reports, and file Forms ADV-E with the Commission. Alternatively, they failed to withdraw from the engagements and notify the client on a timely basis.

Respondents Failed to Conduct Fieldwork

26. Smith (for the 2006 exam), Santicchia (for both exams) and Cheaney (for the 2008 exam) failed to ensure that the Accounting Firm engagement team conducted fieldwork.

27. An accountant should conduct the surprise exam, or withdraw from the engagement, in accordance with U.S. Generally Accepted Auditing or Attestation Standards as established by the AICPA ("AICPA Attest Standards"), which are described in AT Section 101, "*Attest Engagements*." See *Custody of Funds or Securities of Clients by Investment Advisers*, Release No. IA-2176 (Sept. 25, 2003).

28. On May 26, 1966, the Commission issued Accounting Series Release No. 103[5], which described the nature of the exam required by Rule 206(4)-2(a) of the Advisers Act.[6]

[5] ASR No. 103 has been incorporated into Financial Reporting Codification Section 404.01.b.

[6] *The Nature of the Examination and Certificate Required by Paragraph (a)(5) of Rule 206(4)-2 Under the Investment Advisers Act of 1940*, Accounting Series Release No. 103, Investment Advisers Act Release No. 201 (May 26, 1966) ("ASR No. 103").

According to ASR No. 103, to conduct an appropriate exam, an accountant should, among other things, conduct the following procedures:

- Make a physical examination of securities and obtain confirmation as appropriate;
- Obtain confirmation of funds on deposit in banks; and
- Reconcile the physical count and confirmations to the books and records.

ASR No. 103 further states that these books and records should be verified by examination of the security records and transactions since the last examination and by obtaining written confirmations from clients of the funds and securities in the clients' accounts as of the date of the physical examination. Also, if clients' accounts have been closed or securities or funds of such clients have been returned since the last examination, the accountant should confirm these on a test basis.

29. All of these procedures were applicable to Freedom One's 2006 and 2008 surprise exams, however, the Accounting Firm engagement team did not obtain confirmation of securities or funds held by Custodians 1 and 2 and did not send any confirmation requests to Freedom One's clients. Therefore, they also did not reconcile the confirmations to the books and records.

30. For the 2006 exam, the engagement team tested reconciliations, but the workpapers were not included in the Accounting Firm's official file. Also, the testing was not performed as of the surprise exam date – it was as of March 31, 2007, rather than December 31, 2006. Finally, the reconciliations compared Freedom One's books to the Custodian 2 IRA Account, but not to the Custodian 2 Managed Account and to the Custodian 1 Account.

31. For the 2008 exam, the Accounting Firm engagement team selected August 31, 2008 as the examination date. The engagement team tested reconciliations, but they were not performed as of the surprise exam date – they were as of August 18, 2008. Also, they only compared Freedom One's books to the Custodian 2 IRA Account, but not to the Custodian 2 Managed Account and to the Custodian 1 Account.

Respondents Failed to Issue Surprise Exam Reports or Withdraw from the Engagements

32. The Respondents failed to ensure that reports were issued for the surprise exams. Alternatively, they failed to withdraw from the engagements and notify the client on a timely basis.

33. The AICPA Attest Standards require that a "practitioner who accepts an attest engagement should issue a report on the subject matter or the assertion or withdraw from the attest engagement." AT §§101.64

Respondents Failed to File Forms ADV-E

34. The Respondents failed to ensure that Forms ADV-E were filed for the surprise exams.

35. Under the Prior Custody Rule, an accountant must transmit to the Commission, within 30 days of completing the surprise exam, a Form ADV-E along with a certificate stating that it has examined the funds and securities and describing the nature and extent of the exam (the "Exam Certificate").

36. For the 2006 exam, Smith exchanged draft Forms ADV-E with Freedom One's CCO at the time. On March 30, 2007, Smith emailed Freedom One's CCO a blank Form ADV-E and stated "Please see the attached form which you must fill out for us to send." Then, on April 10, Freedom One's CCO emailed Smith a completed Form ADV-E that had an examination completed date of February 28, 2007. Finally, on July 12, Freedom One's CCO emailed Smith attaching an updated Form ADV-E with an examination completed date of June 30, 2007. No drafts of Form ADV-E were contained in the workpapers.

37. No Form ADV-E or Exam Certificate was filed with the Commission for either exam.

Respondents Santicchia and Cheaney Failed to Meet the AICPA Standards Requiring "Due Professional Care"

38. AT Section 101 requires a practitioner to "exercise due professional care in the planning and performance of the engagement and the preparation of the report." AT §§101.39, 101.40 and 101.41.

39. An accountant should also perform certain procedures during the course of the surprise exam in order to comply with the AICPA Attest Standards, as described in AT Section 601, "*Compliance Attestation*" ("AICPA Compliance Attest Procedures"). The AICPA Compliance Attest Procedures state that a practitioner should exercise (a) due care in planning, performing, and evaluating the results of his or her examination procedures…" AT §601.38.

40. Santicchia and Cheaney failed to exercise due professional care in accordance with AICPA Attest Standards AT §§101.39, 101.40 and 101.41, and AICPA Compliance Attest Procedure AT §§601 in performing the surprise exams. First, they did not have adequate knowledge or understanding of the Custody Rule and its requirements. They had never before conducted a surprise exam, and they did not consult with anyone from Accounting Firm that had conducted a surprise exam. Santicchia and Cheaney did not have any prior experience or training regarding the Custody Rule or surprise exams, and they did not determine or consider the requirements for the exams. In addition, Santicchia did not understand that the surprise exam was being conducted pursuant to the Custody Rule. The only reference to the Custody Rule requirements in the official workpapers is in the engagement letters, which include an excerpt from the rule.

41. Second, Santicchia and Cheaney did not follow Accounting Firm's quality control practices and procedures. As to client acceptance and continuance, Santicchia did not evaluate whether the Accounting Firm engagement team had sufficient technical skills, knowledge of the industry, and personnel to perform the engagements, and document the client acceptance

evaluation procedures. Santicchia also failed to obtain the required sign-offs to accept Freedom One as a client – he failed to consult with the Michigan SEC "Leader" in his office and, because Freedom One was an SEC registered investment adviser, he should have consulted with Accounting Firm's Office of the Managing Partner and the Director of Quality Control.

42. Santicchia did not follow Accounting Firm's planning procedures, including reviewing background information on Freedom One, holding planning meetings, documenting the plans and approving the plans. There are no completed planning forms or any workpapers in the official file that detail the scope and objective of the exam.

43. Santicchia and Cheaney did not follow Accounting Firm's supervisory procedures, including documenting the supervisory personnel responsible for reviewing the work performed, and ensuring that the surprise exams were supervised and reviewed by partners who had appropriate knowledge and expertise for the engagement. They also did not consult with any Accounting Firm partners who had experience with, or specialized in, SEC matters or the SEC rules that apply to investment advisers.

44. Third, Santicchia (for both exams) and Cheaney (for the 2008 exam) failed to ensure that the surprise exam engagements were completed. That is, they failed to ensure that fieldwork was conducted. Also, Cheaney failed to prepare a surprise exam report, and Santicchia failed to issue surprise exam reports. In addition, Cheaney failed to prepare a Form ADV-E, and Santicchia failed to file Forms ADV-E. Alternatively, they failed to withdraw from the engagements and notify the client on a timely basis.

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

45. Rule 102(e) of the Commission's Rules of Practice, which has been codified into Section 4C of the Exchange Act, allows the Commission to censure a person, or deny the person, either permanently or temporarily, from appearing or practicing before the Commission if the Commission finds the person to be lacking in character or integrity or to have engaged in unethical or improper professional conduct or to have willfully aided and abetted the violation of any provision of the federal securities laws or the rules and regulations thereunder. Section 4C(a)(2) and (3) of the Exchange Act and Rule 102(e)(1)(ii) and (iii) of the Commission's Rules of Practice.

46. Rule 102(e)(1)(iv) and Section 4C(b) defines "improper professional conduct" as including: (A) intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards; or (B) negligent conduct, including repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission.[7]

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[7] Rule 102(e)(1)(iv) describes improper professional conduct with respect to persons licensed as accountants; Section 4C describes improper professional conduct with respect to any registered public accounting firm or associated person.

Respondent Smith Willfully Aided and Abetted Freedom One's 2006 Custody Rule Violation

47. Smith willfully aided and abetted Freedom One's 2006 violation of Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder.

48. Smith was part of the 2006 surprise exam engagement team. He drafted the engagement letter for that exam and therefore knew that Accounting Firm was engaged to conduct an annual surprise exam, to verify funds and securities by actual examination, and to file a certificate on Form ADV-E with the Commission within 30 days after the completion of the examination.

49. Smith did not have adequate knowledge or understanding of the Custody Rule and its requirements in order to complete the engagement. He had never before conducted a surprise exam, and did not consult with anyone from Accounting Firm that had conducted a surprise exam. Smith did not have any prior experience or training regarding the Custody Rule or surprise exams, and he did not determine or consider the requirements for the exams. The only reference to the Custody Rule requirements in the official workpapers is in the engagement letters, which include an excerpt from the rule.

50. For the 2006 surprise exam, he exchanged draft Forms ADV-E before fieldwork was conducted. Before leaving Accounting Firm in November 2008, he took no action to ensure that the 2006 surprise exam fieldwork was conducted and that the surprise exam report was prepared, which meant that a Form ADV-E could not be issued. Alternatively, he failed to withdraw from the engagement and notify the client on a timely basis.

Respondents Santicchia and Cheaney Engaged in Improper Professional Conduct

51. Santicchia (for both exams) and Cheaney (for the 2008 exam) engaged in improper professional conduct. First, they failed to complete the surprise exams. That is, they failed to ensure that fieldwork was conducted. Also, Cheaney failed to prepare a surprise exam report, and Santicchia failed to issue reports. In addition, Cheaney failed to prepare a Form ADV-E, and Santicchia failed to file Forms ADV-E. Alternatively, they failed to withdraw from the engagements and notify the client on a timely basis.

52. Santicchia and Cheaney also failed to exercise due professional care in accordance with AICPA Attest Standards AT §§101.39, 101.40, and 101.41, and AICPA Compliance Attest Procedure AT §§601. They: (1) did not have adequate knowledge or understanding of the Prior Custody Rule and its requirements; (2) did not follow Accounting Firm's quality control practices and procedures; and (3) failed to ensure that the surprise exams were completed or withdraw from the engagements and notify the client on a timely basis.

Violations

53. As a result of the conduct described above, Smith (for the 2006 and 2008 surprise exams), Santicchia (for the 2006 and 2008 surprise exams), and Cheaney (for the 2008 surprise

exam) caused Freedom One's violations of Section 206(4) of the Advisers Act and Rule 206(4)-2 promulgated thereunder.

54. As a result of the conduct described above, Smith willfully aided and abetted Freedom One's 2006 violation of Section 206(4) of the Advisers Act and Rule 206(4)-2 promulgated thereunder.

55. As a result of the conduct described above, Santicchia and Cheaney engaged in improper professional conduct within the meaning of Section 4C of the Exchange Act and Rule 102(e)(1)(ii) of the Commission's Rules of Practice.

IV.

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

Accordingly, pursuant to Section 203(k) of the Advisers Act, Section 4C of the Exchange Act, and Rule 102(e) of the Commission's Rules of Practice, it is hereby ORDERED that:

A. Respondents Smith, Santicchia and Cheaney cease and desist from committing or causing any violations and any future violations of Section 206(4) of the Advisers Act and Rule 206(4)-2 promulgated thereunder.

Smith

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

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

Santicchia

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

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

1. a preparer or reviewer, or a person responsible for the preparation or review, of any public company's financial statements that are filed with the Commission. Such an application must satisfy the Commission that Respondent Santicchia's work in his practice

before the Commission will be reviewed either by the independent audit committee of the public company for which he works or in some other acceptable manner, as long as he practices before the Commission in this capacity; and/or

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

(a) Respondent Santicchia, or the public accounting firm with which he is associated, is registered with the Public Company Accounting Oversight Board ("Board") in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective;

(b) Respondent Santicchia, or the registered public accounting firm with which he is associated, has been inspected by the Board and that inspection did not identify any criticisms of or potential defects in his or the firm's quality control system that would indicate that he will not receive appropriate supervision;

(c) Respondent Santicchia has resolved all disciplinary issues with the Board, and has complied with all terms and conditions of any sanctions imposed by the Board (other than reinstatement by the Commission); and

(d) Respondent Santicchia acknowledges his responsibility, as long as he appears or practices before the Commission as an independent accountant, to comply with all requirements of the Commission and the Board, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews and quality control standards.

F. The Commission will consider an application by Respondent Santicchia to resume appearing or practicing before the Commission provided that his state CPA license is current and he has resolved all other disciplinary issues with the applicable state boards of accountancy. However, if state licensure is dependent on reinstatement by the Commission, the Commission will consider an application on its other merits. The Commission's review may include consideration of, in addition to the matters referenced above, any other matters relating to Respondent Santicchia's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

<u>Cheaney</u>

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

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

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

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

(a) Respondent Cheaney, or the public accounting firm with which he is associated, is registered with the Board in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective;

(b) Respondent Cheaney, or the registered public accounting firm with which he is associated, has been inspected by the Board and that inspection did not identify any criticisms of or potential defects in his or the firm's quality control system that would indicate that he will not receive appropriate supervision;

(c) Respondent Cheaney has resolved all disciplinary issues with the Board, and has complied with all terms and conditions of any sanctions imposed by the Board (other than reinstatement by the Commission); and

(d) Respondent Cheaney acknowledges his responsibility, as long as he appears or practices before the Commission as an independent accountant, to comply with all requirements of the Commission and the Board, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews and quality control standards.

I. The Commission will consider an application by Respondent Cheaney to resume appearing or practicing before the Commission provided that his state CPA license is current and he has resolved all other disciplinary issues with the applicable state boards of accountancy. However, if state licensure is dependent on reinstatement by the Commission, the Commission will consider an application on its other merits. The Commission's review may include consideration of, in addition to the matters referenced above, any other matters relating to Respondent Cheaney's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9495 / December 13, 2013

SECURITIES EXCHANGE ACT OF 1934
Release No. 71075 / December 13, 2013

INVESTMENT ADVISERS ACT OF 1940
Release No. 3739 / December 13, 2013

INVESTMENT COMPANY ACT OF 1940
Release No. 30831 / December 13, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15249

In the Matter of
CRAIG BERKMAN, d/b/a VENTURES TRUST LLC, JOHN B. KERN, FACE OFF ACQUISITIONS, LLC, FACE OFF MANAGEMENT, LLC, a/k/a FACE OFF ACQUISITIONS MANAGEMENT, LLC, VENTURES TRUST II LLC, VENTURES TRUST III LLC, VENTURES TRUST IV LLC, VENTURES TRUST V LLC, VENTURES TRUST VI LLC, VENTURES TRUST ASSET FUND LLC, VENTURES TRUST MANAGEMENT LLC, VENTURES TRUST ASSET MANAGEMENT, LLC, a/k/a VENTURES TRUST II ASSET MANAGEMENT, LLC, ASSENSUS CAPITAL, LLC AND ASSENSUS CAPITAL MANAGEMENT, LLC,

Respondents.

CORRECTED 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(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940 AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940 AS TO CRAIG BERKMAN, D/B/A VENTURES TRUST LLC

I.

On March 19, 2013, the Securities and Exchange Commission ("Commission") instituted public administrative and cease-and-desist 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(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, among others, Craig Berkman, d/b/a Ventures Trust LLC ("Berkman" or "Respondent"), Face Off Acquisitions, LLC ("Face Off Acquisitions"), Face Off Management, LLC, a/k/a Face Off Acquisitions Management, LLC ("Face Off Management"), Ventures Trust II LLC ("Ventures II"), Ventures Trust III LLC ("Ventures III"), Ventures Trust IV LLC ("Ventures IV"), Ventures Trust V LLC ("Ventures V"), Ventures Trust VI LLC ("Ventures VI"), Ventures Trust Asset Fund LLC ("Ventures Asset Fund"), Ventures Trust Management LLC, Ventures Trust Asset Management, LLC a/k/a Ventures Trust II Asset Management, LLC (Ventures Trust Management LLC and Ventures Trust Asset Management, LLC are collectively referred to hereinafter as "Ventures Trust Management"), Assensus Capital, LLC ("Assensus Capital"), Assensus Capital Management, LLC ("Assensus Management").

II.

In response to 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 consent to the Commission's jurisdiction over him and the subject matter of these proceedings and 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(f) and 203(k) of the Investment Advisers Act of 1940, and Section 9(b) of the Investment Company Act of 1940 as to Craig Berkman, d/b/a Ventures Trust LLC ("Order"), as set forth below:

III.

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

SUMMARY

1. From approximately October 2010 through September 2012, Berkman fraudulently raised at least $13.2 million from approximately 120 investors by selling membership interests in

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

limited liability companies ("LLCs") that Berkman controlled, including Face Off Acquisitions, Assensus Capital and several LLCs with the words "Ventures Trust" in their names.

2. Berkman made material misrepresentations he knew were false to investors in three different sets of offerings. In one set of offerings, Berkman told investors in Ventures II, III, IV, V, and VI (collectively, the "Ventures LLCs") that their funds would be used to acquire highly coveted, pre-initial public offering ("pre-IPO") shares of Facebook, Inc., LinkedIn, Inc., Groupon, Inc., and Zynga Inc. In another offering, Berkman told investors in Face Off Acquisitions that their money would be used either to purchase pre-IPO shares of Facebook or to acquire a company that held pre-IPO Facebook shares. In a third offering, Berkman told investors in Assensus Capital that he would use their money to fund various new, large-scale, technology ventures.

3. Instead of using the investor funds to acquire pre-IPO shares or fund technology ventures, Berkman misappropriated most of the offering proceeds. Berkman used most of the money to make payments to investors in his earlier investment schemes and to some of the victims of this fraud in Ponzi scheme fashion, including approximately $5.43 million to satisfy a prior judgment against him and another $4.8 million to investors who had invested either in this pre-IPO scheme or in other schemes. Berkman also used approximately $1.6 million to fund his own personal expenses, including large cash withdrawals and dining and travel expenses.

4. Of the $13.2 million raised, Berkman used $600,000 to purchase a small interest in an unrelated fund that had acquired pre-IPO Facebook stock. That purchase did not provide any of the Ventures LLCs, or any other company affiliated with Berkman, with ownership of Facebook shares. Berkman and/or one of his associates nevertheless used a forged letter about that investment to falsely represent to investors that Ventures II owned nearly half a million shares of Facebook stock. Upon discovering the forgery, the fund informed Berkman that it was immediately terminating and liquidating the Ventures II interest, leaving Ventures II without even an indirect interest in Facebook shares.

SETTLING RESPONDENT

5. **Berkman**, age 72, is currently incarcerated in the Metropolitan Detention Center in Brooklyn, New York. At all relevant times, Berkman controlled each of the Respondent entities.. Berkman has pleaded guilty to criminal conduct relating to the findings in this Order. Specifically, in *United States v. Craig L. Berkman*, Crim. No. 13-CR-00732 (SAS) (S.D.N.Y.) ("Parallel Criminal Action"), Berkman pleaded guilty to violations of Section 10(b) of the Exchange Act [15 U.S.C. §78j(b)], and wire fraud [18 U.S.C. §1343]. In connection with that guilty plea, Berkman admitted, among other things, that:

(a) From around October 2010 through March 2013, he controlled a series of limited liability companies that solicited money from investors. He told investors that their investments would be used to purchase pre-IPO shares of companies, such as Facebook, LinkedIn, Zynga and others, and they were expected to go public soon;

(b) In the course of soliciting investments, he made false statements of material fact. For example, he knowingly over-represented the number of Facebook shares his companies controlled; and

(c) He engaged in further fraud and deceit. He used the money invested with his companies for purposes other than purchasing pre-IPO shares of companies, as he had promised investors. For example, he used close to $6 million to pay creditors in a bankruptcy proceeding.

In connection with his guilty plea in the Parallel Criminal Action, Berkman also agreed (i) to forfeit to the United States the amount of $13,239,006; (ii) to pay restitution in the amount of $8,435,888; and (iii) a stipulated sentencing guideline range of 97 to 121 months imprisonment and an applicable criminal fine range of up to $5 million.

6. During the time of the events described herein, Berkman acted as an investment adviser and was associated with multiple investment advisers, including Face Off Management, Ventures Trust Management, Ventures Trust Asset Management and Assensus Management.

NON-SETTLING RESPONDENTS

7. **Face Off Acquisitions** is a Delaware LLC formed on May 24, 2011.

8. **Face Off Management** is a Delaware LLC formed on May 24, 2011.

9. **Ventures II** is a Delaware LLC formed on June 15, 2010. Ventures II purported to have offices in Tampa, Florida, Los Angeles, California, and New York, New York. Ventures II purported to be a private equity firm with a "unique opportunity to purchase discounted shares of Facebook." The majority of the investor funds at issue were deposited into Ventures II bank accounts and comingled with investor funds initially deposited into accounts held in the names of the other Ventures LLCs.

10. **Ventures Trust Asset Management** is a Delaware LLC formed on March 7, 2007. Berkman owns or owned 100% of the membership interests of Ventures Trust Asset Management.

11. **Ventures Trust Management** is a Delaware LLC formed on August 8, 2011.

12. **Ventures III** is a Delaware LLC formed on December 28, 2010. Ventures III purported to have offices in Los Angeles, California. It purported to be a private equity firm with a "unique opportunity to purchase discounted shares" and whose "first investment will be made in LinkedIn."

13. **Ventures IV** is a Delaware LLC formed on January 27, 2011. Ventures IV purported to have offices in Los Angeles, California. Ventures IV purported to be a private equity firm with a "unique opportunity to purchase discounted shares," whose "first investment will be made in Groupon." Ventures IV holds a bank account through which Berkman funneled investor

funds and whose title is "Ventures Trust IV Groupon." Berkman is listed as a signatory on the bank account.

14. **Ventures V** is a Delaware LLC formed on January 27, 2011. It also holds a bank account through which Berkman funneled investor funds.

15. **Ventures VI** is a Delaware LLC formed on January 27, 2011. It similarly holds a bank account through which Berkman funneled investor funds.

16. **Ventures Trust Asset Fund** is a State of Washington LLC formed on January 11, 2007. A portion of the misappropriated investor funds at issue were transferred to Ventures Trust Asset Fund.

17. **Assensus Capital** is a Delaware LLC formed on July 14, 2011. Assensus Capital purported to have offices in Tampa, Florida and New York, New York. It purported to be a private equity firm focused on "funding affiliated, groundbreaking companies in surgical technology fields and in the forefront of a new generation of nuclear power plant design."

18. **Assensus Management** is a Delaware LLC formed on July 14, 2011. It purported to serve as Assensus Capital's Managing Member and to be "responsible for the sourcing, structuring and oversight of the portfolio investments."

19. **John B. Kern** ("Kern"), age 49, resides in Charleston, South Carolina. Kern is an attorney licensed to practice law in South Carolina and also has an office in the Republic of San Marino. Kern is or was Ventures II's general counsel and Face Off Acquisitions' general counsel. Kern represented Ventures II in the staff's investigation of this matter.

OTHER RELEVANT PERSONS AND ENTITIES

20. **The Manager**, age 49, resides in Encinitas, California. At all relevant times, the Manager managed and provided "day-to-day leadership" for the respective managing members of Face Off Acquisitions, Ventures Trust, and Assensus Capital.

21. **Actual Facebook Funds** are two single-purpose, pooled investment vehicles associated with a registered broker-dealer in New York City. The two Actual Facebook Funds both held pre-IPO Facebook stock during the relevant period.

22. **Actual Facebook Fund 2** is a Delaware LLC (unrelated to the Actual Facebook Funds) formed to acquire pre-IPO securities of Facebook. Actual Facebook Fund 2 held only pre-IPO Facebook stock during the relevant period.

FACTUAL BACKGROUND

Berkman's Prior Securities Violations and Bankruptcy

23. In 2001, the Oregon Division of Finance and Securities issued a cease-and-desist order against Berkman for offering and selling convertible promissory notes without a brokerage license to Oregon residents between 1983 and 1997. Berkman received a $50,000 fine.

24. In June 2008, an Oregon jury found Berkman liable in a private action for breach of fiduciary duty, conversion of investor funds, and misrepresentation to investors, among other things, arising from Berkman's involvement with a series of purported venture capital funds known as Synectic Ventures (collectively "Synectic"). Berkman's improper use of Synectic funds included more than $5 million in purported "personal loans" and the misuse of investor funds to cover personal expenses and execute personal stock purchases. The court entered a $28 million judgment against Berkman ("2008 Oregon Judgment").

25. In March 2009, Synectic filed an involuntary Chapter 7 bankruptcy petition against Berkman in the Middle District of Florida alleging that he owed more than $15.4 million in unpaid debts arising from the 2008 Oregon Judgment. On August 11, 2010, the court entered three judgments against Berkman totaling nearly $15 million, plus 9% interest and costs, deemed non-dischargeable in bankruptcy.

26. The parties to the bankruptcy proceeding then reached a settlement in which Berkman was required to pay $4.75 million in seven installments, beginning on November 30, 2010. After making the first four payments, totaling $1.5 million, Berkman failed to make the fifth payment, due on March 17, 2011. He defaulted on several subsequent revised payment schedules, which also included 5% annual interest. The Chapter 7 Trustee recommenced adversary proceedings, leading to a further revised settlement agreement with a final payment date of May 11, 2012. On May 9, 2012, Berkman paid the remaining balance of more than $3.2 million and the pending adversary proceedings against him were dismissed with prejudice.

27. As detailed below, Berkman used a substantial part of the proceeds of his pre-IPO offering fraud (and none of his own money) to pay the Florida bankruptcy claims.

The Ventures Fraud

28. From approximately October 2010 through February 2012, Berkman and the Manager made numerous misrepresentations to Ventures LLC investors when offering and selling membership interests in the various Ventures LLCs, both orally and in writing, including in the formal offering documents.

29. Berkman and the Manager falsely told investors that each of the Ventures LLCs would use their funds to acquire highly coveted, pre-IPO shares in one or more social media companies that were planning IPOs at the time, including Facebook, LinkedIn, Groupon or Zynga. For example, Berkman and the Manager falsely told certain investors that Ventures II was going to

purchase pre-IPO Facebook shares and falsely told other investors that Ventures II had already purchased such shares.

30. Berkman and the Manager sent prospective investors offering documents that contained a host of materially false statements.

31. Berkman and the Manager provided investors with at least three different versions of a private placement memorandum ("Memorandum") for Ventures II and other formal offering materials, all of which contained false statements about acquiring Facebook shares. For example, Berkman provided a February 2012 Ventures II Memorandum to at least one potential investor, and the Manager provided Memoranda dated November 2010 and September 2011 to other investors. These Memoranda all represent that "investment proceeds will be used to purchase Facebook shares" and that "Facebook shares will be purchased" at various prices per share.

32. Berkman and the Manager also provided investors with the Ventures II operating agreement, which states that "the purpose of the Company is to acquire Facebook stock." Both Berkman and the Manager signed Ventures LLC membership certificates falsely stating that the investor is a "registered holder of one unit invested in Facebook." The Manager provided these certificates to investors.

33. Berkman signed letters to Ventures II investors acknowledging receipt of their investment proceeds and falsely stating, among other things, that the "investment was used to purchase . . . shares of Facebook stock at a cost basis of [a certain amount] per share." In addition, Berkman signed Ventures II "Quarterly Reports" and a "Letter of Ownership," which the Manager provided to investors, falsely stating that their Ventures II investment purchased a specific number of shares of pre-IPO Facebook shares at a specific price. The Manager further provided investors with a Ventures II "Facebook Opportunity Fund Overview," which falsely stated that their "investment is solely allocated to the purchase of Facebook stock."

34. Berkman also lied to Ventures II investors about the annual interest rate they would receive. The Ventures II Memoranda and other documents represented that members "will receive a 5% annual simple interest return on the investment until 100% of their principal and accumulated interest has been returned." Berkman signed a quarterly report falsely stating that the value of the investment had increased, apparently due to the 5% annual interest. Berkman had the Manager give the quarterly report to Ventures II investors.

35. Berkman knew all of these statements were false, because he knew that none of the Ventures LLCs owned pre-IPO Facebook, LinkedIn, Groupon or Zynga shares and because he was personally misappropriating the investors' funds.

36. In late 2010, Ventures II used $600,000 of investor funds to acquire an interest in the Actual Facebook Funds. This acquisition did not entitle Ventures II to the ownership of Facebook shares owned by the Actual Facebook Funds, but it did entitle Ventures II to an approximately 3.19% interest in the Actual Facebook Funds. At most, Ventures II's $600,000

interest in the Actual Facebook Funds represented an indirect interest equivalent to approximately 22,253 shares of Facebook.

37. In September 2011, Kern asked the Law Firm, counsel to the Actual Facebook Funds, for a letter on the firm's letterhead describing Ventures II's interest in the Actual Facebook Funds and Facebook. In response, an associate at the Law Firm sent a letter with his signature to a purported Ventures II office in Manhattan at an address Kern provided. The letter, dated October 19, 2011, was addressed to Berkman and the Manager. The letter accurately stated that Ventures II held a 3.1899% interest in the Actual Facebook Funds and that the Actual Facebook Funds held an unspecified amount of Facebook shares. The letter did not state that Ventures II actually owned any Facebook shares.

38. The letter was subsequently altered with Berkman's participation, knowledge and consent. The altered version was dated February 22, 2012. It was printed on the Law Firm's letterhead and had a forged version of the Law Firm associate's signature on it. The letter falsely represented that the Actual Facebook Funds "ha[ve] allocated 497,625 shares of Facebook, Inc. in Ventures Trust II LLC['s] capital account."

39. In or prior to February 2012, a prospective investor, who happened to be a securities attorney, asked the Manager for some assurance that Ventures II had acquired the pre-IPO Facebook shares that the Manager had claimed it acquired. In approximately February 2012, the Manager showed the forged letter to the investor, who then invested $108,000 in Ventures II. The Manager refused to let the investor retain a copy of the letter.

40. On February 27, 2012, the Manager sent an email to another prospective investor with a copy of the forged letter attached.

41. On March 1, 2012, the Law Firm wrote a letter addressed to Berkman and the Manager. The letter enclosed a copy of the forged letter and stated that the forged letter "constitutes a fraudulent misrepresentation of your participation and interest in" the Actual Facebook Funds, "since your investment represents only 22,253 shares of Facebook, Inc. stock." The letter continued: "[The forged letter] was not drafted, executed or distributed by this law firm, is an unlawful and unauthorized use of this law firm's name and letterhead and contains a forged signature of an attorney at this law firm." The letter further informed Berkman and the Manager that "[y]our misconduct is consistent with a general pattern of deceit" and therefore that Ventures II's interest in the Actual Facebook Funds "is hereby terminated effective as of the dates of your initial investments."

42. On March 9, 2012, Kern, "as counsel to Ventures [II]," wrote back to the Law Firm. Kern's letter claimed that Ventures II "is the victim of some other party's fabrication of the letter" and "we do not know the source of that letter." Kern's letter took issue with the termination of "important legal and economic rights of Ventures [II]" and threatened to file an NASD complaint.

43. On approximately March 12, 2012, a partner at the Law Firm informed Kern by telephone that Ventures II's $600,000 interest in the Actual Facebook Funds had been rescinded and that the proceeds would be held in a segregated account to satisfy potential future claims. In other words, Ventures II no longer held even an indirect interest in Facebook shares.

44. Despite Kern's threats of legal action, neither Kern nor anyone else associated with Ventures II took legal action against the Actual Facebook Funds. The Actual Facebook Funds transferred Ventures II's interest to another investor and placed the cash proceeds in a segregated account.

45. In total, Berkman and the Manager raised more than $9.9 million from all the Ventures LLC investors. Of that amount, approximately $6.56 million was deposited in various Ventures II bank accounts, purportedly to be used to acquire pre-IPO Facebook shares; approximately $1.68 million was deposited in a Ventures III account, purportedly to be used to acquire pre-IPO LinkedIn shares; approximately $624,000 was deposited in a Ventures IV account, purportedly to be used to acquire pre-IPO Groupon shares; and approximately $1.07 million was deposited in a Ventures VI account, purportedly to be used to acquire pre-IPO Zynga shares.

46. Other than $600,000 that was used to purchase an interest in the Actual Facebook Funds that was subsequently terminated, none of the Ventures LLCs' investor funds were ever used to purchase pre-IPO shares of Facebook, LinkedIn, Groupon, Zynga, or any other company, as Berkman knew.

The Face Off Acquisition Fraud

47. From approximately 2011 through July 2012, while he was conducting the Ventures fraud, Berkman fraudulently raised approximately $2.6 million by selling membership interests in Face Off Acquisitions.

48. Actual Facebook Fund 2 owned a significant amount of pre-IPO Facebook shares.

49. Berkman told prospective investors over the telephone and in face-to-face meetings that Face Off Acquisitions would use its investor funds to acquire Actual Facebook Fund 2 or would otherwise acquire pre-IPO Facebook shares.

50. Berkman's effort to acquire Actual Facebook Fund 2 was perfunctory, at best. Berkman approached Actual Facebook Fund 2 about a proposal to purchase it, and Actual Facebook Fund 2's manager told Berkman in approximately April 2011 that it would cost at least $28 million. Because Berkman and his entities never had the money, a deal was never likely or imminent, yet Berkman falsely portrayed the Actual Facebook Fund 2 deal as imminent to prospective investors.

51. Yet Berkman and Kern falsely portrayed the Actual Facebook Fund 2 deal as imminent to prospective investors.

52. In a letter dated April 14, 2012, Kern sent Berkman a letter that described the status of negotiations between Face Off Acquisitions and Actual Facebook Fund 2 and falsely implied that Face Off Acquisitions' purchase of Actual Facebook Fund 2 was likely and imminent. Kern captioned his letter "Memorandum of Understanding for Investors in Face Off Acquisitions, LLC to acquire [Actual Facebook Fund 2] (1,012,500 shares of Facebook)." Kern's letter stated:

- "I am writing to confirm that yesterday afternoon I spoke with . . . legal counsel for [Actual Facebook Fund 2]. . . and the Company's Managing Director . . . about the prospect for a timely acquisition of the Company by Face Off Acquisitions;"

- "The purpose of this letter is to provide direction for completing [Face Off Acquisitions'] purchase of [Actual Facebook Fund 2]."

- "[Counsel for [Actual Facebook Fund 2] confirms that under the right set of circumstances, [Actual Facebook Fund 2] is willing to enter into a transaction in the coming few days with Face Off Acquisitions."

- "[T]he sole assets of [Actual Facebook Fund 2] are 1,012,500 shares of Class B Common shares of Facebook, Inc."

- "With proof of funds, a summary Term Sheet will be prepared and we will immediately set upon organizing a 'Securities Transaction Agreement' for the purchase and sale of the ownership interests of [Actual Facebook Fund 2]. Because the Facebook IPO is expected to be effective in early May[,] the [Actual Facebook Fund 2] purchase must occur on or before April 24, 2012."

53. Berkman knew the letter was misleading. The seemingly urgent negotiations were a charade, because Berkman knew Face Off Acquisitions could not possibly pay $28 million (or any amount even close to $28 million) to purchase Actual Facebook Fund 2.

54. In approximately April 2012, Berkman provided Kern's letter to at least one prospective investor.

55. Berkman also provided at least one other Face Off Acquisitions investor with an Actual Facebook Fund 2 Memorandum and Actual Facebook Fund 2's due diligence materials to lend the purported acquisition the appearance of legitimacy.

56. In an email on May 15, 2012, Berkman told another Face Off Acquisitions investor that Berkman was "[i]n NY for the closing. We have agreed on a $35.00 per [s]hare price. Will check in with you when the deal is done." In fact, as Berkman knew, there was no closing, no agreement on a share price, and no money to close any such deal.

57. Berkman also provided prospective investors with Face Off Acquisitions Memoranda and other formal offering materials that contained false statements regarding the use of investor funds to purchase pre-IPO Facebook shares or to purchase Actual Facebook Fund 2.

58. Berkman sent at least one investor an April 2012 Face Off Acquisitions Memorandum stating that "Face Off Acquisitions is focused on generating above average financial returns by purchasing up to 1,012,500 pre IPO Facebook common shares, and significant preferred shareholder interest in five proprietary medical technology, capacitor, and water treatment companies."

59. Berkman sent at least one other investor a May 2012 Face Off Acquisitions Memorandum stating that "investment proceeds will be used solely to acquire up to 1,012,500 pre IPO Facebook shares at a $35.00 per share cost basis," and described the "use of proceeds [as] one hundred percent invested in pre Facebook IPO stock."

60. In addition to the Memoranda, Berkman provided investors with other documents that contained similar misrepresentations, including:

- A Face Off Acquisitions operating agreement, which claimed that Face Off Acquisitions "has been formed to acquire, hold and/or dispose of all the issued and outstanding limited liability interests in [Actual Facebook Fund 2];"
- A Face Off Acquisitions memorandum dated April 11, 2012, which thanks the investor for his "willingness to review the Face Off Acquisitions investment opportunity to acquire 1,012,500 series B common pre IPO Facebook shares;" and
- A letter dated May 8, 2012, in which Berkman acknowledges receipt of a $250,000 investment and tells the investor that it was "for the purpose of purchasing seven thousand one hundred forty two Facebook Series B common Rule 144 shares at a cost basis of $35.00 per share."

61. Berkman knew that each of the foregoing statements in the offering documents was false and misleading, because he intended to and did misappropriate all the funds invested in Face Off Acquisitions.

The Assensus Capital Fraud

62. After Facebook's IPO on May 18, 2012, Berkman shifted gears and began focusing on another phony investment vehicle called Assensus Capital. Berkman made similar misrepresentations to prospective investors in Assensus Capital: The investors' money would be invested in some new cutting edge venture, when Berkman was in fact misappropriating the offering proceeds.

63. Berkman sent one investor a June 2012 Assensus Capital Memorandum that stated: "Investment proceeds will be used to acquire significant equity interest in unique enterprises that serve large and growing markets, with superior profit margins [through] investing in state-of-the-art medical devise, infrastructure (water), distressed debt, and advanced nanotechnology materials companies."

64. Berkman also wrote memoranda to prospective Assensus Capital investors that named specific companies in which Assensus Capital would invest and extended an investment "guaranty" purportedly backed up by cash or shares from one of its "portfolio" companies, including Facebook.

65. One such memorandum to a prospective investor, dated August 27, 2012, stated: "Upon making [an] Assensus Capital LLC investment, you will receive a 5% simple interest from the date of your investment, which will be returned together with your principal investment [in cash] or the equivalent in Facebook shares." That investor later invested approximately $150,000.

66. Afterwards, Berkman tried to solicit another investment from the same investor by again offering a "guaranty" linked to Facebook stock, this time making the following representations about the nature and basis for the guaranty:

- "Assensus Capital LLC and Face Off Acquisitions LLC will obtain the removal of all Facebook share legends upon the expiration of the Facebook November lock-up period in order to allow all or a portion of the shares to be sold as soon as allowed after the expiration date;"

- "Assensus Capital is willing to provide this guaranty for two specific reasons: (1) a high degree of confidence that [EVI] will be acquired within the next 6-12 months; and (2) the value of my carried interest in previous investment activities relating to the acquisition of Facebook shares, that is represented by share certificates for 165,713,000 common shares that I am holding as part of my compensation;" and

- "If you decide to exercise the investment guaranty, you can elect to receive the amount of your prospective investment together with the accumulated five percent annual simple interest or, a partial or complete distribution of 6,500 [Facebook] shares in addition to the 51,666 Facebook shares that are in your capital account as the result of your initial $150,000 [investment] with a cost basis of $7.74 per share."

67. As Berkman knew, each of these representations was false. He intended to and did misappropriate all of the funds invested in Assensus Capital and knew neither he nor Assensus Capital had Facebook shares with which to guaranty investments.

68. Despite Berkman's assurances, the investor declined to invest additional funds.

69. In total, Berkman raised approximately $718,000 from Assensus Capital investors.

The Misappropriation of Investor Funds

70. None of the statements made by Berkman about the use of the funds invested in the Venture LLCs, Face Off Acquisitions, or Assensus Capital were true. Other than the $600,000 investment in the Actual Facebook Funds, none of the offering proceeds were used to make any

investments at all, much less the purchase of pre-IPO shares in Facebook, LinkedIn, Groupon or Zynga.

71. Berkman personally transferred approximately $5.1 million of investor funds to his personal bank account. Berkman used most of that $5.1 million, plus a $925,000 direct transfer from a Ventures LLC account, to pay his judgment creditors in the bankruptcy proceeding.

72. Berkman used the remaining money that he had transferred to his personal account (approximately $600,000) and another approximately $1 million taken directly from the Ventures LLC accounts to make large cash withdrawals, pay legal fees, fund his own travel and other personal expenses and make numerous other payments unrelated to the purported business of the Ventures LLCs, Face Off Acquisitions or Assensus Capital. For example, Berkman spent approximately $300,000 on dining, travel, retail and healthcare expenses and withdrew at least another $165,000 in cash or cash equivalents.

73. The Manager received approximately $502,000 from accounts into which investor funds were deposited.

74. The majority of the rest of the offering proceeds, approximately $4.8 million, was used to make payments to earlier investors in the pre-IPO scheme or, in some cases, to investors in Berkman's prior investment schemes. For example, in 2010 and 2011, Berkman transferred $400,000 from a Ventures LLC account to two individuals to whom Berkman owed money from investments they had made in unrelated Berkman ventures in approximately 2004.

Misrepresentations To Conceal The Scheme

75. As the end of the lock up period for pre-IPO Facebook stock approached and investors began making requests for their distributions, the fraud began to unravel. In response, Berkman, Kern, and others knowingly or recklessly made, or caused to be made, misrepresentations to investors to keep them from learning of the fraud and demanding the return of their funds.

76. For example, in August 2012, Kern wrote and signed a "Memorandum to Investors About Ventures Trust II LLC Efforts to Secure and Protect Interests with Our Trading Counterparties." Kern's memorandum stated that he was writing "to advise [investors] on the status of our efforts to address concerns that have been raised about the integrity of the funds."

77. Kern's memorandum represented that "Ventures Trust II has utilized two separate counterparties in securing the investments in privately held Facebook stock," and that "we are in the process of attempting to secure the transfer of these shares to our own trading account in order to avoid any complications arising out of the counterparty's trading practices."

78. Kern's memorandum represented that with respect to the first counterparty, "which involves approximately 20% of the investment capital of Ventures Trust II in Facebook stock," the counterparty "and its counsel have repeatedly affirmed that it has the requisite shares and

reconfirmed to us that we have the securities interests to which we subscribed." The memorandum then suggested that the counterparty may have "more-or-less fabricated" the price of the shares, creating a "collateral issue," but assured investors that Ventures II would "address this in due course on behalf of our investors," if necessary.

79. Kern's memorandum further represented that the second counterparty "holds approximately 80% of our investments in Facebook."

80. The memorandum also stated that Ventures II "is subject to non-disclosure agreements with [both] counterparties which prevent us from disclosing the identity of these New York based groups at this time" and that Ventures II "is not a Ponzi scheme and absolutely and affirmatively rejects this assertion as false and malicious."

81. These statements were false. Berkman knew these statements were false.

82. In August 2012, the Manager emailed Kern's memorandum to certain investors, with a copy to Berkman. Berkman thereafter told investors that he had decided to liquidate the fund investments and that the funds would soon start making distributions. As Berkman knew, such statements were false and, as recently as in or around March 2013, Berkman gave investors a series of false excuses for why the distributions were still being delayed.

THE RESPONDENT'S LIABILITY

83. As a result of the conduct described above, Berkman , Face Off Acquisitions, Face Off Management, Ventures II, Ventures III, Ventures IV, Ventures V, Ventures VI, Ventures Trust Asset Fund, Ventures Trust Management, Ventures Trust Asset Management, Assensus Capital, and Assensus Management committed violations of, and Berkman 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.

84. As a result of the conduct described above, Berkman, Face Off Management, Ventures Trust Management, Ventures Trust Asset Management and Assensus Management committed violations of, and Berkman willfully violated, Sections 206(1), 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8, which prohibit fraudulent conduct by an investment adviser.

85. As a result of the conduct described above, Berkman willfully aided and abetted and caused: (a) the violations committed by Ventures II, Ventures III, Ventures IV, Ventures V, Ventures VI, Ventures Trust Asset Fund, Ventures Trust Management, Ventures Trust Asset Management, Face Off Acquisitions, Face Off Management, Assensus Capital, and Assensus Management of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; and (b) the violations committed by Ventures Trust Management, Ventures Trust Asset Management, Face Off Management, and Assensus Management of Sections 206(1), 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8.

IV.

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

Accordingly, pursuant to Section 8A of the Securities Act, Section 21C of the Exchange Act, Sections 203(f) and 203(k) of the Advisers Act and Section 9(b) of the Investment Company Act, it is hereby ORDERED that:

A. Respondent Berkman cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1), 206(2), and 206(4) of the Advisers Act and Rule 206(4)-8 promulgated thereunder.

B. Respondent Berkman 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;

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.

C. Any reapplication for association by Respondent Berkman 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. In view of Berkman's agreement to forfeit $13,239,006 and pay restitution in the amount of $8,435,888 in conjunction with his guilty plea in the Parallel Criminal Action, in which he was criminally charged with engaging in the same conduct that is alleged in the Order Instituting Proceedings herein ("OIP"), Berkman is not additionally liable in this proceeding for disgorgement of ill-gotten gains he received as a result of the conduct alleged in the OIP; and (b) based on Berkman's agreement, in connection with his guilty plea in the Parallel Criminal Action, to a stipulated sentencing guideline range of 97 to 121 months imprisonment and an applicable criminal fine range of up to $5 million, Berkman is not being ordered to pay a civil monetary penalty.

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. 71069 / December 12, 2013

INVESTMENT ADVISERS ACT OF 1940
Release No. 3737 / December 12, 2013

INVESTMENT COMPANY ACT OF 1940
Release No. 30829 / December 12, 2013

ADMINISTRATIVE PROCEEDING
File No. 3- 15644

In the Matter of **Mark M. Wayne,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934, SECTIONS 203(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act"), Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act"), and Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act") against Mark M. Wayne ("Wayne" or "Respondent").

II.

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

Administrative and Cease-and-Desist Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Sections 203(f) and 203(k) of the Investment Advisers Act of 1940, and Section 9(b) of the Investment Company Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

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

Summary

1. This matter involves violations of the custody, compliance, and books and records provisions of the Advisers Act by Freedom One Investment Advisors, Inc. ("Freedom One"), a formerly registered investment adviser, which were willfully aided and abetted and caused by Wayne, its former President, Chief Executive Officer ("CEO"), and Chief Compliance Officer ("CCO"). From 2008 through 2010, Freedom One had custody of client assets held in two omnibus accounts (the "IRA Accounts" and the "Managed Accounts") and was therefore required to comply with Section 206(4) of the Advisers Act and Rule 206(4)-2 promulgated thereunder (the "Custody Rule").[2] For all three years, Freedom One violated the Custody Rule because it took no action to determine whether the independent public accountants it retained to conduct annual surprise exams to verify the assets over which it had custody performed those exams. For 2008, Freedom One engaged a national accounting firm ("Accounting Firm 1") to perform a surprise exam, but Accounting Firm 1 did not complete the exam. For 2009 and 2010, Freedom One engaged another national accounting firm ("Accounting Firm 2") to conduct surprise exams, but the exams were insufficient because Freedom One told Accounting Firm 2 that only the IRA Accounts were subject to the exams and thus the exams did not include the Managed Accounts.

2. Freedom One and Wayne also violated the Custody Rule requirement regarding client account statements. From 2008 through 2010, an affiliate of Freedom One, Freedom One Retirement Services, Inc. ("FORS"), which was not a qualified custodian, provided quarterly account statements to clients with IRA Accounts and Managed Accounts. Consequently, for 2008 and 2009, Freedom One violated the prior Custody Rule requirement that a qualified custodian provide statements to clients in the absence of a surprise exam. Furthermore, for 2010, when the current Custody Rule became effective, Freedom One was required to have a reasonable basis for believing that a qualified custodian was sending quarterly statements to clients regardless of whether a surprise exam was completed, but it failed to do so.

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

[2] On December 31, 2009, the Commission revised Rule 206(4)-2. Freedom One's conduct for 2008 and 2009 was governed by the custody rule in effect before the December 31, 2009 amendments. See *Custody of Funds or Securities of Clients by Investment Advisers*, Release No. IA-2176 (Sept. 25, 2003). Freedom One's conduct for 2010 was governed under the revised custody rule, which became effective on March 12, 2010. *See Custody of Funds or Securities of Clients by Investment Advisers*, Release No. IA-2968 (Dec. 30, 2009).

3. Freedom One and Wayne also failed to adopt and implement written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules promulgated thereunder, in violation of Section 206(4) of the Advisers Act and Rule 206(4)-7 promulgated thereunder (the "Compliance Rule"). From October 2008 through March 2011, Freedom One did not have policies and procedures reasonably designed to prevent violations of the Custody Rule.

4. Finally, Freedom One and Wayne failed to maintain accurate books and records, in violation of Section 204 of the Advisers Act and Rule 204-2 promulgated thereunder. From January 2009 through July 2010, certain Freedom One transactions were not properly reflected in its books and records.

Respondent

5. **Mark M. Wayne**, age 49, of Clarkston, Michigan, co-founded Freedom One in 1995 and was the sole owner of Freedom One Financial Group, LLC ("FOFG"), the 66% owner of Freedom One and FORS until December 31, 2012, when FOFG was acquired by a dually-registered broker-dealer and investment adviser registered with the Commission. Wayne was Freedom One's CEO, President, and a Director, and since October 2008, he was also its CCO. From 2009 through 2011, Wayne was also associated with a registered broker-dealer.

Other Relevant Entities

6. **Freedom One Investment Advisors, Inc.**, was a Michigan corporation headquartered in Clarkston, Michigan and registered with the Commission as an investment adviser from December 1995 until April 2, 2013, when it filed a Form ADV-W to withdraw its registration with the Commission.

7. **Freedom One Retirement Services, LLC**, was a Michigan and North Carolina limited liability company headquartered in Clarkston, Michigan. FORS provided retirement plan services, including record keeping services, to Freedom One. FORS was an affiliate of Freedom One.

Background

8. From 2008 through 2010, Freedom One offered discretionary and non-discretionary investment management services to: (1) qualified retirement plans that were subject to the Employee Retirement Income Security Act of 1974, as amended ("Qualified Plans"); (2) participants of the Qualified Plans; (3) individuals with IRA accounts ("IRA Accounts"); and (4) individuals with personal taxable accounts ("Managed Accounts"). During the relevant period, Freedom One managed approximately $625 million in assets, approximately $69 million of which were held in the IRA Accounts (approximately 1,456 accounts) and Managed Accounts (approximately 66 accounts).

Freedom One Failed to Comply with the Custody Rule

9. The Custody Rule – Rule 206(4)-2 under the Advisers Act – requires registered investment advisers with custody of client funds or securities to implement certain controls designed to protect those client assets from loss, misappropriation, misuse, or the adviser's insolvency. Before the amendment of Rule 206(4)-2, the rule required these advisers to have a reasonable basis for believing that a qualified custodian, such as a bank or broker-dealer, was sending quarterly account statements to each of the clients for which it maintained funds or securities, or to send the quarterly account statements itself and obtain an annual surprise examination by an independent public accountant to verify all of the client assets. The amended rule generally requires these advisers to have a reasonable basis for believing that a qualified custodian is sending quarterly statements to clients and to be subject to an annual surprise examination.

10. From 2008 through 2010, funds and securities for the IRA Accounts and Managed Accounts were held in one omnibus account at a broker-dealer registered with the Commission ("Custodian 1"). A third-party custodian and trustee ("Custodian 2") instructed Custodian 1 as to which trades to execute, based on instructions it received from Freedom One. Custodian 2 maintained two separate omnibus accounts – one for the IRA Accounts and one for the Managed Accounts.

11. From 2008 through 2010, FORS maintained the records for Custodian 2's omnibus accounts on a participant level (i.e. keeping track of how the assets in the IRA and Managed Accounts broke down by client) and directed Custodian 2 to make distributions. Since FORS' responsibilities gave it the authority to obtain possession of clients' funds and securities held in Custodian 2's omnibus accounts, and FORS was an affiliate of Freedom One, Freedom One was deemed to have custody of the assets contained in Custodian 2's omnibus accounts.

12. From 2008 through 2010, Freedom One's clients that had assets in the IRA Accounts and Managed Accounts did not receive quarterly account statements from a qualified custodian. Instead, Custodian 2 paid FORS, which was not a qualified custodian, to prepare and send those statements.

Freedom One Failed to Have a Surprise Exam Completed for 2008

13. On behalf of FOFG, Freedom One's CCO at the time executed an engagement letter with Accounting Firm 1 dated November 5, 2007 covering Freedom One's 2008 surprise exam. According to the engagement letter, Accounting Firm 1 was to perform an "annual surprise audit" of a "previously tested product that [Freedom One has] developed [i.e. the IRA Accounts]..." Although the letter did not refer to the Custody Rule itself, it provided surprise exam guidance directly from it, stating:

> An independent public accountant verifies all of those funds and securities by actual examination at least once during each calendar year...and files a certificate on Form ADV-E (17 CFR 279.8) with the Commission within 30 days after the

completion of the examination, stating that it has examined the funds and securities and describing the nature and extent of the examination.

14. The engagement letter referenced a November 2006 email from the CCO to Accounting Firm 1, which stated, "The following is some of the regulatory language spelling our [sic] the requirement...§ **275.206(4)-2 Custody of funds or securities of clients by investment advisers**." The email also includes the entire text of the prior Custody Rule.

15. During 2008, Accounting Firm 1 conducted some field work for the 2008 surprise exam, with a surprise exam date of August 31, 2008.

16. As CEO, principal and CCO of Freedom One, Wayne knew that Freedom One was required to comply with the Custody Rule. In October 2008, Wayne designated himself as Freedom One's CCO.[3] At the time, he had no formal training in investment adviser compliance. In addition, Wayne had only a general understanding of what the Custody Rule required Freedom One to do - that Freedom One needed an accountant to perform a surprise exam. After becoming CCO, he did not adequately familiarize himself with the Custody Rule or surprise exam requirements, or attend any formal investment adviser compliance training. Wayne did not know that the accountant Freedom One engaged to conduct the surprise exam was required to file a Form ADV-E with the Commission.

17. Accounting Firm 1 never completed the 2008 exam procedures, never prepared the required surprise exam report, and never filed a Form ADV-E with the Commission.

18. When Wayne took over as CCO, he knew that Accounting Firm 1 had been engaged to conduct Freedom One's 2008 exam, but took no action to determine whether Accounting Firm 1 actually completed it. Wayne did not receive a copy of the 2008 surprise exam report, and did not specifically ask Accounting Firm 1 for one until 2009. Furthermore, Wayne did not receive a copy of a filed Form ADV-E or Exam Certificate. These factors indicated that Accounting Firm did not complete the 2008 exam.

19. In July 2010, Freedom One learned that Accounting Firm 1 had not issued a report for the 2008 exam. By mid-April 2011, Freedom One knew that Accounting Firm 1 did not complete the exam or file a Form ADV-E with the Commission.

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[3] On December 18, 2006, Freedom One's former CCO engaged Accounting Firm 1 to conduct a first surprise exam. During 2006 and 2007, Accounting Firm 1 conducted some field work for that exam, with a surprise exam date of December 31, 2006, but, like the 2008 exam, never completed the exam by filing a Form ADV-E, which at the time required a paper filing, rather than an electronic filing. Although during 2007, Accounting Firm 1 exchanged draft Forms ADV-E with the former CCO, by the spring of 2011, Freedom One knew that Accounting Firm 1 did not complete either exam. Freedom One did not engage an accountant to conduct a 2007 surprise exam.

Freedom One Failed to Have Surprise Exams of Its Managed Accounts Performed for 2009 and 2010

20. Wayne delegated responsibility for the 2009 surprise exam to a Freedom One employee, who worked in Freedom One's recordkeeping and administration department, and who did not have any training or experience in securities law or investment adviser compliance ("Recordkeeping Employee").

21. In the spring of 2009, Recordkeeping Employee began discussions with Accounting Firm 2 about the 2009 surprise exam. Accounting Firm 2 had no prior experience with Freedom One's IRA Accounts and Managed Accounts.

22. Freedom One counsel defined the scope of the surprise exam in a December 7, 2009 email to Accounting Firm 2, with a copy to Recordkeeping Employee, stating that "the only accounts subject to the surprise audit are the Freedom One IRA accounts which are held at [Custodian 2]." Recordkeeping Employee was the only Freedom One employee copied on this email. At the time, Recordkeeping Employee did not know which accounts Freedom One had custody over.

23. From January through December 2010, Accounting Firm 2 conducted the 2009 and 2010 surprise exams. These exams did not comply with the requirements of the Custody Rule because Accounting Firm 2 examined only the IRA Accounts, and not the Managed Accounts.[4]

24. On February 7, 2011, Accounting Firm 2 filed Forms ADV-E and surprise exam reports with the Commission for 2009 and 2010.

25. Wayne knew that Accounting Firm 2 had been engaged to conduct surprise exams for 2009 and 2010, but had no direct involvement in the exams other than delegating oversight responsibility of them to Recordkeeping Employee.

Freedom One Failed to Adopt and Implement Sufficient Written Compliance Policies and Procedures Regarding Custody

26. The Compliance Rule – Rule 206(4)-7 under the Advisers Act – requires investment advisers registered with the Commission to adopt and implement written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules.

27. From October 2008 through March 2011, Freedom One's policies and procedures were not reasonably designed to prevent violations of the Custody Rule.

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[4] Freedom One engaged an accounting firm to validate transaction activity in the Managed Accounts for September 1, 2008 through June 30, 2011. The accounting firm found no exceptions for transactional activity occurring in the Managed Accounts.

28. On September 16, 2004, Freedom One adopted policies and procedures regarding custody and possession of clients' funds or securities. The relevant portion of Freedom One's compliance manual containing these policies and procedures was not updated in 2008 to properly identify the firm's custody over assets in the IRA and Managed Accounts. Thus, the firm's written policies and procedures did not meet the requirements of the Custody Rule.

29. In July 2010, Freedom One revised these policies and procedures. The relevant portion of Freedom One's revised compliance manual misstated that it only had custody over the IRA Accounts, and it did not contain policies and procedures reasonably designed to prevent violations of the Custody Rule.

30. In August 2011, Freedom One revised its compliance manual to state that if it is deemed to have custody of client funds or securities, it will comply with the SEC's Current Custody Rule and have a surprise exam conducted. It also revised its compliance manual to include procedures regarding the receipt of cash and checks, billing, qualified custodians, and account statements.

31. From October 2008 through March 2011, Wayne was Freedom One's CCO and ultimately approved Freedom One's compliance manuals in effect at the time, which were not reasonably designed to prevent violations of the Advisers Act as they related to custody over Freedom One's assets.

Freedom One Failed to Keep Accurate Books and Records

32. Section 204 of the Advisers Act and Rule 204-2 promulgated thereunder require that registered investment advisers make and keep certain books and records. Rule 204-2(a) sets forth certain categories of books and records that registered investment advisers are required to "make and keep true, accurate and current" with respect to their investment advisory business.

33. From January 1, 2009 through July 30, 2010, Freedom One failed to maintain accurate books and records. During that time, Freedom One's books and records were maintained by its Controller, who did not possess the skills necessary to properly perform her job. The Controller maintained Freedom One and FORS' accounting and financial records as separate departments within one company on an accounting system. Generally, intercompany accounts were used to reflect the sharing of employee and office expenses between Freedom One and FORS, as well as other transactions. However, due to the Controller's inexperience and shortcomings in the accounting software used by the firm, not all of Freedom One's transactions were properly reflected in Freedom One's accounts.

34. For example, Freedom One failed to properly record transactions in connection with a $52,500 loan it made to Karmichael Properties, LLC ("Karmichael"), a Freedom One affiliate that owns the building where Freedom One had its offices. On September 10, 2009, Freedom One made the loan and recorded as a debit to FORS' intercompany account with Karmichael and a credit to Freedom One's checking account. On October 2, Karmichael paid back the loan to FORS and the transaction was recorded as a credit to FORS' intercompany account and

a debit to FORS' checking account. No entry was made on Freedom One's books for this closing transaction. The loan should not have been recorded on FORS' books. The transaction should have been recorded in Freedom One's general ledger as a debit to an intercompany account with Karmichael and a credit to Freedom One's checking account. The entry should have been reversed when Karmichael paid back the loan. In addition, Karmichael should have paid back the loan to Freedom One, not FORS.

35. In addition, on October 1, 2009, $143,940.17 was transferred from a FORS money market account to a Freedom One payroll account. A number of other related transactions also occurred. However, no intercompany transactions were recorded to reflect this movement of money which caused the intercompany general ledger account to be misstated on Freedom One's books and records. The transactions were incorrectly balanced across Freedom One and FORS' records as a debit to a Freedom One payroll account and a credit to a FORS money market account. The transaction should have been recorded on Freedom One's books as a debit to a Freedom One payroll account and a credit to an intercompany account.

36. Finally, every month, FORS used a brokerage account to collect advisory income from most of Freedom One's advisory clients. The advisory fees were withdrawn from Freedom One's advisory client accounts at Custodian 1 and then deposited into a Custodian 1 brokerage account in the name of FORS. These fees were then aggregated and transferred to a bank account in the name of Freedom One. There were no journal entries to indicate an intercompany balance while the advisory fees were in the FORS brokerage account. In fact, the FORS brokerage account was not reflected on FORS' chart of accounts or on FORS or Freedom One's general ledger. For example, on January 6, 2009, Freedom One deposited $210,475.38 into a checking account. This money came from the FORS brokerage account. There was no credit entered on the Freedom One general ledger to balance the debit associated with this deposit into the checking account.

37. Wayne, as Freedom One's CEO and primary control person, knew that Freedom One was required to maintain accurate books and records. He appointed a Controller who lacked the necessary skills and did not provide her with adequate support and training to accurately maintain Freedom One's books and records.

Violations

38. As a result of the conduct described above, Wayne willfully aided and abetted and caused Freedom One's violations of Section 206(4) of the Advisers Act and Rule 206(4)-2 promulgated thereunder.

39. As a result of the conduct described above, Wayne willfully aided and abetted and caused Freedom One's violations of Section 206(4) of the Advisers Act and Rule 206(4)-7 promulgated thereunder.

40. As a result of the conduct described above, Wayne willfully aided and abetted and caused Freedom One's violations of Section 204 of the Advisers Act and Rule 204-2 promulgated thereunder.

Undertakings

41. In anticipation of the bar referenced in Sections IV.B. and IV.C, Respondent Wayne shall, before making any reapplication for association, complete thirty (30) hours of compliance training relating to the Advisers Act.

42. Certification of Compliance. Wayne shall certify, in writing, compliance with the undertaking set forth above. The certification shall identify the undertaking, provide written evidence of compliance in the form of a narrative, and be supported by exhibits sufficient to demonstrate compliance. The Commission staff may make reasonable requests for further evidence of compliance, and Wayne agrees to provide such evidence. The certification and supporting material shall be submitted to Paul A. Montoya, Assistant Regional Director, Securities and Exchange Commission, 175 West Jackson Blvd., Suite 900, Chicago Illinois 60604, or such other address as the Commission staff may provide, with a copy to the Office of Chief Counsel of the Enforcement Division, no later than sixty (60) days from the date of the completion of the undertaking.

IV.

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

Accordingly, pursuant to Section 15(b) of the Exchange Act, Sections 203(f) and 203(k) of the Advisers Act, and Section 9(b) of the Investment Company Act, it is hereby ORDERED that:

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

B. Respondent Wayne be, and hereby is barred from acting as the chief compliance officer of any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization with the right to apply for reentry after one (1) year to the appropriate self-regulatory organization, or if there is none, to the Commission; and prohibited from serving or acting as the chief compliance officer for a registered investment company or for an affiliated person of an investment adviser, depositor of, or principal underwriter for, a registered investment company, 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 will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against Respondent Wayne, 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 Wayne shall, within (10) days of the entry of this Order, pay a civil money penalty in the amount of $40,000 to the United States Treasury. 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:

(1) 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
(2) 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 Wayne 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 Montoya, Assistant Regional Director, Chicago Regional Office, Securities and Exchange Commission, 175 West Jackson Blvd., Suite 900, Chicago, IL 60604.

E. Respondent Wayne shall comply with the undertakings enumerated in Sections 41 and 42 above.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9495 / December 13, 2013

SECURITIES EXCHANGE ACT OF 1934
Release No. 71075 / December 13, 2013

INVESTMENT ADVISERS ACT OF 1940
Release No. 3739 / December 13, 2013

INVESTMENT COMPANY ACT OF 1940
Release No. 30831 / December 13, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15249

In the Matter of CRAIG BERKMAN, d/b/a VENTURES TRUST LLC, JOHN B. KERN, FACE OFF ACQUISITIONS, LLC, FACE OFF MANAGEMENT, LLC, a/k/a FACE OFF ACQUISITIONS MANAGEMENT, LLC, VENTURES TRUST II LLC, VENTURES TRUST III LLC, VENTURES TRUST IV LLC, VENTURES TRUST V LLC, VENTURES TRUST VI LLC, VENTURES TRUST ASSET FUND LLC, VENTURES TRUST MANAGEMENT LLC, VENTURES TRUST ASSET MANAGEMENT, LLC, a/k/a VENTURES TRUST II ASSET MANAGEMENT, LLC, ASSENSUS CAPITAL, LLC AND ASSENSUS CAPITAL MANAGEMENT, LLC, 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(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940 AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940 AS TO CRAIG BERKMAN, D/B/A VENTURES TRUST LLC

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I.

On March 19, 2013, the Securities and Exchange Commission ("Commission") instituted public administrative and cease-and-desist 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(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, among others, Craig Berkman, d/b/a Ventures Trust LLC ("Berkman" or "Respondent"), Face Off Acquisitions, LLC ("Face Off Acquisitions"), Face Off Management, LLC, a/k/a Face Off Acquisitions Management, LLC ("Face Off Management"), Ventures Trust II LLC ("Ventures II"), Ventures Trust III LLC ("Ventures III"), Ventures Trust IV LLC ("Ventures IV"), Ventures Trust V LLC ("Ventures V"), Ventures Trust VI LLC ("Ventures VI"), Ventures Trust Asset Fund LLC ("Ventures Asset Fund"), Ventures Trust Management LLC, Ventures Trust Asset Management, LLC a/k/a Ventures Trust II Asset Management, LLC (Ventures Trust Management LLC and Ventures Trust Asset Management, LLC are collectively referred to hereinafter as "Ventures Trust Management"), Assensus Capital, LLC ("Assensus Capital"), Assensus Capital Management, LLC ("Assensus Management").

II.

In response to 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 consent to the Commission's jurisdiction over him and the subject matter of these proceedings and 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(f) and 203(k) of the Investment Advisers Act of 1940, and Section 9(b) of the Investment Company Act of 1940 as to Craig Berkman, d/b/a Ventures Trust LLC ("Order"), as set forth below:

III.

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

SUMMARY

1. From approximately October 2010 through September 2012, Berkman fraudulently raised at least $13.2 million from approximately 120 investors by selling membership interests in

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

limited liability companies ("LLCs") that Berkman controlled, including Face Off Acquisitions, Assensus Capital and several LLCs with the words "Ventures Trust" in their names.

2. Berkman made material misrepresentations he knew were false to investors in three different sets of offerings. In one set of offerings, Berkman told investors in Ventures II, III, IV, V, and VI (collectively, the "Ventures LLCs") that their funds would be used to acquire highly coveted, pre-initial public offering ("pre-IPO") shares of Facebook, Inc., LinkedIn, Inc., Groupon, Inc., and Zynga Inc. In another offering, Berkman told investors in Face Off Acquisitions that their money would be used either to purchase pre-IPO shares of Facebook or to acquire a company that held pre-IPO Facebook shares. In a third offering, Berkman told investors in Assensus Capital that he would use their money to fund various new, large-scale, technology ventures.

3. Instead of using the investor funds to acquire pre-IPO shares or fund technology ventures, Berkman misappropriated most of the offering proceeds. Berkman used most of the money to make payments to investors in his earlier investment schemes and to some of the victims of this fraud in Ponzi scheme fashion, including approximately $5.43 million to satisfy a prior judgment against him and another $4.8 million to investors who had invested either in this pre-IPO scheme or in other schemes. Berkman also used approximately $1.6 million to fund his own personal expenses, including large cash withdrawals and dining and travel expenses.

4. Of the $13.2 million raised, Berkman used $600,000 to purchase a small interest in an unrelated fund that had acquired pre-IPO Facebook stock. That purchase did not provide any of the Ventures LLCs, or any other company affiliated with Berkman, with ownership of Facebook shares. Berkman and/or one of his associates nevertheless used a forged letter about that investment to falsely represent to investors that Ventures II owned nearly half a million shares of Facebook stock. Upon discovering the forgery, the fund informed Berkman that it was immediately terminating and liquidating the Ventures II interest, leaving Ventures II without even an indirect interest in Facebook shares.

SETTLING RESPONDENT

5. **Berkman**, age 72, is currently incarcerated in the Metropolitan Detention Center in Brooklyn, New York. At all relevant times, Berkman controlled each of the Respondent entities.. Berkman has pleaded guilty to criminal conduct relating to the findings in this Order. Specifically, in *United States v. Craig L. Berkman*, Crim. No. 13-CR-00732 (SAS) (S.D.N.Y.) ("Parallel Criminal Action"), Berkman pleaded guilty to violations of Section 10(b) of the Exchange Act [15 U.S.C. §78j(b)], and wire fraud [18 U.S.C. §1343]. In connection with that guilty plea, Berkman admitted, among other things, that:

(a) From around October 2010 through March 2013, he controlled a series of limited liability companies that solicited money from investors. He told investors that their investments would be used to purchase pre-IPO shares of companies, such as Facebook, LinkedIn, Zynga and others, and they were expected to go public soon;

(b) In the course of soliciting investments, he made false statements of material fact. For example, he knowingly over-represented the number of Facebook shares his companies controlled; and

(c) He engaged in further fraud and deceit. He used the money invested with his companies for purposes other than purchasing pre-IPO shares of companies, as he had promised investors. For example, he used close to $6 million to pay creditors in a bankruptcy proceeding.

In connection with his guilty plea in the Parallel Criminal Action, Berkman also agreed (i) to forfeit to the United States the amount of $13,239,006; (ii) to pay restitution in the amount of $8,435,888; and (iii) a stipulated sentencing guideline range of 97 to 121 months imprisonment and an applicable criminal fine range of up to $5 million.

6. During the time of the events described herein, Berkman acted as an investment adviser and was associated with multiple investment advisers, including Face Off Management, Ventures Trust Management, Ventures Trust Asset Management and Assensus Management.

NON-SETTLING RESPONDENTS

7. **Face Off Acquisitions** is a Delaware LLC formed on May 24, 2011.

8. **Face Off Management** is a Delaware LLC formed on May 24, 2011.

9. **Ventures II** is a Delaware LLC formed on June 15, 2010. Ventures II purported to have offices in Tampa, Florida, Los Angeles, California, and New York, New York. Ventures II purported to be a private equity firm with a "unique opportunity to purchase discounted shares of Facebook." The majority of the investor funds at issue were deposited into Ventures II bank accounts and comingled with investor funds initially deposited into accounts held in the names of the other Ventures LLCs.

10. **Ventures Trust Asset Management** is a Delaware LLC formed on March 7, 2007. Berkman owns or owned 100% of the membership interests of Ventures Trust Asset Management.

11. **Ventures Trust Management** is a Delaware LLC formed on August 8, 2011.

12. **Ventures III** is a Delaware LLC formed on December 28, 2010. Ventures III purported to have offices in Los Angeles, California. It purported to be a private equity firm with a "unique opportunity to purchase discounted shares" and whose "first investment will be made in LinkedIn."

13. **Ventures IV** is a Delaware LLC formed on January 27, 2011. Ventures IV purported to have offices in Los Angeles, California. Ventures IV purported to be a private equity firm with a "unique opportunity to purchase discounted shares," whose "first investment will be made in Groupon." Ventures IV holds a bank account through which Berkman funneled investor

funds and whose title is "Ventures Trust IV Groupon." Berkman is listed as a signatory on the bank account.

14. **Ventures V** is a Delaware LLC formed on January 27, 2011. It also holds a bank account through which Berkman funneled investor funds.

15. **Ventures VI** is a Delaware LLC formed on January 27, 2011. It similarly holds a bank account through which Berkman funneled investor funds.

16. **Ventures Trust Asset Fund** is a State of Washington LLC formed on January 11, 2007. A portion of the misappropriated investor funds at issue were transferred to Ventures Trust Asset Fund.

17. **Assensus Capital** is a Delaware LLC formed on July 14, 2011. Assensus Capital purported to have offices in Tampa, Florida and New York, New York. It purported to be a private equity firm focused on "funding affiliated, groundbreaking companies in surgical technology fields and in the forefront of a new generation of nuclear power plant design."

18. **Assensus Management** is a Delaware LLC formed on July 14, 2011. It purported to serve as Assensus Capital's Managing Member and to be "responsible for the sourcing, structuring and oversight of the portfolio investments."

19. **John B. Kern** ("Kern"), age 49, resides in Charleston, South Carolina. Kern is an attorney licensed to practice law in South Carolina and also has an office in the Republic of San Marino. Kern is or was Ventures II's general counsel and Face Off Acquisitions' general counsel. Kern represented Ventures II in the staff's investigation of this matter.

OTHER RELEVANT PERSONS AND ENTITIES

20. **The Manager**, age 49, resides in Encinitas, California. At all relevant times, the Manager managed and provided "day-to-day leadership" for the respective managing members of Face Off Acquisitions, Ventures Trust, and Assensus Capital.

21. **Actual Facebook Funds** are two single-purpose, pooled investment vehicles associated with a registered broker-dealer in New York City. The two Actual Facebook Funds both held pre-IPO Facebook stock during the relevant period.

22. **Actual Facebook Fund 2** is a Delaware LLC (unrelated to the Actual Facebook Funds) formed to acquire pre-IPO securities of Facebook. Actual Facebook Fund 2 held only pre-IPO Facebook stock during the relevant period.

FACTUAL BACKGROUND

Berkman's Prior Securities Violations and Bankruptcy

23. In 2001, the Oregon Division of Finance and Securities issued a cease-and-desist order against Berkman for offering and selling convertible promissory notes without a brokerage license to Oregon residents between 1983 and 1997. Berkman received a $50,000 fine.

24. In June 2008, an Oregon jury found Berkman liable in a private action for breach of fiduciary duty, conversion of investor funds, and misrepresentation to investors, among other things, arising from Berkman's involvement with a series of purported venture capital funds known as Synectic Ventures (collectively "Synectic"). Berkman's improper use of Synectic funds included more than $5 million in purported "personal loans" and the misuse of investor funds to cover personal expenses and execute personal stock purchases. The court entered a $28 million judgment against Berkman ("2008 Oregon Judgment").

25. In March 2009, Synectic filed an involuntary Chapter 7 bankruptcy petition against Berkman in the Middle District of Florida alleging that he owed more than $15.4 million in unpaid debts arising from the 2008 Oregon Judgment. On August 11, 2010, the court entered three judgments against Berkman totaling nearly $15 million, plus 9% interest and costs, deemed non-dischargeable in bankruptcy.

26. The parties to the bankruptcy proceeding then reached a settlement in which Berkman was required to pay $4.75 million in seven installments, beginning on November 30, 2010. After making the first four payments, totaling $1.5 million, Berkman failed to make the fifth payment, due on March 17, 2011. He defaulted on several subsequent revised payment schedules, which also included 5% annual interest. The Chapter 7 Trustee recommenced adversary proceedings, leading to a further revised settlement agreement with a final payment date of May 11, 2012. On May 9, 2012, Berkman paid the remaining balance of more than $3.2 million and the pending adversary proceedings against him were dismissed with prejudice.

27. As detailed below, Berkman used a substantial part of the proceeds of his pre-IPO offering fraud (and none of his own money) to pay the Florida bankruptcy claims.

The Ventures Fraud

28. From approximately October 2010 through February 2012, Berkman and the Manager made numerous misrepresentations to Ventures LLC investors when offering and selling membership interests in the various Ventures LLCs, both orally and in writing, including in the formal offering documents.

29. Berkman and the Manager falsely told investors that each of the Ventures LLCs would use their funds to acquire highly coveted, pre-IPO shares in one or more social media companies that were planning IPOs at the time, including Facebook, LinkedIn, Groupon or Zynga. For example, Berkman and the Manager falsely told certain investors that Ventures II was going to

purchase pre-IPO Facebook shares and falsely told other investors that Ventures II had already purchased such shares.

30. Berkman and the Manager sent prospective investors offering documents that contained a host of materially false statements.

31. Berkman and the Manager provided investors with at least three different versions of a private placement memorandum ("Memorandum") for Ventures II and other formal offering materials, all of which contained false statements about acquiring Facebook shares. For example, Berkman provided a February 2012 Ventures II Memorandum to at least one potential investor, and the Manager provided Memoranda dated November 2010 and September 2011 to other investors. These Memoranda all represent that "investment proceeds will be used to purchase Facebook shares" and that "Facebook shares will be purchased" at various prices per share.

32. Berkman and the Manager also provided investors with the Ventures II operating agreement, which states that "the purpose of the Company is to acquire Facebook stock." Both Berkman and the Manager signed Ventures LLC membership certificates falsely stating that the investor is a "registered holder of one unit invested in Facebook." The Manager provided these certificates to investors.

33. Berkman signed letters to Ventures II investors acknowledging receipt of their investment proceeds and falsely stating, among other things, that the "investment was used to purchase . . . shares of Facebook stock at a cost basis of [a certain amount] per share." In addition, Berkman signed Ventures II "Quarterly Reports" and a "Letter of Ownership," which the Manager provided to investors, falsely stating that their Ventures II investment purchased a specific number of shares of pre-IPO Facebook shares at a specific price. The Manager further provided investors with a Ventures II "Facebook Opportunity Fund Overview," which falsely stated that their "investment is solely allocated to the purchase of Facebook stock."

34. Berkman also lied to Ventures II investors about the annual interest rate they would receive. The Ventures II Memoranda and other documents represented that members "will receive a 5% annual simple interest return on the investment until 100% of their principal and accumulated interest has been returned." Berkman signed a quarterly report falsely stating that the value of the investment had increased, apparently due to the 5% annual interest. Berkman had the Manager give the quarterly report to Ventures II investors.

35. Berkman knew all of these statements were false, because he knew that none of the Ventures LLCs owned pre-IPO Facebook, LinkedIn, Groupon or Zynga shares and because he was personally misappropriating the investors' funds.

36. In late 2010, Ventures II used $600,000 of investor funds to acquire an interest in the Actual Facebook Funds. This acquisition did not entitle Ventures II to the ownership of Facebook shares owned by the Actual Facebook Funds, but it did entitle Ventures II to an approximately 3.19% interest in the Actual Facebook Funds. At most, Ventures II's $600,000

interest in the Actual Facebook Funds represented an indirect interest equivalent to approximately 22,253 shares of Facebook.

37. In September 2011, Kern asked the Law Firm, counsel to the Actual Facebook Funds, for a letter on the firm's letterhead describing Ventures II's interest in the Actual Facebook Funds and Facebook. In response, an associate at the Law Firm sent a letter with his signature to a purported Ventures II office in Manhattan at an address Kern provided. The letter, dated October 19, 2011, was addressed to Berkman and the Manager. The letter accurately stated that Ventures II held a 3.1899% interest in the Actual Facebook Funds and that the Actual Facebook Funds held an unspecified amount of Facebook shares. The letter did not state that Ventures II actually owned any Facebook shares.

38. The letter was subsequently altered with Berkman's participation, knowledge and consent. The altered version was dated February 22, 2012. It was printed on the Law Firm's letterhead and had a forged version of the Law Firm associate's signature on it. The letter falsely represented that the Actual Facebook Funds "ha[ve] allocated 497,625 shares of Facebook, Inc. in Ventures Trust II LLC['s] capital account."

39. In or prior to February 2012, a prospective investor, who happened to be a securities attorney, asked the Manager for some assurance that Ventures II had acquired the pre-IPO Facebook shares that the Manager had claimed it acquired. In approximately February 2012, the Manager showed the forged letter to the investor, who then invested $108,000 in Ventures II. The Manager refused to let the investor retain a copy of the letter.

40. On February 27, 2012, the Manager sent an email to another prospective investor with a copy of the forged letter attached.

41. On March 1, 2012, the Law Firm wrote a letter addressed to Berkman and the Manager. The letter enclosed a copy of the forged letter and stated that the forged letter "constitutes a fraudulent misrepresentation of your participation and interest in" the Actual Facebook Funds, "since your investment represents only 22,253 shares of Facebook, Inc. stock." The letter continued: "[The forged letter] was not drafted, executed or distributed by this law firm, is an unlawful and unauthorized use of this law firm's name and letterhead and contains a forged signature of an attorney at this law firm." The letter further informed Berkman and the Manager that "[y]our misconduct is consistent with a general pattern of deceit" and therefore that Ventures II's interest in the Actual Facebook Funds "is hereby terminated effective as of the dates of your initial investments."

42. On March 9, 2012, Kern, "as counsel to Ventures [II]," wrote back to the Law Firm. Kern's letter claimed that Ventures II "is the victim of some other party's fabrication of the letter" and "we do not know the source of that letter." Kern's letter took issue with the termination of "important legal and economic rights of Ventures [II]" and threatened to file an NASD complaint.

43. On approximately March 12, 2012, a partner at the Law Firm informed Kern by telephone that Ventures II's $600,000 interest in the Actual Facebook Funds had been rescinded and that the proceeds would be held in a segregated account to satisfy potential future claims. In other words, Ventures II no longer held even an indirect interest in Facebook shares.

44. Despite Kern's threats of legal action, neither Kern nor anyone else associated with Ventures II took legal action against the Actual Facebook Funds. The Actual Facebook Funds transferred Ventures II's interest to another investor and placed the cash proceeds in a segregated account.

45. In total, Berkman and the Manager raised more than $9.9 million from all the Ventures LLC investors. Of that amount, approximately $6.56 million was deposited in various Ventures II bank accounts, purportedly to be used to acquire pre-IPO Facebook shares; approximately $1.68 million was deposited in a Ventures III account, purportedly to be used to acquire pre-IPO LinkedIn shares; approximately $624,000 was deposited in a Ventures IV account, purportedly to be used to acquire pre-IPO Groupon shares; and approximately $1.07 million was deposited in a Ventures VI account, purportedly to be used to acquire pre-IPO Zynga shares.

46. Other than $600,000 that was used to purchase an interest in the Actual Facebook Funds that was subsequently terminated, none of the Ventures LLCs' investor funds were ever used to purchase pre-IPO shares of Facebook, LinkedIn, Groupon, Zynga, or any other company, as Berkman knew.

The Face Off Acquisition Fraud

47. From approximately 2011 through July 2012, while he was conducting the Ventures fraud, Berkman fraudulently raised approximately $2.6 million by selling membership interests in Face Off Acquisitions.

48. Actual Facebook Fund 2 owned a significant amount of pre-IPO Facebook shares.

49. Berkman told prospective investors over the telephone and in face-to-face meetings that Face Off Acquisitions would use its investor funds to acquire Actual Facebook Fund 2 or would otherwise acquire pre-IPO Facebook shares.

50. Berkman's effort to acquire Actual Facebook Fund 2 was perfunctory, at best. Berkman approached Actual Facebook Fund 2 about a proposal to purchase it, and Actual Facebook Fund 2's manager told Berkman in approximately April 2011 that it would cost at least $28 million. Because Berkman and his entities never had the money, a deal was never likely or imminent, yet Berkman falsely portrayed the Actual Facebook Fund 2 deal as imminent to prospective investors.

51. Yet Berkman and Kern falsely portrayed the Actual Facebook Fund 2 deal as imminent to prospective investors.

52. In a letter dated April 14, 2012, Kern sent Berkman a letter that described the status of negotiations between Face Off Acquisitions and Actual Facebook Fund 2 and falsely implied that Face Off Acquisitions' purchase of Actual Facebook Fund 2 was likely and imminent. Kern captioned his letter "Memorandum of Understanding for Investors in Face Off Acquisitions, LLC to acquire [Actual Facebook Fund 2] (1,012,500 shares of Facebook)." Kern's letter stated:

- "I am writing to confirm that yesterday afternoon I spoke with . . . legal counsel for [Actual Facebook Fund 2]. . . and the Company's Managing Director . . . about the prospect for a timely acquisition of the Company by Face Off Acquisitions;"

- "The purpose of this letter is to provide direction for completing [Face Off Acquisitions'] purchase of [Actual Facebook Fund 2]."

- "[Counsel for [Actual Facebook Fund 2] confirms that under the right set of circumstances, [Actual Facebook Fund 2] is willing to enter into a transaction in the coming few days with Face Off Acquisitions."

- "[T]he sole assets of [Actual Facebook Fund 2] are 1,012,500 shares of Class B Common shares of Facebook, Inc."

- "With proof of funds, a summary Term Sheet will be prepared and we will immediately set upon organizing a 'Securities Transaction Agreement' for the purchase and sale of the ownership interests of [Actual Facebook Fund 2]. Because the Facebook IPO is expected to be effective in early May[,] the [Actual Facebook Fund 2] purchase must occur on or before April 24, 2012."

53. Berkman knew the letter was misleading. The seemingly urgent negotiations were a charade, because Berkman knew Face Off Acquisitions could not possibly pay $28 million (or any amount even close to $28 million) to purchase Actual Facebook Fund 2.

54. In approximately April 2012, Berkman provided Kern's letter to at least one prospective investor.

55. Berkman also provided at least one other Face Off Acquisitions investor with an Actual Facebook Fund 2 Memorandum and Actual Facebook Fund 2's due diligence materials to lend the purported acquisition the appearance of legitimacy.

56. In an email on May 15, 2012, Berkman told another Face Off Acquisitions investor that Berkman was "[i]n NY for the closing. We have agreed on a $35.00 per [s]hare price. Will check in with you when the deal is done." In fact, as Berkman knew, there was no closing, no agreement on a share price, and no money to close any such deal.

57. Berkman also provided prospective investors with Face Off Acquisitions Memoranda and other formal offering materials that contained false statements regarding the use of investor funds to purchase pre-IPO Facebook shares or to purchase Actual Facebook Fund 2.

58. Berkman sent at least one investor an April 2012 Face Off Acquisitions Memorandum stating that "Face Off Acquisitions is focused on generating above average financial returns by purchasing up to 1,012,500 pre IPO Facebook common shares, and significant preferred shareholder interest in five proprietary medical technology, capacitor, and water treatment companies."

59. Berkman sent at least one other investor a May 2012 Face Off Acquisitions Memorandum stating that "investment proceeds will be used solely to acquire up to 1,012,500 pre IPO Facebook shares at a $35.00 per share cost basis," and described the "use of proceeds [as] one hundred percent invested in pre Facebook IPO stock."

60. In addition to the Memoranda, Berkman provided investors with other documents that contained similar misrepresentations, including:

- A Face Off Acquisitions operating agreement, which claimed that Face Off Acquisitions "has been formed to acquire, hold and/or dispose of all the issued and outstanding limited liability interests in [Actual Facebook Fund 2];"
- A Face Off Acquisitions memorandum dated April 11, 2012, which thanks the investor for his "willingness to review the Face Off Acquisitions investment opportunity to acquire 1,012,500 series B common pre IPO Facebook shares;" and
- A letter dated May 8, 2012, in which Berkman acknowledges receipt of a $250,000 investment and tells the investor that it was "for the purpose of purchasing seven thousand one hundred forty two Facebook Series B common Rule 144 shares at a cost basis of $35.00 per share."

61. Berkman knew that each of the foregoing statements in the offering documents was false and misleading, because he intended to and did misappropriate all the funds invested in Face Off Acquisitions.

The Assensus Capital Fraud

62. After Facebook's IPO on May 18, 2012, Berkman shifted gears and began focusing on another phony investment vehicle called Assensus Capital. Berkman made similar misrepresentations to prospective investors in Assensus Capital: The investors' money would be invested in some new cutting edge venture, when Berkman was in fact misappropriating the offering proceeds.

63. Berkman sent one investor a June 2012 Assensus Capital Memorandum that stated: "Investment proceeds will be used to acquire significant equity interest in unique enterprises that serve large and growing markets, with superior profit margins [through] investing in state-of-the-art medical devise, infrastructure (water), distressed debt, and advanced nanotechnology materials companies."

64. Berkman also wrote memoranda to prospective Assensus Capital investors that named specific companies in which Assensus Capital would invest and extended an investment "guaranty" purportedly backed up by cash or shares from one of its "portfolio" companies, including Facebook.

65. One such memorandum to a prospective investor, dated August 27, 2012, stated: "Upon making [an] Assensus Capital LLC investment, you will receive a 5% simple interest from the date of your investment, which will be returned together with your principal investment [in cash] or the equivalent in Facebook shares." That investor later invested approximately $150,000.

66. Afterwards, Berkman tried to solicit another investment from the same investor by again offering a "guaranty" linked to Facebook stock, this time making the following representations about the nature and basis for the guaranty:

- "Assensus Capital LLC and Face Off Acquisitions LLC will obtain the removal of all Facebook share legends upon the expiration of the Facebook November lock-up period in order to allow all or a portion of the shares to be sold as soon as allowed after the expiration date;"

- "Assensus Capital is willing to provide this guaranty for two specific reasons: (1) a high degree of confidence that [EVI] will be acquired within the next 6-12 months; and (2) the value of my carried interest in previous investment activities relating to the acquisition of Facebook shares, that is represented by share certificates for 165,713,000 common shares that I am holding as part of my compensation;" and

- "If you decide to exercise the investment guaranty, you can elect to receive the amount of your prospective investment together with the accumulated five percent annual simple interest or, a partial or complete distribution of 6,500 [Facebook] shares in addition to the 51,666 Facebook shares that are in your capital account as the result of your initial $150,000 [investment] with a cost basis of $7.74 per share."

67. As Berkman knew, each of these representations was false. He intended to and did misappropriate all of the funds invested in Assensus Capital and knew neither he nor Assensus Capital had Facebook shares with which to guaranty investments.

68. Despite Berkman's assurances, the investor declined to invest additional funds.

69. In total, Berkman raised approximately $718,000 from Assensus Capital investors.

The Misappropriation of Investor Funds

70. None of the statements made by Berkman about the use of the funds invested in the Venture LLCs, Face Off Acquisitions, or Assensus Capital were true. Other than the $600,000 investment in the Actual Facebook Funds, none of the offering proceeds were used to make any

investments at all, much less the purchase of pre-IPO shares in Facebook, LinkedIn, Groupon or Zynga.

71. Berkman personally transferred approximately $5.1 million of investor funds to his personal bank account. Berkman used most of that $5.1 million, plus a $925,000 direct transfer from a Ventures LLC account, to pay his judgment creditors in the bankruptcy proceeding.

72. Berkman used the remaining money that he had transferred to his personal account (approximately $600,000) and another approximately $1 million taken directly from the Ventures LLC accounts to make large cash withdrawals, pay legal fees, fund his own travel and other personal expenses and make numerous other payments unrelated to the purported business of the Ventures LLCs, Face Off Acquisitions or Assensus Capital. For example, Berkman spent approximately $300,000 on dining, travel, retail and healthcare expenses and withdrew at least another $165,000 in cash or cash equivalents.

73. The Manager received approximately $502,000 from accounts into which investor funds were deposited.

74. The majority of the rest of the offering proceeds, approximately $4.8 million, was used to make payments to earlier investors in the pre-IPO scheme or, in some cases, to investors in Berkman's prior investment schemes. For example, in 2010 and 2011, Berkman transferred $400,000 from a Ventures LLC account to two individuals to whom Berkman owed money from investments they had made in unrelated Berkman ventures in approximately 2004.

Misrepresentations To Conceal The Scheme

75. As the end of the lock up period for pre-IPO Facebook stock approached and investors began making requests for their distributions, the fraud began to unravel. In response, Berkman, Kern, and others knowingly or recklessly made, or caused to be made, misrepresentations to investors to keep them from learning of the fraud and demanding the return of their funds.

76. For example, in August 2012, Kern wrote and signed a "Memorandum to Investors About Ventures Trust II LLC Efforts to Secure and Protect Interests with Our Trading Counterparties." Kern's memorandum stated that he was writing "to advise [investors] on the status of our efforts to address concerns that have been raised about the integrity of the funds."

77. Kern's memorandum represented that "Ventures Trust II has utilized two separate counterparties in securing the investments in privately held Facebook stock," and that "we are in the process of attempting to secure the transfer of these shares to our own trading account in order to avoid any complications arising out of the counterparty's trading practices."

78. Kern's memorandum represented that with respect to the first counterparty, "which involves approximately 20% of the investment capital of Ventures Trust II in Facebook stock," the counterparty "and its counsel have repeatedly affirmed that it has the requisite shares and

reconfirmed to us that we have the securities interests to which we subscribed." The memorandum then suggested that the counterparty may have "more-or-less fabricated" the price of the shares, creating a "collateral issue," but assured investors that Ventures II would "address this in due course on behalf of our investors," if necessary.

79. Kern's memorandum further represented that the second counterparty "holds approximately 80% of our investments in Facebook."

80. The memorandum also stated that Ventures II "is subject to non-disclosure agreements with [both] counterparties which prevent us from disclosing the identity of these New York based groups at this time" and that Ventures II "is not a Ponzi scheme and absolutely and affirmatively rejects this assertion as false and malicious."

81. These statements were false. Berkman knew these statements were false.

82. In August 2012, the Manager emailed Kern's memorandum to certain investors, with a copy to Berkman. Berkman thereafter told investors that he had decided to liquidate the fund investments and that the funds would soon start making distributions. As Berkman knew, such statements were false and, as recently as in or around March 2013, Berkman gave investors a series of false excuses for why the distributions were still being delayed.

THE RESPONDENT'S LIABILITY

83. As a result of the conduct described above, Berkman , Face Off Acquisitions, Face Off Management, Ventures II, Ventures III, Ventures IV, Ventures V, Ventures VI, Ventures Trust Asset Fund, Ventures Trust Management, Ventures Trust Asset Management, Assensus Capital, and Assensus Management committed violations of, and Berkman 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.

84. As a result of the conduct described above, Berkman, Face Off Management, Ventures Trust Management, Ventures Trust Asset Management and Assensus Management committed violations of, and Berkman willfully violated, Sections 206(1), 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8, which prohibit fraudulent conduct by an investment adviser.

85. As a result of the conduct described above, Berkman willfully aided and abetted and caused: (a) the violations committed by Ventures II, Ventures III, Ventures IV, Ventures V, Ventures VI, Ventures Trust Asset Fund, Ventures Trust Management, Ventures Trust Asset Management, Face Off Acquisitions, Face Off Management, Assensus Capital, and Assensus Management of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; and (b) the violations committed by Ventures Trust Management, Ventures Trust Asset Management, Face Off Management, and Assensus Management of Sections 206(1), 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8.

IV.

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

Accordingly, pursuant to Section 8A of the Securities Act, Section 21C of the Exchange Act, Sections 203(f) and 203(k) of the Advisers Act and Section 9(b) of the Investment Company Act, it is hereby ORDERED that:

A. Respondent Berkman cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1), 206(2), and 206(4) of the Advisers Act and Rule 206(4)-2 promulgated thereunder.

B. Respondent Berkman 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;

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.

C. Any reapplication for association by Respondent Berkman 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. In view of Berkman's agreement to forfeit $13,239,006 and pay restitution in the amount of $8,435,888 in conjunction with his guilty plea in the Parallel Criminal Action, in which he was criminally charged with engaging in the same conduct that is alleged in the Order Instituting Proceedings herein ("OIP"), Berkman is not additionally liable in this proceeding for disgorgement of ill-gotten gains he received as a result of the conduct alleged in the OIP; and (b) based on Berkman's agreement, in connection with his guilty plea in the Parallel Criminal Action, to a stipulated sentencing guideline range of 97 to 121 months imprisonment and an applicable criminal fine range of up to $5 million, Berkman is not being ordered to pay a civil monetary penalty.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-71083; File No. SR-OCC-2013-807)

December 16, 2013

Self-Regulatory Organizations; The Options Clearing Corporation; Advance Notice Concerning the Governance Committee Charter

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4(n)(1)(i),[2] notice is hereby given that on September 14, 2012, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") the advance notice described in Items I and II below, which Items have been prepared by OCC. The Commission is publishing this notice to solicit comments on the advance notice from interested persons.

I. Clearing Agency's Statement of the Terms of Substance of the Advance Notice

This advance notice concerns the charter of the Governance Committee ("GC Charter") of OCC's Board of Directors ("Board").

II. Clearing Agency's Statement of the Purpose of, and Statutory Basis for, the Advance Notice

In its filing with the Commission, OCC included statements concerning the purpose of and basis for the advance notice and discussed any comments it received on the advance notice. The text of these statements may be examined at the places specified in Item IV below. OCC has prepared summaries, set forth in sections (A) and (B) below, of the most significant aspects of such statements.

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4(n)(1)(i).

(A) Clearing Agency's Statement of the Purpose of, and Statutory Basis for, the Advance Notice

This advance notice concerns the GC Charter. The Board authorized formation of the Governance Committee ("GC") at its May 21, 2013, meeting and approved the GC Charter at its September 24, 2013, meeting. As set forth in the GC Charter, the purpose of the GC is to review the overall corporate governance of OCC and recommend improvements to OCC's Board. The GC Charter describes the role the GC plays in assisting the Board in fulfilling its responsibilities, as described in OCC's By-Laws and Rules, as well as specifying the policies and procedures governing the membership and organization, scope of authority, and specific functions and responsibilities of the GC. In addition, the guidelines for the composition of the GC as well as the policies regarding its meeting schedule, quorum rules, minute-keeping and reporting requirements are set forth in the GC Charter and conform to applicable requirements specified in OCC's By-Laws and Rules.

The GC is composed of not fewer than five Directors with at least one Public Director, one Exchange Director and one Member Director. Management Directors will not be members of the GC. The Board will designate a GC Chair and if the Chair is not present at a meeting, the members who are present will designate a member to serve as the Acting Chair. The GC will meet at least four times a year and a majority of the GC members constitutes a quorum. The GC is permitted to call executive sessions from which guests of the GC may be excluded, and GC members are permitted to participate in all meetings by conference telephone call or other means of communication that permit all meeting participants to hear each other. The GC Chair, or the Chair's designee, will report regularly to the Board on the GC's activities.

The GC Charter sets forth certain functions and responsibilities for the GC including, but not limited to, the following: review the composition of the Board as a whole, including the

Board's balance of participant and non-participant directors, business specialization, technical skills, diversity and other desired qualifications; review the Board's Charter for consistency with regulatory requirements, transparency of the governance process and other sound governance practice and recommend changes to the Board, where appropriate; review the committee structure of the Board, including the GC, and recommend changes to the Board, where appropriate; review OCC's policies and procedures for identifying and reviewing Board nominee candidates, including the criteria for Board nominees; develop and recommend to the Board a periodic process of self-evaluation of the role and performance of the Board, its committees and management in the governance of OCC; review OCC's policies on conflicts of interest of directors, including the OCC Directors Code of Conduct and recommend changes, where appropriate; and, review OCC's new director orientation program as well as OCC's training and education programs for Board members and recommend changes, where appropriate. In addition to the foregoing, the GC may undertake other and different activities, as appropriate, or as may be delegated to it by the Board. In discharging its role, the GC shall confer with management and other employees of OCC to the extent the GC deems it necessary to so to fulfill its duties.[3]

This advance notice is consistent with Section 806(e)(1)(A)[4] of the Clearing Supervision Act because the proposed change could be deemed to materially affect the nature or level of risks presented by OCC. The implementation of the GC may result in changes that will improve OCC's overall risk management process. In addition, the adoption of the GC Charter will reduce the amount of systemic risk OCC presents to the financial system because it will enhance the

3 The GC, subject to the approval of the Board, is permitted to hire specialists or rely on outside advisors or specialists to assist it in carrying out the GC's activities. The GC has the authority to approve the fees and retention terms of such advisors and specialists.

4 12 U.S.C. 5465(e)(1)(A).

transparency of OCC's governance arrangements. The advance notice is not inconsistent with any existing OCC By-Laws or Rules.

(B) Clearing Agency's Statement on Comments on the Advance Notice Received from Members, Participants, or Others

Written comments on the advance notice were not and are not intended to be solicited with respect to the advance notice and none have been received.

III. Date of Effectiveness of the Advance Notice and Timing for Commission Action

The proposed changes contained in the advance notice may be implemented pursuant to Section 806(e)(1)(G) of Clearing Supervision Act[5] if the Commission does not object to the proposed changes within 60 days of the later of (i) the date that the advance notice was filed with the Commission or (ii) the date that any additional information requested by the Commission is received. The clearing agency shall not implement the proposed changes contained in the advance notice if the Commission objects to the proposed changes.

The Commission may extend the period for review by an additional 60 days if the proposed changes raise novel or complex issues, subject to the Commission providing the clearing agency with prompt written notice of the extension. Proposed changes may be implemented in fewer than 60 days from the date the advance notice is filed, or the date further information requested by the Commission is received, if the Commission notifies the clearing agency in writing that it does not object to the proposed changes and authorizes the clearing agency to implement the proposed changes on an earlier date, subject to any conditions imposed by the Commission.

OCC has also filed the advance notice as a proposed rule change pursuant to Section

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5 12 U.S.C. 5465(e)(1)(G).

19(b)(1) of the Act[6] and Rule 19b-4 thereunder.[7] Pursuant to those provisions, within 45 days of the date of publication of this notice in the Federal Register or within such longer period up to 90 days (i) as the Commission may designate if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove the proposed rule change or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

The clearing agency shall post notice on its web site of proposed changes that are implemented.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/sro.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-OCC-2013-807 on the subject line.

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6 15 U.S.C. 78s(b)(1).

7 17 CFR 240.19b-4.

Paper Comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, N.E., Washington, DC 20549-1090.

All submissions should refer to File Number SR-OCC-2013-807. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/sro.shtml). Copies of the submission, all subsequent amendments, all written statements with respect to the advance notice that are filed with the Commission, and all written communications relating to the advance notice between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, N.E., Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filings also will be available for inspection and copying at the principal office of OCC and on OCC's website at http://www.theocc.com/about/publications/bylaws.jsp.

All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-OCC-2013-807 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

By the Commission.

Kevin M. O'Neill

Kevin O'Neill
Deputy Secretary

Chair White
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 71109 / December 17, 2013

INVESTMENT ADVISERS ACT OF 1940
Release No. 3741 / December 17, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15648

In the Matter of

RONALD GENE ANGLIN,

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 Ronald Gene Anglin ("Respondent" or "Anglin").

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENT

1. Anglin was a registered representative of dually registered broker-dealer and investment adviser Merrill Lynch, Pierce, Fenner & Smith Inc. from approximately September 2008 to May 2011. Anglin also was an investment adviser representative for Merrill Lynch from approximately September 2008 to May 2011. Anglin, 38 years old, is a resident of Canyon Country, California.

B. ENTRY OF RESPONDENT'S CRIMINAL CONVICTION

2. On October 4, 2012, Anglin pleaded guilty to one count of mail fraud in violation of Title 18 United States Code, Section 1341 before the United States District Court for

the Central District of California in *U.S. v. Ronald Gene Anglin*, 2:12-CR-00232-SJO. On March 25, 2013, a judgment in the criminal case was entered against Anglin. He was sentenced to three years of probation including 27 months in home detention, and ordered to make restitution in the amount of $73,000.

3. The count of mail fraud to which Anglin pleaded guilty alleged, inter alia, that in or around 2010, Anglin executed a scheme whereby he forged letters of authorization purportedly from a customer to Merrill Lynch that requested the disbursement of the customer's funds from the customer's Merrill Lynch accounts to be sent by the United States Postal Service or a commercial interstate carrier to addresses that Anglin specified in the forged letters of authorization. Pursuant to the forged letters of authorization, the checks that Anglin caused to be mailed from the customer's accounts at Merrill Lynch were made payable to people or entities that had no connection to the addresses to which he had the checks sent. When the checks arrived at those addresses, Anglin picked up the checks or had them brought either to him or to others acting under his instructions. Those checks from the customer's accounts at Merrill Lynch then would be deposited in bank accounts under Anglin's control or the control of someone in his wife's family for their use.

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;

B. What, if any, remedial action is appropriate in the public interest against Respondent pursuant to Section 15(b)(6) 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

Commissioner Aguilar
Commissioner Gallagher
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 71097 / December 17, 2013

INVESTMENT COMPANY ACT OF 1940
Release No. 30834 / December 17, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15646

In the Matter of **Alex Halimi,** **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 Alex Halimi ("Respondent" or "Halimi").

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 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,

35 of 68

Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

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

Summary

1. This case involves violations of the broker-dealer registration provisions by Alex Halimi. From November 2008 through August 2012 (the "relevant period"), Halimi, operating through Cannes Capital Advisors, LLC ("Cannes"), solicited investors and regularly placed orders for securities transactions on behalf of others in exchange for transaction-based compensation. Halimi placed orders for at least fifty-four customers and received approximately $522,785 in illegal brokerage commissions. Although Halimi had previously been licensed and associated with registered broker-dealers, he failed to register Cannes with the Commission as a broker-dealer. By this conduct, Halimi violated Section 15(a) of the Securities Exchange Act of 1934 ("Exchange Act").

Respondent

2. Alex Halimi, age 42, resides in Brooklyn, New York. From 1991 through 1996 Halimi was a registered representative of several registered broker-dealers and held Series 6, Series 7, Series 63, and Series 65 licenses. Halimi subsequently worked in an unregistered capacity, for brief periods, at a number of other registered broker-dealers before founding Cannes.

Related Entity

3. Cannes Capital Advisors, LLC, was at all relevant times a limited liability company organized under the laws of Delaware and located in Brooklyn, New York and was wholly owned by its Managing Member, Halimi Fund Management LLC, which was in turn wholly owned and operated by Halimi. Cannes ceased operations in August 2012.

Facts

4. During the relevant period, Halimi, acting through Cannes, effected securities transactions on behalf of others. Not only did Halimi operate as a broker, but he held Cannes out as a broker-dealer. Cannes' website described Cannes as a "full service stock brokerage company, specializing in margin lending." Halimi also compared Cannes to registered broker-dealers and touted the leverage Cannes offered, telling at least one prospective customer: "Our lending capacity alone differentiates us as compared to almost every other Stock Brokerage Firm in the business." Halimi also distinguished Cannes from large, well-known registered broker-dealers, which he said required customers to put up a minimum of $25,000 to day-trade, whereas Cannes offered its customers substantial leverage for day-trading and overnight trades, without any deposit.

5. Cannes' customers executed an agreement with Cannes providing that in exchange for executing brokerage transactions for the customer Cannes would receive transaction fees and commissions, usually $0.03 per share.

6. Customers' trades were placed through brokerage accounts in Cannes' name at two registered broker-dealers. The Cannes brokerage accounts were margin accounts and were treated by the registered broker-dealers as institutional accounts. As a result, Cannes' customers were extended greater margin than they would have been able to obtain directly from the registered broker-dealers.

7. Customers placed orders through Halimi, either by calling him or using computers located in Cannes' office, and, briefly, through a direct market access platform arranged by one of the registered broker-dealers through which Cannes traded. With the exception of the transactions executed through the direct market access platform, Cannes customers did not have access to records of their transactions generated by the registered broker-dealers. Instead, the customers relied on Halimi to report on their transactions and the performance of their accounts. Halimi provided such reports, albeit sporadically and sometimes only upon request.

8. During the relevant period, Halimi, through Cannes, effected securities transactions for at least fifty-four customers. In total, customers transferred approximately $1.8 million to Cannes for purposes of placing securities trades. Halimi received approximately $522,785 in commissions and transaction fees for effecting customers' securities transactions.

Legal Analysis

9. Section 15(a) of the Exchange Act requires that any person selling securities be registered with the Commission as a broker or dealer, or, in the case of a natural person, be associated with a registered broker or dealer. Specifically, Section 15(a)(1) makes it illegal for a broker-dealer to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security unless such broker-dealer is registered with the Commission. Scienter is not an element of the violation. SEC v. Nat'l Exec. Planners, Ltd., 503 F. Supp. 1066, 1073 (M.D.N.C. 1980). Section 3(a)(4) of the Exchange Act defines a "broker" as any person, other than a bank, in certain circumstances, "engaged in the business of effecting transactions in securities for the account of others." A person "effects transactions in securities" if he or she participates in such transactions "at key points in the chain of distribution." Massachusetts Fin. Servs., Inc. v. Security Investor Protection Corp., 411 F. Supp. 411, 415 (D. Mass.), aff'd, 545 F. 2d 754 (1st Cir. 1976).

10. As described above, Halimi, through Cannes, engaged in the business of effecting transactions in securities for the account of others. Cannes was not registered with the Commission as a broker-dealer, however, nor was Halimi associated with a registered broker-dealer during the relevant period. Accordingly, Halimi willfully violated Section 15(a) of the Exchange Act.

11. Halimi had previously been licensed to sell securities and had worked for registered broker-dealers. Moreover, he advertised Cannes as an alternative to registered broker-dealers. Accordingly, Halimi deliberately or recklessly disregarded the broker-dealer registration requirement.

IV.

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

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

A. Respondent Halimi cease and desist from committing or causing any violations and any future violations of Section 15(a) of the Exchange Act.

B. Respondent Halimi 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 five (5) 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 Halimi shall, within ten days of the entry of this Order, pay disgorgement of $522,785, prejudgment interest of $17,174.34 and civil penalties of $125,000 to the United States Treasury. 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 make direct payment from a bank account via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm; or
(2) 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 Halimi 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, Regional Director, New York Regional Office, Securities and Exchange Commission, Brookfield Place, 200 Vesey Street, Suite 400, New York, NY 10281.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

Commissioner Gallagher
Commissioner Piwowar
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 71117 / December 18, 2013

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3519 / December 18, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15651

In the Matter of James Vincent Poti, CPA, Respondent.	ORDER INSTITUTING PUBLIC ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 4C OF THE SECURITIES EXCHANGE ACT OF 1934 AND RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS

I.

The Securities and Exchange Commission (the "Commission") deems it appropriate that public administrative proceedings be, and hereby are, instituted against James Vincent Poti, CPA (the "Respondent" or "Poti") pursuant to Section 4C[1] [15 U.S.C. § 78d-3] of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 102(e)(1)(ii)[2] of the Commission's Rules of Practice [17 C.F.R. § 201.102(e)(1)(ii)].

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Public Administrative Proceedings Pursuant to Section 4C of the Securities Exchange Act of 1934 and

1 Section 4C provides, in relevant part, that "[t]he Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found to . . . have engaged in . . . improper professional conduct . . . ."

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

Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions (the "Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds[3] that:

A. Summary

1. Poti engaged in improper professional conduct during Witt Mares, PLC's ("Witt Mares") 2008 year-end audit of Commonwealth Bankshares, Inc., the holding company for Bank of the Commonwealth (collectively, "Commonwealth" or the "Bank"). He did so by failing to subject Commonwealth's loan loss estimates – one of the audit areas that Witt Mares identified as higher risk – to appropriate scrutiny. As engagement partner on the audit since 2006, Poti had ultimate responsibility for the audit decisions, the audit programs, the review of audit work papers, and the failures to follow the Public Company Accounting Oversight Board (the "PCAOB") audit standards that are the subject of this proceeding.[4]

2. Beginning in 2006, Commonwealth – then a small Norfolk, Virginia-based community bank – embarked on a strategic plan to accumulate assets over $1 billion. It did so by lending more and more money to construction and development projects in Norfolk, Hampton, Newport News, Chesapeake, Portsmouth and Virginia Beach, Virginia. At the same time that Commonwealth underwrote more and more construction and development loans on its quest to become a billion-dollar bank, those cities began to show signs of distress. During 2008, as a result of the financial crisis and related real estate market crash, the construction and development projects funded by Commonwealth began to flounder and Commonwealth experienced a dramatic increase in the number of its troubled real estate loans. Commonwealth's classified loans – loans that could expose Commonwealth to partial or complete loss – had increased over the course of a year from approximately $8 million to $80 million – a tenfold increase. The dramatic run-up of these so-called classified loans – a major component of Commonwealth's loan losses – coincided with a significant lack of critical information necessary to assess potential losses in its loan portfolio. Specifically, Commonwealth lacked current appraisals on the collateral securing the loans and financial information on the guarantors behind the loans.

3. Poti was well aware of Commonwealth's loan documentation problems and the effect of these issues on the estimation of loan losses. In fact, since at least 2006, the Witt Mares audit team, under Poti's supervision, as well as Commonwealth's primary regulators, had repeatedly criticized the Bank's Board of Directors and management that the failure to obtain and update critical information in Commonwealth's loan files posed a concern. During the 2008 audit, Poti and the other members of the audit team identified the loan loss reserves as presenting

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

[4] All citations to PCAOB auditing standards refer to the standards in effect at the time of the conduct discussed herein.

significant risk of material misstatement and fraud risk. Notwithstanding the audit team's identification of the loan loss reserve as a potentially significant problem area, the actual audit work in this area was inadequate and the resulting audit opinion was not supported by reliable or persuasive evidence. In fact, based on the audit tests of the troubled loans, the audit team concluded that, for a significant percentage of the loans reviewed, there was "[i]nadequate financial information in [the] file to determine if additional reserve is necessary." Despite this and other audit-identified issues that are detailed below, Poti authorized the issuance of an unqualified audit opinion on Commonwealth's financial statements and internal control over financial reporting for the year ended December 31, 2008.

4. In sum, Poti failed to obtain sufficient, competent evidential matter to support the issuance of unqualified audit opinions. He further failed to act with due professional care and to exercise professional skepticism. These failures, detailed below, resulted in repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission.

B. Respondent

5. **James Vincent Poti, CPA**, age 63, is a resident of Midlothian, Virginia. Poti has been an auditor and partner at PBMares, LLP since the firm was formed on January 1, 2013 through the merger of PBGH LLP and Witt Mares, PLC ("Witt Mares"), and an auditor and partner at Witt Mares from November 2002 until the merger. Poti was a member of the Commonwealth audit team from 2006 through September 23, 2011, when federal and state banking regulators closed Commonwealth's banking subsidiary, and was the engagement partner for the 2008 audit. As engagement partner, Poti was responsible for the audit and its performance, for proper supervision of the work of the audit team members, and for compliance with PCAOB standards. Poti is currently licensed as a CPA in Virginia and has no disciplinary history.

C. Other Relevant Entities

6. **Commonwealth Bankshares, Inc.** ("Commonwealth" or the "Bank"), formerly a Virginia corporation, was, during the relevant time period, a holding company for Bank of the Commonwealth, a Virginia state-chartered commercial bank headquartered in Norfolk, Virginia. Commonwealth's common stock was initially registered with the Commission pursuant to Section 12(g) of the Exchange Act and was quoted on the NASDAQ National Market under the stock symbol "CWBS." On July 31, 2006, after the NASDAQ became a national exchange, pursuant to Commission global order, all NASDAQ National Market issuers became Section 12(b) registrants listed on the new NASDAQ Global Market ("NASDAQ"). On September 23, 2011, the Virginia State Corporation Commission's Bureau of Financial Institutions (the "SCC") and the Federal Deposit Insurance Corporation (the "FDIC"), which insured the deposits held by the Bank, closed the Bank and entered into a purchase and assumption agreement with a subsidiary of a privately held bank holding company to assume the deposits of the Bank. On November 10, 2011, NASDAQ filed a Form 25 with the Commission, in which it stated that it had delisted Commonwealth's common stock from the NASDAQ exchange for failing to satisfy the exchange's requirements effective on November 21, 2011 and deregistered it from Section 12(b), effective 90 days after the filing of the Form 25. After the effective date of NASDAQ's deregistration of

Commonwealth from Section 12(b), Commonwealth reverted to its prior Section 12(g) registration. Commonwealth remained an inactive corporate entity until May 31, 2013, when the SCC terminated Commonwealth's corporate registration. On July 31, 2013, the Commission revoked Commonwealth Section 12(g) registration by consent.

7. **Witt Mares, PLC** ("Witt Mares") was, during the relevant time period, a public limited company headquartered in Richmond, Virginia engaged in the business of providing accounting and auditing services. Witt Mares audited Commonwealth's financial statements and internal control over financial reporting for the year ended December 31, 2008 and issued unqualified opinions. On January 1, 2013, Witt Mares merged with PBGH LLP to form PBMares, LLP.

D. Commonwealth's Troubled Loan Portfolio and the Failure of the Bank

8. Commonwealth was a Norfolk, Virginia-based bank that had historically focused on commercial banking and residential loans. By 2006, Commonwealth's assets had grown to approximately $715 million, of which the Bank's loan portfolio accounted for $670 million.

9. In July 2006, Commonwealth adopted a strategic plan to reach one billion in assets by December 31, 2009. As part of this goal, Commonwealth began to make substantially more construction and development loans than it previously had made. By December 31, 2006, Commonwealth's exposure to such loans climbed to approximately $179 million, or 27%, of gross loans. Commonwealth's exposure to commercial and construction and development loans continued to climb in 2007 and 2008, when its exposure to such loans amounted to approximately $223 million, or 28%, and $295 million, or 29%, of gross loans, respectively. Virtually all of Commonwealth's construction and development loans related to properties located in Norfolk and Virginia Beach, Virginia.

10. Beginning in or about 2006, the Norfolk commercial real estate market began to show signs of distress. As time progressed, the market trends grew worse. Condominiums and office space were particularly hit. At the end of 2008, office space and condominium prices were both down approximately 10% from 2007 nationally. At the end of 2009, the trend had deteriorated for these two categories of real estate, with office space prices down approximately 23% and condominium prices down approximately 22% nationally.

11. The decline in Norfolk's commercial real estate market had a direct impact on Commonwealth's allowance for loan and lease losses (the "ALLL") during the relevant period. The ALLL is an estimate of probable losses that reduces the book value of loans and leases to the amount that is expected to be collected. The ALLL is a material financial metric for banks, like Commonwealth, whose principal assets are loans. Inasmuch as the ALLL represents the Bank's assessment of probable losses on its loans, increases to the ALLL reflect an assessed deterioration of its loan portfolio. In addition, any increase in the ALLL (a balance sheet item) is accompanied by the recording of a provision for loan losses (an income statement item), thereby impacting a company's reported income or losses.

12. Commonwealth's ALLL principally had two components – smaller, homogeneous loans that were pooled and accorded generalized treatment under the Financial Accounting Standards Board's ("FASB") Statement of Financial Accounting Standards[5] No. 5 ("FAS 5") and larger and non-homogeneous loans – typically development and construction loans – that were individually analyzed under Statement of Financial Accounting Standards No. 114 ("FAS 114"). Throughout 2008, Commonwealth experienced a dramatic rise in high-risk problem loans that were deemed "impaired" pursuant to FAS 114, meaning it was probable the Bank would not recover all amounts contractually due. In fact, the portion of Commonwealth's ALLL that was attributed to FAS 114 impaired loans grew from approximately $3 million as of December 31, 2006 to more than $21 million as of December 31, 2008.

13. A key consideration in assessing the amount of ALLL required for impaired loans is the "fair value" of the collateral. Although GAAP does not specify the precise manner in which fair value is to be determined, fair value is measured from the perspective of factors considered by market participants. In commercial real estate, a current appraisal provides persuasive evidence of current market conditions on the appraised value of collateral.[6] Commonwealth's Credit Policy Manual provided that a written appraisal was the only way to determine the fair value of collateral securing collateral-dependent loans. Notwithstanding these considerations and Commonwealth's own policies, Witt Mares and Commonwealth's banking regulators found that the Bank lacked current appraisals for a significant percentage of collateral-dependent impaired loans.

14. Current financial information for borrowers and guarantors also is critical for evaluating the condition of a loan. Guarantor financial information is particularly important for impaired loans where the fair value of the collateral securing the loan was less than the unpaid principal balance on the loan because, in the event the borrower defaults and the fair value of the collateral is not enough to satisfy the loan's unpaid principal balance, the bank can seek to satisfy the remaining balance from the guarantor. The absence of current and complete guarantor financial information makes it difficult for the bank to assess whether the guarantor is in a position to make the bank whole if the collateral is not enough to satisfy the loan. Recognizing this, Commonwealth's Credit Policy Manual highlighted the importance of guarantor financial information to evaluating collectability, describing one characteristic of "problem loans" as a loan where "[t]he borrower or guarantor displays deterioration of financial condition as evidenced by financial statements or other available information."

15. Commonwealth's primary regulators – the SCC and the Federal Reserve Bank of Richmond (the "FRB") – had raised concerns that Commonwealth's lending and underwriting

[5] In 2009, FASB codified existing standards into the Accounting Standards Codification (the "ASC"). The ASC is the current single source of United States Generally Accepted Accounting Principles ("GAAP"). During most of the time period relevant to this Order, the ASC had not yet been published; thus, the Order cites to pre-codification GAAP in effect at the time of the conduct discussed herein.

[6] *See, e.g.*, Commission Staff Accounting Bulletin No. 102, 66 Fed. Reg. 36,457, 36,462 n.44 (July 6, 2001).

practices were not keeping pace with the scope of loan growth. Specifically, the SCC's October 16, 2006 report of examination concluded that credit administration weaknesses existed, in part, due to numerous "[d]ocumentation exceptions" which "included missing or stale financial statements and/or income information along with the lack of final title policies, recorded deeds of trust, and cash flow analyses." The FRB's January 11, 2008 report of examination similarly concluded that "[a]n inordinate number of loans reviewed at this examination reflected lacking or stale financial information."

16. In September 2008, the SCC conducted an examination of Commonwealth that focused on capital adequacy, asset quality, management, earnings performance, liquidity and funds management, and sensitivity to market risk ("CAMELS"). As a result of that examination, the SCC downgraded the Bank's composite CAMELS rating to a 3 (indicating a financial institution with "a combination of weaknesses in risk-management practices and financial condition that range from fair to moderately severe"). The SCC provided the Bank with a report of examination (the "2008 SCC Report") that deemed the institution to be in troubled condition and board and management performance to be poor. The 2008 SCC Report concluded that Commonwealth had experienced a significant deterioration in asset quality because "[t]he focus on loan growth overshadowed the need to properly observe effective credit-administration and underwriting practices." In particular, the 2008 SCC Report determined that "adversely classified assets" – loans that would have to be measured for impairment under FAS 114 – had, over the course of a year's time, increased from approximately $8 million to $80 million, a tenfold increase. According to the 2008 SCC Report, "[a] key contributing factor in the problems with the risk-identification system and the reserve methodology is the pervasive lack of current financial information on borrowers."

17. Despite the dire warnings in the 2008 SCC Report, Commonwealth failed adequately to address the concerns regarding the loan portfolio. As a result, in 2009, the FRB further downgraded the Bank's CAMELS score to a 5 (indicating a financial institution with "extremely unsafe and unsound practices or conditions . . . and are of the greatest supervisory concern").

18. Due in large part to Commonwealth's persistent failure to obtain and update appraisals and guarantor financial information, the FRB identified an understatement in Commonwealth's ALLL for the period ended September 30, 2009. On January 29, 2010, Commonwealth issued a press release disclosing $23 million in additional ALLL for that period. The $23 million ALLL increase caused Commonwealth to file amended and restated financials for the quarter ended September 30, 2009 with the Commission. Of the $23 million increase, approximately $10 million was attributable to downgrades of individual loans and loan relationships evaluated under the ASC's codification of FAS 114.[7]

19. After the restatement, Commonwealth's financial condition continued to deteriorate. On June 30, 2011, the FRB found that Commonwealth was "critically undercapitalized." On September 23, 2011, SCC and the FDIC, which insured the deposits held by

[7] *See generally* ASC 310.

Commonwealth, closed the Bank and entered into a purchase and assumption agreement with a subsidiary of a privately held bank holding company to assume the deposits of the Bank.

E. The Auditors Recognized the Risks in Commonwealth's Troubled Loan Portfolio

20. Prior to and during Witt Mares' 2008 audit of Commonwealth, Poti was aware of the risk and significance of the Bank's ALLL, and of the component related to the Bank's FAS 114 loans specifically.

1. Poti Identified Risks During Witt Mares' 2006 and 2007 Audits

21. Poti served as the lead partner on the Commonwealth audit for the year-end 2006 through 2009 audits and had raised concerns regarding Commonwealth's loan portfolio to Commonwealth during earlier audits. On March 13, 2007 and March 10, 2008, Poti signed, on Witt Mares' behalf, reports to Commonwealth's audit committee. These reports commented on the lack of current financial statements and other loan documentation in Commonwealth's loan files and noted that "credit decisions made on outdated or inaccurate financial information can potentially lead to an increase in classified assets and losses for the Bank."

22. By the time that Witt Mares began its audit work for the year ended December 31, 2008, despite the repeated comments in reports to Commonwealth's audit committee described above in Paragraph 21, Commonwealth's management had not corrected the previously-identified deficiencies.

2. Poti Identified ALLL Risks During Witt Mares' 2008 Audit

23. The year-end 2008 audit planning document – which Poti reviewed and approved – identified the ALLL as a "High Risk Audit Area." A risk assessment summary work paper noted that the Bank's ALLL presented a significant risk of material misstatement, with respect to inherent risk and the risk of fraud.

3. The Initial Calculation of Commonwealth's ALLL Was Performed by A Senior Loan Officer

24. During Witt Mares' walk-through of Commonwealth's internal controls, a manager on the audit learned that the senior loan officer performed the initial ALLL calculation, which was then reviewed by, among others, the Bank's vice president for credit administration, Chief Financial Officer (the "CFO") and the Board of Directors. Poti, who reviewed the memorandum summarizing the manager's walkthrough of Commonwealth's ALLL controls, had significant concerns about having the senior loan officer perform the initial ALLL calculation since the loan officer was evaluating many loans that he originated and closed.

4. The SCC Identified a Significant Understatement of the ALLL

25. In connection with its September 2008 examination, the SCC identified a deficiency in Commonwealth's ALLL as of September 30, 2008 in the amount of $19 million, representing an approximate 200% increase over the ALLL reported the previous year of

approximately $9 million. Poti was aware of this deficiency: A manager had directly identified "the need for significant additions" to the ALLL in a work paper summarizing the 2008 SCC Report that Poti reviewed. Further, the 2008 SCC Report, discussed above in Paragraph 16, was provided to Witt Mares and included in the work papers.

5. Witt Mares' Testing Identified A Significant Deficiency in Internal Control Over Financial Reporting in Commonwealth's ALLL Process and Controls

26. The summary of the 2008 SCC Report, discussed above in Paragraph 25, also highlighted for Poti the following issues, among others: (a) The lack of current guarantor financial statements; (b) excessive financial statement exceptions; (c) inadequate cash flow analyses and loan review; (d) a significant deterioration in asset quality; and (e) a significant understatement of Commonwealth's ALLL. The results of the SCC were a surprise to Poti, who remarked in an e-mail to a colleague that he felt that Commonwealth's management had "mislead [sic] us about the severity of the State exam."

27. Poti was sufficiently concerned by the SCC's findings that he caused additional audit testing of Commonwealth's internal controls to be conducted. The audit tests designed were:

a. Testing of controls designed to ensure that all nonaccrual loans were placed on the nonaccrual list;

b. Testing of controls designed to ensure that loan officers had obtained updated financial information for loans placed on the Bank's watch list;

c. Testing of controls designed to confirm that the Bank's loan officers were obtaining or performing current cash flow projections, appraisals or other analyses for loans placed on the Bank's watch list;

d. Testing of controls designed to confirm that extensions of credit and renewed loans were being closed in a manner consistent with terms approved by the Board of Directors;

e. Testing of controls designed to determine the proper treatment of capitalized interest; and

f. Testing of controls designed to determine if critical items were being cleared in a timely fashion from the Bank's exception reports and confirm that management was monitoring the reports.

28. Of the six specific tests described above in Paragraph 27, Witt Mares noted deviations from Commonwealth's controls in all but one of the tests (described in Paragraph 27.a). Witt Mares noted deviations from Commonwealth's controls for four of the tests (described in Paragraphs 27.b, 27.c, 27.d, and 27.e). Witt Mares' work papers did not document the results of the sixth test (described in Paragraph 27.f). The results of the specific tests and led the Witt Mares audit team to conclude that a significant deficiency in internal control over financial reporting existed as of the year ended December 31, 2008.

6. The Audit's Substantive Testing of ALLL Identified Significant Problems

29. Through the audit team's work, Poti was aware that, despite market declines, Commonwealth management often did not get updated appraisals on the collateral underlying the Bank's FAS 114 loans or guarantor financial information for the guarantors of the loans. In fact, around the same time as the audit of Commonwealth was taking place, Poti understood that "appraisals as current as 6 months ago could be considered stale and not reflective of true market values." During the audit team's review of Commonwealth's loan portfolio as of year-end 2008, members of the audit team noted appraisals more than a year old and a significant lack of current guarantor financial information in loan files. In fact, during Witt Mares' review of Commonwealth's loan portfolio, the audit team noted that there was:

a. "Inadequate financial information in [the] file to determine if additional reserve is necessary" for loan files representing approximately 30% of the value of the total loan sample balance and approximately 5% of the value of the FAS 114 loans in the ALLL;

b. Approximately 75% of the value of the total loan sample balance and approximately 52% of the value of the FAS 114 loans in the ALLL represented loan files that were missing, or contained stale, guarantor financial information; and

c. Approximately 33% of the value of the total loan sample balance and approximately 37% of the value of the FAS 114 loans in the ALLL consisted of loan files that contained appraisals that were dated between 2005 and 2007 – dates more than a year before the loan review took place.

F. Commonwealth's FAS 114 Loans Were Material

30. The portion of the ALLL related to Commonwealth's FAS 114 loans was approximately $21 million and was material.[8] It far exceeded the approximately $5 million planning materiality threshold established for the 2008 audit. It was reasonably possible that even a small change in the value of the Bank's FAS 114 loans would cause a material error in the financial statements.

31. The portion of the ALLL related to Commonwealth's FAS 114 loans was material for additional reasons:

a. The trend in Commonwealth's reported ALLL was in precipitous decline. As of December 31, 2006, Commonwealth's reported ALLL was slightly more than $8 million. At year-end 2007, the ALLL slightly increased to approximately $9 million. By year-end 2008, the ALLL had more than tripled to approximately $31 million.

[8] AU § 312 ¶ 3 ("The concept of materiality recognizes that some matters, either individually or in the aggregate, are important for fair presentation of financial statements in conformity with generally accepted accounting principles, while other matters are not important.") (footnote omitted).

b. On November 6, 2008, Commonwealth issued a press release announcing its third quarter results, which included disclosure of the $19 million ALLL deficiency described above in Paragraph 25. The next trading day following this disclosure, the value of Commonwealth's common stock plummeted approximately 14%.

c. Commonwealth itself acknowledged the importance of its ALLL, including the FAS 114 loans, devoting several pages in its Form 10-K for the year ended December 31, 2008 (the "2008 10-K") to a discussion of problem loans and the ALLL. Indeed, Commonwealth's 2008 10-K expressly warned that "[if] our allowance for loan losses becomes inadequate, our results of operations may be adversely affected."

32. Given the risk and materiality of the ALLL related to the Bank's FAS 114 loans, and the many identified red flags described above in Paragraphs 21 through 29, Poti had heightened responsibility in auditing this area, and was required to obtain sufficient competent evidential matter to support his opinion. He failed in this responsibility.

G. Poti Caused Witt Mares to Issue an Unqualified Opinion

33. On March 16, 2009, Commonwealth filed audited consolidated financial statements as an exhibit to the 2008 10-K. Filed with the financial statements was Witt Mares' audit report dated March 11, 2009, which stated, among other things, that "[i]n our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Commonwealth Bankshares, Inc. and subsidiaries as of December 31, 2008 and 2007, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2008, in conformity with accounting principles generally accepted in the United States of America[,]" and that "in our opinion, Commonwealth Bankshares, Inc. and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008 . . . ."

H. Poti's Improper Professional Conduct

34. The Commission's Rules allow the Commission to censure or deny, temporarily or permanently, the privilege of appearing or practicing before it in any way certain professionals who violate "applicable professional standards."[9] For auditors of issuers such as Commonwealth, the applicable professional standards include auditing standards issued by the PCAOB.

1. General Standards

35. The PCAOB's three general standards of auditing require that an auditor, among other things, exercise due professional care in the performance of the audit.[10] The three basic standards of field work require the auditor to (1) adequately plan and properly supervise the audit,

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9 Rule 102(e) [17 C.F.R. § 201.102(e)].

10 AU § 150 ¶ 2.

(2) obtain a sufficient understanding of internal control to plan the audit, and (3) obtain sufficient competent evidential matter to afford a reasonable basis for an opinion.[11]

36. Auditors are required to obtain "sufficient competent evidential matter" to afford a reasonable basis for the auditor's opinions.[12] "Gathering and objectively evaluating audit evidence requires the auditor to consider the competency and sufficiency of the evidence."[13] PCAOB standards note that evidential matter obtained from independent sources outside an entity provides greater assurance of reliability than that secured solely within the entity, and that the auditor's direct personal knowledge, obtained through physical examination, observation, computation, and inspection, is more persuasive than information obtained indirectly.[14]

37. Further, audit procedures, and the amount and persuasiveness of evidence auditors are required to obtain, are driven by risk. "Audit risk and materiality, among other matters, need to be considered together in determining the nature, timing, and extent of auditing procedures and in evaluating the results of those procedures."[15] When auditors identify a significant risk of material misstatement, as they did here, that fact is relevant to, among other things, the nature and extent of the audit procedures to be applied.[16] "Higher risk may cause the auditor to expand the extent of procedures applied, apply procedures closer to or as of year-end, particularly in critical audit areas, or modify the nature of procedures to obtain more persuasive evidence."[17]

38. Poti, as the engagement partner, was responsible for the audit and its performance, for proper supervision of the work of the audit team members, and for compliance with PCAOB standards.

39. At the completion of the audit, Poti signed off that he had "reviewed the completed audit programs" and was "satisfied that our audit(s) of the financial statement and internal control"

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[11] *Id.*

[12] AU § 326 ¶ 1; *see also* AU § 230 ¶ 11 ("The independent auditor's objective is to obtain sufficient competent evidential matter to provide him or her with a reasonable basis for forming an opinion.").

[13] AU § 230 ¶ 8.

[14] AU § 326 ¶ 21.

[15] AU § 312 ¶ 1; *see also id.* ¶ 12 ("The auditor should consider audit risk and materiality both in (a) planning the audit and designing auditing procedures and (b) evaluating whether the financial statements taken as a whole are presented fairly, in all material respects, in conformity with generally accepted accounting principles. The auditor should consider audit risk and materiality in the first circumstance to obtain sufficient competent evidential matter on which to properly evaluate the financial statements in the second circumstance.").

[16] *Id.* ¶ 17.

[17] *Id.*

were "sufficient and appropriate to support the auditor's report(s) and were conducted in accordance with PCAOB standards and other applicable legal and regulatory requirements."

40. As detailed below, Poti's conduct in planning, supervising, and performing Witt Mares' audit of Commonwealth's 2008 internal control over financial reporting and financial statements – specifically the portions of the audit relating to the Bank's FAS 114 loans – violated numerous PCAOB standards. Most prominently, the auditors violated the requirements of AS No. 5 (An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements), and AU Sections 328 (Auditing Fair Value Measurements and Disclosures) and 342 (Auditing Accounting Estimates) related to the substantive audit procedures. Poti also violated the third standard of field work (Audit Documentation).

2. The Audit of Commonwealth's Internal Control over Financial Reporting Violated Professional Standards

41. For year-end 2008, Witt Mares performed an integrated audit of Commonwealth, meaning that the audit of Commonwealth's internal controls over financial reporting was integrated with the audit of Commonwealth's financial statements. When an auditor assesses control risk below the maximum level, as the auditors did here, he or she should obtain sufficient evidential matter to support that assessed level.[18] Moreover, if one or more material weaknesses exist, the company's internal control over financial reporting cannot be considered effective.[19] "A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis."[20]

42. AS No. 5 provides specific requirements for auditing internal control over financial reporting in an integrated audit, including that the auditors should determine the likely sources of potential misstatements that would cause the financial statements to be materially misstated and focus more of his or her attention on the areas of highest risk.[21] As described below, the audit

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[18] AU § 319 ¶¶ 80, 90.

[19] AS No. 5 ¶ 2.

[20] *Id.* App. A ¶ A7.

[21] *Id.* ¶¶ 11 ("A direct relationship exists between the degree of risk that a material weakness could exist in a particular area of the company's internal control over financial reporting and the amount of audit attention that should be devoted to that area. In addition, the risk that a company's internal control over financial reporting will fail to prevent or detect misstatement caused by fraud usually is higher than the risk of failure to prevent or detect error. The auditor should focus more of his or her attention on the areas of highest risk. On the other hand, it is not necessary to test controls that, even if deficient, would not present a reasonable possibility of material misstatement to the financial statements."), 30 ("As part of identifying significant accounts and disclosures and their relevant assertions, the auditor also should determine the likely sources of potential misstatements that would cause the financial

team, under Poti's supervision, identified a source of potential misstatement in Commonwealth's ALLL processes – the senior loan officer's initial calculation of the ALLL. The audit team also identified a control that they believed addressed the potential for a material misstatement posed by the senior loan officer's role in calculating the ALLL: the review by the Bank's vice president for credit administration, CFO and the Board of Directors. However, the audit team failed to test this control despite being put on notice before the audit opinion was issued that it was not effective.[22] Poti therefore violated AS No. 5, and further lacked a reasonable basis for causing Witt Mares to conclude that there were no material weaknesses in Commonwealth's internal control over financial reporting.

a. Relevant PCAOB Standards

43. In an integrated audit, an auditor should design tests of controls to obtain sufficient evidence both to support his or her opinion on internal control over financial reporting and to support his or her control risk assessments for the purpose of the audit of the financial statements.[23]

44. Auditors also should determine the likely sources of potential misstatements that would cause the financial statements to be materially misstated. One of the ways to do so is "by asking himself or herself 'what could go wrong?' within a given significant account or disclosure."[24]

45. To further understand the likely sources of potential misstatements, and as part of selecting the controls to test, the auditor should, among other things, understand the flow of transactions related to the relevant assertions, identify the points within the company's processes at which a misstatement could arise that would be material, and identify the controls that management has implemented to address these potential misstatements.[25]

46. Performing a "walkthrough" is often the most effective way to understand likely sources of potential misstatements and identify the appropriate controls to test.[26] Walkthroughs require the auditor to "follow[] a transaction from origination through the company's processes . . .

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statements to be materially misstated. The auditor might determine the likely sources of potential misstatements by asking himself or herself 'what could go wrong?' within a given significant account or disclosure.").

22 *See id.* ¶ 39 ("The auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion.").

23 *Id.* ¶ 7.

24 *Id.* ¶ 30.

25 *Id.* ¶ 34.

26 *Id.* ¶ 37.

until it is reflected in the company's financial records, using the same documents and information technology that company personnel use."[27]

47. The selection of the controls to test, and the evidence needed to evaluate a given control, are driven by the auditor's risk assessment.[28] "The auditor should focus more of his or her attention on the areas of highest risk," taking into consideration risks of material misstatement due to fraud with respect to significant management estimates.[29] Further, the level of evidence needed increases as the risk associated with the control increases.[30]

48. Some types of tests, by their nature, produce greater evidence of the effectiveness of controls than other tests.[31] PCAOB standards include a hierarchy of tests. Inquiry, which ordinarily produces the lowest level of evidence, is never alone sufficient to support a conclusion about the effectiveness of a control.[32]

49. If there are deficiencies in a company's internal control over financial reporting that, individually or in combination, result in one or more material weaknesses, the auditor "must express an adverse opinion on the company's internal control over financial reporting, unless there is a restriction on the scope of the engagement."[33]

50. The internal control test work that Poti supervised did not comply with the foregoing PCAOB standards.

b. Failure to Identify Effective Controls Over The Review of the ALLL Calculation

51. In order to understand the likely sources of a potential misstatement of the ALLL, a manager, under Poti's supervision, performed a walkthrough of Commonwealth's internal controls over the ALLL. As described above in Paragraph 24, the manager documented his walkthrough in audit work papers that Poti reviewed and identified the senior loan officer's initial calculation of the ALLL as a point in the ALLL processes at which a material misstatement could arise. The manager also identified a control that he believed addressed the potential for a material misstatement posed by the senior loan officer's role in calculating the ALLL: the review by the

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[27] *Id.*

[28] *Id.* ¶ 10.

[29] *Id.* ¶¶ 11, 14.

[30] *Id.* ¶¶ 46-47.

[31] *Id.* ¶ 50.

[32] *Id.* ¶¶ 45, 50.

[33] *Id.* ¶ 90.

Bank's vice president for credit administration, CFO and the Board of Directors. The manager observed that the processes for calculating Commonwealth's ALLL did not constitute "a significant deficiency due to the review performed by the CFO, and that [the] VP of Credit Administration is heavily involved in the discussions of impaired loans though he does not actually do the manual calculation. Board and Management both review and approve [the] calculation." In fact, the audit team assessed the ALLL's control risk to be "moderate" based on "relatively strong controls and procedures over the allowance" and identified the review by the Bank's vice president for credit administration, CFO and Board of Directors as one of four key controls over the ALLL..

52. The audit work papers do not reflect that any testing of the design or operating effectiveness of the CFO's, the vice president of credit administration's, or the Board of Directors' review of the ALLL was performed. Moreover, other than an assertion that such a review was done, the audit work papers do not describe what the CFO, vice president of credit administration, or the Board of Directors were required to do or what they actually did to review the ALLL. Poti did not know what steps the CFO, the vice president of credit administration, or the Board of Directors took to review the senior loan officer's calculation of the ALLL. In fact, the only evidence of review in the audit work papers was a review of the minutes of Commonwealth's Board of Directors to confirm that the minutes reflected the Board's approval of the ALLL. Thus, though the audit team correctly identified the senior loan officer's initial calculation of the ALLL as creating a potential risk for material misstatement, the audit work does not provide a basis to conclude that it did not represent a material weakness.

53. In fact, before Poti authorized the issuance of an unqualified audit opinion on Commonwealth's financial statements and internal control over financial reporting for the year ended December 31, 2008, Commonwealth's internal auditor wrote to Poti that, based on the internal auditor's testing of the control designed to ensure that the vice president of credit administration had adequate information to review the ALLL, the internal auditor had determined that the review control was not working properly as of year-end 2008 because, among other things, the vice president of credit administration had not received information from loan officers to independently assess if loans had become impaired.

c. The Absence of These Controls Was an Indicator of a Material Weakness in Commonwealth's Internal Control Over Financial Reporting

54. PCAOB audit standards define a material weakness as "a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis."[34] Whether a deficiency or combination of deficiencies rises to the level of a material weakness depends on the severity of the deficiencies.[35] The absence of effective controls over the review of the ALLL calculation should

[34] *Id.* App. A ¶ A7.

[35] *Id.* ¶¶ 62-63.

have been treated as an indicator of a material weakness in Commonwealth's internal control over financial reporting as of December 31, 2008.[36] Had Poti tested the control over the review of the ALLL calculation, he would have learned that it was not effective since one of the key components of the control – the review by the vice president for credit administration – was not working properly because the vice president for credit administration did not have current guarantor financial information to independently assess if loans had become impaired. Without having tested this important control over the ALLL, and having information, including from internal audit, indicating that it was deficient, Poti did not have a sufficient basis to conclude that no material weaknesses existed and to issue an unqualified opinion on the Bank's internal control over financial reporting.[37] Moreover, the inappropriate conclusion that controls were effective led to an unsupported – and incorrect conclusion that, for purposes of the financial statement audit, the risk of material misstatement with respect to the ALLL was only "moderate."

3. Substantive Testing of Commonwealth's FAS 114 Loans Violated Professional Standards

55. Adding to the failures in connection with auditing Commonwealth's internal control over financial reporting were Poti's deficient substantive audit procedures. Specifically, the audit team failed to follow PCAOB standards in reviewing the reasonableness of management's estimates of impairment of the Bank's FAS 114 loans – one of the riskiest and most critical elements of the Bank's FAS 114 loss estimate calculation. The audit team found that, in estimating the ALLL, Commonwealth relied on the appraisals in the loan files, many of which were dated between 2005 and 2007 – over a year before the loan review took place. Poti was aware of the significance of the dates of the appraisals because of his understanding that "appraisals as current as 6 months ago could be considered stale and not reflective of true market values." In addition, the audit team found that, for approximately 30% of the total loan sample balance the team felt that there was "[i]nadequate financial information in [the loan] file to determine if additional reserve is necessary." Poti reviewed the audit team's FAS 114 test work prior to signing the audit opinion. By failing to subject the ALLL to appropriate scrutiny, Poti violated PCAOB standards, including AU Sections 328 and 342, which address auditing fair value and accounting estimates, respectively. Poti failed to obtain sufficient competent evidential matter to support management's estimate of the ALLL.

a. Relevant PCAOB Standards

56. Commonwealth's calculation of the portion of the ALLL attributable to the Bank's FAS 114 loans, which was based largely on an assessment of the value of the underlying collateral, was an estimate. As such, the auditor's responsibility was to obtain sufficient competent evidence to provide reasonable assurance that the estimates were reasonable and presented in conformity with the relevant accounting principles.[38]

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36 *Id.* ¶¶ 69-70.

37 *Id.* ¶ 71.

38 AU §§ 328 ¶ 3; 342 ¶ 7.

57. In evaluating reasonableness, the auditor should obtain an understanding of how management developed the estimate. Based on that understanding, the auditor should use one or a combination of the following approaches: (a) review and test the process used by management to develop the estimate; (2) develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate; or (3) review subsequent events or transactions occurring prior to the date of the auditor's report.[39]

58. Where management's estimate is based on a valuation, such as an appraisal, that was made prior to the financial reporting date, the following is an example of a consideration in the development of audit procedures: "obtain[ing] evidence that management has taken into account the effect of events, transactions, and changes in circumstances occurring between the date of the fair value measurement and the reporting date."[40]

59. Further, as Poti had correctly identified Commonwealth's ALLL as presenting a risk of fraud and a higher risk of error, Poti had a heightened responsibility over this area.[41]

60. The risk of material misstatement generally increases where, as here, the relevant account includes an estimate.[42] While estimates may differ, an unreasonable estimate should be considered a likely misstatement.[43]

61. The auditor should be thorough in his or her search for evidential matter and unbiased in its evaluation.[44] The auditor cannot express the conclusion in the auditor's standard report that the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles without obtaining sufficient competent evidential matter to support that conclusion.[45]

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[39] AU § 342 ¶ 10; *see also* AU § 328 ¶ 23.

[40] AU § 328 ¶ 25.

[41] AU § 312 ¶ 17 ("Higher risk may cause the auditor to expand the extent of procedures applied, apply procedures closer to or as of year-end, particularly in critical audit areas, or modify the nature of procedures to obtain more persuasive evidence.").

[42] *Id.* ¶ 36.

[43] *Id.*

[44] AU § 326 ¶ 25; *see also id.* ("In developing his or her opinion, the auditor should consider relevant evidential matter regardless of whether it appears to corroborate or to contradict the assertions in the financial statements.").

[45] *See* AU § 508 ¶ 7 ("The auditor's standard report states that the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. This conclusion may be

62. Finally, auditors are required to clearly document the work they perform.[46] "Audit documentation should be prepared in sufficient detail to provide a clear understanding of its purpose, source, and the conclusions reached."[47] "The auditor must document the procedures performed, evidence obtained, and conclusions reached with respect to relevant financial statement assertions."[48] "Audit documentation must clearly demonstrate that the work was in fact performed."[49] "Because audit documentation is the written record that provides the support for the representations in the auditor's report, it should," among other things, "[d]emonstrate that the engagement complied with the standards of the PCAOB."[50]

63. The substantive audit procedures Poti designed and implemented fell short of these standards.

b. Failure to Obtain Sufficient Audit Evidence

64. Commonwealth estimated the value of the collateral underlying the Bank's FAS 114 loans on a loan-by-loan basis because the Bank's FAS 114 portfolio was made up of large, non-homogenous loans. Therefore, the audit team performed a loan-by-loan review of a sample of the Bank's FAS 114 loan portfolio to test whether management's estimates of value were reasonable. However, the substantive audit procedures and the evidence obtained from those procedures were insufficient to meet PCAOB standards.

65. As part of Witt Mares' testing of Commonwealth's FAS 114 loans, the audit team selected a sample of Commonwealth's loan portfolio for in-depth review that represented approximately 14% of the total loan balance, and approximately 55% of the ALLL, at year-end 2008. After selecting the sample of loans to review, the audit team examined the loan file documentation, estimated the specific allowance or allocation needed for each loan, and assessed the reasonableness of management's estimate of the ALLL comparing the estimated ALLL to the recorded ALLL. However, as documented in the audit work paper, for a significant portion of the loans reviewed, there was inadequate information to perform this assessment.

66. Witt Mares' 2008 loan review found that approximately 30% of the total loan sample balance and approximately 5% of the ALLL, respectively, had "[i]nadequate financial information in [the loan] file to determine if additional reserve is necessary;" approximately 75%

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expressed only when the auditor has formed such an opinion on the basis of an audit performed in accordance with generally accepted auditing standards.").

[46] *See* AS No. 3.

[47] *Id.* ¶ 4.

[48] *Id.* ¶ 6.

[49] *Id.*

[50] *Id.* ¶ 5.

of the total loan sample balance and 52% of the ALLL consisted of loans whose files were missing, or contained stale, guarantor financial information; and approximately 33% of the total loan sample balance and approximately 37% of the ALLL consisted of loans whose files contained appraisals that were dated between 2005 and 2007 – dates more than a year before the loan review took place. In short, the files lacked critical information necessary to assess the FAS 114 loans and their reserves.

67. Despite the critical lack of information needed to assess the reasonableness of management's loss estimates on the FAS 114 loans, Witt Mares auditors agreed with management's loss estimates for all of the loans in the loan sample except one and concluded that "the Bank appears to have enough reserved to sustain any immediate short term losses." That conclusion was not supported by the available audit evidence. To the contrary, the audit evidence would lead a reasonable auditor to the opposite conclusion – that the ALLL was not a reasonable estimate because there was not sufficient information in the loan files to evaluate its reasonableness.

c. Failure to Adequately Document Audit Work

68. In addition to the audit failures noted above, Poti failed to adequately document audit work.[51] Witt Mares' loan work papers do not contain any explanation as to how the audit team evaluated whether management took into account the effect of deteriorating market conditions that had occurred between the appraisal dates for the approximately 33% of the total loan sample balance and approximately 37% of the ALLL that consisted of loans whose files contained appraisals that were dated between 2005 and 2007 – dates more than a year before the loan review took place. In addition, the work papers do not explain how Witt Mares was able to develop an independent estimate of the ALLL given that approximately 30% of the total loan sample balance and approximately 5% of the ALLL, respectively, had "[i]nadequate financial information in [the loan] file to determine if additional reserve is necessary."

D. FINDINGS

69. Based on the foregoing, the Commission finds that Poti engaged in improper professional conduct within the meaning of Rule 102(e)(1)(ii) of the Commission's Rules of Practice [17 C.F.R. § 201.102(e)(1)(ii)].[52] Specifically, the Commission finds that Poti engaged in repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards that indicate a lack of competence to practice before the Commission.

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[51] *Id.*

[52] *See also* Rule 102(e)(1)(iv)(B)(2) (defining improper professional conduct) [17 C.F.R. § 201.102(e)(1)(iv)(B)(2)].

IV.

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

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

A. Poti is denied the privilege of appearing or practicing before the Commission as an accountant.

B. After two (2) years from the date of this order, Respondent may request that the Commission consider his reinstatement by submitting an application (attention: Office of the Chief Accountant) to resume appearing or practicing before the Commission as:

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

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

(a) Respondent, or the public accounting firm with which he is associated, is registered with the PCAOB in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective;

(b) Respondent, or the registered public accounting firm with which he is associated, has been inspected by the PCAOB and that inspection did not identify any criticisms of or potential defects in the Respondent's or the firm's quality control system that would indicate that the respondent will not receive appropriate supervision;

(c) Respondent has resolved all disciplinary issues with the PCAOB, and has complied with all terms and conditions of any sanctions imposed by the PCAOB (other than reinstatement by the Commission); and

(d) Respondent acknowledges his responsibility, as long as Respondent appears or practices before the Commission as an independent accountant, to comply with all requirements of the Commission and the PCAOB, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews and quality control standards.

D. The Commission will consider an application by Respondent to resume appearing or practicing before the Commission provided that his state CPA license is current and he has resolved all other disciplinary issues with the applicable state boards of accountancy. However, if state licensure is dependent on reinstatement by the Commission, the Commission will consider an application on its other merits. The Commission's review may include consideration of, in addition to the matters referenced above, any other matters relating to Respondent's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

By the Commission.

Elizabeth M. Murphy
Secretary

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

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

December 18, 2013

In the Matter of **Golden Elephant Glass Technology, Inc., and Pacific Alliance Corp.** **File No. 500-1**

ORDER OF SUSPENSION OF TRADING

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Golden Elephant Glass Technology, Inc. because it has not filed any periodic reports since the period ended September 30, 2010.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Pacific Alliance Corp. because it has not filed any periodic reports since the period ended September 30, 2010.

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. EST on December 18, 2013, through 11:59 p.m. EST on January 2, 2014.

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. 71113 / December 18, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15649

In the Matter of Golden Elephant Glass Technology, Inc., and Pacific Alliance Corp., Respondents.	ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents Golden Elephant Glass Technology, Inc. and Pacific Alliance Corp.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Golden Elephant Glass Technology, Inc. (CIK No. 1006384) is a revoked Nevada corporation located in Liaoning, China with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Golden Elephant 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, 2010, which reported a net loss of over $2.5 million for the prior nine months. As of December 2, 2013, the company's stock (symbol "GOEG") was quoted on OTC Link (previously, "Pink Sheets") operated by OTC Markets Group, Inc. ("OTC Link"), had six market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

2. Pacific Alliance Corp. (CIK No. 801904) is a Delaware corporation located in North Salt Lake, Utah with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Pacific Alliance 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, 2010. As of December 2, 2013, the company's stock (symbol "PALC") was quoted on OTC Link, had four market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

B. DELINQUENT PERIODIC FILINGS

3. 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.

4. 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.

5. As a result of the foregoing, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and/or 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 them upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondents personally or by certified, registered, or Express Mail, or by other means 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

美利坚合众国

证券交易委员会

《1934 年证券交易法》
发行编号

行政程序
文件编号

关于 金象玻璃科技公司 **(Golden Elephant Glass Technology)** 与 太盟投资集团**(Pacific Alliance Corp.)**事宜 答辩人	**依据** **《1934 年证券交易法》第 12(j) 节** **行政程序启动令以及听证通知书**

I

证券交易委员会（"委员会"）认为，为保护投资者，根据《1934 年证券交易法》（"交易法"）第 12(j) 节对答辩人金象玻璃科技公司与太盟投资集团启动公共行政程序是必要和适当的。据此，对答辩人启动公共行政程序。

II

经过调查，执法司提出：

A. 答辩人

1.金像玻璃科技公司（CIK 代码：1006384）位于中国辽宁，是一家已吊销执照的内达华州公司，该公司根据《证券交易法》第 12(g) 节在委员会注册了一类证券。金象拖欠应定期向委员会提交的文件，自其在 2010 年 9 月 30 日最后一次提交了 10-Q 表格后就未提交过任何定期报告。该 10-Q 表格显示，金象在前 9 个月的综合净损失超过 250 万美元。截至 2013 年 12 月 2 日止，该公司股票（名称为"GOEG"）在场外交易市场集团公司操作的场外交易市场链接("OTC Link")（原名"粉单市场"）仍有报价，有 6 位做市商，符合《交易法》第 15c2-11(f)(3) 条"捎带"例外的资格。

2.太盟投资集团（CIK 代码：801904）位于犹他州北盐湖城，是一家特拉华州公司，该公司根据《证券交易法》第 12(g) 节在委员会注册了一类证券。太盟投资集团拖欠应定期向委员会提交的文件，自其在 2010 年 9 月 30 日最后一次提交了 10-Q 表格后就未提交过任何定期报告。截至 2013 年 12 月 2 日止，该公司股票（名称为“PALC”）在场外交易市场链接仍有报价，有 4 位做市商，符合交易法第 15c2-11(f)(3) 条“捎带”例外的资格。

B.拖欠定期申报书

3.如上详述，所有答辩人拖欠了应提交给委员会的定期申报书，多次未能履行提交定期报告的义务，而且未能遵守由企业财务司所寄并要求其遵守定期申报义务之拖欠函。或者，由于答辩人未能依委员会规则的要求在委员会的档案中保有一有效地址，未收到该类信函。

4.《交易法》第 13(a) 条以及据此颁布的规则要求根据《交易法》第 12 节登记的证券发行人向委员会提交定期报告，报告中应有当前的准确信息，即使是根据第 12(g) 节的自愿登记也要提交。具体来说，第 13a-1 条要求发行人提交年度报告，第 13a-13 条要求国内发行人提交季度报告。

5.由于上述原因，答辩人未能遵守《交易法》第 13(a) 节以及该节下之第 13a-1 条和/或第 13a-13 条之规定。

III

鉴于执法司提出的指控，委员会认为，为保护投资者而启动公共行政程序是必要和适当的，据此决定：

A. 本文件中第二节中的指控是否真实，并据此给答辩人机会以便其对指控提出抗辩；以及，

B. 为保护投资者的利益是否有必要适当暂停其证券登记，暂停期不超过十二个月，或者撤销在本文件第二节中所指出的答辩人依《交易法》第 12 节所登记注册的每一类证券，以及撤销任何以《交易法》第 12b-2 条或第 12g-3 条规定下之继任者名义和以答辩人任何新公司名称所登记注册的每一类证券。

IV

兹在此命令，在待决定的时间和地点召开公开听证会，以就在本文件第三节中提出的问题听取各方证据，听证会由行政法官主持。依照委员会《实务规则》第 110 条 [17 C.F.R. § 201.110] 规定，行政法官将由进一步的命令来指派。

兹此进一步命令，答辩人应当依照委员会《实务规则》第 220 (b) 条 [17 C.F.R. § 201.220(b)]，在收到本命令之后十 (10) 天之内，对本命令下的指控提供答辩状。

如果答辩人未提交指定答辩，或在被正式通知后未出席听证会，答辩人以及任何根据交易法第 12b-2 条或第 12g-3 条规定下的继任者，以及以新公司名义下的答辩人可被视为缺席，且考虑到该命令可能根据委员会《实务规则》第 155(a)、220(f)、221(f) 和 310 条 [17 C.F.R. §§ 201.155(a)、 201.220(f)、201.221(f) 及 201.310]规定被视为真实，本程序可能对答辩人不利。。

此命令应立即送达答辩人本人，或经由保证邮件、挂号、或特快专递，或委员会《实务规则》所允许的其他方式送达答辩人。

兹此进一步下令，根据委员会《实务规则》第 360(a)(2) 条 [17 C.F.R. § 201.360(a)(2)] 规定，行政法官应从本命令送达之日起 120 天内出具一份初步裁决。

如果没有适当的豁免书，任何在本程序中担任调查或起诉职能的委员会官员或雇员，或是任何在与本听证程序事实相关的程序中担任调查或检举职能的委员会官员或雇员，除了根据通知在听证程序中作为证人或律师以外，均不可参与本程序的决策或对本程序提出建议。由于本程序不是《行政程序法》第 551 节所指的"规则制定"，本程序不受第 553 节所限制，任何最终的委员会行动生效日期不可再予延迟。

委员会在此提交。

Elizabeth M. Murphy
秘书

送达列表

委员会《实务规则》第 141 条规定，秘书或委员会的另一位经过正式授权的人员应将“依据《1934 年证券交易法》第 12(j) 节行政程序启动令以及听证通知书”（“命令”）送达至答辩人及其法定代理人处。

所附命令已被送往有权收到该通知的各方及其他人员：

Brenda P. Murray 法官
首席行政法官
证券交易委员会
100 F Street, N.E.
Washington, D.C. 20549-2557

Neil J. Welch, Jr., Esq.
执法司
证券交易委员会
100 F Street, N.E.
Washington, D.C. 20549-6010

根据《海牙公约》送达
金象玻璃科技公司(Golden Elephant Glass Technology, Inc.)
转交司法部国际法律合作中心 (ILCC)
中国北京市
朝阳区朝阳门南大街 6 号
100020

通过特快专递送达：
太盟投资集团(Pacific Alliance Corp.)
160 North 400 West
North Salt Lake, UT 84054

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

December 18, 2013

In the Matter of The Enlightened Gourmet, Inc., Eternal Image, Inc., NMT Medical, Inc., and Wits Basin Precious Minerals, 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 The Enlightened Gourmet, Inc. because it has not filed any periodic reports since the period ended September 30, 2010.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Eternal Image, Inc. because it has not filed any periodic reports since the period ended September 30, 2010.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of NMT Medical, Inc. because it has not filed any periodic reports since the period ended September 30, 2010.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Wits Basin Precious

Minerals, Inc. because it has not filed any periodic reports since the period ended September 30, 2010.

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. EST on December 18, 2013, through 11:59 p.m. EST on January 2, 2014.

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. 71115 / December 18, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15650

In the Matter of The Enlightened Gourmet, Inc., Eternal Image, Inc., Maxconcept International Holdings, Inc., NMT Medical, Inc., U.S. Fuel Corp., and Wits Basin Precious Minerals, 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 The Enlightened Gourmet, Inc., Eternal Image, Inc., Maxconcept International Holdings, Inc., NMT Medical, Inc., U.S. Fuel Corp., and Wits Basin Precious Minerals, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. The Enlightened Gourmet, Inc. (CIK No. 1342882) is a revoked Nevada corporation located in Hamden, Connecticut with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Enlightened Gourmet 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, 2010, which reported a net loss of $662,925 for the prior nine months. As of October 15, 2013, the company's stock (symbol "ENLG") was quoted on OTC Link (previously, "Pink

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

2. Eternal Image, Inc. (CIK No. 868756) is a void Delaware corporation located in Farmington, Michigan with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Eternal Image 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, 2010, which reported a net loss of $125,562 for the prior three months. On April 13, 2012, an involuntary Chapter 7 proceeding was filed against the company in the U.S. Bankruptcy Court for the Eastern District of Michigan, and the case was still pending as of September 25, 2013. As of October 15, 2013, the company's stock (symbol "ETNLQ") 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. Maxconcept International Holdings, Inc. (CIK No. 1445192) is a void Delaware corporation located in Kowloon, Hong Kong with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Maxconcept 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, 2010, which reported a net loss of $500 for the prior three months.

4. NMT Medical, Inc. (CIK No. 1017259) 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). NMT Medical is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 2010, which reported a net loss of over $8.7 million for the prior nine months. As of October 15, 2013, the company's stock (symbol "NMTI") was quoted on OTC Link, had seven market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

5. U.S. Fuel Corp. (CIK No. 1116112) is a Nevada corporation located in Atco, New Jersey with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). U.S. Fuel 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, 2012, which reported a net loss of $357,933 for the prior twelve months.

6. Wits Basin Precious Minerals, Inc. (CIK No. 912875) is a Minnesota corporation located in Minneapolis, Minnesota with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Wits Basin 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, 2010, which reported a net loss of over $7.4 million for the prior nine months. As of October 15, 2013, the company's stock (symbol "WITM") was quoted on OTC Link, had eleven market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

B. DELINQUENT PERIODIC FILINGS

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

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

9. As a result of the foregoing, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and/or 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 them upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondents personally or by certified, registered, or Express Mail, or by other means 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 Gallagher
Commissioner Piwowar
Disapproved

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT of 1934
Release No. 71118 / December 18, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-13532

In the Matter of **Prime Capital Services, Inc.,** **Gilman Ciocia, Inc.,** **Michael P. Ryan,** **Rose M. Rudden,** **Christie A. Andersen,** **Eric J. Brown,** **Matthew J. Collins,** **Kevin J. Walsh,** **Mark W. Wells,** **Respondents,**	**ORDER DIRECTING DISBURSEMENT OF FAIR FUND RESIDUAL**

On March 16, 2010, the Securities and Exchange Commission (the "Commission") issued an Order Making Findings and Imposing Remedial Sanctions Pursuant to Section 8A of the Securities Act of 1933 and Sections 15(b) and 21C of the Securities Exchange Act of 1934 as to Prime Capital Services, Inc. and Gilman Ciocia, Inc. (Securities Act Release No. 9113 (Mar. 16, 2010)) (the "Order"). Simultaneously with the entry of the Order, the Commission accepted settlement offers from Respondents Prime Capital Services, Inc. ("PCS") and Gilman Ciocia, Inc. ("G&C") in which they consented to the entry of the Order without admitting or denying the Commission's findings. PCS was ordered to pay total of $144,262.58 in disgorgement and prejudgment interest to the Commission, and G&C was ordered to pay total of $450,001.00 in disgorgement and civil penalties to the Commission. The Commission established a Fair Fund pursuant to Section 308 of the Sarbanes-Oxley Act of 2002 for these payments (the "Fair Fund").

On March 14, 2011, the Commission issued an Order Approving Distribution Plan of a Fair Fund and Appointing a Fund Administrator (Exchange Act Release No. 64081 (Mar. 14, 2011)). On May 8, 2012, the Commission issued an Order Approving and Ratifying Prior Disbursement of $390,054.77 to eligible investors who paid fees and charges associated with their variable annuity investment and who were described in the Order and/or who testified about their investment experience at an administrative hearing (Exchange Act Release No. 66947 (May 8, 2012)).

Pursuant to Sections 21(d)(4) and 21B(e) of the Securities Exchange Act of 1934 ("Exchange Act"), the Commission authorizes payments from the Fair Fund residual to the following seven investors in the amounts set forth below.

Accordingly, IT IS HEREBY ORDERED that, pursuant to Exchange Act Sections 21(d)(4) and 21B(e), residual funds totaling $141,500 from the Fair Fund shall be disbursed as follows:

1. Investor # 1: $18,260
2. Investor # 2: $6,810
3. Investor # 3: $63,460
4. Investor # 4: $9,330
5. Investor # 5: $7,090
6. Investor # 6: $18,260
7. Investor # 7: $18,290

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. 71119 / December 18, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-14909

In the Matter of **OPPENHEIMERFUNDS, INC.,** **and** **OPPENHEIMERFUNDS DISTRIBUTOR, INC.,** **Respondents.**	**NOTICE OF PROPOSED PLAN OF DISTRIBUTION AND OPPORTUNITY FOR COMMENT**

Notice is hereby given, pursuant to Rule 1103 of the Securities and Exchange Commission's ("Commission") Rules on Fair Fund and Disgorgement Plans, 17 C.F.R. § 201.1103, that the Division of Enforcement has submitted to the Commission a proposed plan for the distribution of monies placed into a Fair Fund established in the above-captioned matter.

On June 6, 2012, the Commission issued an Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Section 15(b)(4) of the Securities Exchange Act of 1934, Sections 203(e) and 203(k) of the Investment Advisers Act of 1940, and Sections 9(b) and 9(f) of the Investment Company Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order against Oppenheimerfunds, Inc. ("OFI") and Oppenheimerfunds Distributor, Inc. (collectively, "Respondents") (the "Order") (Securities Act Rel. No. 9329 (June 6, 2012)). As set forth in the Order, prior to and during the height of the 2008 financial crisis, Respondents made misrepresentations regarding two fixed income mutual funds managed by OFI: Oppenheimer Champion Income Fund and Oppenheimer Core Bond Fund. The Order required OFI to pay disgorgement of $9,879,706, prejudgment interest of $1,487,190, and a civil money penalty of $24 million for a total of approximately $35.4 million. The Order also created a Fair Fund pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002, as amended.

OPPORTUNITY FOR COMMENT

Pursuant to this Notice, all interested parties are advised that they may obtain a copy of the Proposed Plan of Distribution from the Commission's public website, http://www.sec.gov. Interested parties may also obtain a written copy of the Proposed

Plan of Distribution by submitting a written request to Nancy Chase Burton, Esq., United States Securities and Exchange Commission, 100 F Street, N.E., Washington, DC 20549-5631. All persons who desire to comment on the Proposed Plan of Distribution may submit their comments, in writing, no later than thirty (30) days from the date of this Notice:

1. To the Office of the Secretary, United States Securities and Exchange Commission, 100 F Street, N.E., Washington, DC 20549-1090;

2. By using the Commission's Internet comment form (http://www.sec.gov/litigation/admin.shtml); or

3. By sending an e-mail to rule-comments@sec.gov.

Comments submitted should include "Administrative Proceeding File Number 3-14909" in the subject line. Comments received will be publicly available. Persons should submit only information that they wish to make publicly available.

THE DISTRIBUTION PLAN

The Fair Fund is comprised of the amounts of disgorgement, prejudgment interest and civil monetary penalties paid by OFI, plus any accumulated interest, less any federal, state, or local taxes and fees and expenses. The Proposed Plan of Distribution provides for injured investors to receive monies from the Fair Fund pursuant to a two phase process. First, injured investors will be allocated their share of the advisory fees paid by each fund during the applicable recovery periods. Second, injured investors will be compensated, on a *pro rata* basis, for the decline in value of their investment in fund shares after benchmark indexing. The Fair Fund is not intended to compensate investors for losses they incurred because of fluctuations in securities markets that are unrelated to Respondents' conduct.

The Proposed Plan of Distribution follows a modified notice and claims process. The Fund Administrator, Epiq Class Actions & Claims Solutions, Inc. ("Epiq"), also acted as the Class Action Administrator in two class actions which arose out of similar violations alleged in the Order. The Proposed Plan of Distribution authorizes the Fund Administrator to use the claims information submitted in those class actions. The class actions recovery periods were longer than, but completely subsume, the recovery periods in this action. Consequently the

Proposed Plan of Distribution allows for the identification by Epiq of "Class Action SEC Authorized Claimants" who will automatically be deemed eligible claimants under the proposed plan. All other claimants will need to file a proof of claim form in order to establish their eligibility to participate in the Fair Fund.

By the Commission.

Elizabeth M. Murphy
Secretary

By: Lynn M. Powalski
Deputy Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR PARTS 230, 232, 239, 240 AND 260

[Release Nos. 33-9497; 34-71120; 39-2493; File No. S7-11-13]

RIN 3235-AL39

Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rules.

SUMMARY: We are proposing rule amendments to Regulation A to implement Section 401 of the Jumpstart Our Business Startups Act. Section 401 of the JOBS Act added Section 3(b)(2) to the Securities Act, which directs the Commission to adopt rules exempting offerings of up to $50 million of securities annually from the registration requirements of the Securities Act. The proposed rules include issuer eligibility requirements, content and filing requirements for offering statements and ongoing reporting requirements for issuers.

DATES: Comments should be received by [insert date 60 days after publication in the Federal Register].

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

Electronic Comments:

- Use the Commission's Internet comment forms (http://www.sec.gov/rules/proposed.shtml);
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-11-13 on the subject line; or

- Use the Federal Rulemaking Portal (http://www.regulations.gov). Follow the instructions for submitting comments.

Paper Comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-11-13. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (http://www.sec.gov/rules/proposed.shtml). Comments also are available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Room 1580, Washington, DC 20549. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Zachary O. Fallon, Special Counsel; Shehzad K. Niazi, Attorney-Advisor; or Karen C. Wiedemann, Attorney Fellow; Office of Small Business Policy, Division of Corporation Finance, at (202) 551-3460, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-3628.

SUPPLEMENTARY INFORMATION: We propose to amend Rules 251-263[1] under Regulation A.[2]

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1 17 CFR 230.251 through 230.263.

2 17 CFR 230.251 through 230.263.

We also propose to revise Form 1-A,[3] rescind Form 2-A,[4] and create four new forms, Form 1-K (annual updates), Form 1-SA (semiannual updates), Form 1-U (current reporting), and Form 1-Z (exit report).

We further propose to revise Rule 4a-1[5] under the Trust Indenture Act[6] to increase the dollar ceiling of the exemption from the requirement to issue securities pursuant to an indenture, and to amend Rule 15c2-11[7] of the Securities Exchange Act of 1934 (the "Exchange Act")[8] to permit an issuer's ongoing reports filed under Regulation A to satisfy a broker-dealer's obligations to review and maintain certain information about an issuer's quoted securities. In addition, we propose a technical amendment to Exchange Act Rule 15c2-11 to amend subsection (d)(2)(i) of the rule to update the outdated reference to the "Schedule H of the By-Laws of the National Association of Securities Dealers, Inc." which is now known as the "Financial Industry Regulatory Authority, Inc." and to reflect the correct rule reference.

As a result of the proposed revisions to Regulation A, conforming and technical amendments would be made to Rule 157(a),[9] in order to reflect amendments to Section 3(b) of the Securities Act, and Rule 505(b)(2)(iii),[10] in order to reflect the

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3 17 CFR 239.90.

4 17 CFR 239.91.

5 17 CFR 260.4a-1.

6 15 U.S.C. 77aaa *et seq.*

7 17 CFR 240.15c2-11.

8 15 U.S.C. 78a *et seq.*

9 17 CFR 230.157(a).

10 17 CFR 230.505(b)(2)(iii).

proposed changes to Rule 262 of Regulation A. Additionally, Item 101(a)[11] of Regulation S-T[12] would be revised to reflect the mandatory electronic filing of all issuer initial filing and ongoing reporting requirements under proposed Regulation A. The portion of Item 101(c)(6)[13] of Regulation S-T dealing with paper filings related to a Regulation A offering, and Item 101(b)(8)[14] of Regulation S-T dealing with the optional electronic filing of Form F-X by Canadian issuers, would therefore be rescinded.

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[11] 17 CFR 232.101(a).

[12] 17 CFR 232.10 *et seq.*

[13] 17 CFR 232.101(c)(6).

[14] 17 CFR 232.101(b)(8).

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I. INTRODUCTION AND BACKGROUND

A. JOBS Act Section 401

This rulemaking would implement a statutory directive under the Jumpstart Our Business Startups Act (the "JOBS Act")[15] to create a new exemption from registration under the Securities Act of 1933 (the "Securities Act") for small offerings. Section 401 of the JOBS Act amended Section 3(b) of the Securities Act by designating existing Section 3(b), the Commission's exemptive authority for offerings of up to $5 million, as Section 3(b)(1), and creating a new Section 3(b)(2). New Section 3(b)(2) directs the Commission to adopt rules adding a class of securities exempt from the registration requirements of the Securities Act for offerings of up to $50 million of securities within a twelve-month period. Issuers conducting offerings in reliance on Section 3(b)(2) would be required to follow terms and conditions established by the Commission, and, where applicable, to make ongoing disclosure.

Congress enacted Section 3(b)(2) against a background of public commentary suggesting that Regulation A, an exemption for small issues originally adopted by the Commission in 1936 under the authority of Section 3(b) of the Securities Act,[16] should be expanded and updated to make it more useful to small companies.[17] Section 3(b)(2)

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15 Pub. L. No. 112-106, 126 Stat. 306.

16 SEC Release No. 33-632 (Jan. 21, 1936). Prior to codification as such, Regulation A was a collection of individual rules issued by the Federal Trade Commission and the Commission during the period of 1933-1936. Each such rule exempted particular classes of securities from registration under the Securities Act. Regulation A's initial annual offering limit was raised from $100,000 to $300,000 in 1945, $500,000 in 1970, $1.5 million in 1978, and to its current level of $5 million in 1992.

17 H.R. Rep. No. 112-206 (2011), at 3-4. *See also* Remarks and prepared statements of William Hambrecht, CEO of WR Hambrecht + Co., ("A confluence of . . . reasons . . . has made Regulation A a poor alternative for small growth-oriented companies seeking to raise development capital and also explains why the offering mechanism has virtually disappeared from the capital raising landscape."), and Michael Lempres, Asst. General Counsel, SVB Financial Group,

requires us to engage in rulemaking that is meant to increase the use of Regulation A, thereby helping to make capital available to small companies.[18]

To implement Section 401 of the JOBS Act, as mandated by Section 3(b)(2), we have endeavored to craft a workable revision of Regulation A that would both promote small company capital formation and provide for meaningful investor protection. We propose to amend Regulation A to create two tiers of offerings: Tier 1, for offerings of up to $5 million in a twelve-month period, and Tier 2, for offerings of up to $50 million in a twelve-month period. Both Tiers would be subject to basic requirements as to issuer eligibility, disclosure, and other matters, drawn from the current provisions of Regulation A and updated in some areas to align Regulation A with current practice for

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("Regulation A has not proved to be a useful capital raising vehicle for small issuers. . . . An average of eight filings a year, with a maximum amount of $5 million each, proves the irrelevance of Regulation A as it stands today. It simply is not a viable vehicle for raising funds and is providing benefit to neither companies nor investors.") before the H. Comm. on Fin. Serv. for the 111th Congress, Serial No. 111-168 (December 8, 2010), *available at*: http://archives.financialservices.house.gov/Hearings/hearingDetails.aspx?NewsID=1381; Remarks and prepared statement of David Weild, Sr. Advisor, Grant Thorton, ("[A]n increase to the Regulation A [offering] ceiling will provide a less costly and more effective alternative for smaller, entrepreneurial companies that want to access the public capital markets. It may also enable smaller, growth-oriented companies to access the public market at an earlier stage in their growth cycle.") before the H. Comm. on Fin. Serv., Subcommittee on Capital Markets and Gov't Sponsored Entities for the 112th Congress, Serial No. 112-19 (March 16, 2011), *available at*: http://financialservices.house.gov/calendar/eventsingle.aspx?EventID=231755; Remarks and prepared statements of Professor John C. Coffee, Columbia Law School ("[I]n 2010 only seven offerings went effective under Regulation A (which is based on Section 3(b)). Most issuers saw Section 3(b) as unattractive (in comparison to a private placement under Regulation D) both because of Section 3(b)'s low ceiling (*i.e.*, $5 million) and the need to file an offering document that is reviewed by the SEC."), before the U.S. Senate Comm. on Banking, Housing and Urban Affairs (December 1, 2011), *available at*: http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=a96c1bc1-b064-4b01-a8ad-11e86438c7e5; U.S. Government Accountability Office (GAO), *Factors that May Affect Trends in Regulation A Offerings* (July 2012) (*available at*: http://www.gao.gov/assets/600/592113.pdf).

18 H.R. Rep. No. 112-206, at 3 (2011) ("The low number of Regulation A filings—each for the maximum amount of $5 million—demonstrates that a revision to Regulation A is necessary. To increase the use of Regulation A offerings and help make capital available to small companies, Representative Schweikert introduced H.R. 1070, which increases the offering threshold to $50 million.").

registered offerings. In addition to these basic requirements, Tier 2 offerings would be subject to additional requirements, including the provision of audited financial statements, ongoing reporting obligations, and certain limitations on sales.

B. Current Regulation A

Currently, Regulation A permits unregistered public offerings of up to $5 million of securities in any twelve-month period by non-reporting U.S. and Canadian companies, including no more than $1.5 million of securities offered by securityholders of the company.[19] The exemption requires that an offering statement on Form 1-A be filed with the Commission.[20] Filings are made on paper,[21] rather than electronically, and are subject to staff review. The offering statement must be "qualified,"[22] which, in the absence of a delaying notation, would occur without Commission action on the 20th calendar day after filing.[23] The core of the offering statement is the offering circular, a disclosure document much like an abbreviated version of the prospectus in a registered offering.[24] The offering circular, which must be delivered to prospective purchasers,[25] can be in a

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19 17 CFR 230.251(a), (b). Under Rule 251(b), affiliates resales are prohibited unless the issuer has had net income from continuing operations in at least one of its last two fiscal years.

20 17 CFR 230.251(d), 17 CFR 230.252.

21 17 CFR 232.101(c)(6).

22 17 CFR 230.251(g). *See also* 17 CFR 200.30-1(b)(2) (delegated authority to authorize the qualification of offering statements under Regulation A to the Director of the Division of Corporation Finance).

23 The qualification process under Regulation A is similar to the process of a registration statement being declared effective under the Securities Act. As with registration, the staff review process for an offering circular generally takes more than the 20 calendar days provided by rule, even taking into account that pre-qualification amendments to an offering statement restart the 20 calendar-day period. Issuers include a delaying notation on Form 1-A to ensure that both the issuer and staff reviewing the offering statement have completed the review process before an offering statement is qualified.

24 17 CFR 230.253.

25 17 CFR 230.251(d).

question-and-answer format or a more traditional narrative disclosure format.[26]

Regulation A permits issuers to communicate with potential investors, or "test the waters" for potential interest in the offering, before filing the offering statement.[27] Any solicitation material used to test the waters must be submitted to the Commission not later than the time of first use and must contain a required legend or disclaimer.[28]

Regulation A offering circulars are required to contain issuer financial statements,[29] but the financial statements are not required to be audited unless the issuer otherwise has audited financial statements available.[30] Qualification of a Regulation A offering statement does not trigger reporting obligations under the Exchange Act. A Regulation A offering is a public offering, with no prohibition on general solicitation and general advertising. Securities sold under Regulation A are not "restricted securities" under the Securities Act and, therefore, are not subject to the limitations on resale that apply to securities sold in private offerings.[31]

Because Regulation A offerings are exempt from the registration requirements of the Securities Act, issuers and other offering participants are not subject to the liability provisions of Section 11 of the Securities Act. Instead, other anti-fraud and civil liability

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26 Form 1-A, Part II (Offering Circular), 17 CFR 239.90.

27 17 CFR 230.254.

28 17 CFR 230.254(b)(2). Testing the waters solicitation materials must state: i) that no money is being solicited or will be accepted, if sent in response; ii) that no sales will be made or commitment to purchase accepted until delivery of an offering circular that includes complete information about the issuer and the offering; iii) that an indication of interest by a prospective purchaser is non-binding; and iv) the identity of the chief executive officer of the issuer and a brief description of the issuer's business and products.

29 17 CFR 230.253(a).

30 Form 1-A, Part F/S, 17 CFR 239.90. Market participants have indicated that the laws of some states may require audited financial statements for offerings conducted under Regulation A.

31 *See, e.g.,* 17 CFR 230.502(d); *see also* Rule 144 (17 CFR 230.144).

provisions of the securities laws, including Sections 12(a)(2) and 17 of the Securities Act, Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5, apply to the offer and sale of securities in reliance upon Regulation A.[32] Securities offerings conducted pursuant to Regulation A are subject to state securities law registration and qualification requirements, unless an exemption is available under state law.

C. Use of Regulation A

In recent years, Regulation A offerings have been rare in comparison to offerings conducted in reliance on other Securities Act exemptions or on a registered basis. From 2009 through 2012, there were 19 qualified Regulation A offerings for a total offering amount of approximately $73 million.[33] During the same period, there were approximately 27,500 offerings of up to $5 million (*i.e.*, at or below the cap on Regulation A offering size), for a total offering amount of approximately $25 billion, claiming a Regulation D exemption, and 373 offerings of up to $5 million, for a total offering amount of approximately $840 million, conducted on a registered basis. In 2012 alone, there were eight qualified Regulation A offerings for a total offering amount of approximately $34.5 million, compared to approximately 7,700 Regulation D offerings of up to $5 million for a total offering amount of approximately $7 billion, and 52 registered offerings of up to $5 million for a total offering amount of approximately $132 million.[34]

Section 402 of the JOBS Act required the Comptroller General to conduct a study

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[32] *See* SEC Rel. No. 33-6924 (March 20, 1992) [57 FR 9768], at fn. 57 (discussing the anti-fraud and civil liability provisions applicable to Regulation A).

[33] One qualified offering involved a dividend reinvestment plan by an issuer that did not include an offering amount.

[34] The figures cited above are derived from information contained in the Commission's EDGAR database and the S&P Capital IQ database. *See also* Section IV. below for a discussion on the usage of current methods of raising capital of up to $50 million.

on the impact of state "Blue Sky" laws on offerings conducted under Regulation A, and to report its findings to Congress. The resulting U.S. Government Accountability Office ("GAO") report to Congress indicates that various factors may have influenced the use of Regulation A, including the type of investors businesses seek to attract, the process of filing the offering statement with the Commission, state securities law compliance, and the cost-effectiveness of Regulation A relative to other exemptions.[35]

D. The Section 3(b)(2) Exemption

Section 401 of the JOBS Act imposes a number of requirements for the rules the Commission must adopt under Section 3(b)(2), and also provides for the exercise of Commission discretion in setting additional terms and conditions for the exemption.

The mandatory provisions, in addition to the $50 million annual offering limit, include:

- Features based on the current provisions of Regulation A:
  - the securities may be offered and sold publicly;
  - the securities are not "restricted securities" within the meaning of federal securities laws and regulations;
  - the civil liability provisions of Section 12(a)(2) of the Securities Act would apply to offers and sales of the securities; and
  - issuers may solicit interest in the offering before filing an offering statement;

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35 *Factors that May Affect Trends in Regulation A Offerings,* GAO-12-839 (July 2012) (*available at*: http://www.gao.gov/assets/600/592113.pdf). The GAO report concludes that it is unclear whether increasing the Regulation A offering ceiling from $5 million to $50 million will improve the utility of the exemption.

- A new requirement for issuers to file audited financial statements with the Commission annually;[36] and
- A limitation on the types of securities eligible for exemption under Section 3(b)(2) to equity securities, debt securities, and debt securities convertible into or exchangeable for equity interests, including any guarantees of such securities.

The Commission, in its discretion, may determine to include other terms, conditions, or requirements, including:

- electronic filing of offering materials, the form and content of which would be prescribed by the Commission, including audited financial statements, issuer business description, issuer financial condition, issuer corporate governance principles, use of investor funds, and other appropriate matters;
- "bad actor" disqualification provisions (which, if included, must be substantially similar to the regulations adopted under Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"));[37] and
- periodic disclosures regarding the issuer, its business operations, financial condition, corporate governance principles, use of investor funds, and other appropriate matters.[38]

Section 401 of the JOBS Act also requires the Commission to review the $50 million offering limit not later than two years after enactment of the JOBS Act and

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36 JOBS Act Section 401(a)(2).

37 Pub. L. No. 111-203, § 926, 124 Stat. 1376, 1851 (July 21, 2010). Among other things, Section 926 required the issuance of disqualifying rules substantially similar to the "bad actor" disqualification provisions of Rule 262 of existing Regulation A.

38 JOBS Act Section 401(a)(2).

every two years thereafter and, if the Commission decides not to increase the amount, requires that it report its reasoning to Congress.

II. PROPOSED AMENDMENTS TO REGULATION A

A. Overview

Title IV of the JOBS Act amended Section 3(b) of the Securities Act to add Section 3(b)(2), which, subject to various terms and conditions, directs the Commission to enact rules that add a class of securities exempt from the registration provisions of the Securities Act. Prior to the amendment, Section 3(b) contained the statutory authority relied upon to establish current Regulation A. Although the JOBS Act amended Section 3(b) to designate this existing authority as Section 3(b)(1) and add new Section 3(b)(2), it did not amend the existing statutory authority of Regulation A or direct the Commission to amend specific rules adopted thereunder.[39] We propose to implement this JOBS Act mandate by expanding Regulation A into two tiers: Tier 1, for offerings of up to \$5 million; and Tier 2, for offerings of up to \$50 million.[40] The proposals for offerings under Tier 1 and Tier 2 build on current Regulation A, and preserve, with some modifications, existing provisions regarding issuer eligibility, offering circular contents, testing the waters, and "bad actor" disqualification. We also propose to modernize the Regulation A filing process for all offerings and align practice in certain areas with prevailing practice for registered offerings, to create additional flexibility and streamline compliance for Regulation A issuers. Issuers in Tier 2 offerings would be required to

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39 *Cf.* Title II of the JOBS Act, Pub. L. No. 112-106, § 201 (directing the Commission to amend Rule 506 of Regulation D, 17 CFR § 230.506).

40 An issuer of \$5 million or less of securities could elect to proceed under either Tier 1 or Tier 2.

include audited financial statements in their offering documents and to file annual, semiannual and current reports with the Commission, and purchasers in Tier 2 offerings would be subject to certain limitations on their investment. The differences between Tier 1 and Tier 2 offerings are described more fully below.

In developing the current proposals, we considered the statutory language of JOBS Act Section 401, the legislative history, the current Regulation A exemption, comment letters received to date on Title IV of the JOBS Act[41] and recent recommendations of the Commission's Government-Business Forum on Small Business Capital Formation,[42] the Advisory Committee on Small and Emerging Companies,[43] and the Equity Capital Formation Task Force.[44]

Following are the key provisions of the proposed amendments to Regulation A:

Scope of the exemption:

- Tier 1: annual offering limit of $5 million, including no more than $1.5 million on behalf of selling securityholders.
- Tier 2: annual offering limit of $50 million, including no more than $15 million

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[41] To facilitate public input on JOBS Act rulemaking before the issuance of rule proposals, the Commission has invited members of the public to make their views known on various JOBS Act initiatives in advance of any rulemaking by submitting comment letters to the Commission's website at http://www.sec.gov/spotlight/jobsactcomments.shtml. Comment letters received to date on Title IV of the JOBS Act are *available at*: http://www.sec.gov/comments/jobs-title-iv/jobs-title-iv.shtml.

[42] Prior recommendations of the Commission's Government-Business Forum on Small Business Capital Formation ("Small Business Forum") are *available at*: http://www.sec.gov/info/smallbus/sbforum.shtml.

[43] Prior recommendations of the Advisory Committee on Small and Emerging Companies ("Advisory Committee") are *available at*: http://www.sec.gov/info/smallbus/acsec.shtml.

[44] Equity Capital Task Force, *From the On-Ramp to the Freeway: Refueling Job Creation and Growth by Reconnecting Investors with Small-Cap Companies*, presentation to the U.S. Dep't. of Treasury (November 11, 2013), *available at*: http://www.equitycapitalformationtaskforce.com/ ("ECTF Report").

on behalf of selling securityholders.

- Update the restrictions on issuer eligibility to exclude from Regulation A issuers that are or have been subject to any order of the Commission pursuant to Section 12(j) of the Exchange Act entered within five years before the filing of the offering statement.
- Update the restrictions on issuer eligibility to exclude from Regulation A issuers that have not filed with the Commission the ongoing reports required by the proposed rules during the two years immediately preceding the filing of an offering statement.
- Limit the amount of securities an investor can purchase in a Tier 2 offering to no more than 10% of the greater of annual income and net worth.
- Exclude asset-backed securities, as defined in Regulation AB, from the list of eligible securities.
- Update the safe harbor from integration and provide additional guidance on the potential integration of offerings conducted concurrently with, or close in time after, a Regulation A offering.

Solicitation materials:

- Permit issuers to "test the waters" or solicit interest in a potential offering with the general public either before or after the filing of the offering statement, so long as any solicitation materials used after publicly filing the offering statement are preceded or accompanied by a preliminary offering circular or contain a notice informing potential investors where and how the most current preliminary offering circular can be obtained. This requirement could be satisfied by providing the uniform resource locator ("URL") where the preliminary offering circular or the offering statement may be obtained on EDGAR.

Qualification, communications, and offering process:

- Require issuers and intermediaries in the prequalification period to deliver a preliminary offering circular to prospective purchasers at least 48 hours in advance of sale.
- Modernize the qualification, communications, and offering process in Regulation A to reflect analogous provisions of the Securities Act registration process:[45]
  - Permit issuers and intermediaries to satisfy their delivery requirements as to the final offering circular under an "access equals delivery" model when the final offering circular is filed and available on EDGAR;
  - Require issuers that sell to prospective purchasers in reliance on the delivery of a preliminary offering circular to, not later than two business days after completion of the sale, provide the purchasers with a copy of the final offering circular or a notice that the sale occurred pursuant to a qualified offering statement that includes the URL where the final offering circular or to the offering statement of which such final offering circular is part may be obtained and contact information sufficient to notify a purchaser where a request for a final offering circular can be sent and received in response; and
  - Permit issuers to file offering circular supplements after qualification of the offering statement in certain circumstances in lieu of post-qualification

amendments, including to provide the types of information that may be excluded from a prospectus under Rule 430A.

- Permit continuous or delayed offerings under the proposed rules, but require issuers in continuous or delayed Tier 2 offerings to be current in their annual and semiannual reporting obligations.
- Permit issuers to qualify additional securities in reliance on Regulation A by filing a post-qualification amendment to a qualified offering statement.

Offering statement:

- Require issuers to electronically file offering statements with the Commission.
- Permit the non-public submission of offering statements and amendments for review by Commission staff before filing such documents with the Commission, so long as all such documents are publicly filed not later than 21 calendar days before qualification.
- Eliminate the Model A (Question-and-Answer) disclosure format under Part II (Offering Circular) of Form 1-A.
- Update and clarify the Model B (Narrative) disclosure format under Part II of Form 1-A (renaming it as Offering Circular), while continuing to permit the use of Part I of Form S-1 narrative disclosure as an alternative.
- Allow an offering statement to be qualified only by order of the Commission rather than, in the absence of a delaying notation on the offering statement, without Commission action on the 20th calendar day after filing.
- Require issuers in a Tier 2 offering to include audited financial statements in their

[45] *See* Securities Offering Reform, SEC Rel. No. 33-8591 (July 19, 2005) [70 FR 44722].

offering circulars.

- Requirè all issuers to file balance sheets for the two most recently completed fiscal year ends (or for such shorter time that they have been in existence).
- Permit issuers to provide financial statements in Form 1-A that are dated not more than nine months before the date of non-public submission or filing, and require issuers to include financial statements in Form 1-A that are dated not more than nine months before qualification, with the most recent annual or interim balance sheet not older than nine months. If interim financial statements are required, they must cover a period of at least six months.

Ongoing reporting:

- Require issuers that conduct a Tier 1 offering to electronically file a Form 1-Z exit report with the Commission not later than 30 calendar days after termination or completion of a qualified Regulation A offering to provide information about sales in such offering and to update certain issuer information.
- Require issuers that conduct a Tier 2 offering to electronically file with the Commission annual and semiannual reports, as well as current event updates.
- Require issuers that conduct a Tier 2 offering to, where applicable, provide special financial reports to provide information to investors in between the time the financial statements are included in Form 1-A and the issuer's first periodic report due after qualification of the offering statement.
- Permit the ongoing reports filed by an issuer conducting a Tier 2 offering to be used to satisfy a broker-dealer's obligations under Exchange Act Rule 15c2-11.
- Provide that issuers conducting Tier 2 offerings would exit the Regulation A

ongoing reporting regime when they become subject to the ongoing reporting requirements of Section 13 of the Exchange Act, and may exit the Regulation A reporting regime at any time by filing a Form 1-Z exit report after completing reporting for the fiscal year in which the offering statement was qualified, so long as the securities of each class to which the offering statement relates are held of record by fewer than 300 persons and offers or sales made in reliance on a qualified Regulation A offering statement are not ongoing.

- Require issuers that conduct a Tier 2 offering to include in their first annual report after termination or completion of a qualified Regulation A offering, or in their Form 1-Z exit report, information about sales in the terminated or completed offering and to update certain issuer information.
- Eliminate the requirement that issuers file a Form 2-A with the Commission to report sales and the termination of sales made under Regulation A every six months after qualification and within 30 calendar days after the termination, completion, or final sale of securities in the offering.

"Bad actor" disqualification provisions:

- Substantially conform the "bad actor" disqualification provisions of Rule 262 to new Rule 506(d) and add a new disclosure requirement similar to Rule 506(e).

Application of state securities laws:

- In light of the total package of investor protections proposed to be included in the implementing rules for Regulation A, provide for the preemption of state securities law registration and qualification requirements for securities offered or sold to "qualified purchasers," defined to be all offerees of securities in a

Regulation A offering and all purchasers in a Tier 2 offering.

B. Scope of Exemption

1. Eligible Issuers

Section 401 of the JOBS Act does not include any express issuer eligibility requirements.[46] Currently, Regulation A is limited to companies organized in and with their principal place of business inside the United States or Canada. It is unavailable to:

- companies subject to the ongoing reporting requirements of Section 13 or 15(d) of the Exchange Act ("reporting companies");
- companies registered or required to be registered under the Investment Company Act of 1940 ("investment companies");[47]
- development stage companies that have no specific business plan or purpose or have indicated their business plan is to engage in a merger or acquisition with an unidentified company or companies ("blank check companies");[48] and
- issuers of fractional undivided interests in oil or gas rights, or similar interests in other mineral rights.[49]

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46 Section 3(b)(2)(G)(ii) specifies that if the Commission chooses to enact so-called "bad actor" disqualification provisions, such provisions must be substantially similar to the regulations adopted in accordance with Section 926 of the Dodd-Frank Act. Proposed "bad actor" disqualification provisions are discussed below in Section II.F.

47 15 U.S.C. 80a-1 *et seq.* ("Investment Company Act"). The proposed rules would clarify the current exclusion of business development companies from Regulation A. *See* SEC Rel. No. 33-6924, at fn. 65 (noting that companies registered or required to be registered under the Investment Company Act of 1940, including business development companies, are prohibited from using Regulation A).

48 Rule 251(a)(3); *see also* SEC Rel. No. 33-6949 [57 FR 36442] (July 30, 1992), at fn. 50 (clarifying that blank check companies regardless of whether they are issuing penny stock are precluded from relying on Regulation A).

49 Regulation B formerly provided exemptive relief for such issuers. Regulation B was rendered obsolete in light of other exemptions, such as those afforded issuers under Section 4(a)(2) of the Securities Act and Regulation D, and was rescinded in May 1996. *See* SEC Release No. 33-7300 [61 FR 30398] (May 31, 1996).

Several commenters have suggested that the expanded exemption should continue to be unavailable to blank check companies,[50] two of which also suggested that the exemption should be unavailable to special purpose acquisition companies ("SPACs").[51] Two commenters suggested that business development companies ("BDCs") should be permitted to rely on the exemption,[52] and also suggested that shell companies should no longer be permitted to rely on Regulation A.[53] One commenter expressed concern over allowing BDCs, as well as real estate investment trusts ("REITs"), to rely on the exemption without additional entity-specific disclosure requirements,[54] while another suggested that REITs should be allowed to rely on the exemption without additional

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50 Letter from Catherine T. Dixon, Chair, Federal Regulation of Securities Committee, American Bar Association, Sept. 7, 2013 ("ABA Letter"); Letter from William R. Hambrecht, Chairman and CEO, WR Hambrecht + Co., Jan. 4, 2013 ("WR Hambrecht + Co. Letter"); Letter from A. Heath Abshure, President, North American Securities Administrators Association ("NASAA"), April 10, 2013 ("NASAA Letter 2"); *see also* Letter from Robert R. Kaplan, Jr. and Mark A. Cleaves, Kaplan Voekler Cunningham & Frank PLC ("Kaplan Voekler"), May 14, 2013 (Kaplan Voekler Letter 2").

51 NASAA Letter 2; WR Hambrecht + Co. Letter; *see also* Kaplan Voekler Letter 2 (noting that there are important distinctions between SPACs, blank check companies, and shell companies). A SPAC is a type of blank check company created specifically to pool funds in order to finance a merger or acquisition opportunity within a set timeframe.

52 ABA Letter (suggesting that permitting BDCs to rely on Regulation A would be consistent with the policy goals behind enactment of Section 3(b)(2) of the Securities Act, and Commission staff guidance on the JOBS Act and the treatment of BDCs as emerging growth companies under Title I of the JOBS Act); WR Hambrecht + Co. Letter (suggesting that permitting BDCs to rely on Regulation A would be consistent with the policy goals behind enactment of Section 3(b)(2) of the Securities Act). A BDC is a closed-end company that, among other things, is operated for the purpose of making investments in certain types of securities, and makes available to issuers of such securities significant managerial assistance. *See* Section 2(a)(48) of the Investment Company Act.

53 ABA Letter; WR Hambrecht + Co. Letter. A shell company is a company that has, or at any time previously has had, no or nominal operations, and either no or nominal assets, assets consisting solely of cash or cash equivalents, or assets consisting of any amount of cash and cash equivalents and nominal other assets. 17 CFR 230.405; *see also* 17 CFR 144(i)(1)(i).

54 NASAA Letter 2 (citing the unique "nature and timing of [such companies'] capital formation and investment strategies, fee structures, and liquidity, necessitate disclosure fitting for these specific entities."). We solicit comment on potential BDC- and REIT-specific disclosure in Section II.C.3.b. below.

disclosure obligations.[55] One commenter suggested that the Commission permit reporting companies, and foreign private issuers[56] that expressly consent to Exchange Act Section 10(b) liability, to rely on the exemption.[57] One commenter proposed limiting the availability of the exemption to non-reporting companies, and to operating companies, while continuing to make the exemption unavailable to pooled investment funds.[58]

We propose to add two new categories of ineligible issuers to, but to otherwise maintain, Regulation A's existing issuer eligibility requirements. As proposed, the exemption would continue to be available to companies organized in, and with their principal place of business inside, the United States or Canada. Under the proposal, the exemption would continue to be unavailable to Exchange Act reporting companies, investment companies, blank check companies, certain issuers disqualified from participation in such offerings under the "bad actor" provisions of Rule 262, as proposed

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55 Kaplan Voekler Letter 2. A REIT is a company that owns and generally operates income-producing real estate or real estate-related assets. *See* Sections 856 through 859 of Internal Revenue Code, 26 U.S.C. 856-859; *see also* general discussion of REIT characteristics in SEC Rel. No. IC-29778 (Aug. 31, 2011) [76 FR 55300], at 55302. Among other things, a REIT must have the bulk of its assets and income connected to real estate investment and must distribute at least 90 percent of its taxable income to shareholders annually in the form of dividends.

56 Under Rule 405 (17 CFR § 230.405), a foreign private issuer is any foreign issuer—other than a foreign government—except an issuer meeting the following conditions as of the last business day of its most recently completed second fiscal quarter:

(i) More than 50 percent of the outstanding voting securities of such issuer are directly or indirectly owned of record by residents of the United States; and

(ii) Any of the following:

(A) The majority of the executive officers or directors are United States citizens or residents;

(B) More than 50 percent of the assets of the issuer are located in the United States; or

(C) The business of the issuer is administered principally in the United States.

57 ABA Letter.

58 WR Hambrecht + Co. Letter.

to be amended,[59] and to issuers of fractional undivided interests in oil or gas rights, or similar interests in other mineral rights.[60]

Additionally, we propose to make the exemption unavailable to issuers that have not filed with the Commission the ongoing reports required by the proposed rules during the two years immediately preceding the filing of a new offering statement (or for such shorter period that the issuer was required to file such reports).[61] We recently proposed a similar eligibility requirement for issuers in our proposed rules for securities-based crowdfunding transactions pursuant to Section 4(a)(6) of the Securities Act.[62] We believe that our rules for ongoing reporting in Regulation A, as proposed to be amended, would benefit investors by enabling them to consider updated information about the issuer, make informed investment decisions, facilitate the development of an efficient secondary market in such securities, and would enhance our ability to analyze and monitor the Regulation A market. We therefore believe fulfilling an obligation to file ongoing reports pursuant to proposed Regulation A is an important investor protection that should be a factor in determining issuer eligibility.

We further propose to exclude from the category of eligible issuers under Regulation A issuers that are or have been subject to an order by the Commission denying, suspending, or revoking the registration of a class of securities pursuant to Section 12(j) of the Exchange Act that was entered within five years before the filing of

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59 *See* discussion in Section II.G. below.

60 *See* proposed Rules 251(b) and 262.

61 *See* Section II.E.1. below for a discussion on proposed ongoing reporting requirements applicable to Tier 1 and Tier 2 offerings.

the offering statement. Under Section 12(j) of the Exchange Act, an issuer's securities registered under the Exchange Act may be subject to a denial, suspension, or revocation of registration pursuant to an order by the Commission if, after notice and opportunity for a hearing, the Commission finds that the issuer of such securities has failed to comply with any of the provisions of, or the rules and regulations enacted under, the Exchange Act. We do not believe that issuers that, after notice and opportunity for a hearing, are or have been subject to such orders by the Commission within a five-year period immediately preceding the filing of the offering statement should benefit from the provisions of Regulation A, as proposed to be amended. We would therefore exclude such issuers from the category of eligible issuers.

We solicit comment on the proposed issuer eligibility requirements, the suggestions made in the advance comments to date, and on the issues discussed below.

Request for Comment

1. As proposed, in addition to the two newly proposed issuer eligibility requirements, should we otherwise maintain the existing categories of Regulation A issuer eligibility requirements? Why or why not? If not, which categories of issuer eligibility requirements should we alter, and why? Please explain.
2. As proposed, should we add an additional issuer eligibility requirement to exclude issuers that have not filed with the Commission the ongoing reports required by the proposed rules during the two years immediately preceding

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62 *See* SEC Rel. No. 33-9470 (Oct. 23, 2013), at 36 [78 FR 66427] (proposed rules for Regulation Crowdfunding under Title III of the JOBS Act) *and* proposed Rule 100(b)(5) of Regulation Crowdfunding.

the filing of a new offering statement (or for such shorter period that the issuer was required to file such reports)? If so, should we only require issuers to be current in their Regulation A ongoing reporting at the time of the filing of a new offering statement in order to be eligible? Alternatively, should we consider a time period other than two years? Why or why not?

3. As proposed, should we add an additional issuer eligibility requirement to exclude issuers that are or have been subject to an order by the Commission denying, suspending, or revoking the registration of a class of securities pursuant to Section 12(j) of the Exchange Act that was entered within five years before the filing of the offering statement? Why or why not? If not, please explain. Alternatively, should we alter the proposed five-year period during which an issuer could not have been subject to an order by the Commission pursuant to Section 12(j) to cover a longer or shorter period of time? Why or why not? If so, please explain.

a. U.S. nexus other than organization and domicile

We are seeking comment on whether we should expand availability of the Regulation A exemption to issuers that may not satisfy domicile-based requirements, particularly those that have a substantial United States nexus, such as certain foreign companies with domestic operations, or domestic subsidiaries of foreign multinational companies.[63]

[63] A domestic subsidiary of a foreign multinational company (*i.e.*, one organized in the United States or Canada) would be eligible to rely on Regulation A if its principal place of business were located in the United States or Canada.

As its name suggests, one goal of the JOBS Act was the creation of jobs within the United States.[64] Expansion of issuer eligibility to include foreign issuers with a substantial U.S. nexus may serve to better implement the JOBS Act goal of domestic job creation. According to statistics from the U.S. Department of Commerce's Bureau of Economic Analysis ("BEA"), many American jobs are created not only by U.S. companies, but by the U.S. affiliates of foreign multinational companies.[65] According to the report, total U.S. employment by majority-owned U.S. affiliates of foreign multinational companies rose in 2011 at nearly twice the rate of employment in the U.S. private-industry sector as a whole.[66] As the BEA data suggest, domestic job creation is not necessarily dependent on company domicile or principal place of business.[67]

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64 *See, e.g.*, H.R. Rep. No. 112-206, at 4 (2012) ("Small companies are critical to economic growth in the United States. Amending Regulation A to make it viable for small companies to access capital will permit greater investment in these companies, resulting in economic growth and jobs. By reducing the regulatory burden and expense of raising capital from the investing public, [Title IV of the JOBS Act] will boost the flow of capital to small businesses and fuel America's most vigorous job-creation machine.").

65 *See* Anderson, Thomas, U.S. Dep't of Commerce, Bureau of Econ. Analysis, *Summary Estimates for Multinational Companies: Employment, Sales, and Capital Expenditures for 2011* (Apr. 18, 2013) ("BEA Release 13-16"), at Table 3, *available at:* http://www.bea.gov/newsreleases/international/mnc/2013/_pdf/mnc2011.pdf. The BEA's advance summary estimates for 2011 show total employment of approximately 22.9 million workers by U.S. parents of multinational companies (some of which are themselves foreign-owned), accounting for approximately one-fifth of total U.S. private sector employment, and total employment of approximately 5.6 million workers by majority-owned U.S. affiliates of foreign multinational companies, accounting for approximately five percent of total U.S. private sector employment. *Id.* at 1-2. As some U.S. parents of multinational companies are themselves foreign-owned, there is some overlap between the employment figures of U.S. parents of multinational companies and U.S. affiliates of foreign multinational companies. For more information on multinational companies, *see http://www.bea.gov/iTable/index_MNC.cfm.*

66 *BEA Release 13-16*, at 2.

67 *See id.; see also* Matthew J. Slaughter, *American Companies and Global Supply Networks: Driving U.S. Economic Growth and Jobs by Connecting with the World*, Business Roundtable et al. (January 2013), at 9, *available at:* http://businessroundtable.org/uploads/studies-reports/downloads/BRT-SlaughterPaper-singles-Dec21.pdf (noting that both U.S.-headquartered multinational companies and foreign-headquartered multinational companies that operate in the U.S. create tens of millions of well-paying jobs domestically).

Currently, Regulation A is limited to companies organized, and with their principal place of business, in the United States or Canada.[68] The Commission could make the Regulation A exemption available to all non-U.S. issuers, rather than only Canadian issuers. Additionally, we could subject issuers to conditions intended to ensure that the capital raised in the offering is put to work in the United States. For example, we could add a requirement that a minimum percentage of the offering proceeds be used in the United States, in connection with the issuer's domestic operations.[69] Such a requirement could, however, be difficult to administer because of challenges in delineating domestic versus foreign operations and in tracing use of proceeds.

Alternatively, issuer eligibility under Regulation A could be extended to "domestic issuers," defined as any issuer that is not a foreign government or a "foreign private issuer."[70] Domestic issuers would, in general, have a demonstrated presence in the United States, which could increase the likelihood that proceeds from the offering are used within the United States.[71] We could limit issuer eligibility further by adding a

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68 The Commission originally proposed the elimination of Canadian issuers from the Regulation A exemptive scheme in 1992 on the grounds that such issuers rarely used the exemption. *See* SEC Rel. No. 33-6924, at 19. In response to public comment, however, this proposal was not adopted. SEC Rel. No. 33-6949, at 36443. No Canadian issuers have qualified an offering in reliance on Regulation A since 2002.

69 *Cf.* Rule 147. 17 CFR 230.147. Rule 147 is a safe harbor from registration under Section 3(a)(11) of the Securities Act. Section 3(a)(11) is more commonly known as the intrastate exemption, and requires, among other things, that issuers conducting an intrastate offering use at least 80% of the net proceeds of the offering in connection with their business operations in the relevant state.

70 In Regulation S (17 CFR 230.901 *et seq.*), a "domestic issuer" is defined as any issuer other than a "foreign government" or "foreign private issuer." 17 CFR 230.902(e). A "foreign government" means the government of any foreign country or of any political subdivision of a foreign country. *See* 17 CFR 230.405. *See* fn. 56. above for the definition of a "foreign private issuer."

71 The Commission previously used the term "domestic issuers" in the proposed amendments to Regulation A in 1992 to refer to entities organized and with a principal place of business in the United States. *See* SEC Rel. No. 33-6924, at 19, 156.

condition that most of the offering proceeds be used in connection with the issuer's U.S. domestic operations.

Request for Comment

4. Should issuer eligibility to rely on Regulation A continue to require an issuer to be organized under the laws of the United States or Canada with a principal place of business in the United States or Canada? Or should Regulation A be limited to issuers organized and with a principal place of business in the United States, thereby excluding Canadian issuers? Should Regulation A be made available to "domestic issuers" as described above, or to all issuers, including foreign private issuers? Is there a reason to treat Canadian issuers differently from other foreign issuers? What would the impact be on issuers, investors, and other market participants if the issuer eligibility criteria were broadened? Please explain.

5. If we modify or eliminate current requirements regarding domicile and principal place of business, should we limit availability of the exemption in some other way that reflects a U.S. nexus? If so, how should we define, or in what ways should we limit the availability of the exemption to issuers that demonstrate, a U.S. nexus? Are there criteria we could use that would be easy to administer? If so, what criteria?

6. If we extend issuer eligibility to include foreign private issuers, should we require express consent from such issuers to Exchange Act Section 10(b)

liability?[72] Should we consider requiring additional or alternative conditions for the eligibility of such issuers? Why or why not? Should we make other changes in Regulation A to accommodate such issuers? For example, as proposed with respect to Canadian issuers,[73] should we permit all non-U.S. issuers to prepare their financial statements using International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB), rather than U.S. Generally Accepted Accounting Principles (U.S. GAAP)?

b. Additional and alternative types of issuers

As noted above, we propose not to amend Regulation A's existing prohibitions on use of the exemption by investment companies registered or required to be registered under the Investment Company Act, including BDCs; blank check companies and SPACs; and issuers of fractional undivided interests in oil or gas rights, or similar interests in other mineral rights. As proposed, shell companies that do not meet the definition of "blank check company" would continue to be able to rely on the exemption.[74] We seek comment on whether to permit BDCs, blank check companies and SPACs, and oil, gas and mineral interest rights issuers to rely on Regulation A, as well as on the potential exclusion of shell companies.

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72 In 2010, the U.S. Supreme Court held that Section 10(b) of the Exchange Act, 15 U.S.C. 78j(b), covers only transactions in securities listed on domestic exchanges, and securities purchased or sold domestically. *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869 (2010). *But see*, Section 929P(b) of the Dodd-Frank Act, Pub. L. No. 111-203, § 929P(b).

73 *See* discussion in Section II.C.3.b(2). below.

74 A shell company that is a development stage company with no specific business plan or purpose would not be an eligible issuer under the exclusion for blank check companies.

BDCs. BDCs are a type of closed-end company operated for the purpose of making investments in small, developing, or financially troubled companies. Typically, BDCs are subject to the registration and reporting requirements of the Securities Act and Exchange Act. The Investment Company Act requires BDCs to have at least 70% of their investment portfolio in eligible portfolio companies and certain other assets at the time they make any new investment.[75] Rules 2a-46 and 55a-1 of the Investment Company Act define eligible portfolio companies to include all private companies and companies whose securities are listed on a national securities exchange but have an aggregate market value of less than $250 million, or that met such requirements at the time of the BDC's initial investment in such company.[76] Currently, BDCs are able to rely on Regulation E[77] for offerings of up to $5 million in any twelve-month period. Extension of Regulation A issuer eligibility to BDCs could assist small companies with capital formation by indirectly providing such companies—otherwise qualifying as eligible portfolio companies—with greater access to investment capital. As noted above, however, one commenter expressed concern about the potential extension of Regulation A to BDCs absent disclosure requirements that are more appropriately tailored for these issuers.[78]

Blank Check Companies and SPACs. By its terms, the definition of blank check companies under the federal securities laws can include early stage and startup companies

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75 *See* Section 2(a)(48) of the Investment Company Act.

76 17 CFR 270.2a-46; 17 CFR 270.55a-1.

77 17 CFR 230.601 *et seq.*

78 NASAA Letter 2; *see also* fn. 54 above.

with no specific business plans.[79] Extension of Regulation A issuer eligibility to include companies with characteristics that are similar to blank check companies could therefore be consistent with Title IV's goal of increasing the capital formation options for smaller companies.[80] As noted above, however, some commenters have expressed concern about, and recommended against, permitting blank check companies and SPACs to use Regulation A.[81] As currently proposed, blank check companies and SPACs would not be permitted to rely on the exemption. We seek comment on whether the Commission should revisit this exclusion, and, if so, on what basis.

Shell Companies. A shell company is a company that has, or at any time previously has had, no or nominal operations, and either no or nominal assets, assets consisting solely of cash or cash equivalents, or assets consisting of any amount of cash and cash equivalents and nominal other assets.[82] Shell companies are not expressly excluded from Regulation A, although any shell company that met the definition of a blank check company would be excluded on that basis. As noted above, some commenters have suggested that the Commission consider an express exclusion for shell companies.[83] At their earliest stages of development, however, many small early stage

79 A blank check company is a development stage company that has no specific business plan or purpose or has indicated its business plan is to engage in a merger or acquisition with an unidentified company or companies or other entity. *See* 17 CFR 230.419.

80 *See* fn. 85 below. The Commission recently acknowledged, in proposing rules for securities-based crowdfunding transactions under Section 4(a)(6) of the Securities Act, the challenges associated with distinguishing between early stage companies that can provide information sufficient to support such transactions and those whose business plan is so indeterminate that they may not be able to provide adequate information. *See* SEC Rel. No. 33-9470, at 37.

81 *See* fn. 89 below; *see also* fn. 51 above for the definition of a SPAC.

82 17 CFR 230.405; *see also* 17 CFR 144(i)(1)(i).

83 ABA Letter; WR Hambrecht + Co. Letter (suggesting that shell company access to Regulation A is inconsistent with the JOBS Act because such companies do not promote job creation).

and startup companies have limited operations and few, if any, assets. We anticipate that some Regulation A issuers would be startups where it may be uncertain as to whether they fall within the shell company definition.[84] We believe, however, that Regulation A, as proposed to be amended, is intended to provide smaller companies, including early stage companies, the opportunity to raise capital from the general public in a manner that is consistent with the proposed rules. In our view, excluding such companies from proposed Regulation A would be contrary not only to the provisions of current Regulation A, but also to Title IV of the JOBS Act.[85] We do not therefore propose to exclude shell companies from reliance on Regulation A. For the same reasons we are soliciting comment on potential blank check companies' access to, or exclusion from, the exemptive scheme; however, we also seek comment on whether shell companies should be prohibited from relying on Regulation A.

Operating Companies. We are also seeking comment on whether we should take a different approach with respect to issuer eligibility requirements and, instead of prohibiting blank check company access to the exemption (as is currently proposed and consistent with current Regulation A), to limit availability of the exemption to companies satisfying a new definition of "operating company."[86] The Commission previously

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84 *But see* SEC Rel. No. 33-8869 (December 6, 2007) at fn. 172 ("Rule 144(i)(1)(i) is not intended to capture a 'startup company,' or, in other words, a company with a limited operating history, in the definition of a reporting or non-reporting shell company, as we believe that such a company does not meet the condition of having 'no or nominal operations.'").

85 H.R. Rep. No. 112-206, at 4 (2012) ("Small companies are critical to economic growth in the United States. Amending Regulation A to make it viable for small companies to access capital will permit greater investment in these companies, resulting in economic growth and jobs. By reducing the regulatory burden and expense of raising capital from the investing public, [Title IV of the JOBS Act] will boost the flow of capital to small businesses and fuel America's most vigorous job-creation machine.").

86 An operating company definition would not alter our current proposal to continue to prohibit reporting company and investment company reliance on Regulation A.

proposed to limit Regulation A to operating companies in 1992.[87] Though not adopted at that time, the Commission proposed to make the exemption available only "to raise funds to put into the operations of an actual business and not simply for investment." The proposal would have specifically excluded "those enterprises with the principal business of investing or reinvesting funds in securities, properties, commodities, business opportunities or similar media of speculative opportunity."[88] Along the same lines, we seek comment on whether we should exclude certain non-operating companies from Regulation A. We could, for example, limit availability of the exemption to operating companies, defined to include issuers that have generated total revenue in excess of a certain amount (*e.g.*, $1,000,000) over a certain period of time (*e.g.*, its prior two fiscal years) through the provision of goods or services, or based on similar or different criteria intended to facilitate access to the proposed rules by small companies. Adopting an operating company definition could more effectively eliminate the types of blank check companies, SPACs, and shell companies that are not otherwise the intended beneficiaries of Regulation A from eligibility, an issue we discuss above, request comment on below, and about which several commenters have expressed concern.[89]

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87 *See* SEC Rel. No. 33-6924, at 20-21.

88 *Id.* The adopting release noted that partnerships or certain other entities organized primarily for investment purposes had historically been eligible to use Regulation A, and that after consideration of public comment it was appropriate to continue to make the exemption available to such issuers. See SEC Rel. No. 33-6949, at 36443.

89 ABA Letter ("The purpose and goal of Section 3(b)(2) should . . . be to expand the capital raising opportunities available to operating companies. We are concerned about the possibility of abuse should non-operating companies be able to rely on the exemption. The Commission's proposed rules should . . . provide that Section 3(b)(2) will not be available for use by issuers that are blank check companies or shell companies and should define "eligible issuer" for purposes of Section 3(b)(2) to exclude specifically these types of issuers."); WR Hambrecht + Co. Letter (suggesting limiting Regulation A issuers to operating companies, and prohibiting reliance on the exemption by blank check companies, SPACs, and shell companies); NASAA Letter 2 (indicating that

Issuers of Interests in Mineral Rights. Issuers of fractional undivided interests in oil or gas rights, or similar interests in other mineral rights, have historically been prohibited from relying on Regulation A. Instead, such issuers were permitted to conduct offerings in reliance on Regulation B.[90] Regulation B was rescinded in 1996, however, as it was deemed no longer necessary in light of other exemptions available to these types of issuers, such as Section 4(a)(2) of the Securities Act and Regulation D.[91] In light of the elimination of Regulation B and the current ability of such issuers to conduct offerings under, *e.g.*, Rule 506 of Regulation D, we seek comment on whether such issuers should continue to be ineligible to rely on Regulation A, or should now be permitted to conduct offerings under Regulation A.

Request for Comment

7. Should we amend Regulation A to make BDCs eligible to rely on it? Why or why not? Would it raise particular concerns about investor protection? If so, please explain.

8. Would extension of Regulation A issuer eligibility to BDCs be inconsistent with the exemption's current prohibition on use by reporting companies? If so, should we limit the extension of Regulation A issuer eligibility to only non-Exchange Act reporting BDCs? If not, should we permit BDC ongoing reporting under the Exchange Act to satisfy their reporting obligations under

offerings by blank check companies and SPACs are generally prohibited as fraudulent offerings under state securities laws).

90 Regulation B was an exemption from registration under the Securities Act relating to fractional undivided interests in oil or gas. *See* 17 CFR 230.300 – 230.346 (1995).

91 *See* SEC Release No. 33-7300 (May 31, 1996) [61 FR 30397].

Regulation A?[92] If Regulation A eligibility were extended to BDCs, should other rules be amended to require additional disclosure about such issuers? If so, what specific additional disclosure should we require about BDCs?

9. Should we extend Regulation A issuer eligibility to include blank check companies? Or would such an extension be inconsistent with the intent of Title IV of the JOBS Act, or the Commission's investor protection mandate? Why or why not?

10. If all or some segment of blank check companies are permitted to rely on Regulation A, should we specifically exclude SPACs from being able to rely on the exemption? Why or why not?

11. Should we amend Regulation A to make shell companies ineligible to rely on it? Or would the exclusion of shell companies from Regulation A be too broad, such that many small companies or startups would become ineligible to rely on the exemption?

12. Should we limit access to Regulation A to issuers that qualify as "operating companies"? If so, should we use the operating company definition described above, or some modified version? Please include a discussion of the effects on issuer access to the exemption that would result from using such a definition as a condition to issuer eligibility.

13. Should we reconsider the continued prohibition on use of the Regulation A exemptive scheme by issuers of fractional undivided interest in oil or gas

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[92] *See* Section II.E. below for a discussion of an issuer's ongoing reporting obligations under proposed Regulation A.

rights, or similar interests in other mineral rights? If so, please explain. Are there risks associated with this type of issuer that merit maintaining Regulation A's current prohibition on use by such issuers?

14. Are there other limitations on issuer eligibility that we should consider? Alternatively, are there other types of issuers that could benefit from Regulation A, as proposed to be amended? Please provide data, if available, on the impact of imposing fewer, more, or different limitations on issuer eligibility than we have proposed.

c. Potential limits on issuer size

Regulation A currently limits the size of offerings that can be conducted under the exemption, but not the size of issuers eligible to rely on the exemption. We do not currently propose any issuer size-based limitations and to date we have not received any public comment on this issue. While we appreciate that limitations on offering size may, to some extent, create a practical limitation on the ability of larger issuers to rely on Regulation A, we are soliciting comment on potentially limiting access to Regulation A on the basis of issuer size.

We could, for example, look to the standards for "smaller reporting companies" and limit availability of the exemption to issuers with less than $75 million in public float, or, if unable to calculate the public float, less than $50 million in annual revenue.[93] Alternatively, consistent with a recent recommendation by the Commission's Advisory Committee on Small and Emerging Companies ("Advisory Committee") as to the

[93] *See* 17 CFR 229.10(f).

appropriate size limits for "smaller reporting companies,"[94] we could limit access to Regulation A to companies with a public float of up to $250 million, or, if unable to calculate the public float, less than $100 million in annual revenue.[95] Limiting access to the exemption on the basis of issuer size might more effectively target the segment of the market that Congress sought to assist by enacting Title IV of the JOBS Act. We solicit comment below on whether the reference to "public float" would be an appropriate metric for the non-reporting companies using Regulation A.

Request for Comment

15. Should we limit availability of the Regulation A exemption to smaller issuers? Or does the $50 million annual offering limit effectively limit availability of the exemption to smaller issuers such that the Commission need not consider issuer size-based limitations? Why or why not? Should we use issuer size-based limitations to determine the imposition of certain requirements of proposed Regulation A such as the on-going disclosure requirements?

16. If we include size-based issuer eligibility requirements, is a test based on the smaller reporting company public float and revenue thresholds appropriate for potential Regulation A issuers? Should we look to the higher thresholds recommended by the Advisory Committee, or other size thresholds?

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94 *See* SEC Rel. No. 33-9258 (Sept. 12, 2011) [76 FR 57769] (the Advisory Committee was formed to provide the Commission with advice on its rules, regulations, and policies as they relate to, among other things, capital raising by emerging privately-held small businesses and publicly traded companies with less than $250 million in public float), *available at*: http://www.sec.gov/rules/other/2011/33-9258.pdf.

95 *Recommendations Regarding Disclosure and Other Requirements for Smaller Public Companies*, Securities and Exchange Commission, Advisory Committee on Small and Emerging Companies (February 1, 2013), at 2-3 (the Advisory Committee recommendation was made in the context of potentially revising the definition of a smaller reporting company), *available at:* http://www.sec.gov/info/smallbus/acsec/acsec-recommendation-032113-smaller-public-co-ltr.pdf.

Alternatively, are there better metrics on which to determine issuer size-based eligibility (*e.g.*, an assets test)? Would the concept of public float have any applicability to non-reporting companies, or to repeat Regulation A issuers, which could develop a trading market for their securities?

d. Reporting companies

We do not propose to make Regulation A available to companies that are subject to the reporting requirements of Section 13 of the Exchange Act.[96] Before the amendments to Regulation A adopted in 1992, reporting companies were permitted to conduct offerings in reliance on Regulation A, provided they were current in their public reporting.[97] In 1992, however, the Commission determined that it was no longer necessary to permit reporting companies to rely on the exemption in light of the small business integrated registration and reporting system adopted at that time.[98] Simplified registration and reporting forms under Regulation S-B were presumed to meet the capital raising needs of reporting small business issuers.[99] As a result, reporting companies were excluded from the Regulation A exemptive scheme.[100] While the forms and form of the disclosure rules that apply to smaller issuers has changed since that time, their content is substantially the same as in 1992.[101]

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96 As discussed in Section II.E.3. below, however, we solicit comment on whether we should permit Regulation A issuers to register under the Exchange Act by means of a simplified process under certain circumstances.

97 17 CFR 230.252(f) (1992).

98 SEC Rel. No. 33-6949, at 36443.

99 "Small business issuers" were defined as companies with annual revenues of less than $25 million whose voting stock does not have a public float of $25 million or more. *Id.*, at 36446.

100 SEC Rel. No. 33-6924 (March 20, 1992) [57 FR 9768], at 9771.

101 In 2007, the Commission rescinded Regulation S-B (enacted in tandem with the 1992 amendments to Regulation A, *see* SEC Rel. No. 33-6949), eliminated the SB forms and the definition of "small

The two public comments we have received to date on this issue take opposing positions on whether Regulation A should be available to reporting companies. One commenter suggested that reporting companies should be allowed to rely on the exemption because it would permit issuers to conduct a public offering of unrestricted securities that is less burdensome, quicker and less expensive than a public offering subject to full Securities Act registration (*e.g.*, by permitting issuers to incorporate by reference Exchange Act reports into an abbreviated offering statement).[102] This commenter suggested that reporting company access could be limited on the basis of the issuer's size.[103] The other commenter suggested that reporting companies should not be permitted to rely on Regulation A, but companies should be permitted to become a reporting company by means of a Regulation A offering.[104]

Given the availability of scaled disclosure requirements for Securities Act registration and Exchange Act reporting by smaller reporting companies, we continue to believe that reporting companies would not necessarily benefit from access to Regulation A, as proposed to be amended. We therefore do not propose to permit reporting companies to rely on the proposed rules. We are soliciting comment, however, on whether reporting companies should be permitted to rely on Regulation A.

business issuer," and adopted the current smaller reporting company regime. *See* SEC Rel. No. 33-8876 (Dec. 19, 2007) [73 FR 934].

102 ABA Letter.

103 *Id.* (suggesting reporting company access to the exemptive scheme should be limited to issuers with less than $1 billion in revenue).

104 WR Hambrecht + Co. Letter.

Request for Comment

17. Should we amend issuer eligibility requirements to permit reporting companies to rely on the Regulation A exemption? Why or why not? Would reporting companies find Regulation A a useful means of raising capital? How would such a change affect issuers, investors, financial intermediaries, and other market participants?

18. If reporting companies were permitted to rely on Regulation A, should we impose limitations on their use of the exemption? For example, should reporting companies be eligible to use Regulation A only for a limited period of time, *e.g.*, a three-year period after they begin Exchange Act reporting? Or should we limit reporting company access to the exemptive scheme on the basis of issuer size?

19. If reporting companies are permitted to rely on Regulation A, should the availability of the exemption be conditioned on being current with Exchange Act reporting requirements,[105] which would be consistent with ongoing use of Regulation A?[106] Additionally, if reporting companies are permitted to rely on the exemption, should such companies be permitted to satisfy their disclosure requirements under Regulation A through incorporation by reference to their previous or ongoing reports filed under the Exchange Act? Or, as proposed with respect to issuers of Regulation A securities that register

105 As noted above, before the 1992 amendments to Regulation A, reporting companies were permitted to conduct offerings in reliance on Regulation A, provided they were current in their Exchange Act reporting obligations. *See* former Rule 252(f), 17 CFR 230.252(f) (1991).

106 *See* discussion on proposed issuer eligibility requirements in Section II.B.1. above; *see also* proposed Rule 251(b)(7).

such securities under the Exchange Act, if reporting companies are permitted to rely on Regulation A, should the Regulation A reporting obligation for such issuers be suspended altogether for the duration of any obligation to file ongoing reports under the Exchange Act?[107]

2. Eligible Securities

Section 3(b)(3) of the Securities Act limits the availability of any exemption enacted under Section 3(b)(2) to "equity securities, debt securities, and debt securities convertible or exchangeable into equity interests, including any guarantees of such securities."[108] On the basis of the statutory language, it is unclear which types of securities were meant to be excluded, although there is some evidence that suggests the exemption is meant for ordinary—and not exotic—securities.[109] We solicit comment on the types of securities that should be excluded, if any, consistent with the statutory mandate.

We propose to limit the types of securities eligible for sale under both Tier 1 and Tier 2 of Regulation A to the specifically enumerated list of securities in Section 3(b)(3), with the exception of asset-backed securities. Asset-backed securities are subject to the provisions of Regulation AB, an appropriately-tailored regulatory regime enacted to cover such securities that was not in effect when Regulation A was last updated in

107 *See* discussion in Section II.E. below.

108 15 U.S.C. 77c(b)(3).

109 *Small Company Capital Formation Act of 2011: Markup of H.R. 1070 before the H. Comm. on Fin. Serv. for the 112th Congress*, 157 Cong. Rec. 89, (daily ed. June 21, 2011), *available at*: http://financialservices.house.gov/calendar/eventsingle.aspx?EventID=247453.

1992.[110] We do not believe that Title IV of the JOBS Act was enacted to facilitate the issuance of asset-backed securities, nor do we believe that Regulation A's disclosure requirements are suitable for offerings of such securities. We therefore propose to exclude asset-backed securities from the list of eligible securities under Regulation A.

Request for Comment

20. As proposed, should we exclude asset-backed securities from the list of eligible securities under Regulation A? Why or why not? If asset-backed securities were eligible to be sold under Regulation A, what changes would be required to Form 1-A and the other proposed Regulation A forms to accommodate these issuers?

21. Should any additional types of securities be specifically excluded from offerings conducted in reliance on Regulation A? If so, what types of securities, and why? Should the rules provide more specificity as to the types of securities that are included or excluded from Regulation A offerings? What effects could excluding specified types of securities from Regulation A offerings have on issuers, investors, and other market participants?

3. Offering Limitations and Secondary Sales

Regulation A currently permits offerings of up to \$5 million of securities in any twelve-month period, including up to \$1.5 million of securities offered by selling

110 Regulation AB, 17 CFR 229.1100 *et seq.*, was enacted in 2005. *See* SEC Rel. No. 33-8518 (Dec. 22, 2004). Asset-backed securities are defined in Rule 1101(c)(1) to generally mean a security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial asset, either fixed or revolving, that by their terms convert into cash within a finite time period.

securityholders.[111] Section 3(b)(2)(A) provides that the aggregate offering amount of all securities offered and sold within the prior twelve-months in reliance on Section 3(b)(2) shall not exceed $50 million. As noted above, we propose to amend Regulation A to create two tiers of requirements: Tier 1, for offerings of up to $5 million of securities in a twelve-month period; and Tier 2, for offerings of up to $50 million of securities in a twelve-month period.[112] Proposed Tier 1 would reflect the same offering size limitations that currently apply under Regulation A. Proposed Tier 2 would reflect the Section 3(b)(2) offering size limitation.[113] We believe issuers raising smaller amounts of capital may benefit from a tiered system that affords two options for capital formation based on differing disclosure and other requirements.

We believe sales by selling securityholders to be an important part of the exemptive scheme and therefore propose to preserve in Tier 1 Regulation A's current limitation of no more than $1.5 million of securities offered by selling securityholders, and permit Tier 2 offerings to include up to $15 million of securities offered by selling securityholders. Sales by selling securityholders have been permissible under Regulation A in one form or another since 1940.[114] Initially, sales by an issuer and sales by a "controlling stockholder" were treated as separate categories of exempt transactions; the offering amount of each respective category was not aggregated for purposes of

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111 Rule 251(b), 17 CFR 230.251(b).

112 If the offering included securities that were convertible, exercisable or exchangeable for other securities, the offer and sale of the underlying securities would also be required to be qualified and the aggregate offering price would include the aggregate conversion, exercise, or exchange price of such securities, regardless of when they become convertible, exercisable or exchangeable. This differs from the approach taken in registered offerings that involve similar securities, but we believe would simplify compliance.

113 Offerings of up to $5 million could be conducted under either Tier 1 or Tier 2.

114 SEC Rel. No. 33-2410 (December 3, 1940) [5 FR 4749].

determining the maximum offering amount available under the exemption.[115] Later, Regulation A contained a single offering ceiling for *all* sales of an issuer's securities during a twelve-month period, while each category of seller had a different permissible maximum selling amount.[116] In 1972, the Commission returned to the concept of separate categories of seller transactions, each of which contained an independent offering ceiling.[117] For example, at that time, Rule 254(a) required issuer and affiliate sales in any twelve-month period to be aggregated against the then-current $500,000 offering ceiling with any one affiliate being limited to $100,000 in offers in any twelve-month period.[118] Sales by non-affiliates were excluded from the $500,000 offering ceiling, and any one such seller was permitted to offer up to $100,000, but, in the aggregate with other such non-issuer/affiliate sellers in an amount of no more than $300,000 in any twelve-month period.[119] In 1992, the Commission returned to a single offering ceiling for all sales of an issuer's securities in a twelve-month period, and limited all secondary sales to its current $1.5 million limit (representing 30% of the maximum offering limit permitted in a primary offering), aggregated with issuer sales during the same period for a total of up to $5 million.[120]

115 *Id.*

116 *See, e.g.*, Rule 254(a), 17 CFR 230.254(a) (1956), cited in SEC Rel. No. 33-3663 (July 31, 1956) [21 FR 5739], at 5741. Additionally, at this time, secondary sales by certain newly organized or unproven entities were prohibited. *Id.*, at 5739.

117 *See* SEC Rel. No. 33-5225 (Jan 10, 1972) [37 FR 599].

118 *Id.*

119 *Id.*

120 *See* SEC Rel. No. 33-6949, at 36443; *see also* Rule 251(b).

Two commenters recommended permitting secondary sales by selling securityholders in the expanded exemptive scheme.[121] One such commenter suggested that removing the limitation on the amount of securities available for resale by selling securityholders would decrease the cost of capital for smaller issuers and encourage greater investment in companies by increasing a potential investors liquidity options.[122] The other suggested adopting a limitation similar to the current Regulation A provision in order to encourage investment in companies and improve the liquidity options of investors.[123] Both commenters suggested removing current restrictions on affiliate resales in Rule 251(b),[124] which prohibits such sales when the issuer has not had net income from continuing operations in at least one of its last two fiscal years.

Another commenter, however, urged the Commission to prohibit selling securityholders, such as venture capital and private equity firms, from relying on the expanded exemption.[125] In this commenter's view, superior negotiating power at the time of such parties' initial investment and greater access to information about the issuer should disqualify such parties from the exemption because, while maintaining such advantages, they may seek to offload their investment on the general public (and, sometimes against the wishes of the issuer itself).[126] This commenter further argued that selling securityholder offerings do not provide capital to the issuer or contribute to job

121 ABA Letter; WR Hambrecht + Co. Letter.

122 ABA Letter.

123 WR Hambrecht + Co. Letter.

124 17 CFR 230.251(b).

125 NASAA Letter 2.

126 *Id.*

creation.[127] Alternatively, the commenter suggested that if selling securityholders are permitted to rely on the exemption, the Commission should require approval of a majority of the issuer's independent directors as a pre-condition to any sales.[128]

Selling securityholder access to Regulation A has been a historically important feature of the exemptive scheme. We believe it would continue to be an important part of Regulation A, as proposed to be amended. Allowing selling securityholders access to avenues for liquidity should encourage investment in companies seeking to raise capital.[129] Thus, we believe that allowing selling securityholders to sell securities under Regulation A would facilitate capital formation and be consistent with Title IV of the JOBS Act.

We do not propose to amend Regulation A to eliminate the ability of selling securityholders to conduct secondary offerings.[130] Consistent with the existing provisions of Regulation A, we propose to permit sales by selling securityholders up to 30% of the maximum amount permitted under the applicable offering limitation ($1.5 million in any twelve-month period for Tier 1 and $15 million in any twelve-month period for Tier 2). Sales by selling securityholders under either Tier would be aggregated with sales of Regulation A securities by the issuer and other selling securityholders for purposes of calculating the maximum permissible amount of securities that may be sold during any twelve-month period.

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127 *Id.*

128 *Id.*

129 *See* discussion in Section IV.B.2.c. below.

130 *See* proposed Rule 251(a).

In addition, we propose to eliminate the last sentence of Rule 251(b), which prohibits affiliate resales unless the issuer has had net income from continuing operations in at least one of its last two fiscal years. This provision was originally adopted in Regulation A in 1956 to prohibit secondary sales of securities of certain new companies and companies without net income in at least one of their last two fiscal years[131] in order "to correct . . . the threat of the 'bail-out' by the promoters and insiders of their securities holdings."[132] When the Commission amended Regulation A in 1992, it maintained these restrictions in modified form, by limiting them to affiliate resales where the issuer had no net income from continuing operations in at least one of its last two fiscal years.[133]

While one commenter has expressed concern that affiliates of an issuer could use an informational advantage to sell securities in unsuccessful ventures at the expense of the investing public,[134] we are not persuaded that the absence of net income is necessarily a meaningful indicator of enhanced risk that this could occur. Further, the Commission's current disclosure review and qualification processes and enforcement programs are significantly more sophisticated and robust than they were in the 1950s. In addition, today's proposed rules for Regulation A include revised "bad actor" disqualification provisions and additional issuer eligibility requirements aimed at limiting the market participants that have access to the exemption.[135]

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131 *See* SEC Rel. No. 33-3663, at 5739.

132 SEC Ann. Rep. 29 (1956).

133 *See* SEC Rel. No. 33-6924, at fn. 59; *see also* Rule 251(b).

134 NASAA Letter 2.

135 *See* discussions in Section II.G. (Bad Actor Disqualification) below, and Section II.B.1. (Eligible Issuers) above.

We also do not believe that a focus on issuers that have not had net income from continuing operations in at least one of its last two fiscal years would be appropriately tailored for startup and early stage companies that may devote large portions of their resources to startup expenses and research and development.[136] In this market, net income from continuing operations may not be a material data point in the evaluation of an investment opportunity.[137] In addition, as mentioned above, some commenters have argued that limiting the liquidity options of selling securityholders, including sales by affiliates of the issuer, may discourage investment in the issuer in the first instance and increase the issuer's cost of capital.[138]

On balance, we believe that investor protections provided by Regulation A, as proposed to be amended, support the elimination of the current restriction on affiliate resales, particularly in light of the potential benefits of permitting secondary sales. We therefore do not propose to carry this provision forward in amended Regulation A.

Request for Comment

22. Should we consider different annual offering thresholds for selling securityholder sales than the proposed $1.5 million limitation for Tier 1 offerings and $15 million limitation for Tier 2 offerings? Why or why not? If so, should sales in reliance on Regulation A by selling securityholders be permitted up to the annual offering ceiling for each respective Tier, or limited at a different threshold? Should we limit sales by selling securityholders to a percentage of the total amount offered in conjunction with a primary offering

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136 *See* ABA Letter; WR Hambrecht + Co. Letter.

137 *See* ECTF Report.

of Regulation A securities over a given period of time, or to Regulation A offerings where primary securities are offered? Alternatively, should we prohibit all sales by selling securityholders in Regulation A? Why or why not?

23. Should the rules treat sales by non-affiliate selling securityholders as a separate category of exempt transaction, as was once the case under Regulation A, and not aggregate such sales with issuer sales for purposes of determining the maximum offering amount available under the exemption? If so, should non-affiliate resales be permitted up to the applicable annual offering ceiling, or limited at a different threshold?

24. If selling securityholders are permitted to rely on Regulation A, should we impose eligibility requirements or other limitations on those securityholders? For example, should we require selling securityholders to have owned the securities offered for resale under Regulation A for a specified period of time before resale? If so, why and what should the relevant holding period be (*e.g.* six months or twelve months before initial submission or filing of the offering statement)? If the rules impose a holding period before securities can be offered for resale under Regulation A, should the holding period only apply to affiliates? Or to all selling securityholders?

25. Does the existing Rule 251(b) requirement that an issuer have net income from continuing operations in each of its last two fiscal years, in order for an affiliate to be able to conduct a secondary sale in reliance on Regulation A,

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[138] *See* ABA Letter; WR Hambrecht + Co. Letter.

have continuing validity, and should we therefore retain this provision? Why or why not? Please explain.

4. Investment Limitation

Regulation A does not currently limit the amount of securities an investor can purchase in a qualified Regulation A offering. We recognize, however, that with the increased annual offering limitation provided in Section 3(b)(2) comes a risk of commensurately increased investor losses. To address that risk, Title IV of the JOBS Act mandates certain investor protections[139] and suggests that the Commission consider others as part of its Section 3(b)(2) rulemaking.[140] Additionally, we believe that Congress recognized in Section 3(b)(2) that certain other investor protections—not directly contemplated by Title IV of the JOBS Act—may be necessary in the revised regulation. To that end, Section 3(b)(2)(G) indicates that the Commission may include in the expanded exemption "such other terms, conditions, or requirements . . . necessary in the public interest and for the protection of investors . . . ."

Consistent with Section 3(b)(2)(G) and the Commission's investor protection mandate, in addition to the disclosure, reporting and other requirements of Regulation A, we propose to limit the amount of securities investors can purchase in a Tier 2 offering to no more than 10% of the greater of their annual income and their net worth.[141] For this

139 *See* Section 3(b)(2)(D) (expressly providing for Section 12(a)(2) liability for any person offering or selling Section 3(b)(2) securities); Section 3(b)(2)(F) (requiring issuers to file audited financial statements with the Commission annually).

140 *See* Section 3(b)(2)(G) (inviting the Commission to consider, among other things, requiring audited financial statements in the offering statement and implementing bad actor disqualification provisions); Section 3(b)(4) (inviting the Commission to consider implementing ongoing reporting requirements).

141 If securities that are convertible, exercisable or exchangeable for other securities are being purchased by an investor, the proposed investment limitation would include the aggregate

purpose, annual income and net worth would be calculated for individual purchasers as provided in the accredited investor definition under Rule 501 of Regulation D.[142]

We believe that this proposed new requirement could usefully augment the other requirements for Tier 2 offerings. Limiting the amount of securities that a potential investor could invest in a Tier 2 offering to 10% of the greater of the investor's annual income and net worth would help to mitigate any concern that an investor may not be able to absorb the potential loss of the investment.[143] The additional investor protection afforded by such a loss limitation is similar to the provisions for our recently proposed rules for securities-based crowdfunding transactions under Section 4(a)(6) of the Securities Act.[144] We believe that an investment limitation for Tier 2 offerings, coupled with the additional investor protection requirements discussed above and more fully below, could protect investors in Tier 2 offerings in a similar way as the proposed rules for securities-based crowdfunding transactions.

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conversion, exercise, or exchange price of such securities, in addition to the purchase price. This treatment corresponds to the treatment of such securities for purposes of calculating the offering cap.

142 17 CFR 230.501.

143 An underwriter in a firm commitment underwritten Regulation A offering, or participating broker-dealer that is involved in stabilization activities with respect to an offering of Regulation A securities would not be considered an investor that is subject to the proposed investment limitations

144 *See* Section 4(a)(6)(ii) of the Securities Act, 15 U.S.C. 77d(a)(6)(ii), and SEC Rel. No. 33-9470. In Section 4(a)(6), Congress outlined a new exemption for securities-based crowdfunding transactions intended to take advantage of the internet and social media to facilitate capital-raising by the general public, or crowd. In that provision, Congress established limitations on the amount of securities an investor could acquire through this type of offering, as well as a variety of other investor protections, including disclosure requirements and the use of regulated intermediaries. *See, generally,* the requirements for issuers and intermediaries set forth in Title III of the JOBS Act, Pub. L. No. 112-106, 126 Stat. 306, §§ 301-305.

Under the proposal, issuers would be required to make investors aware of the investment limitations,[145] but would otherwise be able to rely on an investor's representation of compliance with the proposed investment limitation unless the issuer knew, at the time of sale, that any such representation was untrue. We are mindful of the privacy issues and practical difficulties associated with verifying individual income and net worth, and do not therefore propose to require investors to disclose personal information to issuers in order to verify compliance with the investment limitation.[146] We are, however, soliciting comment below on whether verification of the income and net worth limit should be required.

Request for Comment

26. As proposed, should we impose investment limitations on investors in Tier 2 offerings? Or does Regulation A, as proposed to be amended, have sufficient investor protections for Tier 2 offerings, such that an investment limitation for investors is not necessary? Why or why not?

27. Are the proposed investment limitations appropriate in the context of a Tier 2 offering? Why or why not? What impact would the proposed investment limitation restriction have on issuers and investors? Should the proposed limitations on investment not apply to accredited investors? Are there other investment limitation criteria we should consider? For example, should we

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145 *See* cover page of the offering circular of proposed Form 1-A.

146 Investors may, for example, be reluctant to provide issuers with their Internal Revenue Service (IRS) Form W-2 (Wage and Tax Statement) in order to verify compliance with the proposed annual income investment limitation or to disclose documents, such as bank or investment account statements, that would verify net worth. Relatedly, issuers may have difficulty ascertaining the veracity or comprehensiveness of any documentation provided to them by investors. *Cf.* SEC Rel.

impose a limitation based on a percentage of total investment assets in addition to, or instead of, annual income or net worth?

28. Alternatively, should the investment limitation be higher or lower than the 10% proposed? If so, what percentage and why would that percentage be appropriate? Would the proposed investment limitation be appropriate for investors that are entities rather than natural persons? Should we establish a minimum annual investment amount, similar to $2,000 annual investment that would be permitted under our proposed crowdfunding rules, that all investors could make in Regulation A offerings irrespective of their income and net worth? Why or why not?

29. Should the proposed investment limitation apply on a per offering basis, as proposed? Or should the limitation apply on an aggregated basis, across all investments in Regulation A securities? Why or why not? If the limitation were to apply on an aggregated basis, how should the limitation apply? Should we limit the provision so that only Regulation A offerings close in time (for example, within a twelve-month period), or otherwise related, would be aggregated in the 10% calculation?

30. Should we permit issuers, as proposed, to rely on an investor's representation of compliance with the 10% investment limitation, unless the issuer has knowledge that any such representation was untrue? Why or why not? If not, what level of inquiry or verification should issuers have to perform in order to

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No. 33-9415 (July 10, 2013) [78 FR 4471], at II.B (discussing verification of accredited investor status for private offerings under Rule 506(c) of Regulation D).

ensure compliance with the requirement? Should the issuer and its intermediaries be required to have a reasonable belief that the investor certification can be relied upon (*e.g.*, should they be required to conduct further investigation if they have reason to believe that the certification is untrue)? Why or why not? If we permit issuers to rely on an investor's representation regarding compliance with the 10% investment limitation, as proposed, should we require the representation to be made in a particular form, such as an investor questionnaire? Should we require the issuer to provide disclosure or educational materials in connection with the representation?

5. Integration

Existing Rule 251(c) of Regulation A governs the integration of Regulation A offerings with other offerings.[147] This provision provides that offerings under Regulation A are not to be integrated with any of the following:

- prior offers or sales of securities; or
- subsequent offers and sales of securities that are:
  - registered under the Securities Act, except as provided in Rule 254(d);[148]

[147] 17 CFR 230.251(c). The integration doctrine seeks to prevent an issuer from improperly avoiding registration by artificially dividing a single offering into multiple offerings such that Securities Act exemptions would apply to multiple offerings that would not be available for the combined offering.

[148] Rule 254(d) provides a safe harbor for an issuer that has a bona fide change of intention and decides to register an offering under the Securities Act after soliciting interest in a Regulation A offering, but without having filed the related offering statement. To take advantage of the safe harbor, such issuers must wait at least 30 calendar days from the date of the last solicitation of interest before filing a registration statement for the offering with the Commission. 17 CFR 230.254(d). Under existing Regulation A, issuers are not allowed to solicit interest in an offering after filing the offering statement with the Commission. *See* discussion in Section II.D. below.

- made in reliance on Rule 701 under the Securities Act;
- made pursuant to an employee benefit plan;
- made in reliance on Regulation S; or
- made more than six months after completion of the Regulation A offering.

We believe Regulation A's existing integration safe harbors provide issuers, particularly smaller issuers whose capital needs often change, with valuable certainty as to the contours of a given offering and its eligibility for an exemption from Securities Act registration. To date, the public comment we received on integration suggested we maintain Regulation A's existing integration provisions.[149] We propose, subject to certain exceptions discussed below, to generally preserve the existing Regulation A integration safe harbors.[150] We also propose to provide additional guidance on the potential integration of offerings conducted concurrently with, or close in time after, a Regulation A offering.

The safe harbor from integration provided by existing Rule 251(c) expressly provides that any offer or sale made in reliance on Regulation A will not be subject to integration with any other offer or sale made either before the commencement of, or more than six months after, the completion of the Regulation A offering.[151] In other words, for transactions that fall within the provisions of existing Rule 251(c), issuers do not have to conduct an independent integration analysis under the provisions of, for example, another rule-based exemption in order to determine whether, under the terms of that rule, the two

149 ABA Letter.

150 Existing Rule 254(d) of Regulation A would become proposed Rule 255(e).

offerings would be treated as one for purposes of qualifying for an exemption. This bright-line rule assists issuers in analyzing certain transactions, but does not address the issue of potential offers or sales that occur concurrently with, or close in time after, a Regulation A offering.

Currently, the note to Rule 251(c) indicates that, if the provisions of the safe harbor are unavailable, offers and sales may still not be integrated with the Regulation A offering depending on the particular facts and circumstances, so there is no presumption that offerings outside the integration safe harbors should be integrated.[152] Additionally, we believe that an offering made in reliance on Regulation A should not be integrated with another exempt offering made by the issuer, provided that each offering complies with the requirements of the exemption that is being relied upon for the particular offering.[153] For example, an issuer conducting a concurrent exempt offering for which general solicitation is not permitted would need to be satisfied that purchasers in that offering were not solicited by means of the offering made in reliance on Regulation A, including without limitation any "testing the waters" communications.[154] Alternatively, an issuer conducting a concurrent exempt offering for which general solicitation is

151 *Contra* Rule 502(a) of Regulation D, 17 CFR 230.502(a), which states that offers and sales made more than six months before the start, or after the completion, of a Regulation D offering will not be considered part of that Regulation D offering.

152 The note cites to the guidance provided in SEC Rel. No. 33-4552 (Nov. 6, 1962) [27 FR 11316], which states the Commission's traditional five-factor test for integration.

153 We recently proposed a similar approach to integration in the context of offerings under the proposed provisions for securities-based crowdfunding transactions pursuant to Title III of the JOBS Act. *See* SEC Rel. No. 33-9470, text accompanying fn. 33-34.

154 For a concurrent offering under Rule 506(b), an issuer would have to conclude that purchasers in the Rule 506(b) offering were not solicited by means of a Regulation A general solicitation. For example, the issuer may have had a preexisting substantive relationship with such purchasers. Otherwise, the solicitation conducted in connection with the Regulation A offering may preclude reliance on Rule 506(b). *See also* SEC Rel. No. 33-8828 (Aug. 3, 2007) [72 FR 45116].

permitted could not include in any such general solicitation an advertisement of the terms of an offering made in reliance on Regulation A that would not be permitted under Regulation A. An issuer conducting, for example, a concurrent Rule 506(c) offering could not include in its Rule 506(c) general solicitation materials an advertisement of a concurrent Regulation A offering, unless that advertisement also included the necessary legends for, and otherwise complied with, Regulation A.[155]

In addition to this approach to integration, we propose to add to the list of safe harbor provisions subsequent offers or sales of securities made pursuant to the proposed rules for securities-based crowdfunding transactions under Title III of the JOBS Act. Given the unique capital formation method available to issuers and investors in the proposed rules for securities-based crowdfunding transactions and the small dollar amounts involved, we do not propose to integrate offers or sales of such securities that occur subsequent to the commencement of any offers or sales of securities made in reliance on Regulation A.[156]

We further propose to amend Rule 254(d) to provide that where an issuer decides to register an offering after soliciting interest in a contemplated, but abandoned, Regulation A offering, any offers made pursuant to Regulation A would not be subject to integration with the registered offering, unless the issuer engaged in solicitations of interest in reliance on Regulation A to persons other than qualified institutional buyers

155 *See* discussion in Section II.D. below.

156 *See* SEC Rel. No. 33-9470. An issuer contemplating a securities-based crowdfunding transaction pursuant to Section 4(a)(6) subsequent to any offers or sales conducted in reliance on Regulation A, as proposed to be amended, should look to the proposed rules for securities-based crowdfunding transactions to ensure compliance with the advertising provisions of that proposed exemption.

("QIBs") and institutional accredited investors permitted by Section 5(d)[157] of the Securities Act.[158] An issuer (and any underwriter, broker, dealer, or agent used by the issuer in connection with the proposed offering) soliciting interest in a Regulation A offering to persons other than QIBs and institutional accredited investors must wait at least 30 calendar days between the last such solicitation of interest in the Regulation A offering and the filing of the registration statement with the Commission.[159] We believe these updated provisions are necessary, given the broad permissible target audience of Regulation A solicitations, the proposed expanded use of solicitation materials in Regulation A discussed more fully in Section II.D. below, and the addition of similar provisions for registered offerings under Section 5(d).

Request for Comment

31. As proposed, should we adopt an integration safe harbor in Regulation A that largely follows the existing provisions of Rule 251(c), while adding the exemption provided by the proposed JOBS Act crowdfunding rules into the list of safe harbors for subsequent offers or sales? Why or why not? Should we alter or add additional provisions to the list of safe harbors for subsequent offers or sales? If so, please provide supporting analysis for your suggestions. For example, should we reduce the six-month period in Rule 251(c)(2)(v)?

32. Should we amend the provisions of Rule 254(d), as proposed,[160] to take into account the expanded use of solicitation materials in Regulation A, the ability

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157 15 U.S.C. 77e(d).

158 *See* proposed Rule 255(e).

159 *Id.*

160 *See* proposed Rule 255(e).

of emerging growth companies to solicit interest from certain types of investors under Title I of the JOBS Act, and the potential effect that an abandoned Regulation A offering, in which an issuer solicited interest from potential investors, may have on that issuer's ability to immediately thereafter register the offering under the Securities Act? Why or why not? Are there any alternative approaches for the interaction of these two provisions in the context of an abandoned Regulation A offering followed immediately thereafter by a registered offering? If so, please explain.

6. Treatment under Section 12(g)

Exchange Act Section 12(g) requires, among other things, that an issuer with total assets exceeding $10,000,000 and a class of equity securities held of record by either 2,000 persons, or 500 persons who are not accredited investors, register such class of securities with the Commission.[161] Unlike Title III of the JOBS Act, which includes a provision regarding the treatment under Section 12(g) of securities issued in securities-based crowdfunding transactions pursuant to Section 4(a)(6) of the Securities Act, Title IV does not include a provision regarding how Regulation A issuers should be treated under Section 12(g).

Section 12(g) was originally enacted by Congress as a way to ensure that investors in over-the-counter securities about which there was little or no information, but which had a significant shareholder base, were provided with ongoing information about

161 15 U.S.C. 78*l*(g).

their investment.[162] As discussed more fully below, Regulation A, as proposed to be amended, would require issuers that conducted Tier 2 offerings to provide ongoing information to their investors, albeit somewhat less than is required of an Exchange Act reporting company. If securities issued under Regulation A were to be excluded for purposes of determining record holders under Section 12(g), a company may never become subject to mandatory Exchange Act reporting as a result of selling securities under Regulation A, regardless of how many shareholders it has or whether such shareholders were accredited investors. Alternatively, if Regulation A issuers that conducted Tier 2 offerings were current in their ongoing reporting were exempt from registration under Section 12(g), or their obligations to register were suspended, issuers would have the ability to remain in the Regulation A reporting regime on a long-term basis, irrespective of growth in their shareholder base.

One commenter suggested we provide a conditional exemption from mandatory Exchange Act reporting under Section 12(g) for emerging growth companies that have conducted a Regulation A offering and comply with its ongoing reporting requirements; otherwise, emerging growth companies that may cross the Section 12(g) asset and record holder thresholds following a Regulation A offering would be disincentivized from relying on the exemption.[163] In the commenter's view, the exemption from Section 12(g)

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[162] *See, generally, Report of the Special Study of Securities Markets of the Securities and Exchange Commission*, House Document No. 95, House Committee on Interstate and Foreign Commerce, 88th Cong., 1st Sess. (1963), at 60-62.

[163] Letter from Michael L. Zuppone, Paul Hastings LLP, Nov. 26, 2013 ("Paul Hastings Letter").

could be temporary and lapse once the issuer obtains a non-affiliate market capitalization of $250 million.[164]

We believe, however, that the Section 12(g) record holder threshold continues to provide an important baseline, above which issuers should be subject to the more expansive disclosure and compliance obligations of the Exchange Act. We are not proposing to exempt Regulation A securities from the requirements of Section 12(g) or to provide that issuers that are current in their Regulation A ongoing reporting under Tier 2 would be exempt from Section 12(g) or have their obligations to register under Section 12(g) suspended. We do, however, solicit comment as to whether a Section 12(g) exemption or suspension should be provided.

Request for Comment

33. Should Regulation A securities be exempt from Section 12(g), either conditionally or otherwise? Would an exemption from Section 12(g) encourage Regulation A issuers to continue ongoing reporting under the proposed rules for Tier 2 offerings, where such issuers might otherwise cease reporting?[165]

34. Does Section 12(g) continue to serve as a valuable proxy for market interest in the equity securities of an issuer issued pursuant to Regulation A, such that an issuer that crosses its asset and record holder thresholds should become subject to mandatory Exchange Act reporting? Why or why not?

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164 The commenter suggested $250 million of non-affiliate market capitalization to accord with the threshold the Commission set for defining the mandate of its Advisory Committee on Small and Emerging Companies. *See* fn. 94 above.

165 *See* discussion in Section IV.B.2.f. below.

7. Liability under Section 12(a)(2)

The liability provisions of Section 12(a)(2) of the Securities Act apply to any public offering of securities by use of an oral communication or prospectus that includes a material misleading statement or material misstatement of fact.[166] Section 3(b)(2)(D) of the Securities Act provides that "[t]he civil liability provision in section 12(a)(2) [of the Securities Act] shall apply to any person offering or selling [Regulation A] securities." Therefore, consistent with current Regulation A,[167] sellers of Regulation A securities would have liability under Section 12(a)(2) to investors for any offer or sale by means of an offering circular or an oral communication that includes a material misleading statement or material misstatement of fact.[168]

C. Offering Statement

Section 3(b)(2)(G)(i) gives the Commission discretion to require an offering statement in such form and with such content as it determines necessary in the public interest and for the protection of investors. The provision permits electronic filing of offering statements, and provides a non-exhaustive list of potential content that may be required in the offering statement, including audited financial statements, a description of the issuer's business operations, financial condition, corporate governance principles, use of investor funds, and other appropriate matters.

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166 15 U.S.C. 77*l*(a)(2).

167 *See* SEC Rel. No. 33-6924, at fn. 57.

168 Regulation A prohibits sales until the Form 1-A has been qualified. *See* Rule 251(d)(2), 17 CFR 230.251(d)(2); *cf.* Securities Offering Reform, SEC Rel. No. 33-8591, at 173 *et seq.* (discussing Section 12(a)(2) liability in the context of information conveyed at the time of sale).

1. Electronic Filing; Delivery Requirements

Currently, Regulation A offering statements are filed with the Commission in paper form.[169] The paper filing process does not align with the Commission's electronic filing requirements for issuers in registered offerings[170] or notices in connection with offerings under Regulation D.[171] The Commission has required electronic filing of registration statements since 1996,[172] and of Form D filings since 2009.[173] Requiring offering statements to be filed electronically rather than on paper may reduce potential logistical problems and delays that can occur with the receipt, processing and dissemination of paper filings by the Commission for issuers seeking to raise capital under Regulation A. Electronic filing would facilitate a more efficient review process for such filings by Commission staff by allowing the offering and related materials, once submitted or filed, to be rapidly processed and disseminated internally. In addition, paper submissions—while publicly available in a technical sense—are not widely or immediately accessible. Electronic filing of offering statements could facilitate investor and market access to the information contained in offering statements in a more efficient way than paper filings do.

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169 17 CFR 232.101(c)(6). There are no filing fees associated with filing a Form 1-A with the Commission. *See* Section 6(b) of the Securities Act, 15 U.S.C. 77f(b) (permitting the recovery of costs of services to the government only with respect to registered offerings).

170 Offerings registered under the Securities Act are required to be filed electronically on the Commission's Electronic Data Gathering, Analysis, and Retrieval System (EDGAR) system. *See* Rule 101(a)(1)(i) of Regulation S-T (17 CFR 232.101(a)(1)(i)).

171 Issuers relying on Regulation D are required to electronically file a notice of sales on Form D with the Commission. *See* Rule 101(a)(1)(xiii) of Regulation S-T (17 CFR 232.101(a)(1)(xiii)); *see also* Rule 503 of Regulation D (17 CFR 230.503). Form D is also required for offerings under Section 4(a)(5) of the Securities Act.

172 *See* SEC Rel. No. 33-6977 (Feb. 23, 1993) [58 FR 14628]. Foreign private issuers have been required to file their registration statements electronically since 2002. SEC Rel. No. 33-8099 (May 16, 2002).

In Section 3(b)(2)(G)(i), Congress gave the Commission discretion to require issuers to file their offering statements electronically. Commenters are generally supportive of electronic filing.[174] Consistent with these comments and the language of Section 3(b)(2)(G)(i), we propose to require Regulation A offering statements to be filed with the Commission electronically on the EDGAR system.[175]

As proposed, amended Form 1-A would consist of three parts:

- an eXtensible Markup Language (XML) based fillable form, which would capture key information about the issuer and its offering using an easy to fill out online form, similar to Form D,[176] with drop-down menus, indicator boxes or buttons, and text boxes, while also assisting issuers in determining their ability to rely on the exemption. The XML-based fillable form would enable the convenient provision of information to the Commission, and support the assembly and transmission of such information to EDGAR, without requiring the issuer to purchase or maintain additional software or technology;[177]
- a text file attachment containing the body of the disclosure document and financial statements, formatted in HyperText Markup Language (HTML) or

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173 *See* SEC Rel. No. 33-8891 (Feb. 6, 2008) [73 FR 10592].

174 ABA Letter; WR Hambrecht + Co.; Kaplan Voekler Letter 2; *see also* Letter from George W. Beard, Managing Member, Beacon Investment Partners LLC (DE), Oct. 5, 2012 ("Beacon Investment Letter"). *See also* Final Report of the 30th Annual SEC Government-Business Forum on Small Business Capital Formation, Recommendation 16, at 31 (Nov. 17, 2011) (*available at*: http://www.sec.gov/info/smallbus/gbfor30.pdf).

175 In conjunction with this proposed change, the portion of Item 101(c)(6) of Regulation S-T (17 CFR 232.101(c)(6)) dealing with filings related to Regulation A offerings would be rescinded.

176 17 CFR 239.500.

177 Part I (Notification) of Form 1-A. As discussed more fully in Section II.C.3.a. below, the cover page and Part I of current Form 1-A would be converted into, and form the basis of, the XML-based fillable form.

American Standard Code for Information Interchange (ASCII) to be compatible with the EDGAR filing system;[178] and

- text file attachments, containing the exhibits index and the exhibits to the offering statement, formatted in HTML or ASCII to be compatible with the EDGAR filing system.[179]

We further propose to require all other documents required to be submitted or filed with the Commission in conjunction with a Regulation A offering, such as ongoing reports, to be submitted or filed electronically on EDGAR.[180]

We believe this proposed approach to electronic filing would be both practical and useful for issuers of Regulation A securities, investors in such securities, other market participants, and the Commission staff who work with issuers throughout the qualification process. Issuers would maintain better control over their filing process, reduce the printing costs associated with filing seven copies of the offering statement and any amendments with the Commission, obtain immediate confirmation of acceptance of an offering statement, and ultimately save time in the qualification process. Investors would gain real-time access to the information contained in Regulation A filings.[181] The efficiency of the Regulation A market should improve with the increased accessibility of information about Regulation A issuers and offerings. Additionally, as with registered offerings, EDGAR would allow the Commission to store, process, and disseminate filings

178 Part II (Offering Circular) of Form 1-A. *See* discussion in Section II.C.3.b. below.

179 Part III (Exhibits) of Form 1-A. *See* discussion in Section II.C.3.c. below.

180 *See* discussion regarding proposed ongoing reporting requirements at Section II.E. below. Consistent with current Regulation A, there would be no filing fees associated with Regulation A, as proposed to be amended.

in a more efficient manner, which may, in turn, improve the efficiency of the staff review and qualification processes.

As proposed, electronic filing would also facilitate the capture of important financial and other information about Regulation A issuers and offerings that would enable the Commission and market participants to monitor and analyze any market that develops in Regulation A securities, including, for example, issuer size, issuer location, key financial metrics, summary information about securities offered and offering amounts, the jurisdictions in which offerings take place, and expenses associated with the offering.[182]

We appreciate, however, that requiring EDGAR filing would impose costs on issuers that currently are not required to enter the EDGAR filing system or format their disclosure documents in ways that the EDGAR system can accept. For that reason, we are soliciting comment on whether electronic filing should be mandated for Regulation A offerings.

If electronic filing on EDGAR is required, one commenter suggested that the Commission propose for Regulation A offering circulars an analog to the "access equals delivery" model for prospectuses under Securities Act Rule 172.[183] Currently, Regulation A prohibits sales pursuant to a qualified offering statement unless a preliminary offering circular or final offering circular is furnished to an investor at least 48 hours before the mailing of the confirmation of sale, and the final offering circular is

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181 Investors would not, however, have immediate access to non-public submissions of draft offering statements. *See* discussion in Section II.C.2. below.

182 The specific disclosure requirements included in the XML-based fillable form are discussed more fully in Section II.C.3.a. below.

delivered to the investor with the confirmation of sales (unless delivered at any earlier time).[184] By comparison, under Rule 172, a final prospectus in a registered offering is deemed to precede or accompany a security for sale for purposes of Section 5(b)(2) of the Securities Act as long as the final prospectus meeting the requirements of Section 10(a) of the Securities Act is filed with the Commission on EDGAR.[185] Additionally, Rule 172(a), which provides an exemption from Section 5(b)(1) of the Securities Act, permits issuers to send written confirmations and notices of allocations after effectiveness of a registration statement without being accompanied or preceded by a final prospectus, so long as the registration statement is effective and the final prospectus is filed with the Commission.[186]

We are proposing an access equals delivery model for Regulation A final offering circulars. The expanded use of the Internet and continuing technological developments suggest that we should consider alternative methods of final offering circular delivery for Regulation A, particularly given that the regulation has not been substantively updated since 1992. Where, upon qualification of an offering statement, sales of Regulation A securities occur on the basis of offers made using a preliminary offering circular, issuers and intermediaries could presume that investors have access to the Internet, and would be

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183 Kaplan Voekler Letter 2.

184 Rule 251(d)(2).

185 17 CFR 230.172(b); *see also* Securities Offering Reform, SEC Rel. No. 33-8591, at 245 (discussing Rule 172). This provision also applies where the issuer will make a good faith and reasonable effort to file the final prospectus with the Commission as part of the registration statement within the required Rule 424 time period. 17 CFR 230.172(c)(3). Currently, there is no analog in Regulation A to filings permitted in the registered context under Rule 424, although one commenter has suggested we consider one. *See* Kaplan Voekler Letter 2; *see also* discussion in Section II.C.3. below and text accompanying fn. 235.

186 17 CFR 230.172(a); *see also* Securities Offering Reform, SEC Rel. No. 33-8591, at 251 (discussing Rule 172(a)).

permitted to satisfy their delivery requirements for the final offering circular if it is filed and available on EDGAR.[187] We further propose to require issuers to include a notice in any preliminary offering circular they use that would inform potential investors that the issuer may satisfy its delivery obligations for the final offering circular electronically. As with registered offerings, we propose to permit dealers, during the aftermarket delivery period, to be deemed to satisfy their final offering circular delivery requirements if it is filed and available on EDGAR.[188]

Further, consistent with prior Commission releases on the use of electronic media for delivery purposes, "electronic-only" offerings of Regulation A securities would not be prohibited under the proposed rules for Regulation A.[189] In such offerings, however, an issuer and its participating intermediaries would have to obtain the consent of investors to the electronic delivery of:

- the preliminary offering circular and other information, but not the final offering circular, in instances where, upon qualification, the issuer plans to sell Regulation A securities based on offers made using a preliminary offering circular; and
- all documents and information, including the final offering circular, when the issuer sells Regulation A securities based on offers conducted during the post-qualification period using a final offering circular.

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187 *Cf.* Securities Offering Reform, SEC Rel. No. 33-8591, at 244.

188 *See* proposed Rule 251(d)(2)(ii) for the dealer aftermarket delivery requirements.

189 An electronic-only offering is an offering in which investors are permitted to participate only if they agree to accept the electronic delivery of all documents and other information in connection with the offering. *See* SEC Rel. No. 34-37182 (May 9, 1996) [61 FR 24644] (Use of Electronic Media by Broker-Dealers, Transfer Agents and Investment Advisers for Delivery of Information) and SEC Rel. No. 34-42728 (Apr. 28, 2000) [65 FR 25843] (Use of Electronic Media).

We further propose to maintain the existing requirements of Rule 251(d)(2)(ii), which requires dealers to deliver a copy of the current offering circular to purchasers for sales that take place within 90 calendar days after qualification,[190] but to otherwise update and amend Rule 251(d)(2)(i), which currently requires that a preliminary or final offering circular be furnished to prospective purchasers at least 48 hours before the mailing of the confirmation of sale. When originally adopted in 1973, Regulation A's offering circular delivery requirements aligned with the prospectus delivery requirements for registered offerings.[191] In the intervening time, prospectus delivery requirements have changed,[192] with no corresponding updates to Regulation A. Notably, the Commission formalized its 48-hour preliminary prospectus delivery requirement in 1982 by amending Exchange Act Rule 15c2-8 to require only broker-dealers participating in a registered offering of securities by a non-reporting issuer to deliver a preliminary (and not final) prospectus at least 48 hours in advance of the mailing of the confirmation of sale.[193]

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190 *See* proposed Rule 251(d)(2)(ii). As proposed, this provision clarifies the date on which dealer delivery obligations commence in the context of continuous or delayed offerings pursuant to proposed Rule 251(d)(3).

191 *See* SEC Rel. No. 33-5277 (July 26, 1972) (noting that there should be no distinction in the delivery requirements of Regulation A offerings and registered offerings, and therefore proposing (and eventually adopting) rules requiring delivery of the offering circular 48 hours in advance of mailing of a confirmation of sale.); SEC Rel. No. 33-6075 (June 1, 1979) [44 FR 33362], at 33363-64 (permitting for the first time the use of a preliminary offering circular in Regulation A offerings, and imposing the same delivery requirements for such preliminary offering circulars as were then in effect for registered offerings).

192 *See* SEC Rel. No. 33-6383 (March 3, 1982) [47 FR 11380] (Integrated Disclosure Release, which, among other things, added Exchange Act Rule 15c2-8, 17 CFR 240.15c2-8, which requires broker-dealers participating in a registered offering of securities of a non-reporting issuer to deliver a copy of the preliminary prospectus to any prospective purchaser at least 48 hours before the mailing of the confirmation of sale.); *see also* Securities Offering Reform, SEC Rel. No. 33-8591, at 173 *et seq.* and 241 *et seq.* (discussing information conveyed at time of sale for purposes of Section 12(a)(2) liability and prospectus delivery requirement reforms).

193 SEC Rel. No. 33-6383, at 11400. The advance delivery requirements do not, however, apply in the context of registered offerings by issuers subject to a reporting obligation under Section 13 or 15(d) of the Exchange Act. Before the addition of Rule 15c2-8(b), the Commission required assurances that the managing underwriter had taken reasonable steps to send investors a

We believe the delivery of the preliminary offering circular to potential investors before they make an investment decision remains an important investor protection that should be preserved in Regulation A, particularly in light of the proposed expanded use of "testing the waters" solicitation materials to include the period of time after non-public submission or filing of the offering statement discussed further in Section II.D. below.[194] We also recognize the need to update and amend Regulation A's offering circular delivery requirements to accord with the requirements of broker-dealers in the context of registered offerings. We therefore propose to amend Rule 251(d)(2)(i) to require issuers and participating broker-dealers to deliver only a preliminary offering circular to prospective purchasers[195] at least 48 hours in advance of sale when a preliminary offering circular is used during the prequalification period to offer such securities to potential investors.[196] Unlike Exchange Act Rule 15c2-8, this delivery requirement would apply to both issuers and participating broker-dealers.[197] We believe this is an important investor protection that should apply to issuers in advance of sale, and is consistent with current

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preliminary prospectus at least 48 hours in advance of mailing confirmations of sale before accelerating effectiveness of a registration statement. *See* SEC Rel. No. 33-4968 (May 1, 1969) [34 FR 7235]. *Cf.* 17 CFR 230.460 (Distribution of Preliminary Prospectus in Registered Offerings).

194 *Cf.* Securities Offering Reform, SEC Rel. No. 33-8591, at 245 (noting that access equals delivery is not appropriate for preliminary prospectus delivery obligations in IPOs because it is important for potential investors to be sent the preliminary prospectus).

195 Prospective purchasers would include any person that has indicated an interest in purchasing the Regulation A securities before qualification, including, but not limited to, those investors that respond to an issuer's solicitation materials. *See* proposed Rule 251(d)(2)(i).

196 In accordance with time of sale provisions discussed in Securities Offering Reform, *see* SEC Rel. No. 33-8591, at p. 173 *et seq.*, we propose to base the 48-hour period in advance of "sale" rather than the "mailing of the confirmation of sale." *See also* Section II.D. below for a discussion of the delivery requirements for solicitation materials used after publicly filing the offering statement.

197 *Cf.* Exchange Act Rule 3a4-1, 17 CFR 240.3a4-1 (Associated persons of an issuer deemed not to be brokers). Issuers would be able to rely on reasonable assurances of delivery from participating broker-dealers to satisfy their delivery obligations.

Regulation A.[198] Consistent with current Rule 251(d)(1)(iii), we propose to continue to require a final offering circular to accompany or precede any written communications that constitute an offer in the post-qualification period.[199]

In addition to the revised delivery requirements discussed above, we propose to add a provision analogous to Rule 173.[200] Currently, Regulation A requires the delivery of a final offering circular to the purchaser with the confirmation of sale, unless it has been delivered already.[201] The proposed provision would allow issuers and participating broker-dealers that satisfy the 48-hour requirement by furnishing a preliminary offering circular to, not later than two business days after completion of the sale, provide the purchaser with a copy of the final offering circular or a notice stating that the sale occurred pursuant to a qualified offering statement. As proposed, the notice must include the URL[202] where the final offering circular, or the offering statement of which such final offering circular is part, may be obtained on EDGAR and contact information sufficient to notify a purchaser where a request for a final offering circular can be sent and received in response.

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198 *Cf.* 17 CFR 230.460 (Distribution of Preliminary Prospectus in Registered Offerings). Additionally, with continued improvements in information and communication technologies, we believe direct public offerings (*i.e.*, offerings conducted by an issuer without the involvement of an underwriter) may become a more attractive option for certain issuers. For that reason, it is important that the advance preliminary offering circular delivery requirements for participating broker-dealers apply equally to issuers.

199 *See* proposed Rule 251(d)(1)(iii). Consistent with Rule 172(a) in the context of registered offerings, issuers and intermediaries sending written confirmations and notices of allocation in the post-qualification period would be allowed to rely on the EDGAR filing of the final offering circular to satisfy any delivery requirements under Rule 251(d)(1)(iii). For a discussion of Rule 172(a), *see* Securities Offering Reform, SEC Rel. No. 33-8591, at 251.

200 17 CFR 230.173.

201 17 CFR 230.251(d)(2)(i)(C).

202 In the case of an electronic-only offering, the notice must include an active hyperlink to the final offering circular or to the offering statement of which such final offering circular is part.

We propose to allow an issuer to withdraw an offering statement, with the Commission's consent, if none of the securities that are the subject of such offering statement have been sold and such offering statement is not the subject of a Commission order temporarily suspending a Regulation A exemption.[203] Under the proposed rules, the Commission also would be able to declare an offering statement abandoned if the offering statement has been on file with the Commission for nine months without amendment and has not become qualified.[204] These withdrawal and abandonment procedures are similar to the ones that apply to reporting companies.

Request for Comment

35. Should the rules require the electronic filing of Regulation A offering and related documents on EDGAR, as proposed? Why or why not? Please address expected costs of electronic filings and benefits to both issuers and investors of having these documents available in electronic format. Alternatively, for Tier 1 offerings, what would be the benefits, if any, of maintaining Regulation A's current paper filing system for offering statements and related documents? Should we maintain paper filing for issuers conducting Tier 1 Regulation A offerings? Why or why not?

36. As proposed, should we require issuers to file the body of the disclosure document, financial statements, and text file attachments, containing the exhibits index and the exhibits to the offering statement, electronically in a HTML or ASCII format that is compatible with the EDGAR filing system?

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203 *See* proposed Rule 259(a).

204 *See* proposed Rule 259(b).

Or should we permit the filing of offering and related materials in Portable Document Format (PDF) or in some other format that is readily accessible to smaller issuers to constitute an official filing with the Commission under Regulation S-T?[205]

37. Should we adopt, as proposed, an access equals delivery model for final offering circular delivery requirements, in which case investors would be presumed to have access to the Internet, and issuers and intermediaries could satisfy their delivery requirements if the final offering circular were filed with the Commission on EDGAR?[206] Or should we maintain our existing requirement that issuers deliver to purchasers a final offering circular with the mailing of the confirmation of sale to such purchasers (if not delivered previously)? Why or why not?

38. Should we update, as proposed, the delivery requirements in Rule 251(d)(2)(i) to maintain advance delivery requirements of preliminary offering circulars, while eliminating the requirement that issuers and broker-dealers participating in the distribution of Regulation A securities pursuant to an offering statement deliver a final offering circular to investors at least 48 hours before sale? Why or why not? Would updating this provision, as proposed, be inconsistent with the rationale behind similar updates to prospectus delivery requirements for registered offerings? Why or why not?

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205 *See* 17 CFR 232.104 (Unofficial PDF copies included in an electronic submission).

206 Kaplan Voekler Letter 2.

39. While not currently proposed, should we adopt a provision similar to Exchange Act Rule 15c2-8(b), which would only require the advance delivery of a preliminary offering circular in the context of offerings by issuers not already subject to an ongoing reporting obligation under Regulation A? Similarly, should we adopt an analog to Rule 174(b),[207] which applies to registered offerings, so that a dealer would not have an aftermarket delivery obligation to purchasers of Regulation A securities to the extent the issuer of such securities is subject to an ongoing reporting obligation under Regulation A immediately before the time of filing the offering statement? Or, in such circumstances, should we only require dealer aftermarket delivery for a 25 calendar-day period? Why or why not?

40. In conjunction with the proposed access equals delivery model for final offering circular delivery requirements, should we adopt, as proposed, a provision analogous to Rule 173? If so, should compliance with that requirement be made a condition of Regulation A? Why or why not? Does the rationale behind Rule 173 apply to Regulation A offerings?[208]

2. Non-Public Submission of Draft Offering Statements

Unlike Title I of the JOBS Act,[209] Title IV does not provide for confidential submissions of offering statements under Regulation A. Commenters, however,

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207 17 CFR 230.174(b)

208 *See* Securities Offering Reform, SEC Rel. No. 33-8591, at p. 173 *et seq.*

209 Title I of the JOBS Act permits emerging growth companies to confidentially submit draft registration statements to the Commission for nonpublic review, provided the initial confidential submission and all amendments thereto are publicly filed not later than 21 calendar days before the issuer conducts its roadshow. *See* Section 106(a) of Title I, which added subsections 5(d) and 6(e) to the Securities Act.

supported providing issuers with the option of confidential submission of offering statements under Regulation A.[210] We propose to allow the non-public submission of draft offering statements by issuers of Regulation A securities. We note, however, that such submissions would not be subject to the statutorily-mandated confidentiality of draft IPO registration statements confidentially submitted by "emerging growth companies"[211] under Title I of the JOBS Act.[212]

Under Regulation A's proposed non-public submission of draft offering statement provisions, issuers whose securities have not been previously sold pursuant to a qualified offering statement under Regulation A or an effective registration statement under the Securities Act would be permitted to submit to the Commission a draft offering statement for non-public review. As with the confidential submission of draft registration statements, all non-public submissions of draft offering statements would be submitted via EDGAR. The initial non-public submission, all non-public amendments thereto, and correspondence with Commission staff regarding such submissions would be required to be publicly filed as exhibits to the offering statement not less than 21 calendar days before qualification of the offering statement.[213] Unlike emerging growth companies,

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210 Letter from Jonathan C. Guest, McCarter & English, LLP, July 10, 2012 ("McCarter & English Letter"); ABA Letter; WR Hambrecht + Co. Letter.

211 Under Section 2(a)(19) of the Securities Act, an "emerging growth company" is defined as, among other things, an issuer that had total annual gross revenues of less than $1 billion during its most recently completed fiscal year. 15 U.S.C. 77b(a)(19).

212 Under Section 6(e)(2) of the Securities Act, confidential submissions of draft registration statements by emerging growth companies are protected from compelled disclosure under the Freedom of Information Act (FOIA) (5 U.S.C. 552). There is no similar provision under Section 3(b) of the Securities Act. Issuers requesting confidential treatment of draft offering statement submissions under Regulation A could submit such documents under cover of the Commission's Rule 83. *See* 17 CFR 200.83.

213 The timing is consistent with the guidance provided to emerging growth companies under Title I of the JOBS Act, where such issuers do not "test the waters" under Section 5(d) or otherwise

which must publicly file any confidential submissions not later than 21 calendar days before a road show, the timing requirements for filing by issuers seeking qualification under Regulation A would not depend on whether or not the issuer conducts a road show.[214]

Request for Comment

41. As proposed, should the rules permit the non-public submission of draft offering statements under Regulation A? Would there be any adverse impact on public investors of permitting the non-public submission of offering statements?

42. Is the proposed requirement of public filing at least 21 calendar days before qualification appropriate? Should public filing be required sooner or later than proposed?

43. Should the availability of non-public submission of Regulation A offering statements be limited, as proposed, to issuers whose securities have not been previously sold pursuant to a qualified offering statement under Regulation A or an effective registration statement under the Securities Act, in a manner similar to the limitation under Title I of the JOBS Act on the use of confidential submissions to issuers that have not previously sold common equity securities pursuant to an effective registration statement? Or should

conduct a traditional road show. *See* JOBS Act Frequently Asked Questions on Confidential Submission Process for Emerging Growth Companies, Question 9 (April 10, 2012), *available at*: http://www.sec.gov/divisions/corpfin/guidance/cfjumpstartfaq.htm.

214 Regulation A's proposed testing the waters provisions would encompass a variety of activities, including activities that could constitute a traditional road show. *See* Section II.D. below for a discussion on the timing and requirements for the use of testing the waters solicitation materials under Rule 254 as proposed to be amended.

issuers be permitted to use the non-public submission provisions more than once?

44. As proposed, should issuers that non-publicly submit an offering statement under Regulation A be required to request confidential treatment under the cover of the Commission's Rule 83? Or should we adopt a new rule relating to confidential treatment of draft offering statements in Regulation A?

3. Form and Content

Section 3(b)(2)(G)(i) of the Securities Act[215] identifies certain requirements that the Commission may include, among others, in the requirements for offerings relying on the exemption. The requirements largely follow the existing offering statement requirements of Form 1-A.[216] For example, financial statements,[217] a description of the issuer's business operations,[218] financial condition,[219] and use of investor funds[220] are all currently required disclosures in Form 1-A. Additionally, Form 1-A requires issuers to disclose, among other things, their contact information, the price or method for calculating the price of the securities being offered, information about the issuer's property, results of operations, directors, officers, significant employees and certain beneficial owners, material agreements and contracts, past securities sales, material factors that make an investment in the issuer speculative or risky, dilution, the plan of

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215 *See* JOBS Act Section 401(a)(2).

216 The primary exception is the suggestion that issuers be required to submit audited financial statements. Currently, the financial statements required under Regulation A are required to be audited only if the issuer has them available.

217 *See* Form 1-A, Part II, Part F/S.

218 *Id.*, Part II, *e.g.*, Model B, Item 6. (Description of Business).

219 *Id.*, *e.g.*, Part F/S.

220 *Id.*, *e.g.*, Item 5. (Use of Proceeds to Issuer).

distribution for the offering, executive and director compensation, and conflicts of interest and related party transactions. As with Regulation A generally, however, Form 1-A has not been substantively revised by the Commission since 1992.

Currently, Form 1-A consists of three parts: Part I (Notification), Part II (Offering Circular), and Part III (Exhibits). Part I of Form 1-A calls for certain basic information about the issuer and proposed offering that is necessary to determine the availability of the exemption.[221] For example, the existence of any "bad actor" disqualifications under Rule 262 and the presence of proposed affiliate sales in the absence of issuer net income from operations in at least one of the last two fiscal years,[222] both of which may affect availability of the exemption, are required to be disclosed in Part I. Part I is filed with the Commission and publicly available, but is not required to be provided to investors.[223]

Part II of the offering statement consists of an offering circular—similar to the prospectus in a registration statement—which serves as the primary disclosure document to investors of the material facts about the issuer, its securities, and the offering. Issuers organized as corporations are given the option of following any one of three disclosure formats in Part II:

- Model A (Question-and-Answer Format);[224]

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221 *See* SEC Rel. No. 33-6275 (Jan. 9, 1981) [46 FR 2637], at 2638.

222 *See* Rule 251(b).

223 *See* Rule 251(d)(2); *see also* SEC Rel. No. 33-6275, at 2639.

224 Model A is based on the North American Securities Administrators Association's (NASAA) Form U-7, also known as the Small Company Offering Registration (SCOR) form, adopted April 28, 1989. *See* http://www.nasaa.org/industry-resources/corporation-finance/scor-overview/scor-forms/.

- Model B, a somewhat scaled version of Form S-1 that largely follows the Commission's disclosure standards in effect for registration statements when Model B was adopted in 1981;[225] and
- Part I of Form S-1.[226]

Issuers organized in non-corporate form, such as limited partnerships and limited liability companies, have the option of using either Model B or Part I of Form S-1. Part F/S of the offering circular—containing financial statements and notes—is required disclosure for all issuers. Part III requires an exhibits index and a description of exhibits required to be filed as part of the offering statement.

Commenters generally supported maintaining Regulation A's existing Form 1-A, with modifications and updates to implement the provisions of the JOBS Act.[227] While some commenters supported simplifying the form or paring it down to focus on matters of greatest significance,[228] one commenter supported a more expansive disclosure

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225 *See* SEC Rel. No. 33-6275 [46 FR 2637], at 2639-40; SEC Rel. No. 33-6924 [57 FR 9768], at 9771.

226 17 CFR 239.11. Issuers choosing Part I of Form S-1 must, however, follow the financial statement requirements of Form 1-A, Part F/S.

227 ABA Letter; WR Hambrecht + Co.; NASAA Letter 2.

228 Letter from Thomas D. O'Rourke, President, Alpine Ventures, Sept. 26, 2012 ("Alpine Ventures Letter"); Letter from Rutheford B. Campbell, Jr., William L. Matthews Professor of Law, University of Kentucky, Nov. 13, 2012 ("Campbell Letter"); *see also* Letter from Richard Lacey, Small Business Owner, April 23, 2012 ("Lacey Letter") (suggesting the form should be simple); Letter from William Klehm, Fallbrook Technologies, September 23, 2013 ("Fallbrook Letter") (suggesting, among other things, that Regulation A should be simple and user-friendly); Letter from Og Oggilby, Bank Clerk, Jan. 22, 2013 ("Oggilby Letter") (suggesting relaxed regulations on the sale of securities of small companies). *But see* Letter from David R. Burton, General Counsel, National Small Business Association ("NSBA"), June 12, 2012 ("NSBA Letter") (suggesting the Commission not modify or update Regulation A other than by raising the annual offering limitation to $50 million).

regime.[229] This commenter suggested that the Commission coordinate with the States to create a single disclosure document that would address disclosure from both a federal and state securities law perspective. In the opinion of this commenter, a single form with heightened disclosure is better than a less-comprehensive federal form that would thereafter require additional disclosure items (and review) by state securities regulators.[230] According to this commenter, the need for robust disclosure is magnified by the increase in the annual offering amount and by an issuer's ability to solicit indications of interest before filing the offering statement, engage in general solicitation, and sell to investors regardless of investor qualifications.[231]

Separately, one commenter suggested that the Commission implement an offering statement scaled on the basis of offering size.[232] Another commenter suggested that the Commission consider requiring the scaled disclosure requirements available to smaller reporting companies in Form 1-A, while also: i) focusing disclosure on matters of the greatest significance, ii) limiting risk factors to those deemed important, iii) requiring disclosure of valuation assessments (for all offerings made at a fixed price) and internal projections used to set budgets as well as a discussion of management's expectations of future performance, iv) encouraging the use and filing of research reports, and v) if Section 3(b)(2) securities are permitted to list on a national securities exchange

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229 Letter from Jack Herstein, President, NASAA, July 3, 2012 ("NASAA Letter 1") (suggesting that heightened disclosure is better than a less-comprehensive federal form that would thereafter require additional disclosure items (and review) by state securities regulators); NASAA Letter 2.

230 NASAA Letter 1.

231 NASAA Letter 2.

232 Campbell Letter (suggesting scaled disclosure in three tiers for offerings of: $0 – up to $1 million; over $1 million – up to $5 million; over $5 million – up to $50 million).

simultaneously with qualification of the offering statement, incorporating some Form 10[233] disclosure requirements into Form 1-A.[234]

One commenter suggested that the Commission update its rules regarding revisions to the offering statement during the post-qualification period in light of anticipated continuous, best efforts offerings.[235] The commenter suggested that the current rule, which requires any updated or revised offering circular to be filed as an amendment to the offering statement and requalified in accordance with Rule 252,[236] places an unnecessary burden on issuers. This commenter suggested that the Commission adopt rules analogous to those for registered offerings where most information meeting the undertaking requirements of Item 512 of Regulation S-K[237] requires a post-effective registration statement, and other updates to the prospectus in such registration statement may be filed pursuant to Rule 424.[238]

We propose to maintain Form 1-A's existing three-part structure—Part I (Notification), Part II (Offering Circular), and Part III (Exhibits)—while making various revisions and updates to the Form.

233 17 CFR 249.210.

234 WR Hambrecht + Co. Letter; *see also* Letter from Karl M. Sjogern, April 25, 2013 ("Sjogern Letter") (suggesting any issuer of equity securities should be required to disclose the valuation it has given itself given the terms of the offering, and to discuss the factors it considered when setting its valuation).

235 Kaplan Voekler Letter 2. *See* related requests for comment in Section II.C.4. below.

236 *See* Rule 253(e)(3).

237 17 CFR 229.512.

238 17 CFR 230.424.

a. Part I (Notification)

Part I of Form 1-A serves as a notice of certain basic information about the issuer and its proposed offering, which also helps to confirm the availability of the exemption.[239] We propose to continue to require the disclosure of this information in modified and updated form. The current paper version of Part I of Form 1-A would be converted into an online XML-based fillable form with indicator boxes or buttons and text boxes and filed online with the Commission.[240] The information would be publicly available on EDGAR, as an online data cover sheet, but not otherwise required to be distributed to investors.[241] The fillable form would enable issuers to provide information in a convenient medium—without the requirement for specialty software—that would capture relevant data about the issuer and its offering in a structured format to facilitate analysis of the Regulation A market and Regulation A issuers by the Commission, other regulators, third-party data providers, and market participants. As noted above, the XML-based fillable form would enable the convenient provision of information to the Commission, and support the assembly and transmission of such information to EDGAR. Facilitating the capture of important financial and other information about Regulation A issuers and offerings in the proposed XML-based fillable form would enable the

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239 SEC Rel. No. 33-6275 [46 FR 2637], at 2638.

240 As proposed, the cover page to current Form 1-A would be eliminated as a standalone requirement, while portions of the information required on the cover page would be combined with Item 1 of Part I of Form 1-A in the XML fillable form.

241 The Commission would disseminate the information in a format that provides normal text for reading and XML-tagged data for analysis. With the exception of the items that focus issuers on eligibility to use Regulation A, much of the information called for in the XML-based fillable form is also required to be disclosed to investors in Part II of Form 1-A.

Commission and market participants to monitor any developing market in Regulation A securities and the types of issuers relying on the exemption.

The information collected in Part I would continue to focus issuers on eligibility to use Regulation A, and would allow Commission staff reviewing the filings to more easily make a determination about the conditions to the availability of the exemption. If adopted, this could conserve issuer time and resources and enhance the efficiency of review by Commission staff. If, after compiling the information elicited by Part I, an issuer determined that it was ineligible to rely on Regulation A, it could choose to register its offering or, if available, conduct an exempt offering in reliance on a different exemption from registration.

The proposed notification in Part I of Form 1-A would require disclosure in response to the following items:

- Item 1. Issuer Information
- Item 2. Issuer Eligibility
- Item 3. Application of Rule 262 ("bad actor" disqualification and disclosure)
- Item 4. Summary Information Regarding the Offering and other Current or Proposed Offerings
- Item 5. Jurisdictions in Which Securities are to be Offered
- Item 6. Unregistered Securities Issued or Sold Within One Year

As proposed, Item 1 (Issuer Information), Item 2 (Issuer Eligibility), Item 3 (Application of Rule 262 ("bad actor" disqualification and disclosure)), Item 4 (Summary Information Regarding the Offering and other Current or Proposed Offerings), and Item 6

(Unregistered Securities Issued or Sold Within One Year) would represent substantive changes to Part I.

- Item 1 (Issuer Information) would require information about the issuer's identity, industry, number of employees, financial statements and capital structure, as well as contact information.[242]
- Item 2 (Issuer Eligibility) would require the issuer to certify that it meets various proposed issuer eligibility criteria.
- Item 3 (Application of Rule 262 ("bad actor" disqualification and disclosure)) would require the issuer to certify that no disqualifying events have occurred and to indicate whether related disclosure is included in the offering circular (*i.e.*, events that would have been disqualifying but occurred before the effective date of the amendments to Regulation A).[243]
- Item 4 (Summary Information Regarding the Offering and other Current or Proposed Offerings) would include indicator boxes or buttons and text boxes eliciting information about the offering (including whether the issuer was conducting a Tier 1 or Tier 2 offering, amount and type of securities offered, proposed sales by selling securityholders and affiliates, type of offering, estimated aggregate offering price of any concurrent offerings pursuant to Regulation A, anticipated fees in connection with the offering, and the names

242 As proposed, some of the information in Item 1, such as the name of the issuer, jurisdiction of incorporation, contact information, primary Standard Industrial Classification Code Number, and I.R.S. Employer Identification Number is currently required to be included on the cover page of Form 1-A. We propose to eliminate the cover page of Form 1-A and to move the relevant information from the cover page into Item 1 of Part I.

243 *See* discussion of proposed Rule 262(a)(3) and (a)(5) in Section II.G. below.

of auditors, legal counsel, underwriters, and certain others providing services in connection with the offering).

- Item 5 (Jurisdictions in Which Securities are to be Offered) would include data collection about the jurisdiction in which the securities are to be offered.
- Item 6 (Unregistered Securities Issued or Sold Within One Year), which largely restates existing Item 5 to Part I, would eliminate the requirement to provide the names and identities of the persons to whom unregistered securities were issued.

We propose to eliminate Item 1 (Significant Parties) of current Part I, which requires disclosure of the names, business address, and residential address of all the persons covered by current Rule 262. Instead, we propose to only require narrative disclosure in Part II of Form 1-A, as proposed, when the issuer has determined that a relevant party has a disclosable "bad actor" event.[244] We propose to eliminate Item 3 of current Part I because we propose to eliminate the current restrictions on affiliate resales under Rule 251(b).[245] Information regarding the amount of proposed secondary sales and the existence of affiliate sales in the offering, however, would continue to be disclosed in Item 4, as proposed. Item 6 (Other Present or Proposed Offerings) and Item 9 (Use of a Solicitation of Interest Document) of current Part I would be incorporated into proposed Item 4 (Summary Information Regarding the Offering and Other Current or Proposed Offerings). We also propose to eliminate Item 7 (Marketing Arrangements) and Item 8

244 *See* discussion in Section II.G. below.

245 The primary purpose of current Item 3 (Affiliate Sales) in Part I of Form 1-A is to ensure compliance with certain restrictions on affiliate resales under Rule 251(b). *See* discussion in Section II.B.3. above.

(Relationship with Issuer of Experts Named in Offering Statement) of current Part I, as disclosure of this information is required in Part II (Offering Circular).

b. Part II (Offering Circular)

(1) Narrative Disclosure

As noted above, Part II (Offering Circular) in existing Form 1-A provides issuers with three options for their narrative disclosure: Model A, Model B, and Part I of Form S-1.[246] The use of these three options has not been revisited, nor have the Model A and Model B formats been substantively revised by the Commission, since their introduction in 1992.[247] In the context of a broader effort to update Regulation A and make it more useful for market participants, we believe that the form and content of the Regulation A Offering Circular is in need of reconsideration. In this regard, we propose to eliminate Model A as a disclosure option, to update and retain Model B as a disclosure option (renaming it "Offering Circular"), and to continue to permit issuers to rely on Part I of Form S-1 to satisfy the disclosure obligations of Part II of Form 1-A.

Model A. Model A was first introduced as an option for corporate issuers' Regulation A offering statements in 1992. The basis for the form was the Small Company Offering Registration, or SCOR, form developed by NASAA, in coordination with state securities administrators and the securities bar, working through the ABA's

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246 Non-corporate issuers are not permitted to use Model A.

247 Before the 1992 amendments to Regulation A, Model B was the only format permissible in Regulation A. *See* SEC Rel. No. 33-6275 [46 FR 2637]. Model A and Part I of Form S-1 were added as additional issuer options at that time. Model B has not been substantively revised or revisited since it was introduced by the Commission in 1981. *See* SEC Rel. No. 33-6924 [57 FR 9768], at 9771.

State Regulation of Securities Committee.[248] Model A was intended to provide corporate issuers with a "balanced approach to the capital raising process, providing a registration form that small businesses can easily use at a reduced cost while still maintaining investor protection."[249] In practice, however, Model A has been used much less frequently than Model B, and offerings using Model A have generally taken significantly longer to qualify than those using Model B or Part I of Form S-1.[250] Commission staff who review Regulation A filings indicate that Model A's question-and-answer disclosure format often results in disclosure that lacks uniformity and is hard to follow. While the question-and-answer approach taken in Model A may help focus corporate issuers on crucial disclosure issues, we are not convinced that the disclosure format results in clear and understandable disclosure being provided to investors. We therefore propose to eliminate Model A from the narrative disclosure options in Part II of Form 1-A.

Model B. Model B disclosure was first introduced by the Commission in 1981, and was the only available disclosure format at that time.[251] It was preserved as a

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248 NASAA's Form U-7 (Small Company Offering Registration) was first approved for use in connection with certain securities offerings by NASAA in 1989. *See* NASAA's website on SCOR Forms, *available at*: http://www.nasaa.org/industry-resources/corporation-finance/scor-overview/scor-forms/. It was later revised by NASAA in 1999. The revised version has not been approved for use in connection with Regulation A by the Commission. In its comment letter, NASAA suggested that the Commission consider allowing revised Form U-7 to be used in connection with the Section 3(b)(2) exemption. *See* NASAA Letter 2.

249 SEC Rel. No. 33-6924, at 23-24.

250 From 2002 through 2012, approximately 21% of qualified Regulation A offerings have used Model A, 66% have used Model B and 13% have used Form S-1. During the same period, the average time required for an offering to qualify was 301 days for offerings using Model A, 220 days for offerings using Model B and 167 days for offerings using Form S-1. One reason that Model A is used less frequently may be that it was not updated to correspond to the version of the SCOR form adopted by NASAA in 1999, so an issuer may not be able to use the same disclosure document in connection with Regulation A that it can use for state securities regulation disclosure.

251 *See* SEC Rel. No. 33-6275.

disclosure option in the 1992 amendments to Regulation A.[252] It has not been substantively updated or revised since 1981.

Model B was originally the product of a Commission review of the disclosure practices of Regulation A issuers under Model B's predecessor, Schedule I.[253] The Commission found that Regulation A's then-existing disclosure guidance and rules did not provide sufficiently detailed directions for the types of offerings that were being conducted under Regulation A.[254] As a result, issuers and their counsel often looked to the existing disclosure guides for the preparation of registration statements[255] for guidance on disclosure under Regulation A.[256] Such disclosure, however, lacked uniformity, and caused delays in the Commission staff review and comment process.[257] Model B was a codification by the Commission of the disclosure standards that, in practice, were being applied to Regulation A offerings at that time.[258] As enacted, Model B was not intended to increase the disclosure obligations of issuers. Rather, in addition to removing uncertainty as to the content of required disclosures, Model B's more comprehensive and uniform set of disclosure standards was intended to reduce an issuer's total time spent preparing and amending the offering circular, and the Commission staff's time spent reviewing and commenting on it. The result was offering

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252 *See* SEC Rel. No. 33-6949, at 36444.

253 SEC Rel. No. 33-6275, at 2638.

254 *Id.*

255 *See, e.g.*, SEC Rel. No. 33-4936 (Dec. 9, 1968) [33 FR 18617] (Guides for Preparation and Filing of Registration Statements).

256 SEC Rel. No. 33-6275, at 2638.

257 *Id.*

258 *Id.*

statement disclosure that closely followed the disclosure requirements then in effect for registration statements, but scaled for smaller issuers.[259]

Form S-1. The 1992 amendments to Regulation A also permitted issuers to draft offering circular disclosure based on the narrative disclosure requirements for registered offerings found in the then-newly created Form SB-1.[260] When Form SB-1 was rescinded as part of the simplification and modernization of requirements for small businesses, including the adoption of the smaller reporting company concept, Form 1-A was revised to permit issuers to follow the narrative disclosure provisions of Part I of Form S-1.[261] Thus, issuers are currently able to provide narrative disclosure under Part I of Form S-1 based on the disclosure requirements for smaller reporting companies (if applicable) or for larger companies that do not fall within the definition of a smaller reporting company.[262]

Form S-1 and the narrative disclosure requirements of Regulation S-K have been revised numerous times since the introduction of Model B disclosure in 1981 to reflect evolving disclosure requirements and standards. Model B disclosure, however, has remained essentially unchanged, as a version of Part I of Form S-1 circa 1981, scaled for

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259 As an example of the variances between Form 1-A and registered offering disclosure, Item 10 of Part II of Form 1-A called for disclosure of record ownership of voting securities by management and certain securityholders, whereas Form S-18, a simplified registration form available to certain corporate issuers going public for the first time before 1992, called for broader disclosure of beneficial ownership of such securities. *See* SEC Rel. No. 33-6275, at 2640. This distinction between Form 1-A and registered offering disclosure (on Form S-1) remains today.

260 Form SB-1 replaced Form S-18. *See* SEC Rel. No. 33-6949, at 36442.

261 *See* SEC Rel. No. 33-8876, at 166.

262 An issuer that qualifies as a smaller reporting company on the basis of public float or revenue (*see, e.g.*, Exchange Act Rule 12b-2, 17 CFR 240.12b-2) may follow the narrative disclosure requirements in Part I of Form S-1 that apply to such companies.

smaller issuers. Thus, while eliciting disclosure of largely the same information, Model B and Part I of Form S-1 contain different item numbers and language.

Proposed Offering Circular. We propose to retain Model B (which, in light of the proposed elimination of Model A, will be renamed "Offering Circular") as a disclosure option under Part II of Form 1-A, updated as detailed below in accordance with Title IV of the JOBS Act and to reflect developments in disclosure requirements for registered offerings since 1981. Updates to the Offering Circular would also incorporate the disclosure guidelines in the Securities Act Industry Guides and guidance on the disclosure requirements applicable to limited partnerships and limited liability companies.[263] Additionally, we propose to continue to permit issuers to comply with Part II of Form 1-A by providing the narrative disclosure required in Part I of Form S-1.

We solicit comment as to whether it would be more appropriate to eliminate Model B disclosure altogether, and, in its place, to require issuers to follow the disclosure and form requirements of Part I of Form S-1, while maintaining Model B-specific disclosures where noted. As with the proposed updates to Model B, to the extent the Commission chose to require disclosure that tracks Part I of Form S-1, it would not increase the disclosure obligations of issuers except where noted below.

We are aware that eliminating Model A and updating Model B may raise concerns about an increase in the disclosure required for a Regulation A offering. Our proposal would create new requirements for audited financial statements (consistent with the JOBS Act requirement of the annual filing of audited financial statements) and for a

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263 *See* Item 7(c)-(d) to Part II of proposed Form 1-A; *see also* SEC Rel. No. 33-6900 (June 17, 1991) [56 FR 28979] (setting forth the Commission's view on the disclosure requirements for limited partnerships).

section containing management's discussion and analysis (MD&A) of the issuer's liquidity, capital resources, and results of operations.[264] Consistent with the requirements of current Form 1-A, issuers that have not generated revenue from operations during each of the three fiscal years immediately before the filing of the offering statement would be required to describe their plan of operations for the twelve months following qualification of the offering statement.[265] Otherwise, it is not intended to substantially alter current Model B disclosure requirements.

As proposed, Offering Circular disclosure in Part II of Form 1-A would cover:

- Basic information about the issuer and the offering, including identification of any underwriters and disclosure of any underwriting discounts and commissions (Item 1: Cover Page of Offering Circular);
- Material risks in connection with the offering (Item 3: Summary and Risk Factors);
- Material disparities between the public offering price and the effective cash costs for shares acquired by insiders during the past year (Item 4: Dilution);
- Plan of distribution for the offering, including the disclosure required by Item 7 (Marketing Arrangements) of Part I of current Form 1-A and disclosure regarding selling securityholders (Item 5: Plan of Distribution and Selling Securityholders);

264 While not currently an express disclosure requirement in Model B, some disclosure requirements similar to MD&A are included in Form 1-A. Disclosure similar to the MD&A required in registered offerings would provide potential investors with meaningful information upon which to make an investment decision. The proposed MD&A disclosure requirements would provide issuers with comprehensive guidance as to the specific requirements of such disclosure. The primary differences between the MD&A we propose to require in Form 1-A and the MD&A required under Item 303 of Regulation S-K, 17 CFR 229.303, are discussed below.

- Use of proceeds (Item 6: Use of Proceeds to Issuer);
- Business operations of the issuer for the prior three fiscal years (or, if in existence for less than three years, since inception) (Item 7: Description of Business);
- Material physical properties (Item 8: Description of Property);
- Discussion and analysis of the issuer's liquidity and capital resources and results of operations through the eyes of management covering the two most recently completed fiscal years; and, for issuers that have not received revenue from operations during each of the three fiscal years immediately before the filing of the offering statement, the plan of operations for the twelve months following qualification of the offering statement, including a statement about whether the issuer anticipates that it will be necessary to raise additional funds within the next six months (Item 9: Management's Discussion and Analysis of Financial Condition and Results of Operations);
- Identification of directors, executive officers and significant employees with a discussion of any family relationships within that group, business experience during the past five years, and involvement in certain legal proceedings during the past five years (Item 10: Directors, Executive Officers and Significant Employees);
- Executive compensation data for the most recent fiscal year for the three highest paid officers or directors (Item 11: Compensation of Directors and Officers);

265 *See* Item 6(3)(i) of Model B of Part II of Form 1-A.

- Beneficial ownership of voting securities by executive officers, directors, and 10% owners (Item 12: Security Ownership of Management and Certain Securityholders);
- Transactions with related persons, promoters and certain control persons (Item 13: Interest of Management and Others in Certain Transactions);
- The material terms of the securities being offered (Item 14: Securities Being Offered);
- Two years of financial statements, which for Tier 2 offerings would be required to be audited. Tier 1 offerings would be required to provide audited financial statements to the extent the issuer had prepared them for other purposes;[266] and
- Any events that would have triggered disqualification of the offering under Rule 262 if the issuer could not rely on the provisions in proposed Rule 262(b)(1).[267]

The proposed content of the Offering Circular would update the disclosure requirements in some respects to more closely align Regulation A disclosure with the smaller reporting company disclosure requirements for registered offerings, while certain scaled elements exclusive to Model B would be retained.[268] The changes would result in

266 Financial statement requirements are discussed more fully in Section II.C.3.b(2). below.

267 *See* discussion of disqualification provisions in Section II.G. below. We propose to require this "bad actor" disclosure even if the issuer elects to follow the Part I of Form S-1 disclosure format.

268 We are not proposing, however, to include in the Offering Circular all disclosures required of smaller reporting companies under Regulation S-K. For example, we do not propose to include in the Offering Circular disclosure required of certain issuers by the Dodd-Frank Act regarding conflict minerals, payments made by resource extraction issuers, *see* SEC Rel. No. 34-67717 (Aug. 22, 2012) [77 FR 56365], pay ratio, pay for performance, hedging, or clawbacks. We also do not propose to require Regulation A issuers to provide disclosure regarding the market price of

more detailed instructions on issuer disclosure in the MD&A section of the Offering Circular, as well as a description of the issuer's business for a period of three years (as opposed to current Model B's five-year requirement), with the added disclosure of any legal proceedings material to the issuer's business or financial condition. These changes would make Offering Circular disclosure more akin to what is required of smaller reporting companies in a prospectus, but more limited in certain respects. Additionally, as with registered offerings by smaller reporting companies, issuers would be required to disclose beneficial ownership of their voting securities, as opposed to record ownership of voting and non-voting securities. Lastly, as to transactions with related persons, promoters and certain control persons, issuers would no longer be required to disclose such transactions in excess of $50,000 in the prior two years (or similar transactions currently contemplated), but rather to follow the requirements for smaller reporting company disclosure of transactions during the prior two fiscal years that exceed the lesser of $120,000 or 1% of the average total assets at year end for the last two completed fiscal years.[269]

With the exception of the requirements for disclosure of beneficial ownership, material legal proceedings, and related party transactions for certain issuers,[270] these proposed updates should not result in an overall increase in an issuer's disclosure

and dividends on common equity and related stockholder matters under Item 201 of Regulation S-K, 17 CFR 229.201, changes in and disagreements with accountants under Item 304 of Regulation S-K, 17 CFR 229.304, corporate governance matters under Item 407 of Regulation S-K, 17 CFR 229.407, and the determination of offering price under Item 505 of Regulation S-K, 17 CFR 229.505.

269 *See* 17 CFR 229.404(d)(1).

270 As proposed, issuers that have $5 million (or less) in average total assets at year end for the last two completed fiscal years would be required to disclose related party transactions at a lower

obligations. For example, as mentioned above, issuers would be required to provide fewer years of business description and certain issuers would have a higher threshold for reporting transactions with related persons than current Model B.[271] Further, issuers would be permitted to provide more streamlined disclosure of dilutive transactions with insiders by no longer being required to present a dilution table based on the net tangible book value per share of the issuer's securities.[272] Additionally, while issuers would be provided with more detailed instructions on MD&A disclosure, similar disclosure is already called for under current requirements.[273] The proposed MD&A disclosure would clarify existing requirements and save issuers time by providing more express guidance regarding the type of information and analysis that should be included. We believe the clearer requirements should also lead to improved MD&A disclosure, which would provide investors with better visibility into management's perspective on the issuer's financial condition and operations. Investors would also receive the benefit of disclosure that is more consistent across issuers in both registered offerings and Regulation A offerings.

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threshold (*i.e.*, 1% or more) than under the requirements of current Model B, which requires the disclosure of transactions in excess of $50,000 in the prior two years.

271 *See id.*

272 *See* Item 4 (Dilution) to the Offering Circular in Part II of Form 1-A.

273 MD&A disclosure is specifically required by Model A. Model B calls for similar information in Item 6, which requires disclosure of the characteristics of the issuer's operations or industry that may have a material impact upon the issuer's future financial performance. Item 6 also requires disclosure of the issuer's plan of operations and short-term liquidity if the issuer has not received revenue from operations during each of the three fiscal years immediately prior to filing the offering statement.

Issuers providing disclosure in the Offering Circular would retain most of the scaled disclosure provisions currently found in Model B. We propose to continue to permit Regulation A issuers to:

- provide simplified executive compensation data for the three highest paid officers and directors in tabular form for the most recent fiscal year;[274]
- disclose 10% beneficial owners of voting securities;[275] and
- follow fewer specific disclosure requirements for the description of business section.[276]

Additionally, the Offering Circular would, in comparison to Model B of Form 1-A, contain more express MD&A disclosure requirements and guidance.[277] These requirements would not, however, be as extensive as those contained in Item 303 of Regulation S-K.[278] For example, the Offering Circular would include detailed guidance and requirements similar to Item 303 with respect to liquidity, capital resources, and results of operations, including the most significant trend information,[279] but would not require disclosure (in the normal course) of off-balance sheet arrangements or contractual

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274 *Cf.* Item 402(l)-(r) of Regulation S-K, 17 CFR 229.402(l)-(r), which requires more extensive disclosure and tabular information for the two most recent fiscal years.

275 *Cf.* Item 403 of Regulation S-K, 17 CFR 229.403, which requires disclosure of beneficial owners of more than 5% of voting securities.

276 Compare the requirements of Item 6 of Model B, Part II of Form 1-A with the more prescriptive requirements of Item 11 of Form S-1 and Item 101 of Regulation S-K, 17 CFR 229.101.

277 The requirements for financial statements in Part F/S of Part II of Form 1-A are discussed in Section II.C.3.b(2). below.

278 17 CFR 229.303 (Management's discussion and analysis of financial condition and results of operations in the context of registered offerings).

279 17 CFR 303(a)(1)-(3). *Cf.* Form 20-F, at Item 5.

obligations.[280] As with the treatment of smaller reporting companies under Item 303(d), Regulation A issuers would only be required to disclose information about the issuer's results of operations for the two most recently completed fiscal years. Further, consistent with existing Form 1-A, issuers that have not generated revenue from operations during each of the three fiscal years immediately before the filing of the offering statement would have to describe their plan of operations for the twelve months following qualification of the offering statement, including a statement about whether, in the issuer's opinion, it will be necessary to raise additional funds within the next six months to implement the plan of operations.[281]

Consistent with the treatment of issuers in registered offerings, we further propose to permit issuers to incorporate by reference into Part II of the Form 1-A certain items previously submitted or filed on EDGAR. Incorporation by reference would be limited to documents publicly submitted or filed under Regulation A, such as Form 1-A and Form 1-K, and their exhibits. In order to be permitted to incorporate by reference, issuers would have to be subject to the ongoing reporting obligations for Tier 2 offerings.[282] Issuers would be required to describe the information incorporated by reference, which would be required to be accompanied by a separate hyperlink to the relevant document on EDGAR, which need not remain active after the filing of the related offering statement.

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280 During the course of the qualification process, Commission staff reviewing the offering statement may request the disclosure of such information, where the disclosure of such information would be material to an understanding of the issuer's financial condition.

281 *See* Form 1-A, Model B, at Item 6 (Description of Business).

282 Issuers following the Offering Circular disclosure model would be permitted to incorporate by reference Items 2 through 14, whereas issuers following the narrative disclosure in Part I of Form S-1 would be permitted to incorporate by reference Items 3 through 11 of Part I of Form S-1. *See* General Instruction III to proposed Form 1-A. As with Model B, the item numbers

(2) Financial Statements

Part F/S of Form 1-A currently requires issuers in Regulation A offerings to provide the following financial statements prepared in accordance with U.S. GAAP:

- a balance sheet as of a date within 90 days before filing the offering statement (or as of an earlier date, not more than six months before filing, if the Commission approves upon a showing of good cause) but, for filings made more than 90 days after the end of the issuer's most recent fiscal year, the balance sheet must be dated as of the end of the fiscal year;
- statements of income, cash flows, and stockholders' equity for each of the two fiscal years preceding the date of the most recent balance sheet, and for any interim period between the end of the most recent fiscal year and the date of the most recent balance sheet;
- financial statements of significant acquired businesses; and
- pro forma information relating to significant business combinations.

As noted above, the financial statements are not required to be audited unless the issuer has already obtained an audit of its financial statements for another purpose. If the issuer has audited financial statements, the qualifications and reports of the auditor must meet the requirements of Article 2 of Regulation S-X[283] and the audit must be conducted in accordance with U.S. Generally Accepted Auditing Standards (GAAS) or the

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in the Offering Circular model of proposed Part II of Form 1-A and Part I of Form S-1 do not align.

283 17 CFR 210.1 *et seq.*

standards of the Public Company Oversight Board (PCAOB), but auditors are not required to be registered with the PCAOB.[284]

We have not received extensive comment on the potential financial statement requirements for issuers under Title IV of the JOBS Act. One commenter suggested audited financial statements should be required for all offerings.[285] Another commenter urged the Commission to prohibit the use of financial projections unless they are reviewed, and filed along with the issuance of an unqualified opinion, by a licensed certified public accountant.[286] Another commenter suggested—while discussing offering statements generally—that the Commission should consider scaling financial statement requirements on the basis of offering size.[287]

We propose to generally maintain the existing financial statement requirements of current Part F/S for Tier 1 offerings, while requiring issuers in Tier 2 offerings to file audited financial statements in Part F/S.[288] Specifically, we propose to require all issuers to file balance sheets as of the two most recently completed fiscal year ends (or for such shorter time that they have been in existence), instead of the current requirement to file a balance sheet as of only the most recently completed fiscal year end. In light of the requirement in Part F/S for issuers to provide statements of income, cash flows, and

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284 *See* Form 1-A, Part F/S.

285 WR Hambrecht + Co. Letter.

286 NASAA Letter 2.

287 Campbell Letter.

288 *See* paragraph (c) of Part F/S of Form 1-A. An issuer offering up to $5 million that elects to conduct a Tier 2 offering would be required, in addition to filing audited financial statements in the offering statement, to provide ongoing reports to the Commission on the proposed annual and semiannual basis, with interim current event updates, *see* Section II.E.1. below, and only be permitted to terminate their ongoing reporting obligation by satisfying the requirements for filing a Form 1-Z described in Section II.E.4. below.

stockholders' equity for each of the two fiscal years preceding the date of the most recent balance sheet, we believe issuers would already have the additional balance sheet or be in a position to easily generate the additional balance sheet at minimal additional cost, and that comparison between the two balance sheets would provide valuable additional information. Financial statements for U.S.-domiciled issuers would be required to be prepared in accordance with U.S. GAAP, as is currently the case. We propose, however, to permit Canadian issuers to prepare financial statements in accordance with either U.S. GAAP or International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB).[289]

In general, issuers conducting Tier 1 offerings must follow the requirements for the form and content of their financial statements set out in Part F/S, rather than following the requirements in Regulation S-X. However, in certain less common circumstances, such as for an acquired business or subsidiary guarantors, Part F/S directs issuers conducting Tier 1 offerings to comply with certain portions of Regulation S-X, which provides guidance on the financial statements required in such transactions.[290]

For all Tier 2 offerings, however, issuers would be required to follow the financial statement requirements of Article 8 of Regulation S-X, as if the issuer conducting a

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289 If the financial statements comply with IFRS as issued by the IASB, such compliance must be unreservedly and explicitly stated in the notes to the financial statements and the auditor's report must include an opinion on whether the financial statements comply with IFRS as issued by the IASB. *See* General Rule (a)(2) to Part F/S of proposed Form 1-A. *Cf.* Item 17(c) of Form 20-F.

290 We propose to update the requirements for financial statements of businesses acquired or to be acquired in Part F/S to refer to the requirements of Rule 8-04 of Regulation S-X. We also propose to provide specific references to the relevant provisions of Regulation S-X regarding the requirements for financial statements of guarantors and the issuers of guaranteed securities (Rule 3-10 of Regulation S-X), financial statements of affiliates whose securities collateralize an issuance of securities (Rule 3-16 of Regulation S-X), and financial statements provided in connection with oil and gas producing activities (Rule 4-10 of Regulation S-X). The financial

Tier 2 offering were a smaller reporting company, unless otherwise noted in Part F/S. This requirement would include any financial information with respect to acquired businesses required by Rule 8-04 and 8-05 of Regulation S-X.[291]

As with current Regulation A, financial statements in a Tier 1 offering would not be required to be audited. However, we also propose to maintain Regulation A's existing requirement that, if an issuer conducting a Tier 1 offering has already obtained an audit of its financial statements for other purposes, and that audit was performed in accordance with U.S. generally accepted auditing standards or the auditing standards of the PCAOB, and the auditor was independent pursuant to Rule 2-01 of Regulation S-X, then those audited financial statements must be filed. The auditor may, but need not be, registered with the PCAOB.

Issuers conducting Tier 2 offerings would, by contrast, be required to have their financial statements audited. As with Tier 1 offerings, the auditor of financial statements being filed as part of a Tier 2 offering must be independent under Rule 2-01 of Regulation S-X and must comply with the other requirements of Article 2 of Regulation S-X, but need not be PCAOB-registered.[292] Issuers conducting Tier 2 offerings would, however, be required to provide financial statements that are audited in accordance with the standards of the PCAOB. In addition to auditing standards, PCAOB standards include requirements on auditor ethics, independence and quality control that, in comparison to the auditing standards of U.S. GAAS, could improve the quality of the

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statements provided in these circumstances would only be required to be audited to the extent the issuer had already obtained an audit of its financial statements for other purposes.

291 Issuers would, however, follow paragraph (a)(3) of Part F/S of Form 1-A with respect to the age of the financial statements and the periods to be presented.

audit and the financial statements provided to investors in potentially larger Tier 2 offerings.

Additionally, we propose to update the Form 1-A financial statement requirements to be consistent with the proposed timetable for ongoing reporting.[293] Under Regulation A, as currently in effect, issuers are required to prepare a balance sheet as of a date not more than 90 days before filing the offering statement, or not more than six months before filing if the Commission approves upon a showing of good cause.[294] If the financial statements are filed more than 90 days after the end of the issuer's most recently completed fiscal year, the financial statements must include that fiscal year.[295] In practice, however, Commission staff reviewing Form 1-A filings routinely affords issuers the six-month accommodation, subject to the requirement that financial statements must otherwise be dated as of the end of the most recently completed fiscal year if filed more than 90 days after the end of such fiscal year.

We propose to extend the permissible age of financial statements in Form 1-A to nine months, in order to permit the provision of financial statements that are updated on a timetable consistent with our proposed requirement for semiannual interim reporting.[296] We also propose to add a new limitation on the age of financial statements at qualification, under which an offering statement could not be qualified if the date of the

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292 *See* Part F/S of Form 1-A (referencing Article 2 of Regulation S-X, 17 CFR 210.2-01 *et seq.*).

293 Our proposals for ongoing reporting are discussed in Section II.E. below.

294 *See* Form 1-A, Part F/S.

295 *Id.*

296 This age of financial statements requirement is also consistent with the treatment of foreign private issuers in the context of registered offerings. *See* Division of Corporation Finance's Financial Reporting Manual, at 6620, *available at*: http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.pdf#topic6.

balance sheet included under Part F/S were more than nine months before the date of qualification.[297] For filings made more than three months after the end of the issuer's most recent fiscal year, the balance sheet would be required to be dated as of the end of the most recent fiscal year.[298] For filings made more than nine months after the end of the issuer's most recent fiscal year, the balance sheet would be required to be dated no earlier than as of six months after the end of the most recent fiscal year.[299] If interim financial statements are required, they would be required to cover a period of at least six months.[300] Requiring issuers to file interim financial statements no older than nine months and covering a minimum of six months would have the beneficial effect of eliminating what could otherwise be a requirement for certain issuers to provide quarterly interim financial statements during the qualification process and would be consistent with the timing of our proposed ongoing reporting requirements.[301] We propose to generally maintain the timing requirement of existing Form 1-A concerning the date after which an issuer must provide financial statements dated as of the most recently completed fiscal year, but to change the interval from 90 calendar days to three months, which we believe would simplify compliance.

We solicit comment below on whether issuers conducting Tier 2 offerings should be required to provide their financial statements to the Commission and on their

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297 Currently, Form 1-A does not expressly limit the age of financial statements at qualification. In practice, however, Commission staff requires issuers to update financial statements before qualification to the extent such financial statements no longer satisfy Form 1-A's requirements for the age of financial statements at the time of filing.

298 *See* paragraph (a)(3)(i) to Part F/S of proposed Form 1-A.

299 *Id.*

300 *See* paragraph (a)(3)(iv) to Part F/S of proposed Form 1-A.

301 *See* discussion in Section II.E.1.b. below (Semiannual Reports on Form 1-SA).

corporate websites in interactive data format using the eXtensible Business Reporting Language (XBRL).[302] We have not received any public comment on this issue to date and do not propose any such requirement. If the Commission were to adopt any such requirement, as with registered offerings, the interactive data would have to be provided as an exhibit to the offering statement filed with the Commission. On the same basis and subject to the same qualifications, interactive data would be required for all periodic and current reporting, as well as for the annual audited financial statements. Filers would be required to prepare their interactive data using the list of tags the Commission specifies and submit them with any supporting files the EDGAR Filer Manual prescribes.[303] Interactive data would be required for the complete set of their financial statements, which includes the face financial statements and all footnotes.[304] Filers would be required to tag every financial statement line item and "detail tag" the footnotes by tagging each amount.

c. Part III (Exhibits)

We have not received any comments about the exhibits that should be filed with the offering statement.[305] We propose to continue to permit issuers to incorporate by

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302 Data becomes interactive when it is labeled or "tagged" using a computer markup language such as XBRL that software can process for analysis. For a discussion of current financial statement interactive data requirements, *see* SEC Rel. No. 33-9002 (Jan. 30, 2009) [74 FR 6776]. Financial statements for issuers seeking to qualify Tier 1 offerings may be treated differently because audited financial statements may not be required in the offering statements of such issuers.

303 The EDGAR Filer Manual is *available at*: http://www.sec.gov/info/edgar/edmanuals.htm.

304 17 CFR 210.12-01 *et seq.*

305 Part III (Exhibits) of Form 1-A currently requires issuers to file the following exhibits with the offering statement: Underwriting agreement; Charter and by-laws; Instrument defining the rights of securityholders; Subscription agreement; Voting trust agreement; Material contracts; Material foreign patents; Plan of acquisition, reorganization, arrangement, liquidation, or succession; Escrow agreements; Consents; Opinion re legality; Sales material; "Test the water" material;

reference certain information in documents filed under Regulation A that is already available on EDGAR, but, in addition to the requirement to describe the information incorporated by reference, issuers would be required to include a hyperlink to such exhibit on EDGAR.[306] As proposed, such issuers would also have to be subject to the ongoing reporting obligations for Tier 2 offerings. To the extent post-qualification amendments to offering statements must include audited financial statements, the consent of the certifying accountant to the use of such accountant's certificate in connection with the amended financial statements must be included.[307] Additionally, and consistent with the requirements of existing Regulation A, any solicitation materials used by the issuer would have to be included as an exhibit to the offering statement at the time of non-public submission or filing.

d. Signature Requirements

Under current Regulation A, an issuer must file seven copies of the offering statement with the Commission, at least one of which must be manually signed.[308] In light of the proposed electronic filing requirements for Regulation A offering materials discussed above,[309] however, issuers would no longer be required to file a manually

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Appointment for agent for service of process; and any additional exhibits the issuer may wish to file.

306 *See* General Instruction III to proposed Form 1-A and discussion in Section II.C.3.b(1). above regarding incorporation by reference in Part II of Form 1-A. The hyperlink must be active at the time of filing, but need not remain active after filing.

307 This is consistent with current practice under Regulation A, but would be made an express requirement under the proposed rules. *See* proposed Rule 252(h)(1)(ii).

308 *See* Rule 252(e).

309 *See* discussion in Section II.C.1. above.

signed copy of the Form 1-A with the Commission.[310] Similar to the requirement for issuers in the context of registered offerings, issuers would instead be required to manually sign a copy of the offering statement before or at the time of filing that would have to be retained by the issuer for a period of five years.[311] Issuers would be required to produce the manually signed copy to the Commission, upon request.[312]

Additionally, if the issuer filing a Form 1-A under current Regulation A is a Canadian issuer, its authorized representative in the United States is required to sign the offering statement.[313] This requirement corresponds to a similar requirement under Section 6 of the Securities Act for filings of registration statements by foreign issuers.[314] We propose to eliminate this requirement under Regulation A. Offerings qualified under Regulation A are not subject to the liability provisions of Section 11 of the Securities Act, and having a signatory in the United States does not provide purchasers with significant additional protections. In addition, we propose to maintain the requirement that Canadian issuers file a Form F-X[315] to provide an express consent to service of process in connection with offerings qualified under Form 1-A. This treatment is similar to requirements for Canadian companies making filings under the multijurisdictional disclosure system.[316]

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310 This proposed requirement would also apply to any Form 1-A non-publicly submitted to the Commission.

311 *See* Instruction 2 to Signatures in Form 1-A; *cf.* Rule 402(e), 17 CFR 230.402(e).

312 *Id.*

313 *See* Rule 252(f) and Instruction 1 to Signatures of Form 1-A.

314 15 U.S.C. 77f(a).

315 17 CFR 239.42.

316 *See* SEC Rel. No. 33-6902 (June 21, 1991) [56 FR 30036] (adopting the multijurisdictional disclosure system).

Request for Comment

45. Should we continue to require a Part I (Notification) to be filed as part of the offering statement on Form 1-A? If so, should we require additional (or less) information in Part I than is currently required or proposed? If so, provide justifications for such disclosure.

46. As proposed, what would be the costs and benefits associated with requiring an issuer, as part of the electronic filing process, to enter key information about itself and its securities on a formatted cover sheet to accompany the EDGAR-formatted text file attachment?

47. Some market participants have urged us to simplify the disclosure requirements associated with Regulation A in order to facilitate more cost-effective capital formation by small companies.[317] Most commenters, however, have not made specific suggestions. Are there particular disclosure requirements associated with Regulation A that are most in need of simplification? Are there currently required disclosures that could be modified? Alternatively, are there any disclosure standards, not currently required or proposed in Regulation A, that should be included as disclosure requirements in the new Form 1-A? If so, which disclosure could be reduced or eliminated, or should be included?

48. As proposed, should we continue to maintain certain disclosure requirements in the proposed Offering Circular, while updating others to be more in line with the disclosure required of smaller reporting companies? If not, why not?

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317 Alpine Ventures Letter; Campbell Letter; Lacey Letter; Oggilby Letter.

Please provide suggestions as to what disclosure should be preserved in the Offering Circular or updated to accord with the smaller reporting company requirements in the context of registered offerings.

49. Should we provide for scaled narrative disclosure in Form 1-A based on the size of the issuer or size of the offering? Why or why not? If so, on what size-based attributes of an issuer or the offering should we base any such scaled disclosure requirements and what types of scaled disclosure would be applicable to each resulting category?

50. Should we update and provide more specific guidance as to the MD&A section required to be included in the Offering Circular, as proposed? Is there any additional guidance we should provide?

51. As proposed, and consistent with the requirements of smaller reporting companies under Item 303 of Regulation S-K, should we permit Regulation A issuers to provide only two years of information about their results of operations? Why or why not? Are there any other specific provisions from Item 303 of Regulation S-K that would (or would not) be appropriate for the types of issuers likely to rely on Regulation A? If so, please explain why any such provision should (or should not) apply.

52. Should we continue to require, as proposed, the disclosure of an issuer's plan of operations for the twelve months following qualification of the offering statement? Why or why not? Alternatively, is this disclosure requirement appropriate for the types of issuers likely to rely on Regulation A? If not, why not?

53. Should we consider adding a disclosure requirement in Part II of Form 1-A that would require issuers to disclose the value of the issuer prior to the contemplated Regulation A offering (*i.e.*, pre-money value)? If so, are there any practical limitations on the ability of issuers with complicated capital structures to provide investors with an accurate figure or basis for such a calculation? Should we also consider requiring disclosure of how the price to the public of the securities being offered was determined?

54. Would it be an efficiency to issuers if we were to eliminate the proposed Offering Circular disclosure format, and instead have Form 1-A refer issuers item-by-item to Form S-1 requirements, while preserving—where noted in Form 1-A itself—Model B-specific scaling? Alternatively, should we continue to allow issuers to use Part I of Form S-1 as a separate disclosure option in Part II of Form 1-A? Why or why not?

55. Should we make changes to the exhibit requirements of Part III of Form 1-A in addition to those proposed? For example, should we change the standard for filing material contracts by specifically excluding certain types of contracts?

56. As proposed, should we permit issuers that are current in their Tier 2 reporting obligations to incorporate by reference certain information in documents filed under Regulation A into Part II of the offering statement, while also requiring issuers to include a hyperlink to such information on EDGAR? Why or why not? If so, should we also permit successor entities to incorporate by reference to the extent their predecessors were eligible? Why or why not? If

we permit the incorporation by reference of information already available on EDGAR, should we exclude shell companies or any other types of entities from being able to rely on any such accommodation?[318] Why or why not? Should issuers be permitted to incorporate by reference to Exchange Act reports and documents filed in connection with registered offerings?

57. Should we alter the proposed period of time in which an issuer must have been current in their ongoing reporting in order to be able to incorporate by reference certain information into Part II of Form 1-A that is already available on EDGAR? If so, what period of time should apply to any requirement that an issuer be current in filing its ongoing reports?

58. Instead of the proposed general requirement that issuers must file audited financial statements for Tier 2 offerings, should the rules require audited financial statements at a different threshold (*e.g.*, for all offerings—whether under Tier 1 or Tier 2—in excess of the $500,000 requirement for audited financial statements set forth under the Commission's proposed crowdfunding exemption pursuant to Section 4(a)(6) of the Securities Act, or for all Regulation A offerings)? Are there other characteristics of an offering, other than the aggregate offering amount, that should trigger the audited financial statement requirement, such as public float or asset size of the issuer? If so, which other characteristics?

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318 Shell companies (other than business combination shell companies) are currently unable to incorporate by reference prior Exchange Act reports in Form S-1. *See* General Instruction VII.D. to Form S-1.

59. For Tier 2 offerings, should the financial statement updating requirement be changed from the proposed requirements in Part F/S of Form 1-A that would permit issuers to file financial statements based on a balance sheet dated within nine months of non-public submission or filing, but must otherwise be dated as of the end of the most recently completed fiscal year, if non-publicly submitted or filed three months after the end of such fiscal year? Or should Part F/S of Form 1-A require updating for Tier 2 offerings on a schedule similar to what would be required in a registered offering by a smaller reporting company? Why or why not?

60. As proposed, should we require issuers to file balance sheets for the two most recently completed fiscal years, instead of the current requirement to file a balance sheet for only the most recently completed fiscal year? Why or why not?

61. As proposed, should we permit Canadian issuers to prepare their financial statements using IFRS as issued by the IASB, rather than U.S. GAAP? If so, as noted above in Section II.B.1.a., to the extent we extend issuer eligibility to include foreign private issuers, should we permit all foreign private issuers to prepare their financial statements using IFRS as issued by the IASB, rather than U.S. GAAP?

62. As proposed, in Tier 1 offerings should we only refer to Regulation S-X when describing the auditor independence and compliance requirements of Article 2 and the financial statement requirements relating to guarantors and issuers of guaranteed securities, affiliates whose securities collateralize an issuance, or

issuers engaged in oil and gas producing activities? Should we clarify the financial statement requirements in other specific situations? Instead of referring to Regulation S-X, should we develop new standards appropriate for Tier 1 offerings?

63. As proposed, should we permit issuers that do not qualify as a smaller reporting company to only provide two years of audited financial statements for Tier 2 offerings? Or should we require such issuers to file three years of financial statements? Why or why not?

64. As proposed, should we require that, when audited financial statements are required to be filed in Part F/S for Tier 2 offerings, those audits be conducted in accordance with PCAOB standards? Alternatively, as with existing Regulation A, should we require the financial statements audit to be performed in accordance with U.S. GAAS or the PCAOB standards? Should we require auditors to be PCAOB-registered? Why or why not?

65. Would there be a cost difference to issuers of requiring audits in Tier 2 offerings to be conducted in accordance PCAOB standards, as proposed, compared to U.S. GAAS? Would there be a benefit to investors?

66. Would there be a cost difference to issuers if, in addition to requiring auditors to conduct the audits in Tier 2 offerings in accordance with PCAOB standards, as proposed, we also required auditors to be PCAOB-registered? Would there be a benefit to investors?

67. Should we require interactive data tagging of financial statements included in Regulation A offering statements? If so, should we require interactive data for all Regulation A offerings, or only Tier 2 offerings? What effect would the cost of compliance with any interactive data tagging requirements have on the issuers likely to rely on Regulation A? If we require interactive data tagging, should we implement a phase-in period for such tagging and detailed footnote and schedule tagging?

68. As noted above in Section II.B.1.b. discussing issuer eligibility, in order to address concerns regarding the use of Regulation A by REITs (and on the potential use by BDCs) absent additional REIT- (or BDC-) specific disclosures, should we require additional disclosure by REITs (and BDCs, if ultimately permitted to rely on the exemption)? Why or why not? If so, please make specific recommendations as to the form and content of any such additional disclosure.

69. As proposed, should we continue to permit issuers to incorporate by reference certain information into Part III (Exhibits) of the offering statement that was previously filed on EDGAR, while also requiring issuers to be subject to a Tier 2 reporting obligation? Or, as with current Regulation A, should we permit issuers to incorporate by reference in Part III of Form 1-A certain information irrespective of their obligation to file ongoing reports under Tier 2 of Regulation A? Why or why not?

70. As proposed, should we require issuers to retain manually signed copies of the offering statement for a period of five years? Or should we consider an alternative retention period? Alternatively, should we eliminate the requirement altogether in favor of alternative signature methods (*e.g.*, electronic signatures)? Why or why not?

71. As proposed, should we eliminate the requirement that Form 1-A be signed by an authorized representative in the United States when the filer is a Canadian issuer? Should we, as proposed, require Canadian issuers to file a Form F-X to provide an express consent to service of process in connection with offerings qualified under Form 1-A? Why or why not? If so, should Form F-X be required to be filed by Canadian issuers in connection with other filings under Regulation A, including proposed new Form 1-K, Form 1-SA, Form 1-U, or Form 1-Z?[319] Why or why not?

4. Continuous or Delayed Offerings and Offering Circular Supplements

Rule 251(d)(3) currently allows for continuous or delayed offerings under Regulation A if permitted by Rule 415.[320] By reference to the undertakings of Item 512(a) of Regulation S-K,[321] Rule 415 does not necessarily require every change in the information contained in a prospectus to a registration statement in a continuous offering to be reflected in a post-effective amendment.[322] On the other hand, Regulation A requires every revised or updated offering circular in a continuous offering

319 The proposed rules for ongoing reporting, and related forms, are discussed in Section II.E.1. below.

320 17 CFR 230.415.

321 17 CFR 230.415(a)(3).

322 *See* 17 CFR 229.512(a)(1) (requiring issuers to file a post-effective amendment for purposes of an update under Section 10(a)(3) of the Securities Act, to reflect any facts or events arising after effectiveness that, individually or in the aggregate, represent a fundamental change in the information set forth in the registration statement, or to include, subject to certain exceptions, any material information with respect to the plan of distribution not previously disclosed (or material changes to information previously disclosed) in the registration statement).

to be filed as an amendment to the offering statement to which it relates and requalified in a process analogous to the Commission staff review, comment and qualification process for initial offering statements.[323] The requalification process can be costly and time consuming for smaller issuers conducting continuous offerings of securities pursuant to Regulation A.[324] As discussed more fully below, we propose to clarify in the proposed rules for Regulation A the scope of permissible continuous or delayed offerings and the related concept of offering circular supplements.

Rule 415 attempts to promote efficiency and cost savings in the securities markets by allowing for the registration of certain traditional and other shelf offerings.[325] When Rule 415 was adopted, the Commission recognized that certain traditional shelf offerings have been allowed by administrative practice for many years despite the absence of such a rule.[326] Since Rule 415 only addresses registered offerings, however, the precise scope of continuous or delayed offerings under Regulation A has been unclear. We believe that proposed Regulation A should continue to allow for certain traditional shelf offerings to promote flexibility, efficiency, and to reduce unnecessary offerings costs.[327] However,

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323 *See* Rule 253(e); Rule 252(h)(1).

324 *See* Kaplan Voekler Letter 2.

325 *See* SEC Rel. No. 33-6499 [48 FR 52889] (Nov. 23, 1983) (noting the efficiency and cost savings issuers experienced during the eighteen month trial period for a previous temporary version of the rule).

326 Certain "traditional shelf offerings" have been allowed since at least 1968 by the Commission's guides for the preparation and filing of registration statements, such as Guide 4, and related administrative practice. *See id.*; *see also* SEC Rel. No. 33-4936 [33 FR 18617] (Dec. 9, 1968) (adopting Guide 4 and other Commission guides).

327 *See* SEC Rel. No. 33-6499, at IV.A. ("[T]he procedural flexibility afforded by the Rule enables a registrant to time its offering to avail itself of the most advantageous market conditions . . . registrants are able to obtain lower interest rates on debt and lower dividend rates on preferred stock, thereby benefiting their existing shareholders. The flexibility provided by [Rule 415] also permits variation in the structure and terms of securities on short notice, enabling registrants to match securities with the current demands of the marketplace.").

we propose to condition the ability to sell securities in a continuous or delayed offering on being current with ongoing reporting requirements at the time of sale. We believe this additional condition will not impose incremental costs on issuers, which are in any case required to update their offering statement and to file such ongoing reports, and will insure parity of information in secondary markets.

To provide clarity regarding the application of Rule 415 concepts to Regulation A offerings, we propose to add a provision to Regulation A similar to Rule 415, but with limitations we believe would be appropriate in the context of Regulation A. The provision would establish time limits similar to those in Rule 415 and make conforming changes as necessary.[328]

The proposed rule would provide for continuous or delayed offerings for the following types of offerings:

- securities offered or sold by or on behalf of a person other than the issuer or its subsidiary;
- securities offered and sold pursuant to a dividend or interest reinvestment plan or an employee benefit plan of the issuer;
- securities issued upon the exercise of outstanding options, warrants, or rights;
- securities issued upon conversion of other outstanding securities;
- securities pledged as collateral; or
- securities the offering of which commences within two calendar days after the qualification date, will be made on a continuous basis, may continue for a period in excess of 30 days from the date of initial qualification, and will be

offered in an amount that, at the time the offering statement is qualified, is reasonably expected to be offered and sold within two years from the initial qualification date.[329]

The Rule 415 offerings we have not proposed to incorporate into Regulation A are those that would not have been available under existing Regulation A, such as those requiring securities to be registered on Form S-3 or Form F-3 or those conducted by issuers ineligible to use Regulation A,[330] as well as certain offerings that we do not currently believe would be appropriate to include in the Regulation A framework. For example, transactions typically done on Form S-4, such as acquisition shelf business combination transactions, would be excluded under the proposed rules. Further, we propose to prohibit all "at the market" offerings under Regulation A.[331] While it is possible that a market in Regulation A securities may develop that is capable of supporting primary and secondary at the market offerings, rather than permit such offerings at the outset, we believe that any Regulation A market that develops on the basis of the proposed rules should be monitored in the short term to determine whether the exemption would be an appropriate method for such offerings going forward. Further, an offering sold at fluctuating market prices may not be appropriate within the context of an exemption that is contingent upon not exceeding a maximum offering size. We do, however, seek comment as to whether the provision should permit primary and/or secondary offerings conducted in reliance on Regulation A to be sold at market prices.

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[328] Proposed Rule 251(d)(3).

[329] *Id.*

[330] Rule 415(a)(1)(xi) discusses investment companies and BDCs.

[331] *See* proposed Rule 251(d)(3)(ii).

Under the proposed rules, changes in the information contained in the offering statement would no longer necessarily trigger an obligation to amend.[332] Offering circulars for continuous Regulation A offerings would continue to be required to be updated, and the offering statements to which they relate requalified, annually to include updated financial statements, and otherwise as necessary to reflect facts or events arising after qualification which, in the aggregate, represent a fundamental change in the information set forth in the offering statement.[333] In addition to post-qualification amendments to the offering statement that must be qualified, however, we also propose to allow issuers to use offering circular supplements in certain situations.[334] Further, we propose to permit issuers in continuous offerings to qualify additional securities in reliance on Regulation A by a post-qualification amendment.[335]

The proposed rules would build on Regulation A to create a regime similar to what is permissible for registered offerings, and would draw from and adapt the language in Rule 424, Item 512 of Regulation S-K, and Rule 430A[336] to do so. Although filing a post-qualification amendment and a review by the Commission staff remains appropriate in some circumstances, we recognize that additional flexibility could be provided in other circumstances. Under the proposed rules, we borrow from the experience in registered offerings under Rule 415 to permit offering circular supplements for continuous or delayed offerings where the offering statement is not required to be amended by

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332 *See* proposed Rule 252(h)(1).

333 Proposed Rule 252(h)(2). *See also* discussion in Section II.E.1. below.

334 One commenter suggested that such supplements be permitted. *See* Kaplan Voekler Letter 2.

335 *See* note to proposed Rule 253(b).

336 17 CFR 230.430A.

Regulation A and there is no fundamental change in the offering statement's disclosure. We also propose to allow the use of offering circular supplements for final pricing information, where the offering statement is qualified on the basis of a bona fide price range estimate.[337] Additionally, offering circulars would be permitted to omit information with respect to the underwriting syndicate analogous to the provisions for registered offerings under Rule 430A.[338] The volume of securities (the number of equity securities or aggregate principal amount of debt securities) to be offered would not, however, be allowed to be omitted.[339] As proposed, an offering circular supplement could also be used to indicate a decrease in the volume of, or to change the price range of, the securities offered in reliance on a qualified offering statement under Regulation A, provided that, in the aggregate, such changes represent no more than a 20% change from the maximum aggregate offering price calculable using the information in the qualified offering statement.[340] In such circumstances, offering circular supplements would not be available where the maximum aggregate offering price resulting from any changes in the price of the securities would exceed the offering amount limitation set forth in proposed Rule 251(a) or if the increase in aggregate offering price would result in a Tier 1 offering

337 *See* proposed Rule 252(h). Relatedly, the Commission noted in the 1992 amendments to Regulation A that pricing information under Rule 430A did not necessarily need to be included in the final offering circular. *See* SEC Rel. No. 33-6949, at fn. 58. As proposed, the bona fide price range estimate could not exceed $2 for offerings where the upper end of the range is $10 or less and 20% if the upper end of the price range is over $10. *See* proposed Rule 253(b)(2).

338 *See* proposed Rule 253(b) (also permitting the omission of underwriting discounts or commissions, discounts or commissions to dealers, amount of proceeds, conversion rates, call prices and other items dependent upon the offering price, delivery dates, and terms of the securities dependent upon the offering date, so long as certain conditions are met); *Cf.* Rule 430A, 17 CFR 430A.

339 *See* proposed Rule 253(b)(4).

340 *See* note to proposed Rule 253(b); *Cf.* Instruction to paragraph (a) in Rule 430A(a), 17 CFR 230.430A(a).

becoming a Tier 2 offering. Allowing for the use of offering circular supplements in the situations outlined above would not alter the legal determination as to whether such information must be provided to investors, but would align Regulation A with prevailing market and Commission staff practices.[341]

We further propose provisions similar to Rule 424 that would require issuers omitting certain information from an offering statement at the time of qualification, in reliance on proposed Rule 253(b), to file such information as an offering circular supplement no later than two business days following the earlier of the date of determination of such pricing information or the date of first use of the offering circular after qualification.[342] Further, these proposed provisions would require offering circulars that contain substantive changes (other than information omitted in reliance on proposed Rule 253(b)) in information previously provided in the last offering circular to be filed within five business days after the date such offering circular is first used after qualification.[343] Offering circular supplements that are not filed within the required time frames provided by the proposed rules would be required to be filed as soon as practicable after the discovery of the failure to file.[344] We are soliciting comment on the scope of changes that should require a post-qualification amendment instead of an offering circular supplement.

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341 *Cf.* SEC Rel. No. 33-6714 [52 FR 21252] (June 5, 1987) (noting that the adoption of Rule 430A and the related changes to the procedures set forth in Rule 424 were "intended to simplify and reduce filing obligations without reducing investor protection.").

342 *See* proposed Rule 253(g).

343 *See* proposed Rule 253(g)(2).

344 *See* proposed Rule 253(g)(4).

Request for Comment

72. Should Regulation A continue to permit traditional shelf offerings, as proposed? Are there types of transactions not currently covered by Rule 415 that should be included in the rules relating to continuous offerings under Regulation A? If so, provide justification for including those transactions in Regulation A.

73. Should we use the time limits for continuous offerings found in Rule 415 for similar Regulation A offerings or should we lengthen or shorten such requirements? If so, please suggest new time limits and explain why they are preferable to the proposed time limits.

74. As proposed, should we permit continuous offerings that would be offered in an amount that, at the time the offering statement is qualified, the issuer reasonably expects to offer and sell within two years from the initial qualification date? Or should we limit this time period to one year from the initial qualification date?

75. We propose to no longer require issuers to amend an offering statement every time any information contained in the offering statement is changed, as is currently required in Rule 252(h), and instead require amendments to the offering statement to be filed and requalified annually to include updated financial statements, and otherwise as necessary to reflect facts or events arising after qualification which, in the aggregate, represent a fundamental change in the information set forth in the offering statement. Are there other types of changes in information or disclosure that should require a post-

qualification amendment that must be qualified, rather than an offering circular supplement? Should we use a standard different from the "fundamental change" standard proposed, which is based on Item 512(a) of Regulation S-K? Please provide justifications for your suggested approach.

76. As proposed, should we permit issuers to qualify additional securities in reliance on Regulation A by filing a post-qualification amendment to a qualified offering statement? Why or why not?

77. As proposed, should we adopt provisions similar to Rule 430A that would permit issuers to omit certain information with respect to, among other things, the underwriting syndicate and related information analogous to the provisions for registered offerings under Rule 430A? Why or why not? Additionally, as proposed, should we permit decreases to the volume of, or deviations from the price range of, the securities offered in reliance on Regulation A within the described limits?

78. As proposed, should we include in Regulation A provisions similar to Rule 424, which would require issuers relying on proposed Rule 253(b) to omit certain information from an offering statement at the time of qualification to file such information as an offering circular supplement no later than two business days following the earlier of the date of determination of such pricing information or the date of first use of the offering circular after qualification? Why or why not? Additionally, as proposed, should we require offering circulars that contain substantive changes (other than information omitted in reliance on proposed Rule 253(b)) in information previously provided in the last offering circular to be filed within five business days after the date such offering circular is first used after qualification? Why or why not?

79. Should we consider additional or alternative amendments to the proposed provisions for continuous offerings and offering circular supplements? Why or why not? If so, please explain.

80. As proposed, Regulation A is not specifically designed for business combination transactions. While such transactions, outside the context of acquisition shelf business combination transactions, are not prohibited, would Part II of proposed Form 1-A provide for appropriate disclosure of business combination transactions? Why or why not? If so, what additional narrative or financial disclosure provisions, if any, should apply to issuers with respect to such transactions?

81. As proposed, should the rules preclude primary and secondary at the market offerings? Or should the rules only preclude primary at the market offerings? Why or why not? If the rules should not prohibit at the market offerings how should the offering size be calculated for purpose of determining whether the offering exceeds the proposed applicable annual offering amount limitations? Please explain.

5. Qualification

Under Regulation A, an offering statement is generally only qualified by order of the Commission in a manner similar to a registration statement being declared effective.[345] In such instances, the issuer includes a delaying notation on the cover of the Form 1-A that states the offering statements shall only be qualified by order of the Commission.[346] In order to remove a delaying notation, an issuer must file an amendment to the offering statement indicating that the offering statement will become qualified on the 20th calendar day after filing.[347] An offering statement that does not include a delaying notation will be qualified without Commission action on the 20th calendar day after filing.[348]

We propose to alter the qualification process of existing Regulation A. As proposed, an offering statement could only be qualified by order of the Commission, and the process associated with the delaying notation would be eliminated. This not only conforms to the general practice of issuers under both Regulation A and registered offerings, but eliminates the risk that an issuer may exclude a delaying notation either in error or in an effort to become qualified automatically without review and comment by the Commission staff. Given our proposed electronic filing processes,[349] scaled disclosure requirements for Tier 1 and Tier 2 offerings,[350] and the preemption of state securities law registration and qualification requirements for Tier 2 offerings,[351] we believe it is appropriate to ensure that the Commission staff has a chance to review and comment on the offering statement before it becomes effective. We do, however, solicit

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345 *See* Rule 252(g)(2).

346 *Id.*

347 *See* Rule 252(g)(3).

348 *See* Rule 252(g)(1).

349 *See* discussion in Section II.C.1. above.

350 *See* discussion in Section II.C.3. above.

351 *See* discussion in Section II.H. below.

comment on whether we should retain provisions for the automatic effectiveness of an offering statement in a manner similar to the current rules, in order to provide issuers with some flexibility and control over the timing of the qualification process.

Request for Comment

82. Should we amend the qualification process, as proposed, so that an offering statement can only become qualified by order of the Commission? Or should we preserve the existing qualification provisions of Regulation A, which permit offering statements to become qualified without an order of the Commission on the 20th calendar day after filing? Why or why not? What effect, if any, would this have on issuers and their ability to control the timing of the qualification process?

D. Solicitation of Interest ("Testing the Waters")

Under Securities Act Section 3(b)(2)(E), issuers are to be permitted to test the waters for interest in an offering before filing an offering statement on such terms and conditions as the Commission prescribes. Testing the waters is currently permitted under Rule 254 of Regulation A, which requires, among other things, that issuers submit all solicitation material to the Commission no later than the time of first use. Issuers are further required to file all solicitation materials used in reliance on Rule 254 as an exhibit under Part III of Form 1-A, and are prohibited from making sales under Regulation A until 20 calendar days after the last publication or delivery of such materials. Under Rule 254(b)(3), issuers must cease using test the waters solicitation materials after the initial filing of the offering statement.

Testing the waters under Rule 254 of Regulation A is different from testing the waters for a registered offering by an emerging growth company under Section 5(d) of the Securities Act. Under Section 5(d), testing the waters is limited to communications with QIBs and institutional accredited investors. Under current Rule 254, however, there is no limitation on the type of investors that may be solicited, as the provision is meant to assist smaller issuers in evaluating potential interest in a public offering before incurring costs associated with preparing mandated disclosure documents.[352] New Securities Act Section 3(b)(2)(E) also does not limit the type of investors that may be solicited, but instead specifies that we can prescribe terms and conditions. We do not believe it is appropriate to adopt provisions in proposed Regulation A that are more restrictive than currently exist in Rule 254 and therefore do not propose to alter the permissible target audience of testing the waters materials.

While one commenter suggested that the Commission permit the use of solicitation materials before the filing of an offering statement,[353] another commenter simply suggested that all such solicitation materials be made readily available.[354] Another commenter suggested that, in addition to the existing requirements of Rule 254(b)(2), the Commission limit the use of testing the waters materials before the

352 SEC Rel. No. 33-6924, at 10-11 (discussing the capital needs of smaller companies, and, in comparison to "limited [private] offerings to more sophisticated professional investors," the need to facilitate greater "access to the public market[s] for startup and developing companies, and . . . lower[] the costs for small businesses that undertake to have their securities traded in the public market.").

353 McCarter & English Letter.

354 Beacon Investment Letter.

filing of an offering statement to solicitations conducted by registered broker-dealers or solicitations in firm commitment underwritings.[355]

Testing the waters was first proposed and approved for use in Regulation A in 1992, to address the risk that small companies faced when expending funds to prepare for an offering of securities without knowing whether there would be any interest in the offering.[356] We do not believe, however, that the existing provisions of Rule 254 have proven as useful as originally intended. We are concerned that the amount of time that typically elapses between initial filing of the Form 1-A and qualification (which, on average, from 2002 through 2012 was approximately 241 days) may limit the possible benefits of testing the waters in advance of initial filing. In addition, we understand that testing the waters activities may not be permissible under many state securities laws.

To address the potential impact of the review period, we propose to permit issuers to use testing the waters solicitation materials both before and after the offering statement is filed, subject to issuer compliance with the rules on filing and disclaimers.[357] In our view, to do otherwise would unnecessarily limit the intended benefits to issuers of testing the waters. As with existing Regulation A, investor protections with respect to such solicitation materials would remain in place, as these materials remain subject to the antifraud and other civil liability provisions of the federal securities laws.[358] In addition,

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355 NASAA Letter 2.

356 SEC Rel. No. 33-6924, at 12.

357 This timing is similar to the "testing the waters" permitted for emerging growth companies under new Section 5(d) of the Securities Act, added by the JOBS Act, which can also be conducted both before and after filing of a registration statement. Under Section 5(d), no legending or disclaimers are required, but testing the waters is limited to potential investors that are "qualified institutional buyers" or institutional "accredited investors."

358 The Commission's antifraud liability provisions in Section 17 of the Securities Act, 15 U.S.C. 77q, apply to any person who commits fraud in connection with the offer or sale of securities.

under the proposal, testing the waters materials used by an issuer or its intermediaries after publicly filing an offering statement would be required to include a current preliminary offering circular or contain a notice informing potential investors where and how the most current preliminary offering circular can be obtained. This requirement could be satisfied by providing the URL where the preliminary offering circular or the offering statement may be obtained on EDGAR.

Since we propose to require issuers to publicly file their offering statements not later than 21 calendar days before qualification, this timing requirement would ensure that, at a minimum, any solicitation made in the 21 calendar days before the earliest date of potential sales of securities would be conducted using the most recent version of preliminary offering circular.[359] While the proposed expansion on use of solicitation materials after filing would potentially result in investors receiving more sales literature in marketed offerings, in such circumstances, potential investors would also be afforded more time with the preliminary offering circular before making an investment decision.[360] Issuers and intermediaries that use testing the waters materials after publicly filing the offering statement would be required to update and redistribute—through any electronic or print media or television or radio broadcast distribution channels previously relied upon by the issuer or its intermediaries to market the offering during this period—such

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Section 3(b)(2)(D) of the Securities Act, 15 U.S.C. 77c(b)(2)(D), states that the civil liability provisions of Section 12(a)(2) apply to any person offering or selling securities under Regulation A. *See also* SEC Rel. No. 33-6924, at fn. 48.

359 *See* discussion of non-public submissions of offering statements in Section II.C.2. above, which proposes to require an issuer to file its offering statement with the Commission not later than 21 calendar days before qualification.

360 *Cf.* The Regulation of Securities Offerings, SEC Rel. No. 33-7606A, at 78 (Nov. 17, 1998) [63 FR 67174] (discussing the importance of providing a preliminary prospectus in conjunction with the distribution of sales materials).

material to the extent that either the material itself or the preliminary offering circular attached thereafter becomes inadequate or inaccurate in any material respect.[361] Additionally, whether or not an issuer or its intermediaries tests the waters, as provided for by proposed Regulation A, such parties would remain obligated in the pre-qualification period to deliver a copy of the preliminary offering circular to prospective purchasers at least 48 hours in advance of sale under proposed Rule 251(d)(2)(i).[362]

We further propose to amend the Rule 254 requirements for submission or filing of solicitation material, so that such material would be submitted or filed as an exhibit when the offering statement is either submitted for non-public review or filed (and updated for substantive changes in such material after the initial non-public submission or filing) but would no longer be required to be submitted at or before the time of first use. This approach is generally consistent with the Commission staff's treatment of solicitation materials used by emerging growth companies under Title I of the JOBS Act, with two exceptions:

- solicitation materials used in Regulation A offerings would be required to be filed;[363] and

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361 Issuers would not, however, be required to update and redistribute solicitation materials to the extent that: i) any such changes occur only with respect to the preliminary offering circular, ii) no similar changes are required in the solicitation materials previously relied upon, and iii) such materials included (when originally distributed) a URL where the preliminary offering circular or the offering statement filed on the issuer's EDGAR filing page and that URL continues to link to the most recent version of the preliminary offering circular.

362 Proposed Rule 251(d)(2)(i) is discussed in Section II.C.1. above.

363 In practice, however, Commission staff reviewing filings by emerging growth companies regularly requests and receives such material as part of the review process to ensure consistency between the information contained in the solicitation materials and the registration statement. *See* 17 CFR 230.418 (Supplemental Information).

- solicitation materials used by Regulation A issuers that file an offering statement with the Commission would be publicly available as a matter of course.[364]

We believe this approach would be consistent with the 1992 amendments to Regulation A that first allowed issuers to test the waters, and would make the use of solicitation materials more beneficial for issuers and investors, reduce the filing requirements for issuers, and entirely eliminate the filing requirement for issuers that, after testing the waters, decide not to proceed with an offering. Additionally, from an investor protection standpoint, it is important to note that sales under Regulation A may occur only under a qualified offering statement that reflects staff review and comment, including, where appropriate, disclosure addressing potentially incomplete or misleading statements made in test the waters solicitation material. For this reason, in addition to the statutory language of Section 3(b)(2)(E), which indicates that "issuer[s] may solicit interest in the offering," we do not believe it is necessary, as one commenter suggested, to limit the availability of this provision to solicitations carried out by registered broker-dealers or by underwriters in firm commitment underwritings.[365]

Currently, Rule 254(b)(2) requires all soliciting materials to bear a legend or disclaimer indicating: i) that no money or other consideration is being solicited, and if sent, will not be accepted; ii) that no sales will be made or commitments to purchase

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364 Where an issuer non-publicly submits an offering statement under Regulation A that is later abandoned before filing, and where that issuer properly submitted the offering statement pursuant to a confidential treatment request pursuant to Commission Rule 83 (17 CFR 200.83), the offering statement and solicitation materials may, under certain circumstances, qualify for an exemption from production pursuant to the FOIA. *See* http://www.sec.gov/foia/conftreat.htm for more information. Such materials, however, will be publicly available on EDGAR if, and when, an offering statement is eventually filed with the Commission.

365 *See* NASAA Letter 2 (suggests limiting the use of solicitation materials to solicitations made by broker-dealers, or in the context of firm commitment underwritten offerings).

accepted until a complete offering circular is delivered; iii) that a prospective purchaser's indication of interest is non-binding; and iv) the identity of the issuer's chief executive officer and a brief description of the issuer's business and products.[366] We propose to amend Rule 254(b)(2)(ii) to more closely follow similar provisions in the context of registered offerings.[367] The amended language would recognize that, similar to the framework for registered offerings, sales made pursuant to Regulation A would be contingent upon the qualification of the offering statement, not the delivery of a final offering circular. Additionally, to provide greater flexibility when using solicitation materials, we propose to eliminate the requirement in Rule 254(b)(2)(iv) to identify the issuer's chief executive officer, business, and products.

Further, as noted above, we do not propose to limit testing the waters to QIBs and institutional accredited investors (as is currently the case with testing the waters under Title I of the JOBS Act), as we do not believe it is appropriate to adopt provisions in proposed Regulation A that are more restrictive than currently exist in the regulation.

Request for Comment

83. As proposed, should we differentiate between the requirements for the use of testing the waters materials before the issuer publicly files an offering statement and after filing (when it is proposed that a preliminary offering circular would have to be provided)? Why or why not? Is the proposed time period during which a preliminary offering circular would be required to be provided together with testing the waters materials appropriate, or should it be

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366 17 CFR 230.254(b)(2).

367 *See* Rule 134(d), 17 CFR 230.134(d), (required disclaimer for solicitations of interest in registered offerings).

longer or shorter? Is the 48-hour period for the delivery of a preliminary offering circular under proposed Rule 251(d)(2)(i) sufficient to address any concerns about the use of solicitation materials at or near the time of qualification?[368] Should we distinguish between the use of testing the waters materials after an offering statement is non-publicly submitted versus publicly filed?

84. Should we amend Rule 254, as proposed, so that solicitation material would no longer be required to be submitted to the Commission at or before the time of first use? If not, in the absence of a confidential treatment request under Commission Rule 83 (17 CFR 200.83), should solicitation material be made publicly available immediately after submission on EDGAR? Or, as proposed, should we only require solicitation materials to be publicly available when included as an exhibit to an offering statement that is filed with the Commission not later than 21 calendar days before the offering statement is qualified?

85. Is the legend or disclaimer required to be included in the solicitation materials under proposed Rule 254 appropriately tailored for the likely recipients of such materials in Regulation A offerings? Why or why not? Should solicitation materials used by the issuer and its intermediaries before the initial public filing of the offering statement be required to include specific information about the issuer or the offering similar to current rules? If so, what information should be required?

[368] *See* discussion of delivery requirements in Section II.C.1. above.

86. While not currently proposed, should we limit the use of testing the waters materials to communications with QIBs and institutional accredited investors in order to be consistent with the treatment of emerging growth companies under Title I of the JOBS Act? Would QIBs or institutional accredited investors be the likely target audience for issuers testing the waters in reliance on Regulation A? Why or why not? As proposed, should issuers and intermediaries that use testing the waters materials after publicly filing an offering statement be required to update and redistribute—through any electronic or print media or television or radio broadcast distribution channels previously relied upon by the issuer or its intermediaries to market the offering during this period—such material if either the material itself or the preliminary offering circular attached thereafter becomes inadequate or inaccurate in any material respect?[369] Why or why not? Would this requirement unduly limit the utility, and potentially raise the costs, of testing the waters after publicly filing an offering statement, or would it help to ensure that issuers and intermediaries that solicit interest in a potential offering during this period of time do so in a measured and judicious manner? Please explain.

87. Should we make the submission or filing of solicitation materials a condition to the Regulation A exemption, such that an issuer that fails to submit such materials as part of an offering statement submitted for non-public review, or to file such materials as part of a filed offering statement, loses its ability to

[369] *But see* fn. 361 above for an exception to the general requirements for updates and redistribution.

rely on the exemption? If so, should we provide for a cure period for inadvertent failures to submit or file solicitation materials as an exhibit to an offering statement?

E. Ongoing Reporting

Currently, Regulation A requires issuers to file a Form 2-A with the Commission every six months after qualification to report sales under Regulation A, with a final filing due within 30 calendar days after the termination, completion, or final sale of securities in the offering.[370] Section 3(b)(2) requires issuers to provide annual audited financial information on an ongoing basis, and expressly provides that the Commission may consider whether additional ongoing reporting should be required. Specifically, Section 3(b)(4) grants the Commission authority to require issuers "to make available to investors and file with the Commission periodic disclosures regarding the issuer, its business operations, its financial condition, its corporate governance principles, its use of investor funds, and other appropriate matters, and also provide for the suspension and termination of such requirement."

Most commenters agree that the Commission should require some form of ongoing reporting in revised Regulation A, but differ on the degree and frequency of such reporting.[371] In general, the comments received acknowledge that the Commission's task

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370 *See* 17 CFR 230.257; *see also* 17 CFR 239.91 (Form 2-A).

371 *See, e.g.*, Letter from Mike Liles, Jr., Attorney, Karr Tuttle Campbell, April 12, 2012 ("Karr Tuttle Letter"); Letter from Kurt N. Schacht, CFA, Managing Director, Standards and Financial Market Integrity, and Linda L. Rittenhouse, Director, Capital Markets Policy, CFA Institute, Aug. 16, 2012 ("CFA Institute Letter"); Fallbrook Letter. *But see* Letter from Robert R. Kaplan, Jr., Esq., Kaplan Voekler, May 10, 2012 ("Kaplan Voekler Letter 1") (suggesting that, in light of the relative costs to issuers in smaller dollar amount offerings, the Commission not require ongoing reports for Regulation A offerings of up to $5 million in securities annually); NSBA Letter (suggesting the only change the Commission should make in Regulation A is raising the dollar limitations from $5 million to $50 million); *see also* ECTF Report (suggesting ongoing periodic

in determining the appropriate level of ongoing reporting requires balancing the risks of imposing issuer disclosure requirements that are too prescriptive[372] or onerous[373] with the risks of providing too little information to either support,[374] or adequately protect investors in,[375] the secondary market. Some commenters suggested that the Commission require ongoing reporting only to the extent necessary to support an active secondary market, such as by requiring quarterly and material event reporting,[376] or semiannual performance updates.[377] Alternatively, one commenter suggested that the Commission only require annual filings under a two-year pilot program to determine whether such reports, without more, provide sufficient information to the market.[378] One commenter suggested that ongoing reporting requirements under Regulation A should be similar to, but less onerous than, Exchange Act reporting.[379] This commenter suggested that the rules require periodic reports that follow the disclosure requirements applicable to smaller reporting companies, or those of Exchange Act Rule 15c2-11. In its view, though, current reporting in a fashion similar to Form 8-K under the Exchange Act might be too burdensome for smaller issuers, while the OTC Markets' proprietary Alternative Reporting System might be more appropriate. The commenter also suggested that, if required, current reporting should be limited to material agreements, financial

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reporting that is reasonable in scope and balances investor protection concerns with regulatory and compliance costs).

372 ABA Letter.

373 McCarter & English Letter.

374 Kaplan Voekler Letter 1.

375 NASAA Letter 1; NASAA Letter 2.

376 Kaplan Voekler Letter 1.

377 CFA Institute Letter.

378 Fallbrook Letter.

obligations, unregistered sales of securities, changes in accountants, changes in and the compensation of directors and officers, and charter amendments. Another commenter suggested periodic reporting that is less prescriptive than Exchange Act reporting, and using Form 1-A disclosure requirements as a base.[380] Several commenters suggested that—to the extent the Commission permits Regulation A offerings to be simultaneously listed, or approved for listing, on a national securities exchange—it should permit Exchange Act reporting to satisfy Title IV's ongoing reporting requirements.[381] Another commenter suggested that any ongoing reporting requirements eventually adopted should be meaningful enough to provide investors with current information about issuers and to permit better informed investment decisions.[382]

The sole advance comment received on how and when to permit terminating ongoing reports suggested that the Commission permit automatic termination (or suspension) of ongoing reporting obligations in a fashion similar to that permitted under Section 15(d) of the Exchange Act.[383] That is, the Commission should allow ongoing reporting to be suspended as to any fiscal year, other than the fiscal year in which the offering was qualified, if at the beginning of such fiscal year the securities of the class sold in the offering are held of record by fewer than 300 persons.

We are mindful that an ongoing reporting regime that is suitable for one type of entity and its investor base may prove too onerous for another entity or provide its

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379 McCarter & English Letter.

380 ABA Letter.

381 ABA Letter; WR Hambrecht + Co. Letter.

382 NASAA Letter 1; NASAA Letter 2.

383 ABA Letter.

investors with more or more frequent information than they necessarily need or seek, resulting in undue costs to the issuer. In the discussion and proposals that follow, we have endeavored to address the potential added costs and benefits associated with the provision of ongoing information about issuers of Regulation A securities to investors in such securities and any market that develops as a result.

1. Continuing Disclosure Obligations

As noted above, Regulation A currently requires issuers to file a Form 2-A with the Commission to report sales and the termination of sales made under Regulation A every six months after qualification and within 30 calendar days after the termination, completion, or final sale of securities in the offering.[384] The summary information about the issuer and its offering required to be disclosed in the Form 2-A is intended to provide the Commission with valuable data about Regulation A offerings and the effectiveness of Regulation A as a capital formation tool for smaller issuers. Currently, however, issuers of securities under Regulation A often neglect to file the form, thereby limiting the amount and utility of the data received.[385] We propose to rescind Form 2-A, but to continue to require Regulation A issuers to file the information generally disclosed in Form 2-A with the Commission electronically on EDGAR.[386] We believe that summary

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384 *See* 17 CFR 230.257; *see also* 17 CFR 239.91 (Form 2-A).

385 Currently, the filing of the Form 2-A is not a condition to an issuer's ability to rely on Regulation A. *See* Rule 257, 17 CFR 230.257. As proposed, the filing of the information required under current Form 2-A would not be a condition to an issuer's ability to rely on Regulation A for the current offering, but would affect the issuer's ability to conduct a follow-on Regulation A offering in the future. *See* the discussion in Section II.B.1. above regarding proposed issuer eligibility requirements.

386 We do not propose to continue to require issuers to disclose the use of proceeds currently disclosed in Form 2-A, as issuers must disclose this information in Part II of Form 1-A and any changes in the use of proceeds after qualification not previously disclosed would require issuers to determine whether a post-qualification amendment or offering circular supplement is necessary.

information and data about an issuer and its Regulation A offering, however, is most valuable when obtained after the offering is completed or terminated. We therefore propose to require issuers to disclose such information only after the termination or completion of the offering. Issuers conducting Tier 1 offerings would be required to provide this information on Part I of proposed new Form 1-Z not later 30 calendar days after termination or completion of the offering,[387] while issuers conducting Tier 2 offerings would be required to provide this information on either Part I of Form 1-Z at the time of filing an exit report or proposed new Form 1-K as part of their annual report.

As proposed, issuers in Tier 2 offerings would be subject to a Regulation A ongoing reporting regime that would, in addition to filing summary information on a recently completed offering and annual reports on proposed new Form 1-K, require issuers to file semiannual updates on proposed new Form 1-SA, current event reporting on proposed new Form 1-U, and to provide notice to the Commission of the suspension of their ongoing reporting obligations on Part II of proposed new Form 1-Z. All of these reports would be filed electronically on EDGAR.

We are concerned that uniform ongoing reporting requirements for all issuers of Regulation A securities could disproportionately affect issuers in smaller offerings.[388] For that reason, we do not propose to require any ongoing reporting for issuers conducting Tier 1 offerings, other than the summary information discussed above, which

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See discussion of continuous or delayed offerings and offering circular supplements in Section II.C.4. above.

387 Proposed new Form 1-Z (exit report) is discussed in Section II.E.4. below.

388 *See also* Kaplan Voekler Letter 1 (recommending that, in light of the relative costs to issuers in smaller dollar amount offerings, the Commission not require ongoing reports for Regulation A offerings of up to $5 million in securities annually).

is already required under the existing rules.[389] Section 3(b)(2)(F) requires issuers to file audited financial statements with the Commission annually, which does not apply to current Regulation A.[390] While Section 3(b)(2) directs the Commission to "add a class of securities exempted pursuant to this section," it does not also direct the Commission to supplant the provisions associated with the existing class of securities exempted under Section 3(b)(1) and Regulation A. We therefore propose to preserve this aspect of current Regulation A for Tier 1 offerings. As proposed, however, issuers in smaller offerings would have the option to conduct a Tier 2 offering and subject themselves to the more expansive ongoing reporting regime and otherwise comply with the proposed Tier 2 requirements.[391]

We believe the proposed approach to ongoing reporting should support a regular flow of information about issuers conducting Tier 2 offerings, which would benefit investors and foster the development of a market in such securities, without imposing unnecessary costs on issuers that elect to conduct a Tier 1 offering. We believe our proposal strikes an appropriate balance between the investor protections associated with the provision of ongoing information about an existing or contemplated investment to potential investors and our goal of facilitating capital formation for smaller companies by not requiring too heavy a reporting obligation.

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389 *See* proposed Rule 257(a).

390 As noted in Section I.A. above, current Regulation A was issued under Section 3(b)(1) of the Securities Act.

391 An issuer offering up to $5 million in a Tier 2 offering would, in addition to providing ongoing reports to the Commission on the proposed annual and semiannual basis, with interim current event updates, be required to file audited financial statements in the offering statement, *see* Section II.C.3.b(2). above, and may be required to file a Form 1-Z to terminate its ongoing reporting obligations as described in Section II.E.4. below.

The following are the proposed ongoing reporting requirements for Tier 2 offerings:

a. Annual Reports on Form 1-K

Proposed new Form 1-K would be comprised of two parts: Part I (Notification) and Part II (Information to be included in the report).

(1) Part I (Notification)

As with Part I of Form 1-A,[392] Part I of Form 1-K would be an online XML-based fillable form that would include certain basic information about the issuer, prepopulated on the basis of information previously disclosed in Part I of Form 1-A, which can be updated by the issuer at the time of filing. Additionally, if, at the time of filing the Form 1-K, an issuer has terminated or completed a qualified Regulation A offering, we propose to require the issuer to provide certain updated summary information about itself and the offering in Part I, including, *e.g.*, the date the offering was qualified and commenced, the number of securities qualified, the number of securities sold in the offering, the price of the securities, any fees associated with the offering, and the net proceeds to the issuer. As discussed above, this information is generally already required to be disclosed under current Regulation A on Form 2-A, which we propose to eliminate.

The portion of the fillable form relating to a completed Regulation A offering would appear when the issuer indicates in Part I that the offering has terminated or been completed. Issuers would only be required to fill out the XML-based portion of Part I that relates to the summary information on a terminated or completed offering once. Alternatively, an issuer that elects to terminate its ongoing reporting obligation under

392 *See* discussion in Section II.C.3.a. above.

Regulation A after terminating or completing an offering, in a fiscal year other than the fiscal year in which the offering statement was qualified, but before reporting the required summary information on Form 1-K,[393] could satisfy its obligation to file the summary offering information in Part I of Form 1-K by filing a Form 1-Z (exit report) that includes such information.[394]

The summary information disclosed would facilitate analysis of Regulation A offerings by the Commission, other regulators, third-party data providers, and market participants, while facilitating the capture of important summary information about an offering that would enable the Commission to monitor the use and effectiveness of Regulation A as a capital formation tool.[395] The fillable form would enable issuers to provide the required information in a convenient medium and only capture relevant data about the recently terminated or completed Regulation A offering. The required disclosure would be publicly available on EDGAR. As with proposed requirements for Part I of Form 1-A, Part I of Form 1-K would not require the issuer to obtain specialty software.

(2) Part II (Information to be included in the report)

As with Part II of Form 1-A, Part II of Form 1-K would be submitted electronically by the issuer as a text file attachment containing the body of the disclosure

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393 An issuer that has completed a Regulation A offering under Tier 2 in a fiscal year other than the fiscal year in which the offering was qualified could, however, continue filing the ongoing reports required in Tier 2 offerings in order to, for example, continually provide updated information to its shareholder or to broker-dealers for purposes of proposed Exchange Act Rule 15c2-11. *See* discussion in Section II.E.2. below.

394 For a discussion of the requirements for terminating an ongoing reporting obligation under Regulation A and proposed new Form 1-Z, *see* Section II.E.4. below.

395 *See also* discussion in Section II.E.4.a. below.

document and financial statements, formatted in HTML or ASCII to be compatible with the EDGAR filing system. Part II would contain information about the issuer and its business based on the financial statement and narrative disclosure requirements of Form 1-A. Form 1-K would further permit issuers to incorporate by reference certain information previously filed on EDGAR, but require issuers to include a hyperlink to such material on EDGAR.[396] Form 1-K would cover:

- Business operations of the issuer for the prior three fiscal years (or, if in existence for less than three years, since inception);
- Transactions with related persons, promoters, and certain control persons;
- Beneficial ownership of voting securities by executive officers, directors, and 10% owners;
- Identities of directors, executive officers, and significant employees, with a description of their business experience and involvement in certain legal proceedings;
- Executive compensation data for the most recent fiscal year for the three highest paid officers or directors;
- MD&A of the issuer's liquidity, capital resources, and results of operations covering the two most recently completed fiscal years;[397] and
- Two years of audited financial statements.

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396 The hyperlink to EDGAR need only be active at the time of filing of the Form 1-K.

397 As proposed, Form 1-K would not include the additional MD&A disclosure required in Form 1-A for issuers that have not received revenue from operations during each of the three fiscal years immediately before the filing of the offering statement. *See* discussion in Section II.C.3.b(1). above.

We anticipate that issuers would generally be able to use the offering materials as a basis to prepare their ongoing disclosure.

We propose that Form 1-K includes financial statements prepared on the same basis, and subject to the same requirements as to audit standards and auditor independence, as the financial statements required in the Regulation A offering circular for Tier 2 offerings.[398] Form 1-K would be required to be filed within 120 calendar days after the issuer's fiscal year end. A manually-signed copy of the Form 1-K would have to be executed by the issuer and related signatories before or at the time of filing and retained by the issuer for a period of five years.[399] Issuers would be required to produce the manually signed copy to the Commission, upon request.[400] Any amendments to the form would have to comply with the requirements of the applicable items and be filed under cover of Form 1-K/A.[401]

b. Semiannual Reports on Form 1-SA

We are proposing semiannual interim reporting for Regulation A issuers. We believe this would strike an appropriate balance between the need to provide information to the market and the cost of compliance for smaller issuers. Issuers would be required to provide semiannual updates on proposed Form 1-SA that, much like Form 10-Q, would consist primarily of financial statements and MD&A.[402] Unlike Form 10-Q, however, Form 1-SA would not, among other things, require disclosure about quantitative and

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398 *See* Section II.C.3.b(2). above.

399 *See* General Instruction C. to proposed Form 1-K.

400 *Id.*

401 *See* proposed Rule 257(c) (also requiring the signature on behalf of an authorized representative of the issuer and the inclusion of any specified certifications).

402 *See* Part I (Financial Information) of Form 10-Q, 17 CFR 249.308a.

qualitative market risk, controls and procedures, updates to risk factors, or defaults on senior securities, as we believe such disclosure is not applicable to, or appropriately-tailored for, issuers in the context of an ongoing report under Regulation A.[403] In addition, Form 1-SA would require disclosure of updates otherwise reportable on Form 1-U. Financial statements included in semiannual reports would not be required to be audited or reviewed by independent auditors. Form 1-SA would permit issuers to incorporate by reference certain information previously filed on EDGAR, but require issuers to include a hyperlink to such material on EDGAR.[404]

We propose to require that Form 1-SA be filed within 90 calendar days after the end of the issuer's second fiscal quarter. A manually-signed copy of the Form 1-SA would have to be executed by the issuer and related signatories before or at the time of filing and retained by the issuer for a period of five years.[405] Issuers would be required to produce the manually signed copy to the Commission, upon request.[406] Any amendments to the form would have to comply with the requirements of the applicable items and be filed under cover of Form 1-SA/A.[407]

c. Current Reports on Form 1-U

In addition to the annual report on Form 1-K and semiannual report on Form 1-SA, we further propose to require issuers to submit current reports on Form 1-U. Issuers would be required to submit such reports in the following events:

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403 *See* Item 3 and Item 4 of Part I of Form 10-Q.

404 The hyperlink to EDGAR need only be active at the time of filing of the Form 1-SA.

405 *See* General Instruction C. to proposed Form 1-SA.

406 *Id.*

407 *See* proposed Rule 257(c).

- Fundamental changes in the nature of business;[408]
- Bankruptcy or receivership;
- Material modification to the rights of securityholders;
- Changes in the issuer's certifying accountant;
- Non-reliance on previous financial statements or a related audit report or completed interim review;
- Changes in control of the issuer;
- Departure of the principal executive officer, principal financial officer, or principal accounting officer; and
- Unregistered sales of 5% or more of outstanding equity securities.

As proposed, the requirement that issuers file a Form 1-U in the event they experience, or would reasonably expect to experience, a fundamental change in the nature of their business would incorporate aspects of each of Item 1.01, 1.02 and 2.01 of Form 8-K under the Exchange Act and change the threshold for reporting from a materiality to a fundamental change standard.[409] Under the proposal, Form 1-U would be required to be filed within four business days after the occurrence of any such event, and, where applicable, permit issuers to incorporate by reference certain information previously filed on EDGAR, but require issuers to include a hyperlink to such material on EDGAR.[410] A

408 A fundamental change in the nature of an issuer's business would include major and substantial changes in the issuer's business or plan of operations or changes reasonably expected to result in such changes, such as significant acquisitions or dispositions, or the entry into, or termination of, a material definitive agreement that has or will result in major and substantial changes to the nature of an issuer's business or plan of operations.

409 *See* Form 8-K, Item 1.01 (Entry into a Material Definitive Agreement), Item 1.02 (Termination of a Material Definitive Agreement), and Item 2.01 (Completion of Acquisition or Disposition of Assets), 17 CFR 249.308.

410 The hyperlink to EDGAR need only be active at the time of filing of the Form 1-U.

manually-signed copy of the Form 1-U would have to be executed by the issuer and related signatories before or at the time of filing and retained by the issuer for a period of five years.[411] Issuers would be required to produce the manually signed copy to the Commission, upon request.[412] Any amendments to the Form 1-U would have to comply with the requirements of the applicable items, and be filed under cover of Form 1-U/A.[413]

d. Special Financial Reports on Form 1-K and Form 1-SA

While not currently a requirement of Regulation A, we propose to require issuers conducting Tier 2 offerings to provide special financial reports analogous to those required under Exchange Act Rule 15d-2.[414] The special financial report would require audited financial statements for the issuer's last completed fiscal year to be filed not later than 120 calendar days after qualification of the offering statement if the offering statement did not include such financial statements. The special financial report would require semiannual financial statements for the first six months of the issuer's fiscal year, which may be unaudited, to be filed 90 calendar days after qualification of the offering statement if the offering statement did not include such financial statements and the offering statement was qualified in the second half of the issuer's current fiscal year. The special financial report would be filed under cover of Form 1-K if it included audited year-end financial statements and under cover of Form 1-SA if it included semiannual financial statements for the first six months of the issuer's fiscal year. The financial statement and auditing requirements would follow the requirements of those forms.

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411 *See* General Instruction C to proposed Form 1-U.

412 *Id.*

413 *See* proposed Rule 257(c).

414 17 CFR 240.15d-2.

Similarly to the special financial report under Exchange Act Rule 15d-2, the issuer would indicate on the front page of the applicable form that only financial statements are included. This report would serve to close lengthy gaps in financial reporting between the financial statements included in Form 1-A and the issuer's first periodic report due after qualification of the offering statement.

e. Reporting by Successor Issuers

Where in connection with a succession by merger, consolidation, exchange of securities, acquisition of assets or otherwise, securities of an issuer that is not subject to the reporting requirements of Regulation A, as proposed to be amended, are issued to the holders of any class of securities of an issuer that is subject to ongoing reporting under Tier 2, we propose to require the issuer succeeding to that class of securities to continue filing reports required for Tier 2 offerings on the same basis as would have been required of the original issuer. The successor issuer may, however, suspend or terminate its reporting obligations on the same basis as the original issuer under proposed Rule 257(d).[415]

Request for Comment

88. Would the proposed requirement that issuers conducting Tier 2 offerings file annual, semiannual, and current reports provide a meaningful benefit for investors by helping to foster a transparent market for securities issued under Regulation A? Should this requirement apply to all issuers of securities under Regulation A, regardless of whether the issuer is conducting a Tier 1 or Tier 2

415 *See* Section II.E.4. below for a discussion of the suspension or termination of disclosure obligations.

offering? Alternatively, should we not impose ongoing reporting requirements beyond the statutory mandate of annual audited financial statements? Or should we require only annual reporting of the type of information required by proposed Form 1-K, without interim periodic reporting or current updates? Should we require only annual reporting and current updates? If we require interim periodic reporting, should it be quarterly instead of the proposed semiannual reporting requirement? Should quarterly or semiannual financial statements be required to be reviewed by an independent auditor?

89. While not currently proposed, should we exempt issuers conducting Tier 1 offerings from the requirement to report certain summary information about the issuer and the offering after termination or completion of the offering? Alternatively, should issuers conducting Tier 1 offerings be required to report on a more frequent basis than currently proposed? Why or why not?

90. If we exempt some issuers from ongoing reporting, should we do so on the basis of criteria other than offering size, such as issuer size or whether the issuer has taken steps to foster a secondary market for their securities? Why or why not?

91. Should the rules require issuers that conduct a Tier 2 offering to file their annual report on new Form 1-K within 120 calendar days of the fiscal year end, and their semiannual report on new Form 1-SA with 90 calendar days of the end of the second fiscal quarter, as proposed? Or should we require such issuers to file reports on a different timetable? For example, should the timetable be the same as for non-accelerated filers under the Exchange Act, who are required to file annual reports within 90 calendar days of the fiscal year end and interim periodic reports within 45 calendar days of the end of a fiscal quarter? What effect, if any, would altering the proposed filing deadlines for annual and semiannual reporting have on the costs to issuers of preparing such reports? Please provide supporting data, if possible.

92. As proposed, does the new Form 1-K provide for the disclosure of adequate information about the issuer on an annual basis? Similarly, does the new Form 1-SA provide for the disclosure of adequate information about the issuer on a semiannual basis? Or should the form(s) require more (or less) disclosure? If so, what additional disclosure should the form(s) require, or what items of proposed disclosure should not be required? Please explain.

93. Should we require current updates, as proposed on new Form 1-U? If not, please explain why. If we require current reporting, should we include more, fewer, or different triggering events for current reporting than are currently proposed? Should the requirement to provide current reporting apply to all Regulation A issuers? Is there an appropriate segment of Regulation A issuers, other than as proposed, for which current reporting would be the most useful or should otherwise be required?

94. Does the proposed requirement that issuers disclose material transactions that would result in, or would reasonably be expected to result in, fundamental changes to the issuer's business or corporate events on new Form 1-U provide enough guidance to issuers? If not, should we provide more guidance as to what constitutes a material transaction or corporate event? If so, please provide suggestions.

95. As proposed, should we permit issuers to incorporate by reference certain information into the Form 1-K, Form 1-SA and Form 1-U that was previously filed on EDGAR under Regulation A, while also requiring issuers to include a hyperlink to such exhibit on EDGAR? Why or why not? Should we permit issuers to incorporate by reference information from other documents, such as Exchange Act reports or Securities Act registration statements?

96. As proposed, should we require special financial reporting similar to that which is required for a registered offering under Exchange Act Rule 15d-2? As proposed, should the rules require audited financial statements for the issuer's last completed fiscal year to be filed 120 calendar days after qualification of the offering statement if the offering statement did not include such financial statements or, alternatively, require semiannual financial statements for the first six months of the issuer's fiscal year to be filed 90 calendar days after qualification of the offering statement if the offering statement did not include such financial statements and the issuer's first required periodic report would be a Form 1-SA? Why or why not?

97. As proposed, should issuers that succeed to a class of securities, in connection with a succession by merger, consolidation, exchange of securities, acquisition of assets or otherwise, that are currently subject to a Tier 2 ongoing reporting obligation, as proposed to be amended, be required to continue filing reports

on the same basis as would have been required of the original issuer? Why or why not? Please explain.

98. Would the proposed ongoing reporting requirements and termination provisions of Regulation A induce companies to migrate to the Regulation A capital raising and reporting regime, such that we may see a decline in smaller reporting companies subject to full Exchange Act reporting?[416] If so, what effect would any population shift of issuers in the registered and reporting regime under the Securities Act and Exchange Act migrating to the Regulation A exemptive scheme have on investor protection?

2. Exchange Act Rule 15c2-11 and other implications of ongoing reporting under Regulation A

Exchange Act Rule 15c2-11 governs broker-dealers' publication of quotations for securities in a quotation medium other than a national securities exchange.[417] The Commission adopted Rule 15c2-11 in 1971 to prevent fraudulent and manipulative trading schemes that had arisen in connection with the distribution and trading of certain unregistered securities.[418] The rule prohibits broker-dealers from publishing quotations (or submitting quotations for publication) in a "quotation medium" for covered over-the-counter securities without first reviewing basic information about the issuer,

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416 *See* discussion of proposed termination of ongoing reporting requirements under Regulation A in Section II.E.4. below.

417 17 CFR 240.15c2-11.

418 SEC Rel. No. 34-9310 (Sept. 13, 1971) [36 FR 18641]. *See* 17 CFR 240.15c2-11(e)(1) (defining quotation medium as any "interdealer quotation system" or any publication or electronic communications network or other device which is used by brokers or dealers to make known to others their interest in transactions in any security, including offers to buy or sell at a stated price or otherwise, or invitations of offers to buy or sell).

subject to certain exceptions.[419] A broker-dealer also must have a reasonable basis for believing that the issuer information is accurate in all material respects and that it was obtained from a reliable source.

A broker-dealer can, however, satisfy its obligations under Rule 15c2-11 if it has reviewed and maintained in its records certain specified information. The particular information that is required by the rule varies depending on the nature of the issuer, including, among other things:

- for an issuer that has filed a registration statement under the Securities Act, a copy of the prospectus;
- for an issuer that has filed an offering statement under the Securities Act pursuant to Regulation A, a copy of the offering circular; or
- for an issuer subject to ongoing reporting under Sections 13 or 15(d) of the Exchange Act, the issuer's most recent annual report and any quarterly or current reports filed thereafter.[420]

We believe that the proposed ongoing reports for Tier 2 offerings under Regulation A, which would update the narrative and financial statement disclosures previously provided in Form 1-A on an annual and semi-annual basis, with additional provisions for current reporting, should also satisfy a broker-dealer's obligations under Rule 15c2-11 to review and maintain records of basic information about an issuer and its securities. We propose to amend Rule 15c2-11 to permit an issuer's ongoing reports filed

419 *See* SEC Rel. No. 34-29094 (April 17, 1991) [56 FR 19148].

420 A broker-dealer can also satisfy its review requirements under Rule 15c2-11 by reviewing certain information published pursuant to a Rule 12g3-2(b) exemption for foreign issuers that claim the registration exemption or information specified in paragraph (a)(5) of the Rule for non-reporting issuers.

in a Tier 2 offering under Regulation A to satisfy a broker-dealer's obligations to review specified information about an issuer and its security before publishing a quotation for a security (or submitting a quotation for publication) in a quotation medium.[421] The single comment we have received to date on the interaction of Rule 15c2-11 and Regulation A also advocated this approach.[422]

We are also soliciting comment on other potential effects that Tier 2 ongoing reporting under Regulation A could have under other provisions of the federal securities laws. For example, it may be appropriate for timely ongoing Regulation A reporting under Tier 2 to constitute "adequate current public information" for purposes of paragraph (c) of Rule 144.[423] Currently, most non-reporting issuers can satisfy the Rule 144 current public information requirement if there is publicly available the information specified in paragraphs (a)(5)(i) to (a)(5)(xiv) and (a)(5)(xvi) of Rule 15c2-11.[424] This information consists of:

- The exact name of the issuer and any predecessor;
- The address of its principal executive offices;
- The state of incorporation, if it is a corporation;
- The exact title and class of the security;
- The par or stated value of the security;

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421 In addition, we are proposing a technical amendment to Rule 15c2-11 to amend subsection (d)(2)(i) of the rule to update the outdated reference to the "Schedule H of the By-Laws of the National Association of Securities Dealers, Inc." which is now known as the "Financial Industry Regulatory Authority, Inc." and to reflect the correct rule reference.

422 McCarter & English Letter.

423 17 CFR 230.144(c).

424 17 CFR 230.144(c)(2). Issuers that are insurance companies are subject to different requirements.

- The number of shares or total amount of the securities outstanding as of the end of the issuer's most recent fiscal year;
- The name and address of the transfer agent;
- The nature of the issuer's business;
- The nature of products or services offered;
- The nature and extent of the issuer's facilities;
- The name of the chief executive officer and members of the board of directors;
- The issuer's most recent balance sheet and profit and loss and retained earnings statements;
- Similar financial information for such part of the two preceding fiscal years as the issuer or its predecessor has been in existence;
- Whether the broker or dealer initiating or resuming quotation or any associated person is affiliated, directly or indirectly with the issuer; and
- Whether the quotation is being submitted or published directly or indirectly on behalf of the issuer, or any director, officer or any person, directly or indirectly the beneficial owner of more than 10 percent of the outstanding units or shares of any equity security of the issuer, and, if so, the name of such person, and the basis for any exemption under the federal securities laws for any sales of such securities on behalf of such person.[425]

With the exception of the last two items, all of this information would be included in our proposed ongoing Regulation A reporting for Tier 2 offerings.

We are also soliciting comment on whether ongoing Regulation A reporting for Tier 2 offerings should satisfy the information requirements of paragraph (d)(4) of Rule 144A.[426] Under that provision, holders of Rule 144A securities must have the right to obtain from the issuer, upon request, a very brief statement of the nature of the issuer's business and the products and services it offers, the issuer's most recent balance sheet and profit and loss and retained earnings statements, and similar financial statements for each of the two preceding fiscal years, which information must be "reasonably current."[427]

Request for Comment

99. In a Tier 2 offering, should the review of an issuer's most recent annual report and any semiannual or current reports filed under Regulation A, as contemplated in this proposal, satisfy a broker-dealer's obligation to review company information in order to quote a security in the over-the-counter market pursuant to Exchange Act Rule 15c2-11? Why or why not? Should the annual or other forms require additional information in order for a broker-dealer to be able to rely on such information for purposes of quotations under Rule 15c2-11?

100. Should ongoing Regulation A reports in Tier 2 offerings be deemed to provide "adequate current public information" about the issuer for purposes of paragraph (c) of Rule 144? Why or why not? What impact would broadening Rule 144 in this way have on affiliate resales of securities of Regulation A

425 17 CFR 240.15c2-11(a)(5).

426 17 CFR 230.144A(d)(4).

issuers? What impact would broadening Rule 144 in this way have on investors?

101. Should ongoing Regulation A reports in Tier 2 offerings satisfy the informational requirements of paragraph (d)(4) of Rule 144A? Why or why not? Are investors or Regulation A issuers likely to benefit?

3. Exchange Act Registration of Regulation A Securities

Under Section 15(d) of the Exchange Act, an issuer that has had a Securities Act registration statement declared effective must comply with the periodic reporting requirements of the Exchange Act.[428] Qualification of a Regulation A offering statement does not have the same effect. An issuer of Regulation A securities would not take on Exchange Act reporting obligations unless it separately registered a class of securities under Section 12 of the Exchange Act, or conducted a registered public offering.

An issuer registering a class of securities under Section 12 of the Exchange Act must file either a Form 10[429] or Form 8-A[430] with the Commission. Form 10 is the general form an issuer must use for Exchange Act registration, while Form 8-A is a short-form registration statement. An issuer must use a Form 10 if, at the time it files its registration statement, it is not already subject to a Section 13 or Section 15(d) reporting obligation. An issuer may use Form 8-A if it is already subject to the provisions of either

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427 *Id.*

428 While issuers with a Section 15(d) reporting obligation are required to file the same periodic reports as issuers that have registered a class of securities under Section 12, Section 15(d) reporting issuers are not subject to additional Exchange Act obligations (*e.g.*, proxy rules, short-swing profit rules, and beneficial ownership reporting) that apply to Exchange Act registrants.

429 17 CFR 249.210. Foreign private issuers must file a Form 20-F, 17 CFR 249.220f, or, where available, a Form 8-A.

430 17 CFR 249.208a.

Section 13 or Section 15(d). Additionally, when an issuer that is not already subject to the provisions of either Section 13 or 15(d) plans to list its securities on a national securities exchange contemporaneously with the effectiveness of a Securities Act registration statement, the Commission staff will not object if that issuer files a Form 8-A in lieu of a Form 10, in order for the issuer to avoid having to restate the contents of its Securities Act registration statement in its Exchange Act registration statement.[431]

Issuers conducting offerings under Regulation A that seek to list the securities on a national securities exchange or otherwise enter the Exchange Act registration system would be required to file Form 10 in order to do so. We solicit comment, however, on whether we should provide a simplified means for Regulation A issuers to register a class of securities under the Exchange Act by, for example, permitting such issuers to file a Form 8-A rather than a Form 10 in conjunction with, or following, the qualification of a Regulation A offering statement on Form 1-A, as some commenters have suggested.[432] The 2010 Government-Business Forum on Small Business Capital Raising made a similar recommendation.[433] Proponents of this approach argue that it would facilitate IPOs and encourage Exchange Act registration and the listing of securities on national securities exchanges, which would provide benefits to both issuers and investors.[434]

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431 *See* SEC Rel. No. 34-38850 (Sept. 2, 1997) [62 FR 39755], at 39757 ("[A]n issuer registering an initial public offering will be permitted to use Form 8-A even though it will not be subject to reporting until after the effectiveness of that Securities Act registration statement.").

432 ABA Letter; WR Hambrecht + Co. Letter.

433 *See* Final Report of the 29th Annual SEC Government-Business Forum on Small Business Capital Formation, Recommendation 5, at 18 (Nov. 18, 2010) (suggesting that issuers be permitted to file reports under Section 13 of the Exchange Act for a one-year period following a Regulation A offering, and thereafter file a Form 8-A to register the securities under Section 12 of the Exchange Act) (*available at*: http://www.sec.gov/info/smallbus/gbfor29.pdf).

434 ABA Letter; WR Hambrecht + Co. Letter.

We also invite comment on ways to facilitate secondary market trading in the securities of Regulation A issuers, such as by encouraging the development of "venture exchanges" or other trading venues that are focused on attracting such issuers. The Commission's Advisory Committee on Small and Emerging Companies, for example, has recommended the establishment of separate U.S. equity markets for small and emerging companies, which it believes could encourage initial public offerings of the securities of these companies.[435] One commenter similarly expressed support for the creation of an equity market venture exchange populated with small and emerging growth companies.[436] In recent years, the Commission has approved more flexible listing standards for an exchange designed for smaller issuers,[437] and some alternative trading systems today trade small company stocks.[438] We solicit comment on how these or similar market models might be used by Regulation A issuers, and how they can be made more viable for facilitating secondary markets for small issuers.

Request for Comment

102. While not currently proposed, should we permit issuers to register under the Exchange Act classes of securities that are qualified under Regulation A by allowing them to file a Form 8-A rather than a Form 10? Why or why not? Would providing a short form registration encourage more Regulation A

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435 *Recommendation Regarding Separate U.S. Equity Market for Securities of Small and Emerging Companies*, Securities and Exchange Commission, Advisory Committee on Small and Emerging Companies (February 1, 2013), *available at*: http://www.sec.gov/info/smallbus/acsec/acsec-recommendation-032113-emerg-co-ltr.pdf.

436 Paul Hastings Letter.

437 *See* SEC Rel. No. 34-64437 (May 6, 2011) [76 FR 27710].

438 *See, e.g.*, Global OTC (f/k/a ArcaEdge), Shares Post Financial Corporation, Second Market, Inc., and OTC Link LLC.

issuers to list their securities on national securities exchanges? Conversely, would permitting eligible issuers to use their Regulation A offering statement in conjunction with a Form 8-A reduce the likelihood that such issuers would use the Securities Act registration process, including the "IPO on-ramp" provisions of Title I of the JOBS Act? Would it serve the intended purpose of Regulation A to make such an accommodation?

103. The disclosure and financial statement requirements of Regulation A, currently and as proposed to be amended, require fewer items of disclosure or less detailed information than Securities Act registrants are required to provide. Would it cause confusion in the market or otherwise create risks for investors if issuers could transition from Regulation A disclosure in Form 1-A to Exchange Act registration without filing Form 10 or providing all the information otherwise called for by Form 10 or Form S-1? Alternatively, while not currently proposed, should simplified Exchange Act registration be available only for issuers that prepare an offering circular based on Part I of Form S-1?

104. What effect, if any, would the ongoing reporting obligations of Section 13 of the Exchange Act have on an issuer considering the potential use of Form 8-A in conjunction with a Regulation A offering as the means by which to become an Exchange Act reporting issuer? Would ongoing reporting under Section 13 of the Exchange Act be an attractive alternative for Regulation A issuers? Or some subset of Regulation A issuers? Please explain.

105. While not currently proposed, should we make Form 8-A available in connection with issuers that are subject to ongoing reporting requirements under Regulation A? Why or why not? Do the proposed ongoing reporting requirements in Regulation A, in addition to the requirement to meet the listing standards of, and be certified by, a national securities exchange provide an adequate justification for the extension of the Form 8-A accommodation to issuers subject to such an obligation?[439] Or should we provide a different means of simplified Exchange Act registration for issuers subject to an ongoing reporting obligation under Regulation A? Please explain.

106. Would encouraging the development of "venture exchanges" or other trading venues that are focused on attracting such issuers facilitate secondary market trading in the securities of Regulation A issuers? If so, how? How could the Commission adjust the regulatory regime to provide for a more viable secondary market for small issuers, with sufficient participation by liquidity providers, that maintains investor protections and fair and orderly markets?

4. Exit Report on Form 1-Z

a. Summary Information on Terminated or Completed Offerings

As discussed in Section II.E.1. above, we propose to rescind Form 2-A, but to continue to require Regulation A issuers to file the information generally disclosed in Form 2-A with the Commission electronically on EDGAR. Consistent with the related

[439] *See* discussion of proposed Regulation A ongoing reporting requirements in Section II.E. above.

portion of proposed new Form 1-K,[440] the Form 2-A information would be converted into an online XML-based fillable form with indicator boxes or buttons and text boxes and filed electronically with the Commission as Part I of proposed new Form 1-Z (exit report). Issuers conducting Tier 1 offerings would be required to provide this information on Form 1-Z not later 30 calendar days after termination or completion of the offering, while issuers conducting Tier 2 offerings would be required to provide this information on Form 1-Z at the time of filing the exit report, if not previously provided on Form 1-K as part of their annual report.[441] The summary offering information disclosed on Form 1-Z would be publicly available on EDGAR, but not otherwise required to be distributed to investors.

The XML-based fillable form would enable issuers to provide information in a convenient medium and capture relevant data about the recently terminated or completed Regulation A offering. As with the related portions of Form 1-K discussed above, the fillable form would be available online and not require issuers to obtain specialty software. The summary information disclosed would, however, facilitate analysis of Regulation A offerings by the Commission, other regulators, third-party data providers, and market participants. Additionally, facilitating the capture of important summary information about an offering would enable the Commission to monitor the use and effectiveness of Regulation A as a capital formation tool.

As noted above in the related proposals for Form 1-K, the summary information collected in Form 1-Z would include the date the offering was qualified and commenced,

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440 *See also* discussion in Section II.C.1. (Electronic Filing; Delivery Requirements) and Section II.C.3.a. (Part I (Notification)) above.

441 *See* Section II.E.1.a. above for a discussion of the requirements for proposed new Form 1-K.

the number of securities qualified, the number of securities sold in the offering, the price of the securities, any fees associated with the offering, and the net proceeds to the issuer.

b. Termination or Suspension of Tier 2 Disclosure Obligations

In light of the proposed ongoing reporting obligations for Tier 2 offerings, we are proposing to permit issuers that conduct a Tier 2 offering to terminate or suspend their ongoing reporting obligations on a basis similar to the provisions that allow issuers to suspend their ongoing reporting obligations under Section 13 and Section 15(d) of the Exchange Act.[442] We acknowledge that, similar to the Exchange Act reporting context, there may be circumstances when an issuer would like to exit the reporting system. We received a comment letter that suggested we adopt a provision similar to Section 15(d) of the Securities Act that would permit an issuer to automatically terminate its Regulation A reporting obligation as to any fiscal year, other than the year in which the offering was made, if at the beginning of such fiscal year, the securities of the class sold in reliance on Regulation A are held of record by fewer than 300 persons.[443] We propose to permit an issuer in a Tier 2 offering that has filed all ongoing reports required by Regulation A for the shorter of (i) the period since the issuer became subject to such reporting obligation, or (ii) its most recent three fiscal years and the portion of the current year preceding the date of filing Form 1-Z to immediately suspend its ongoing reporting obligation under Regulation A at any time after completing reporting for the fiscal year in which the offering statement was qualified, if the securities of each class to which the offering statement relates are held of record by fewer than 300 persons and offers or sales made in

442 *See* Exchange Act Section 15(d), 15 U.S.C. 78*o*(d); Exchange Act Rule 12h-3, 17 CFR 240.12h-3.

443 ABA Letter.

reliance on a qualified offering statement are not ongoing.[444] In such circumstances, an issuer's obligation to continue to file ongoing reports in a Tier 2 offering under Regulation A would be suspended immediately upon the filing of a notice to the Commission on Part II of proposed new Form 1-Z. A manually-signed copy of the Form 1-Z would have to be executed by the issuer and related signatories before or at the time of filing and retained by the issuer for a period of five years.[445] Issuers would be required to produce the manually signed copy to the Commission, upon request.[446]

We further propose that issuers' obligations to file ongoing reports in a Tier 2 offering under Regulation A would be automatically suspended upon registration of a class of securities under Section 12 of the Exchange Act or registration of an offering of securities under the Securities Act, such that Exchange Act reporting obligations would always supersede ongoing reporting obligations under Regulation A. If an issuer terminates or suspends its reporting obligations under the Exchange Act and the issuer would be eligible to suspend its Regulation A reporting obligation by filing a Form 1-Z at that time, the ongoing reporting obligations would terminate automatically and no Form 1-Z filing would be required to terminate the issuer's Regulation A reporting obligation. If the issuer would not be eligible to file a Form 1-Z at that time, it would need to recommence its Regulation A reporting with the report covering any financial period not completely covered by a registration statement or Exchange Act report.[447]

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444 *See* proposed Rule 257(d)(2).

445 *See* Instruction to proposed Form 1-Z.

446 *Id.*

447 *See* proposed Rule 257(d)(1)(and (e).

Request for Comment

107. As currently proposed, should we modify the current requirement in Regulation A that issuers file a Form 2-A to report sales and the termination of sales made under Regulation A to instead require issuers conducting Tier 1 offerings to report such information only after the termination or completion of the offering on Part I of proposed new Form 1-Z and issuers in Tier 2 offerings to report such information on either Part I of Form 1-Z or proposed new Form 1-K? Why or why not?

108. Is there any additional information about an issuer's recently completed or terminated Regulation A offering that should be required to be disclosed? Alternatively, should we not require any disclosure of summary information about an issuer's recently completed Regulation A offering? Why or why not?

109. Should we permit issuers to suspend their reporting obligations in a Tier 2 offering under Regulation A, as proposed, when they take on Exchange Act reporting obligations? Should we otherwise alter the proposed provisions regarding the suspension or termination of an issuer's ongoing reporting obligations in Tier 2 offering? Should issuers in Tier 2 offerings be able to suspend or terminate ongoing reporting under Regulation A on some other basis? For example, should we permit issuers to terminate their ongoing reporting obligations immediately upon completion of the offering, provided, at that time, they have less than 300 holders of record? Why or why not? Should we require a Form 1-Z filing for issuers that would be eligible to immediately file that form upon the suspension or termination of their Exchange Act reporting obligations?

110. Should we alter the number of record holders below which an issuer in a Tier 2 offering can suspend or terminate its ongoing reporting obligations from the proposed 300 record holders? Or should we alter the threshold below which certain types of issuers that are subject to a Tier 2 ongoing reporting obligation would be able to suspend or terminate reporting (*e.g.*, 2,000 or 500 holders of record)? For example, similar to the provisions of Title VI of the JOBS Act, should we allow banks and bank holding companies to terminate their ongoing Regulation A reporting obligations by falling below a higher threshold of record holders (*e.g.*, 1,200 holders of record)?[448] Or should we increase or decrease the number of record holders below which all issuers in Tier 2 offerings, irrespective of issuer-type, could suspend or terminate their ongoing reporting obligations? Why or why not? Please explain.

F. Insignificant Deviations from a Term, Condition or Requirement

Currently, Rule 260 provides that certain insignificant deviations from a term, condition or requirement of Regulation A will not result in the issuer's loss of the exemption from registration under Section 5 of the Securities Act.[449] Under Rule 260, the provisions of current Rule(s) 251(a) (issuer eligibility), 251(b) (aggregate offering price), 251(d)(1) (offers) and 251(d)(3) (continuous or delayed offerings) of Regulation A are, however, deemed to be significant to the offering as a whole, and any deviations

448 *See* Title VI of the JOBS Act, Pub. L. No. 112-106, —601 (Capital Expansion).

449 17 CFR 230.260.

from these provisions would result in the issuer's loss of the exemption. We have not received any comment on Rule 260, nor do we propose to amend the rule. We do, however, solicit comment on whether the provision should be amended to, for example, alter the list of significant deviations.

Request for Comment

111. Should we amend Rule 260 to alter the list of deviations that would be deemed significant to the offering as a whole? Why or why not? If so, which provision(s) should be amended? Alternatively, are there other provisions within Rule 260 that should be amended? If so, please state which provisions and describe why they should be amended.

G. Bad Actor Disqualification

Under Securities Act Section 3(b)(2)(G)(ii), the Commission has discretion to issue rules disqualifying certain "felons and other 'bad actors'" from using the new exemption. Such rules, if adopted, must be "substantially similar" to those adopted to implement Section 926 of the Dodd-Frank Act, which requires the Commission to adopt disqualification rules for securities offerings under Rule 506 of Regulation D. The Commission adopted the disqualification provisions required by Section 926 in Rule 506(d), and a related disclosure requirement in Rule 506(e).[450]

All commenters on potential "bad actor" disqualification provisions in the context of Title IV of the JOBS Act suggest that the Commission apply the same standards for

[450] SEC Rel. No. 33-9414 (July 10, 2013) [78 FR 44729]. The Commission recently proposed rules substantially similar to those adopted pursuant Section 926 of the Dodd-Frank Act in the proposing release for securities-based crowdfunding transactions under Title III of the JOBS Act. *See* SEC Rel. No. 33-9470, at 284.

bad actor disqualification under Regulation A as under Rule 506.[451] One commenter further suggested that the Commission adopt uniform disqualification rules across Regulation D, Section 4(a)(5), and the expanded Regulation A exemption.[452]

Regulation A currently provides for the disqualification of "bad actors" in Rule 262.[453] We propose to amend Rule 262 to include bad actor disqualification provisions in substantially the same form as recently adopted under Rule 506(d), but without the categories of covered persons specific to fund issuers, which would not be eligible to use Regulation A under the proposal.[454] Such "bad actor" disqualification requirements would disqualify securities offerings from reliance on Regulation A if the issuer or other relevant persons (such as underwriters, placement agents, and the directors, officers and significant shareholders of the issuer) have been convicted of, or are subject to court or administrative sanctions for, securities fraud or other violations of specified laws.

Under the proposed amendment, the disqualification provisions would apply to the following categories of persons ("covered persons"):

- the issuer and any predecessor of the issuer or affiliated issuer;
- any director, executive officer, or other officer participating in the offering, general partner, or managing member of the issuer;
- any beneficial owner of 20% or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power;

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451 ABA Letter; WR Hambrecht + Co. Letter; NASAA Letter 2; Kaplan Voekler Letter 2. *See also* Final Report of the 31st Annual SEC Government-Business Forum on Small Business Capital Formation, Recommendation 13B, at 25 (Nov. 15, 2012) (*available at*: http://www.sec.gov/info/smallbus/gbfor31.pdf).

452 NASAA Letter 2.

453 17 CFR 230.262.

- any promoter connected with the issuer in any capacity at the time of filing of the offering statement or any offers or sales after qualification;
- any underwriter or person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with sales of securities in the offering;
- any general partner or managing member of any such solicitor; and
- any director, executive officer or other officer participating in the offering of any such underwriter or solicitor or of a general partner or managing member of any such underwriter or compensated solicitor.

An offering would be disqualified from reliance on the Regulation A exemption if any covered person had been the subject of the following disqualifying events:

- Criminal convictions (felony or misdemeanor) entered within five years before the filing of the offering statement in the case of issuers, their predecessors and affiliated issuers, and ten years in the case of other covered persons:
  - in connection with the purchase or sale of any security;
  - involving the making of a false filing with the Commission; or
  - arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser, or paid solicitor of purchasers of securities;[455]

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[454] *See* proposed Rule 262.

[455] *See* proposed Rule 262(a)(1).

- Court injunctions and restraining orders, including any order, judgment, or decree of any court of competent jurisdiction, entered no more than five years before the filing of the offering statement, that, at the time of such filing, restrains or enjoins such person from engaging or continuing to engage in any conduct or practice:
  - in connection with the purchase or sale of any security;
  - involving the making of a false filing with the Commission; or
  - arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser, or paid solicitor of purchasers of securities;[456]
- Final orders issued by state securities, banking, credit union, and insurance regulators, federal banking regulators, the U.S. Commodity Futures Trading Commission, and the National Credit Union Administration that at the time of filing of the offering statement either:
  - bar the covered person from association with any entity regulated by the regulator issuing the order, or from engaging in the business of securities, insurance or banking, or from savings association or credit union activities; or
  - are based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct within the last ten years;[457]

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456 *See* proposed Rule 262(a)(2).

457 *See* proposed Rule 262(a)(3).

- Commission disciplinary orders entered pursuant to Section 15(b) or 15(B)(c) of the Exchange Act or Section 203(e) or (f) of the Investment Advisers Act of 1940 (the "Advisers Act") that, at the time of filing of the offering statement:
  - suspend or revoke a person's registration as a broker, dealer, municipal securities dealer, or investment adviser;
  - place limitations on the activities, functions, or operations of such person; or
  - bar such person from being associated with any entity or from participating in the offering of any penny stock;[458]
- Commission cease and desist orders entered no more than five years before the filing of the offering statement that, at the time of such filing, order the person to cease and desist from committing or causing a violation or future violation of any scienter-based anti-fraud provision of the federal securities laws or Section 5 of the Securities Act;[459]
- Suspension or expulsion from membership in, or suspension or a bar from association with a member of, an SRO, *i.e.*, a registered national securities exchange or a registered national or affiliated securities association for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade;[460]

458 *See* proposed Rule 262(a)(4).

459 *See* proposed Rule 262(a)(5).

460 *See* proposed Rule 262(a)(6).

- Stop orders applicable to a registration statement and orders suspending the Regulation A exemption for an offering statement that an issuer filed or in which the person was named as an underwriter no more than five years before the filing of the offering statement, and proceedings pending at the time of such filing as to whether such a stop or suspension order should be issued;[461] and
- U.S. Postal Service false representation orders including temporary or preliminary orders entered no more than five years before the filing of the offering statement.[462]

The proposed triggering events are substantially the same as the triggering events included in Rule 506(d).[463] We believe that creating a uniform set of bad actor triggering events should simplify diligence, particularly for issuers that may engage in different types of exempt offerings. It could also foster the creation of third-party databases or other data sources regarding bad actors that could aid issuers in conducting diligence. As noted above, however, the proposed rules in Regulation A would specify that an order must bar the covered person at the time of filing[464] of the offering statement, as opposed to the requirement in Rule 506(d) that the order must bar the covered person at the time of the relevant sale. This clarification accords with the current provisions of Rule 262

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461 *See* proposed Rule 262(a)(7).

462 *See* proposed Rule 262(a)(8).

463 17 CFR 230.506(d).

464 In order to simplify the application of the rules, we do not propose to require that an order bar the covered person at the time of non-public submission of the offering statement. As a practical matter, if a covered person is involved with a proposed Regulation A offering at the time of non-public submission or filing, the issuer would be ineligible to qualify the offering in reliance on Regulation A under either circumstance.

and is appropriate in the context of Regulation A because there is no filing requirement before the time of first sale in Rule 506.[465]

We further propose a reasonable care exception under Regulation A on a basis consistent with Rule 506.[466] Under proposed Rule 262(b)(4), an issuer would not lose the benefit of the Regulation A exemption if it could show that it did not know, and in the exercise of reasonable care could not have known, of the existence of a disqualification.

Proposed Rule 262 is very similar in substance to existing Rule 262, although the format is different. In its current form, Rule 262 provides three different categories of offering participants and related persons, with different disqualification triggers for each category. The amendments we propose are based on a simplified framework of potentially disqualified persons and disqualifying events, which aligns with Rule 506(d). The covered persons are the same as under current Rule 262, except that the proposal includes references to managing members of limited liability companies and, like Rule 506(d), would cover compensated solicitors of investors in addition to underwriters; executive officers and other officers participating in the offering, rather than all officers, of the issuer and any underwriter or compensated solicitor; and beneficial owners of 20% or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power, rather than beneficial owners of 10% of any class of the issuer's equity securities. The proposals would also add two new disqualification triggers: proposed Rule 262(a)(3), which covers final orders and bars of certain state and other federal regulators, and proposed Rule 262(a)(5), which covers Commission cease-and-desist

465 Under Rule 503 of Regulation D, issuers must file a notice of sales on Form D no later than 15 calendar days after the first sale of securities. 17 CFR 230.503(a).

466 *See* proposed Rule 262(b)(4).

orders relating to violations of scienter-based anti-fraud provisions of the federal securities laws or Section 5 of the Securities Act. Finally, the proposals include a "reasonable care" exception modeled on the Rule 506(d) provision. We believe these changes to Rule 262 are appropriate in light of the Section 3(b)(2)(G)(ii) mandate and the benefits of creating a more uniform set of standards for all exemptions that include bad actor disqualification.[467]

Under the proposal, offerings that would have been disqualified from reliance on Regulation A under Rule 262 as currently in effect would continue to be disqualified. Triggering events that are not currently covered by Rule 262—namely, the events specified in proposed Rule 262(a)(3) and 262(a)(5)—and that pre-date effectiveness of any rule amendments would not cause disqualification, but would be required to be disclosed on a basis consistent with new Rule 506(e). Specifically, issuers would be required to indicate in Part I of Form 1-A that disclosure of triggering events that would have triggered disqualification, but occurred before the effective date of the Regulation A amendments, will be provided in Part II of Form 1-A.[468]

In addition to soliciting comment on the proposed amendments to Rule 262, we are also soliciting comment more broadly on the interpretation of the phrase "voting equity securities," as it appears in "any beneficial owner of 20% or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power," a category

467 If adopted, the amendments to Rule 262 would also effectively modify the bad actor disqualification provisions of Rule 505 of Regulation D, which incorporate Rule 262 by reference. We are proposing technical amendments to Rule 505 to update the citations to Rule 262.

468 As discussed in Section II.C.3.a. above, Part I of Form 1-A focuses, in part, on issuer eligibility, and forces issuers to make an eligibility determination at the outset of filling out Form 1-A, while also facilitating quick eligibility determinations by Commission staff reviewing Regulation A offering materials.

of covered persons in Rule 506(d) and proposed Rule 201(r)(2) of Regulation Crowdfunding, as well as in Rule 262, as proposed to be amended. When we adopted Rule 506(d), we did not define "voting equity securities," but rather indicated that our initial intention would be to consider securities as voting equity securities if "securityholders have or share the ability, either currently or on a contingent basis, to control or significantly influence the management and policies of the issuer through the exercise of a voting right."[469] In light of numerous questions and concerns raised about the implications of such an interpretation, however, we are reconsidering our initial views. In particular, we are concerned that our initial interpretation may be overbroad, and that a "bright-line" test may be more workable and would facilitate compliance. We are therefore soliciting comment about alternative interpretations of the phrase "voting equity securities" as it appears in current and proposed bad actor disqualification rules.

Request for Comment

112. Should we amend Rule 262, as proposed, to align with Rule 506(d)? Are there proposed amendments to the covered persons or disqualification triggering events of Rule 262 that we should not make? Why not? Are there other amendments consistent with the statutory mandate of Section 3(b)(2)(G)(ii) that we should consider?

113. How should the phrase "voting equity securities" as it appears in "any beneficial owner of 20% or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power" in Rule 506(d), proposed Rule 201(r)(2) of Regulation Crowdfunding, and Rule 262 as proposed to be

[469] SEC Rel. No. 33-9414 (July 10, 2013) [78 FR 44729], text accompanying fn. 62.

amended, be interpreted? Should we interpret it consistently with the definition of "voting securities" in Rule 405, as equity securities "the holders of which are presently entitled to vote for the election of directors"? Are there factors other than the current ability to vote for directors (or their equivalents) that should be taken into account?

H. Relationship with State Securities Law

Commenters have suggested that the cost of state securities law compliance, which they identify as an obstacle to the use of existing Regulation A, would discourage market participants from using the new exemption. In addition, as discussed previously, Section 402 of the JOBS Act required the Comptroller General to conduct a study on the impact of state "blue sky" laws on offerings conducted under Regulation A, and to report its findings to Congress. The resulting GAO report to Congress indicates that state securities laws were among several central factors that may have contributed to the lack of use of Regulation A.[470]

NASAA recently proposed a coordinated review process for Regulation A offerings, which, if implemented, could potentially reduce the state law disclosure and compliance obligations of Regulation A issuers.[471] As proposed, the coordinated review program would permit issuers to file Regulation A offering materials with the states using an electronic filing depository system currently in development by NASAA. The administrator of the coordinated review program would select a lead disclosure examiner

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470 *See* Section I.C. above.

471 *See* NASAA Release, dated October 30, 2013, Notice of Request for Public Comment: Proposed Coordinated Review Program for Section 3(b)(2) Offerings (the comment period for NASAA's proposal was scheduled to close on November 30, 2013), *available at*:

and, where applicable, a lead merit examiner, which would be responsible for drafting and circulating a comment letter to the participating jurisdictions, and for seeking resolution of those comments with the issuer and its counsel. The draft review protocol also contemplates that certain NASAA statements of policy would be modified or would not apply to offerings undergoing coordinated review. There are a number of open questions about the proposal: whether NASAA will adopt a coordinated review program as proposed; if the proposal were to be adopted in the future, how many states would elect to participate; when such a program, if adopted, could be implemented; and if adopted as proposed, whether the protocol would address the concerns related to state securities law compliance identified by the GAO and commenters.[472] NASAA has stated that its members broadly support the proposed program and would be able to implement it promptly.[473]

In the absence of any such coordinated review, issuers would be required to analyze and comply with separate registration or qualification requirements, or to identify and comply with applicable exemptions, in each state in which they intend to offer or sell securities under revised Regulation A, as is currently the case under Regulation A. Depending on the nature of any such coordinated review process, state securities laws could impose additional requirements and limitations on offerings beyond those imposed

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http://www.nasaa.org/27427/notice-request-public-comment-proposed-coordinated-review-program-section-3b2-offerings/.

472 *See, e.g.,* GAO-12-839, at 14 (discussing the varying standards and degrees of stringency applied during the qualification and review process in merit review states); *see also* Paul Hastings Letter.

473 Letter from Andrea Seidt, President, NASAA, December 12, 2013 ("NASAA Letter 3"). If the proposed coordinated review program were not adopted by every state, we could consider adoption of a "qualified purchaser" definition that would provide preemption as to the non-participating states.

by Regulation A, either currently or as proposed to be amended.[474]

As a result, most commenters strongly supported some form of state securities law preemption.[475] Section 18 of the Securities Act generally provides for exemption from state law registration and qualification requirements for certain categories of securities, defined as "covered securities."[476] Although Section 401(b) of the JOBS Act does not itself exempt offerings made under Section 3(b)(2) and the related rules from state law registration and qualification requirements, it did add Section 18(b)(4)(D) to the Securities Act. That provision states that Section 3(b)(2) securities are covered securities for purposes of Section 18 if they are "offered or sold on a national securities exchange" or "offered or sold to a qualified purchaser, as defined by the Commission pursuant to [Section 18(b)(3)] with respect to that purchase or sale." Section 18(b)(3) provides that "the Commission may define the term 'qualified purchaser' differently with respect to

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474 For example, under the proposed coordinated review protocol, Regulation A offerings would be subject to most aspects of current NASAA policies regarding lock-up of shares held by promoters and disclosure and procedural requirements for loans and other material transactions involving issuer affiliates.

475 Karr Tuttle Letter; Letter from Robert J. Tresslar, Title Company Data Provider, Property Tax Lien Investor, June 28, 2012 "Tresslar Letter"; McCarter & English Letter; ABA Letter; Letter from Paul Getty, Managing Director, Satwik Ventures LLC, Nov. 7, 2012 ("Satwik Ventures Letter"); Campbell Letter; WR Hambrecht + Co. Letter; Kaplan Voekler Letter 2; Fallbrook Letter; Paul Hastings Letter. *See also* Final Report of the 29th Annual SEC Government-Business Forum on Small Business Capital Formation, Recommendation 7B, at 19 (Nov. 18, 2010) (*available at*: http://www.sec.gov/info/smallbus/gbfor29.pdf); Final Report of the 30th Annual SEC Government-Business Forum on Small Business Capital Formation, Recommendation 8, at 30 (Nov. 17, 2011) (*available at*: http://www.sec.gov/info/smallbus/gbfor30.pdf); Final Report of the 31st Annual SEC Government-Business Forum on Small Business Capital Formation, Recommendations 12 and 14, at 25 (Nov. 15, 2012) (*available at*: http://www.sec.gov/info/smallbus/gbfor31.pdf); ECTF Report (Recommendations 1.2, 1.3, and 1.4).

476 *See* Section 18(c), 15 U.S.C. 77r(c). State securities regulators retain authority to impose certain filing and fee requirements and general antifraud enforcement authority with respect to covered securities. *See* Section 18(c), 15 U.S.C. 77r(c).

different categories of securities, consistent with the public interest and the protection of investors."

Some commenters suggested that the Commission preempt state securities laws by permitting Section 3(b)(2) securities to be listed and traded on a national securities exchange,[477] others suggested preemption by means of a "qualified purchaser" definition,[478] while others still suggested some combination of both approaches.[479]

Commenters advocating listing and trading of Section 3(b)(2) securities on a national securities exchange have suggested we permit such listing without attendant registration of the securities under Section 12(b) of the Exchange Act[480] or through short-form Exchange Act registration on Form 8-A.[481] Commission action would not be required to effect the preemption of state securities laws for Regulation A securities that are listed or traded on an exchange. Under Section 18(b)(1) of the Securities Act, any securities that are listed or authorized for listing on a national securities exchange are exempt from state securities law registration and qualification requirements.[482] Section 401(b) of the JOBS Act in effect restated this provision specifically for

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477 *See, e.g.*, Karr Tuttle Letter.

478 *See, e.g.*, Tresslar Letter; McCarter & English Letter; Campbell Letter; Kaplan Voekler Letter 2; *see also* Final Report of the 31st Annual SEC Government-Business Forum on Small Business Capital Formation, Recommendations 12 and 14, at 25 (Nov. 15, 2012); ECTF Report (Recommendation 1.3).

479 *See, e.g.*, ABA Letter; Satwik Ventures Letter; WR Hambrecht + Co. Letter.

480 Karr Tuttle Letter (suggesting a lower tier of exchange-listed security).

481 WR Hambrecht + Co. Letter (suggesting upper tier exchange listing, but on a shorter form Exchange Act registration statement); *see also* Final Report of the 29th Annual SEC Government-Business Forum on Small Business Capital Formation, Recommendation 5, at 18 (Nov. 18, 2010) (*available at*: http://www.sec.gov/info/smallbus/gbfor29.pdf).

482 Section 18(b)(1), 15 U.S.C. 77r(b)(1).

Regulation A securities, by adding Section 18(b)(4)(D)(i) to the Securities Act.[483] We expect, however, that this approach to preemption will have limited impact, because many Regulation A issuers would not meet the standards for listing on a national securities exchange.[484]

From those commenters advocating preemption through a qualified purchaser definition, suggested definitions included:

- Any purchaser in a Regulation A offering;[485]
- Any purchaser meeting a specified net worth standard, set at or lower than the current "accredited investor" definition in Rule 501 of Regulation D;[486]
- Any purchaser meeting a net worth or income test based on thresholds below accredited investor thresholds, combined with an investment cap;[487] or
- Any purchaser who purchased through a registered broker-dealer.[488]

One commenter stated that it did not object to the Commission's defining "qualified purchaser" for Section 3(b)(2) securities, but objected to a definition based on

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483 Section 18(b)(4)(D)(i) uses the language "offered or sold on a national securities exchange," whereas Section 18(b)(1) uses the language, "listed, or authorized for listing, on a national securities exchange."

484 *See also* ECTF Report. As discussed in Section II.E.3. above, we solicit comment on whether we should facilitate the listing of Regulation A securities on a national securities exchange by permitting issuers to file a short-form Exchange Act registration statement on Form 8-A concurrently with the qualification of a Regulation A offering statement.

485 Campbell Letter.

486 Tresslar Letter; McCarter & English Letter; ABA Letter; Satwik Ventures Letter; WR Hambrecht + Co. Letter. *See also* Final Report of the 31st Annual SEC Government-Business Forum on Small Business Capital Formation, Recommendation 14, at 25 (Nov. 15, 2012) (*available at*: http://www.sec.gov/info/smallbus/gbfor31.pdf).

487 Kaplan Voekler Letter 2.

488 ABA Letter; WR Hambrecht + Co. Letter; Paul Hastings Letter (suggesting that, in addition to primary offerings, the qualified purchaser definition apply in connection with secondary trading in Regulation A securities, where the issuer is subject to an ongoing reporting obligation under Regulation A); *see also* ECTF Report (Recommendation 1.2).

transactions effected through a broker-dealer or on purchaser criteria commensurate with or less stringent than current "accredited investor" thresholds.[489] In its view, Congress intended a qualified purchaser definition under Section 18(b)(3) of the Securities Act to require investor qualifications greater than those provided in the accredited investor definition, and sales through broker-dealers do not provide adequate protections.[490] This commenter suggested that "qualified purchaser" could be defined based on existing definitions of "qualified purchaser" in the Investment Company Act[491] or "qualified client" in Rule 205 under the Investment Advisers Act.[492]

In light of the issues raised by commenters and in the GAO study, we are concerned that the costs associated with state securities law compliance may deter issuers from using Regulation A, even if the increased cap on offering size and other proposals intended to make Regulation A more workable are implemented. This could significantly limit the possible impact of an amended Regulation A as a tool for capital formation. We believe that the addition of Section 18(b)(4)(D)(ii) of the Securities Act, which specifically refers to a "qualified purchaser" definition that would apply to transactions under the new 3(b)(2) exemption, suggests that it is appropriate for us to consider including such a definition in our rulemaking to implement Title IV of the JOBS Act.

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[489] NASAA Letter 2; *see also* NASAA Letter 3 (indicating NASAA's concerns with the Commission's use of either the "qualified purchaser" or "accredited investor" definition in the context of implementing rules for Section 3(b)(2) of the Securities Act).

[490] NASAA Letter 2; *see also* NASAA Letter 3. Section 18(b)(3) was enacted under the National Securities Markets Improvement Act of 1996 (NSMIA), Pub. L. 104-290, 110 Stat. 3416 (Oct. 11, 1996).

[491] 15 U.S.C. 80a-2(a)(51). For natural persons to be "qualified purchasers" under this definition, they must own at least $5 million in investment assets.

[492] 17 CFR 275.205-3. For natural persons to be "qualified clients," they must have at least $1 million in assets under management with the investment adviser or have a net worth of more than $2 million, excluding the value of their primary residence.

We also believe that Regulation A, as we propose to amend it, would provide substantial protections to purchasers. Under the proposed amendments, a Regulation A offering statement would continue to provide substantive narrative and financial disclosures about the issuer, including an MD&A discussion. The proposed electronic filing requirement, including the structured data in Part I of the offering circular, would provide ready access to key information about the issuer and the offering, and would facilitate analysis of the offering in relation to comparable opportunities. We expect that Regulation A offering statements would continue to receive the same level of Commission staff review as registration statements. Additional investor protections would be afforded by Regulation A's limitations on eligible issuers and "bad actor" disqualification provisions, which we are proposing to expand.

The requirements for Tier 2 offerings would provide further protection, because the financial statements contained in the offering circular would be required to be audited, the issuer would have an obligation to provide ongoing reporting to purchasers, and such purchasers would be limited in the percentage of income or net worth that could be invested in a single offering. Ongoing reporting would assure a continuing flow of information to investors and could support the development of secondary markets for Regulation A securities, offering the prospect of reduced investor risk through liquidity.

The approach to investor protection for Tier 2 of Regulation A is in some ways similar to the approach taken under Title III of the JOBS Act and our recently proposed rules for securities-based crowdfunding transactions under Section 4(a)(6) of the Securities Act.[493] In Section 4(a)(6), Congress outlined a new exemption for

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[493] *See* Section 4(a)(6)(ii) of the Securities Act, 15 U.S.C. 77d(a)(6)(ii), and SEC Rel. No. 33-9470.

securities-based crowdfunding transactions intended to take advantage of the internet and social media to facilitate capital-raising by the general public, or crowd. In that provision, Congress directly preempted state securities laws relying, in part, on a variety of investor protections, including disclosure requirements, the use of regulated intermediaries and limitations on the amount of securities an investor could acquire through this type of offering required by the JOBS Act.[494]

Like the proposed provisions for securities-based crowdfunding, Regulation A—both as currently in effect and as proposed to be amended—is available to all types of investors, and therefore we believe it should include certain appropriate investor protections. We believe that the substantial investor protections embedded in the issuer eligibility conditions, limitations on investment, disclosure requirements, qualification process and ongoing reporting requirements of proposed Tier 2 of Regulation A, in combination, could address potential concerns that may arise as a result of the preemption of state securities law registration and qualification requirements.

We therefore propose to define the term "qualified purchaser" for certain purposes under Regulation A. As proposed, "qualified purchasers" in a Regulation A offering would consist of:

i) All offerees; and

ii) All purchasers in a Tier 2 offering.[495]

We believe that this approach would protect offerees and investors in Regulation A securities, while streamlining compliance and reducing transaction costs.

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494 *See, generally,* the requirements for issuers and intermediaries and state securities law preemption set forth in Title III of the JOBS Act, Pub. L. No. 112-106, 126 Stat. 306, §§ 301-305.

495 *See* Proposed Rule 256.

We believe it would be appropriate to preempt blue sky requirements with respect to all offerees in a Regulation A offering, in order to make Regulation A a workable approach to capital raising. Issuers relying on Regulation A should be able to communicate with potential investors about their offerings using the internet, social media, and other means of widespread communication, without concern that such communications might trigger registration requirements under state law. We believe this is consistent with Section 3(b)(2)(E) of the Securities Act and the "testing the waters" provisions of Rule 254 of existing Regulation A, which we are proposing to expand, and that it would result in reduced costs to issuers seeking capital while maintaining investor protections.[496]

Alternatively, we could import existing "qualified purchaser" definitions from other regulatory regimes. These other regimes may not, however, account for the regulatory protections and limited offering size of Regulation A, or the likelihood that issuers that target investors meeting these other standards could choose to rely on other Securities Act exemptions, such as Regulation D, rather than Regulation A. We could also consider the involvement of a regulated intermediary or advisor in a transaction as, or as part of, the basis for such a definition. Such intermediaries may, however, increase costs to issuers and investors without commensurate investor protection benefits. Finally, we could consider a broad definition such that any purchaser in any Regulation A

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496 We understand that some state securities regulators do not require the registration of broadly advertised offerings such as internet offerings, if the advertisement indicates, directly or indirectly, that the offering is not available to residents of that state. *See, e.g.*, Washington State Dep't of Financial Institutions, Securities Act Policy Statement – 16, *available at*: http://dfi.wa.gov/sd/securitiespolicy.htm#ps-16; *see also* NASAA Reports ¶ 7,040 (regarding NASAA resolution, dated January 7, 1996, which encourages states to take appropriate steps to exempt from securities registration offers of securities over the Internet).

offering would be treated as a "qualified purchaser." Our preliminary view is that the investment limitations, enhanced disclosure and ongoing reporting obligations associated with Tier 2 would meaningfully bolster the protections otherwise embedded in Regulation A, and justify a difference in treatment to offerings conducted pursuant to Tier 1.

We believe the proposed "qualified purchaser" definition for Tier 2 offerings would help to make Regulation A a more workable means of capital formation. We are soliciting comment, however, on whether we should adopt such a definition or an alternative definition and, if so, what it should require. In particular, we are mindful that, if NASAA and its members are able to implement a coordinated review program for Regulation A offerings, the costs to issuers of state law registration and qualification requirements and the time required for qualification may be substantially lower in the future. We solicit comment below on whether, rather than adopting a definition of "qualified purchaser" for Regulation A as proposed, we should wait to determine whether such a coordinated review program can be finalized, adopted and successfully implemented and, if so, whether such a program would sufficiently address current concerns about the costs of blue sky compliance.[497] We solicit comment on the extent to which state securities law registration and qualification requirements may affect the use of Regulation A, as proposed to be amended. We will also consult with the states and consider any changes to the states' processes and requirements for reviewing offerings before we adopt final amendments.

497 If the proposed coordinated review program were not adopted by every state, we could consider whether a "qualified purchaser" definition that would provide preemption as to the non-participating states would be appropriate.

Request for Comment

114. Should we preempt state securities law registration and qualification requirements for certain Regulation A offerings by adopting a definition of "qualified purchaser," as proposed? Why or why not? Please explain. In responding to this question and the questions below, please address both the practical implications of preemption for capital formation and the impact on investor protection.

115. Is there any potential alternative approach by which we might address the concern raised by commenters and the GAO that state securities regulation poses a significant impediment to the use of Regulation A?[498] In particular, could NASAA's proposed coordinated review program be effectively implemented in the near term? If NASAA implements a coordinated review program, should we consider changes to the proposed "qualified purchaser" definition or other provisions of the proposed rules? Are there other methods to streamline state review, such as a process based on review or qualification in a single state?

116. Does proposed Tier 2 of Regulation A include sufficient investor protections to justify the preemption of state securities law registration and qualification requirements for offerings sold to "qualified purchasers," defined as proposed or otherwise? If not, are there additional investor protections that would justify such preemption? What are they?

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[498] *See* related discussion and requests for comment in Section II.I. below.

117. As proposed, should we adopt a "qualified purchaser" definition for purposes of Regulation A to include all offerees and all purchasers in a Tier 2 offering? Is it appropriate, as proposed, to treat all offerees as qualified purchasers? Is it appropriate to treat all purchasers in a Tier 2 offering as qualified purchasers, or should we impose additional limitations (based on, for example, an income threshold, a net worth threshold and/or an investment assets threshold)? Should we base the definition of "qualified purchasers" on the Investment Company Act definition of that term, or on the definition of "qualified client" under the Investment Advisers Act? Alternatively, should we define all accredited investors as qualified purchasers, as has been previously proposed?[499] Why or why not?

118. Are there other approaches we should consider to defining "qualified purchaser" for Regulation A offerings? For example, should we define "qualified purchaser" as any offeree or purchaser in a Regulation A offering by an issuer that meets certain criteria—for example, specified financial criteria or operating or other criteria indicative of reduced risk? Or should we define it based on attributes of the offering that may reduce risk to investors (*e.g.*, firm commitment underwritten offerings or offerings through a registered broker-dealer)? Alternatively, should we consider a "qualified purchaser" definition that reflects some attributes of the purchaser, issuer and offering?

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[499] *See* SEC Rel. No. 33-8041 (Dec. 19, 2001) [66 FR 66839].

119. Should we consider defining "qualified purchaser" unconditionally, as all offerees and all purchasers in any Regulation A offering? Would such a definition better address potential burdens to capital formation under Regulation A? If so, how? Would such a definition provide sufficient investor protections to support the preemption of state securities law registration and qualification requirements? If not, what would support unconditional preemption of state securities laws? Please explain.

120. In addition to providing blue sky preemption for Tier 2 offerings, should we also consider providing preemption for some or all resales of Regulation A securities? Would the need to comply with blue sky laws prevent the development of a liquid secondary market for Regulation A securities?

121. Would the preemption of state securities law registration and qualification requirements provided by Section 18(b)(1) of the Securities Act for securities that are listed or authorized for listing on a national securities exchange be a viable option for many Regulation A issuers? Why or why not?

I. Regulation A in Comparison to Other Methods of Capital Formation

As noted above, in developing the proposals, we have attempted to create a workable exemption that both promotes small company capital formation and provides for meaningful investor protections. In that context, we are mindful that issuers have a range of possible approaches to capital-raising, including Securities Act registration and other exemptions from registration, such as the statutory exemption under Section 4(a)(2) of the Securities Act, Rules 504, 505 and 506 under Regulation D[500] and Section 4(a)(6) of the Securities Act and the proposed rules for a crowdfunding exemption.[501]

Request for Comment

122. How does Regulation A, as proposed to be amended, compare—in terms of the type of companies that may use the exemption, its requirements, and its potential effectiveness—to other methods of capital raising that issuers may choose for small offerings? How would it compare to the proposed crowdfunding exemption? Either by reference to today's proposals or more generally, are there ways in which Regulation A could be amended that would make it a more usable exemption?

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500 The Regulation D market is large, in recent years approaching the size of the registered market. *See* Vladimir Ivanov and Scott Bauguess, *Capital Raising in the U.S.: An Analysis of Unregistered Offerings Using the Regulation D Exemption*, 2009-2012 (July 2013), *available at*: http://www.sec.gov/divisions/riskfin/whitepapers/dera-unregistered-offerings-reg-d.pdf.

501 *See* SEC Rel. No. 33-9470.

J. Additional Considerations Related to Smaller Offerings

As noted above, in recent years, Regulation A offerings have been rare. Commenters[502] and the GAO identified a number of factors that have influenced the use of Regulation A in its current form, including the process of filing the offering statement with the Commission, state securities law compliance, the types of investors businesses seek to attract, and the cost-effectiveness of Regulation A relative to other exemptions.[503] In developing the proposals, we have attempted to create a more efficient and effective method to raise capital that incorporates important investor protections. We also have been cognizant of how issuers seeking to raise relatively smaller amounts of capital could consider a range of possible approaches to capital-raising.[504]

Under our proposal, offerings for up to $5 million that are conducted under Tier 1 would benefit from the proposed updates to Regulation A's filing and qualification processes, but the proposed amendments would not otherwise substantially alter the existing exemption for such offerings.[505] We are mindful of the possibility that additional changes to Tier 1 could expand its use by, and thus potentially benefit, issuers conducting smaller offerings. An intermediate tier between proposed Tier 1 and Tier 2 could also potentially help increase the effectiveness of Regulation A for smaller offerings by,

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502 *See, e.g.*, Karr Tuttle Letter; Lacey Letter; Kaplan Voekler Letters 1 and 2; McCarter & English Letter; ABA Letter; Alpine Ventures Letter; Campbell Letter; WR Hambrecht + Co. Letter; and Oggilby Letter.

503 *See* fn. 35 above.

504 These methods include, for example, Rules 504, 505 and 506 under Regulation D and Section 4(a)(6) of the Securities Act and the proposed rules for a crowdfunding exemption. *See* Section II.I. above.

505 *See* Kaplan Voekler Letter 1 (suggesting updating the filing and qualification processes of, but otherwise preserving a separate $5 million tier based on, existing Regulation A in the revised exemption); *see also* Beacon Investment Letter (suggesting existing Regulation A be preserved as a separate exemption from the implementing rules for Title IV of the JOBS Act).

among other things, permitting additional modifications to requirements in light of the size of the offering. We are soliciting comment on additional considerations with respect to Tier 1 and an intermediate tier for offerings incrementally larger than Tier 1 offerings and how they would affect investor protection and capital formation.

Request for Comment

123. As proposed, and as is currently the case for Regulation A, state law registration and qualification requirements would not be preempted for Tier 1 offerings. Issuers in offerings of up to $5 million could also elect to proceed under Tier 2, which would provide for preemption by complying with the additional requirements for Tier 2 (investment limitations, audited financial statements in the offering statement and ongoing reporting). Are there circumstances in which we should provide for preemption for Tier 1 offerings? If so, what are the circumstances? Should we consider including in Tier 1 certain elements of Tier 2, such as investment limitations, audited financial statements in the offering statement, or ongoing reporting, or some combination of these requirements in order to provide for preemption? Should we consider including requirements that draw on those for other approaches to capital-raising? If so, which requirements should we include and why? If we require ongoing reporting for issuers that have conducted Tier 1 offerings, should the substance or frequency of the requirements be different from the requirements proposed for Tier 2, such as requiring only an annual report consisting of annual financial statements and a cover sheet or only an annual report, or an annual report and current updates but no semiannual report?

124. Should we consider adding an intermediate tier for offerings exceeding $5 million but significantly less than the $50 million (*e.g.*, $10 million) limitation for Tier 2? Why or why not? If so, what would be an appropriate annual offering limitation for any such intermediate tier? What requirements of Tier 1 and Tier 2 (*e.g.*, audited financial statements, investor limitations) should or should not apply to any such intermediate tier? Should those requirements be modified with respect to the intermediate tier? If so, how? Should we consider other requirements? How would such requirements compare to requirements for other avenues of capital-raising that an issuer might choose? Should offerings made using this intermediate tier be preempted from state law registration and qualification requirements? If so, under what circumstances should we provide for preemption?

125. If an issuer undergoes a registration or qualification process that complies with the coordinated review protocol proposed and being developed by NASAA,[506] assuming such a program is adopted and fully implemented, should an offering under Tier 1 or any potential intermediate tier also be subject to review, in whole or in part, by the Commission's staff? Why or why not? Should the Commission's rules specify the scope or other requirements of any such coordinated review? What standards would apply to the review and what would the review entail (*e.g.*, would the state review for

[506] *See* discussion in Section II.H. above.

compliance with state law requirements, compliance with requirements of the federal securities laws and Commission rules and forms, or both)?

126. Should we provide for preemption in a Tier 1 offering or an offering conducted pursuant to the requirements for any potential intermediate tier if an issuer undergoes a registration or qualification process in a single state? If we develop a process based on registration or qualification in a single state for Tier 1 offerings or for offerings conducted pursuant to the requirements for an intermediate tier, how should it be determined which state would review and qualify the offering? Should we specify how the issuer would determine the state for review (e.g., the state of the issuer's principal place of business or the state in which the issuer is incorporated)? If an offering were subject to a single state review, should the offering also be subject to review, in whole or in part, by the Commission's staff? Why or why not? Would the answer depend on whether the state had a disclosure or merit review program? Should the Commission's rules specify the scope or other requirements of any such state review? What role, if any, would other states have in any such state review? What standards would apply to the review and what would the review entail (e.g., would the state review for compliance with state law requirements, compliance with requirements of the federal securities laws and Commission rules and forms, or both)? How would allowing a single state review or qualification process affect the filing choices made by issuers and the regulatory choices made by states? Would such a process enhance or diminish the comparability and consistency of state regulatory frameworks? If so, how? What would be the impact of such a process on investor protection and capital formation?

K. Regulation A Offering Limitation

As noted above, Section 401 of the JOBS Act requires the Commission to review the \$50 million offering limit not later than two years after enactment of the JOBS Act and every two years thereafter and, if the Commission decides not to increase the amount, requires that it report its reasoning to Congress.[507] The first such review must be completed by April 5, 2014. We solicit comment on whether the Commission should adopt an offering amount under Regulation A, as proposed to be amended, that is higher than the \$50 million limitation for offerings in a twelve-month period provided in Section 3(b)(2) of the Securities Act.

Request for Comment

127. As proposed to be amended, and consistent with Section 3(b)(2), should we limit offerings conducted in reliance on Regulation A in a twelve-month period to \$50 million? Or should the Commission adopt an offering limit under Regulation A that is higher than \$50 million in a twelve-month period?[508] Why or why not? If so, what would be an appropriate threshold for offerings in a twelve-month period conducted in reliance on Regulation A, as proposed to be amended?

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507 *See* discussion in Section I.D. above.

508 *See* Section 3(a)(5) of the Securities Act (requiring the review of the Section 3(b)(2) offering limit every two years after enactment of Title IV of the JOBS Act). 15 U.S.C. 77c(b)(5).

L. Technical and Conforming Amendments

We propose to amend existing Rules 251-263[509] under Regulation A.[510] The proposed rule amendments take into account changes to Regulation A associated with the addition of Section 3(b)(2)[511] to the Securities Act,[512] and the proposals detailed in this release.

In connection with these actions, we propose to revise Form 1-A,[513] to rescind Form 2-A,[514] and to create four new forms, Form 1-K (annual updates), Form 1-SA (semiannual updates), Form 1-U (current reporting), and Form 1-Z (exit report).

We also propose to revise Rule 4a-1[515] under the Trust Indenture Act[516] to increase the dollar ceiling of the exemption from the requirement to issue securities pursuant to an indenture, and to amend Rule 15c2-11[517] of the Exchange Act[518] to permit an issuer's ongoing reports filed under Regulation A to satisfy a broker-dealer's obligations to review and maintain certain information about an issuer's quoted securities. In addition, we are proposing a technical amendment to Exchange Act Rule 15c2-11 to amend subsection (d)(2)(i) of the rule to update the outdated reference to the "Schedule H of the By-Laws of the National Association of Securities Dealers, Inc."

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509 17 CFR 230.251 through 230.263.

510 17 CFR 230.251 through 230.263.

511 15 U.S.C. 77c(b)(2).

512 15 U.S.C. 77a *et seq.*

513 17 CFR 239.90.

514 17 CFR 239.91.

515 17 CFR 260.4a-1.

516 15 U.S.C. 77aaa *et seq.*

517 17 CFR 240.15c2-11.

518 15 U.S.C. 78a *et seq.*

which is now known as the "Financial Industry Regulatory Authority, Inc." and to reflect the correct rule reference.

As a result of the proposed revisions to Regulation A, conforming and technical amendments would be made to Rule 157(a),[519] in order to reflect amendments to Section 3(b) of the Securities Act, and Rule 505(b)(2)(iii),[520] in order to reflect the proposed changes to Rule 262 of Regulation A. Additionally, Item 101(a)[521] of Regulation S-T[522] would be revised to reflect the mandatory electronic filing of all issuer initial filing and ongoing reporting requirements under proposed Regulation A. The portion of Item 101(c)(6)[523] of Regulation S-T dealing with paper filings related to a Regulation A offering, and Item 101(b)(8)[524] of Regulation S-T dealing with the optional electronic filing of Form F-X by Canadian issuers, would therefore be rescinded.

III. GENERAL REQUEST FOR COMMENT

We solicit comment, both specific and general, on each component of the proposals. We request and encourage any interested person to submit comments regarding:

- the proposals that are the subject of this release;
- additional or different revisions to Regulation A; and
- other matters that may have an effect on the proposals contained in this release.

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519 17 CFR 230.157(a).

520 17 CFR 230.505(b)(2)(ii).

521 17 CFR 232.101(a).

522 17 CFR 232.10 *et seq.*

523 17 CFR 232.101(c)(6).

Comment is solicited from the point of view of both issuers and investors, as well as of capital formation facilitators, such as broker-dealers, and other regulatory bodies, such as state securities regulators. Any interested person wishing to submit written comments on any aspect of the proposal is requested to do so. With regard to any comments, we note that such comments are of particular assistance to us if accompanied by supporting data and analysis of the issues addressed in those comments. We urge commenters to be as specific as possible.

IV. ECONOMIC ANALYSIS

As discussed above, Title IV of the JOBS Act requires the Commission to adopt rules under Section 3(b)(2) of the Securities Act exempting from Securities Act registration the offer and sale of securities that, in the aggregate, shall not exceed $50 million in a twelve-month period. Congress enacted Section 3(b)(2) against a background of public commentary suggesting that Regulation A, an existing exemption for offerings of up to $5 million in a twelve-month period adopted under Section 3(b)(1) of the Securities Act, should be expanded and updated to make it more useful to small companies.

We are mindful of the costs imposed by, and the benefits to be obtained from, our rules. Securities Act Section 2(b) and Exchange Act Section 3(f) require us, when engaging in rulemaking that requires us to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation. Exchange Act Section 23(a)(2) requires us, when adopting rules under the Exchange Act,

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[524] 17 CFR 232.101(b)(8).

to consider the impact that any new rule would have on competition and not to adopt any rule that would impose a burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act.

The discussion below addresses the economic effects of the proposed rules, including the likely costs and benefits of the proposed rules, as well as the likely effect of the proposed rules on efficiency, competition and capital formation. The proposed rules include provisions mandated by the statute as well as provisions that rely on the Commission's discretionary authority. As a result, while many of the costs and benefits of the proposed rules stem from the statutory mandate of Title IV, certain costs and benefits are affected by the discretion we propose to exercise in connection with implementing this mandate. For purposes of this economic analysis, we address the costs and benefits resulting from the mandatory statutory provisions and our exercise of discretion together, because the two types of benefits and costs are not separable. We also analyze the potential costs and benefits of significant alternatives to what is proposed.

We request comment on all aspects of our economic analysis, including the potential costs and benefits of the proposed rules.

A. Economic Baseline[525]

The baseline for our economic analysis of proposed amendments to Regulation A, including the baseline for our consideration of the effects of the proposed rules on efficiency, competition and capital formation, is a description of market conditions today, in which companies seeking to raise capital through securities offerings must register the offer and sale of securities under the Securities Act unless they can rely on an exemption from registration under the federal securities laws. The baseline also includes a description of investors in offerings of similar amounts and a discussion of liquidity considerations that impact issuers' choice of capital markets.

1. Current methods of raising up to $50 million of capital

While there are a number of factors that companies consider when determining how to raise capital, a key consideration is whether to issue securities through a registered public offering or through an offering that is exempt from Securities Act registration and ongoing Exchange Act financial reporting requirements. The choice of offering method may also depend on the size of the issuer and the amount of new capital sought. Registered offerings entail initial and ongoing fixed costs that can weigh more heavily on smaller companies, providing incentive to remain private and to pursue capital outside of public markets. As we describe throughout this economic analysis, the proposed amendments to Regulation A are intended to provide small issuers access to

525 Several rules mandated by the JOBS Act have been proposed by the Commission and one has been adopted recently. These rules may affect the economic baseline for proposed Regulation A, but because of data limitations the analysis below cannot account for potential changes that may result from other Commission actions. For example, pursuant to Title II the Commission recently amended Rule 506 of Regulation D to permit issuers relying on the exemption in Rule 506(c) to use general solicitation or general advertising, subject to certain conditions. *See* SEC Rel. No. 33-9415. This recent change could increase the use of Regulation D, but the sample of Regulation D offerings analyzed below does not include offerings utilizing this amendment.

sources for capital unavailable through other offering exemptions without imposing the full registration and ongoing reporting requirements of a registered public offering. This section describes the various currently available offering methods and prevalence of their use.

a. Exempt offerings

Currently, small companies can raise capital by relying on an exemption from registration under the Securities Act, such as Section 3(a)(11),[526] Section 4(a)(2),[527] Regulation D[528] and Regulation A.[529] Each of these exemptions, however, includes restrictions that may limit its utility for small companies. For example, the exemption under Securities Act Section 3(a)(11) is limited to intrastate offerings, and Regulation D offerings may limit or prohibit participation by unaccredited investors. Additionally, offerings relying on Regulation A require submission of offering materials to, and qualification of the offering statement by, the Commission, and may require qualification

526 Under Securities Act Section 3(a)(11), except as expressly provided, the provisions of the Securities Act (including the registration requirement under Securities Act Section 5) do not apply to a security that is "part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory." 15 U.S.C 77c(a)(3)(a)(11).

527 Securities Act Section 4(a)(2) provides that the provisions of the Securities Act shall not apply to "transactions by an issuer not involving a public offering." 15 U.S.C. 77d(4)(a)(2).

528 Regulation D contains three rules providing exemptions from the registration requirements, allowing some companies to offer and sell their securities without having to register the securities with the SEC. 17 CFR 230.504, 505, 506.

529 *See* release text Section I.B. above for a description of the current terms and conditions of Regulation A.

or registration in multiple states.[530] The table below summarizes the main features of each exemption.

[530] *See* Rutheford B. Campbell, *Regulation A: Small Business' Search for a Moderate Capital*, 31 DEL. J. CORP. L. 77, 106 (2005). *See also* GAO-12-839, "Factors that May Affect Trends in Regulation A Offerings", (July 3, 2012).

Type of Offering	Offering Limit[531]	Solicitation	Issuer and Investor Requirements	Filing Requirement	Resale Restrictions	Blue Sky Law Preemption
Section 3(a)(11)	None	No limitations	All issuers and investors must be resident in state	None	Restricted in some cases[532]	No
Section 4(a)(2)	None	No general solicitation	All investors must meet sophistication and access to information test	None	Restricted securities	No
Regulation A	\$5 million with \$1.5 million limit on secondary sales	"Testing the waters" permitted before filing; general solicitation permitted after qualification	U.S. or Canadian issuers, excluding investment companies, blank-check companies, and reporting companies	File "testing the waters" materials, Form 1-A, Form 2-A	No	No
Rule 504 Regulation D	\$1 million	General solicitation permitted in some cases[533]	Excludes investment companies, blank-check companies, and reporting companies	File Form D[534]	Restricted in some cases[535]	No
Rule 505 Regulation D	\$5 million	No general solicitation	Unlimited accredited investors and 35 non-accredited investors	File Form D[536]	Restricted securities	No
Rule 506 Regulation D	None	General solicitation permitted in some cases[537]	Unlimited accredited investors. Limitations on unaccredited investors[538]	File Form D[539]	Restricted securities	Yes

531 Aggregate offering limit on securities sold within a twelve-month period.

532 Resale restrictions are determined by state securities laws, which typically restrict in-state resales for a one-year period.

533 No general solicitation or advertising are permitted unless registered in a state requiring the use of a substantive disclosure document or sold under state exemption for sales to accredited investors with general solicitation.

534 Filing is not a condition of the exemption.

535 Restricted unless registered in a state requiring use of a substantive disclosure document or sold under state exemption for sale to accredited investors.

536 Filing is not a condition of the exemption.

537 No general solicitation or advertising is permitted under Rule 506(b). General solicitation and general advertising permitted under Rule 506(c), provided all purchasers are accredited investors and the issuer takes reasonable steps to verify accredited investor status.

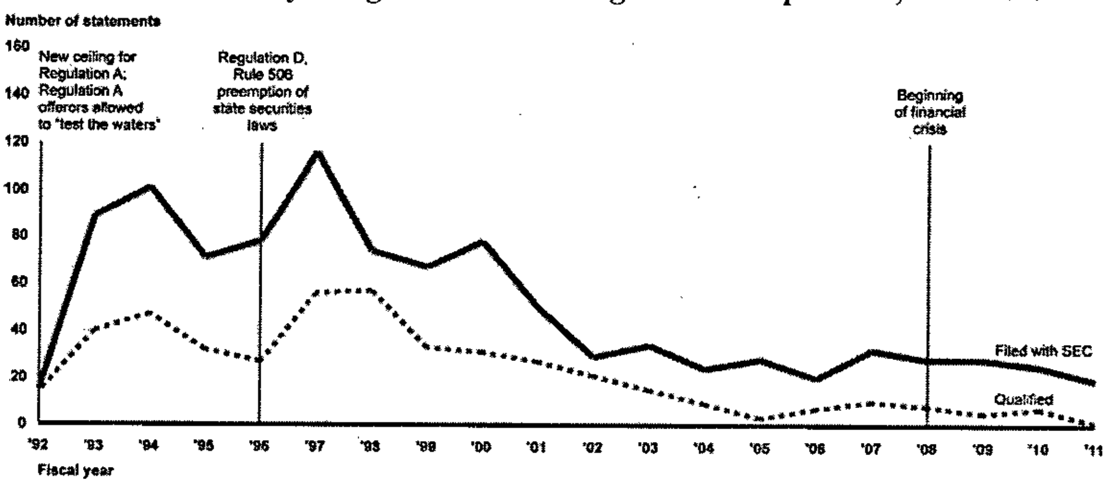
538 Under Rule 506(b), offerings may involve an unlimited number of accredited investors and up to 35 non-accredited investors. Under Rule 506(c), all purchasers must be accredited investors.

While we do not have adequate data on offerings relying on an exemption under Section 3(a)(11) or Section 4(a)(2), certain data available related to Regulation D and Regulation A filings allow us to gauge how frequently issuers currently use these exemptions when raising capital.

(1) Regulation A offerings

Companies rarely rely on existing Regulation A when raising capital. The chart below, from the GAO study,[540] reports the number of filed and qualified Regulation A offerings in fiscal years 1992 to 2011.[541] Specifically, the GAO notes that the number of filed Regulation A offerings decreased from 116 in 1997 to 19 in 2011. The number of qualified offerings dropped from 57 in 1998 to 1 in fiscal year 2011.

Data from GAO Study: Regulation A offerings filed and qualified, 1992-2011



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539 Filing is not a condition of the exemption.

540 *See Factors That May Affect Trends in Regulation A Offerings*, U.S. Government Accountability Office (Jul. 3, 2012), *available at* http://www.gao.gov/products/GAO-12-839 ("GAO Report").

541 A Regulation A offering is considered "filed" when the Commission receives a potential issuer's offering materials through Form 1-A. A Regulation A offering is considered qualified after the Commission has reviewed the offering materials and certified that all conditions have been met. Therefore, offerings that are filed and not qualified are either pending, withdrawn, or abandoned.

Based on information submitted in 1,001 Form 1-A filings between 1993 and 2012, there were 914 unique Regulation A issuers during this period. Of these, 439 offerings by 393 unique issuers were qualified by SEC staff. Examination of these filings shows that 80% of the offerings were for equity. Although issuers may include up to \$1.5 million in secondary sales under existing regulations, more than 95% of Regulation A offerings included only primary shares. Analysis of industry composition indicates that many of the issuers operate in the financial industry (49%). In the year of the offering, the median financial industry issuer had assets and annual revenue of \$29.3 million and \$2.9 million respectively, while the median non-financial industry issuer had assets of \$188,000 and annual revenue of \$34,000.

Section 402 of the JOBS Act required the GAO to study the impact of blue sky laws on Regulation A offerings. The GAO examined (1) trends in Regulation A filings, (2) differences in state registration of Regulation A filings, and (3) factors that may have affected the number of Regulation A filings. In its July 2012 report on Regulation A, the GAO cited four central factors affecting the use of Regulation A offerings: (1) costs associated with compliance with state securities regulations, or "blue sky laws"; (2) the availability of alternative offering methods exempt from registration, such as Regulation D offerings; (3) costs associated with the filing and qualification process with the SEC; and (4) the type of investors businesses sought to attract.

As identified by the GAO, compliance with state securities laws may currently affect the use of existing Regulation A. While state securities law filing fees are likely not significant in any particular state (filing fees are, on average, approximately \$1000 in every state), such fees can become non-trivial when the offering extends across multiple states.[542] For example, state securities law filing fees averaged $35,000 in initial public offerings under $50 million.[543] Legal and compliance costs for issuers seeking to offer securities in multiple states may be significant for issuers due to myriad differences in securities laws and applicable procedures across states. Inconsistencies in state laws and exemptions, as well as in the process of registration or qualification of an offering under state law, can result in an expensive, drawn-out process for issuers that could adversely affect their efforts to raise capital in a timely and cost-effective manner.

The GAO also identified costs associated with the filing and qualification process for Regulation A offerings as a potential reason for its current limited use. As described above, a business that relies on Regulation A must file an offering statement with the Commission that is subject to review by Commission staff and must be qualified before the offering can proceed. From 2002 through 2012, Regulation A filings took an average of 241 days to qualify.[544] While some of this timeframe reflects delays associated with the paper filing method, most of the delay results from the concurrent review by state securities regulators and the fact that the review process may encompass several rounds of discussion between Commission staff and issuers. It may also take longer to qualify when issuers fail to provide all required information in their filings or to address all

542 *See* Paul Hastings Letter, at 2 and Exhibit A (citing estimated costs of state securities law filings under Section 3(b)(2) of $50,000 to $70,000); *Cf.* Regulation D Rule 506 Blue Sky Filing Chart available at http://americansaferetirements.com/agents/wp-content/uploads/2012/09/Blue-Sky-Filing-Chart-Reg-D-506-.pdf.

543 This calculation is based on data provided by Capital IQ and is obtained from S-1 filings from 1996 – 2012 which reports six categories of IPO-related fees, shown in more detail in the "IPO-related fees" table below.

544 This estimate is based on the initial Form 1-A filing and the last Form 1-A filing through which the offering was qualified. The median number of calendar days for an offering to be qualified was approximately 189. The fastest offering qualified in 4 calendar days and the slowest offering took 693 calendar days.

questions from previous correspondence with the Commission. Issuer size may also be related to the speed at which offerings are qualified. For example, larger companies (i.e., those with total assets greater than the median ($1.4 million) for all qualified Regulation A offerings) navigate the qualifying process on average 97 days faster than smaller companies.[545]

Unlike other exemptions, existing Regulation A permits offerings to an unlimited number of unaccredited investors, provided that the total amount sold does not exceed $5 million in a twelve-month period. Further, securities sold under existing Regulation A have no restrictions on resale. As discussed below, Regulation A issuers currently have limited involvement in secondary markets.

(2) Regulation D offerings

Based on information available to us, it appears that the most common way to issue up to $50 million of securities is in reliance on a Regulation D offering exemption. Regulation D includes three rules providing exemptions from the registration requirements of the Securities Act. Specifically, as described in the table above, eligible issuers can rely on Rule 504 to raise up to $1 million within a twelve-month period, Rule 505 to raise up to $5 million within a twelve-month period, and Rule 506 to raise an unlimited amount. As the table notes, the three rules have different requirements that affect their use. In total, based on analysis of issuer offering details reported on Form D, Regulation D accounts for approximately $900 billion in annual capital raising.[546]

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545 *Id.* It is also possible that because most of the larger Regulation A issuers are financial institutions, such as banks and trusts, which are regulated and disclose more information than other Regulation A issuers, they are able to prepare offering materials relatively quickly and easily, based on information they are required to provide to other regulators.

546 These exclude issuances of pooled investment vehicles.

During the 2009 to 2012 period, most issuers chose to raise capital by relying on Rule 506, even when their offering permitted reliance on Rule 504 or Rule 505.[547]

During 2012, there were nearly 22,000 Regulation D offerings reported on Form D. Of these, approximately 12,000 would meet the conditions of Regulation A, as proposed to be amended, which excludes offerings by reporting companies, foreign issuers and investment companies, and offerings of interests in claims on natural resources. The following table reports the breakdown of Regulation D filings from 2012 for all issuers that would be eligible to use Regulation A, as proposed to be amended.[548]

Regulation D offerings during 2012 by issuers eligible to rely on Regulation A[549]

	Rule 504	Rule 505	Rule 506		
Offering size	<$1M	<$5M	<$5M	$5M-$50M	>$50M
Current Reg A Eligible	Yes	Yes	Yes	No	No
Proposed Reg A Eligible	Yes	Yes	Yes	Yes	No
Number of filings	385	142	7,202	2,784	330
Median offering amount ($ millions)	0.4	1.0	1.0	10.0	88.9
Average offering amount ($ millions)	0.5	1.3	1.4	13.7	481
Average amount raised (% of offering)[550]	62.2	67.9	72.1	72.7	76.4
Portion with unaccredited investors (% of deals)	62.1	36.8	7.8	5.0	8.2
Average fees (% of funds raised)	0.1	0.2	0.7	0.7	0.8
Median number of investors	4	4	5	8	12

Excludes offerings by reporting companies, foreign issuers and investment companies, offerings of interests in natural resources, and issuers who failed to sell any securities.

547 This tendency could, in part, be attributed to two features of Rule 506: Blue sky law preemption and an unlimited offering amount. *See also Factors That May Affect Trends in Regulation A Offerings*, U.S. Government Accountability Office (Jul. 3, 2012), *available at* http://www.gao.gov/products/GAO-12-839.

548 These numbers are calculated using data from raw Form D's filed with the Commission. We have adjusted for amended filings by dropping old filings if an amended filing exists. This analysis excludes filings from issuers relying on Regulation D as a pooled investment fund.

549 *Id.*

550 The total offering amount is not always equivalent to the total amount raised at the time of filing. Regulation D permits filing a Form D before completion of the fundraising round. Thus for most companies, the difference between the total offering amount and amount raised results from filing a Form D before securing all funds promised. In addition, some companies (usually pooled investment funds) use Form D for open-ended offerings.

As shown in the table above, most Regulation D offerings that would be eligible for Regulation A under the proposed rules are relying on Rule 506 of Regulation D. A comparison of Rule 506 offerings over $50 million to those below $50 million shows that larger offerings involve more investors and have generally raised a greater percentage of the amount of capital sought at the time of the Form D filing. This evidence indicates potentially higher success rates for larger offerings, although this cannot be confirmed because there is no requirement for issuers to file an amended Form D at the completion of an offering.

Most Regulation D issuers elect not to disclose their revenue range in their Form D filings. The following table shows the breakdown of the issuers potentially eligible to rely on Regulation A that did not disclose, and those that elected to disclose a revenue range for offerings made in 2012.

Amount raised through Regulation D offerings in 2012 by issuers eligible to rely on Regulation A, by issuer revenue range.[551]

Revenue Range	Frequency Offering < $5M	Frequency Offering $5M- $50M	Avg. Raised ($ millions) Offering <$50M
Not Applicable[552]	141	92	4.7
Decline to Disclose	4,543	2091	4.3
No revenues	1,353	264	1.4
$1-$1,000,000	1,168	118	1.0
$1,000,001-$5,000,000	315	64	2.1
$5,000,001-$25,000,000	132	93	3.8
$25,000,001-$100,000,000	53	41	7.7
Over $100,000,000	24	21	6.9

Excludes offerings by reporting companies, foreign issuers and investment companies, offerings of interests in natural resources, and issuers who failed to sell any securities.

551 *Id.*

552 These could be Regulation D issuers (non-registered investment companies) that manage assets and report net asset value, for example, REITS, or spillover from the "No revenues" category.

If issuers that disclose a revenue range are representative of all Form D filers, then nearly half of the issuers that file Form D have no revenues. The portion of issuers without revenues is noteworthy because debt is not likely to be a feasible source of capital for companies without regular cash flows.

b. Registered Offerings

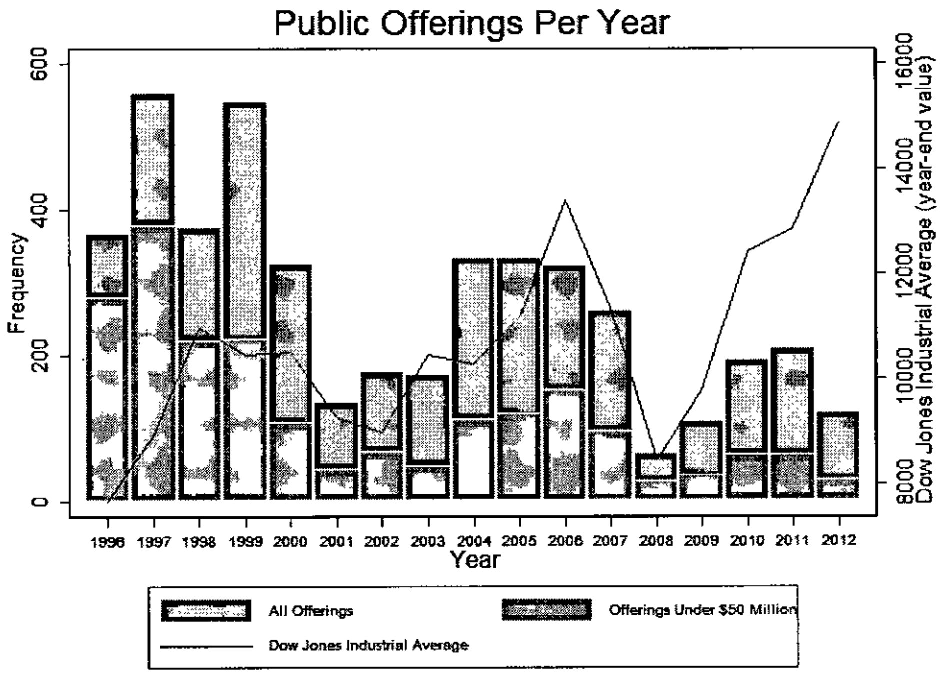
Companies seeking to raise capital without being subject to the restrictions under exempt offerings can register the offer and sale of securities under the Securities Act.

The following figure shows the frequency of IPOs each year for companies issuing above or below $50 million.[553] Consistent with many previous observations about the recent IPO market, the number of IPOs, particularly those under $50 million, has fallen dramatically since the late 1990s.[554]

553 There were approximately 25 registered initial public offerings up to $50 million in 2012 according to data from Capital IQ.

554 *See, e.g.,* D. Weild and E. Kim, *A wake-up call for America*, 2009. In 2011, the Treasury Department hosted a conference on access to capital to better understand how to restore access to capital for emerging companies. The conference featured the findings of an IPO task force comprised of a number of experienced venture capitalists, investment bankers, and lawyers. Their findings provide a number of possible explanations for the decline in the number of IPOs, including that 92% of the surveyed CEOs listed the "Administrative Burden of Public Reporting" as being one of the most significant challenges of an IPO.

Frequency of all initial public offerings and offerings under $50 million by year.[555]



One possible reason for the decreasing number of IPOs under $50 million is that public offerings may be too costly to be a viable alternative for some small companies.[556] In particular, commissions paid to underwriters average 7% for IPOs, 5% for seasoned public issuances, and 1% for bond issuances.[557] Issuers conducting registered public offerings must also pay Commission registration fees and FINRA filing fees, legal and accounting fees and expenses, transfer agent and registrar fees, costs associated with

555 The data is provided by Capital IQ and this sample excludes offerings from blank check companies and non-Canadian foreign issuers.

556 *See also* Gao, Xiaohui, Jay R. Ritter, and Zhongyan Zhu. *Where have all the IPOs gone?*, Working Paper, University of Florida, 2012 (suggesting, among other things, that acquisitions have partially supplanted the traditional IPO as an exit path for smaller companies).

557 *See, e.g.*, H. Chen and J. Ritter (2000), *The Seven Percent Solution*, Journal of Finance 55, pp. 1105–1131; S. Corwin (2000), *The Determinants of Underpricing for Seasoned Equity Offers*, Journal of Finance 58 pp. 2249–2279; L. Fang (2005), *Investment Bank Reputation and the Price and Quality of Underwriting Services*, Journal of Finance 60, pp. 2729–2761.

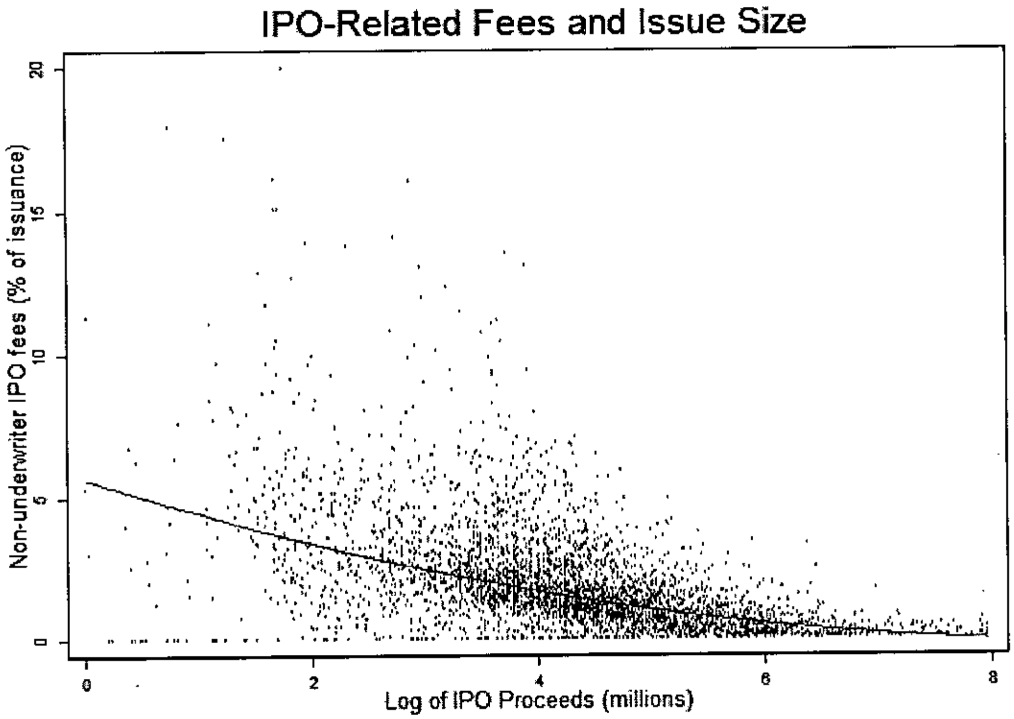
periodic reporting requirements and other regulatory requirements and various other fees. Two surveys concluded that regulatory compliance costs of IPOs average $2.5 million initially, followed by an ongoing $1.5 million per year.[558]

Because of the fixed-cost nature of many of the fees associated with public offerings, size may be one of the most important determinates of whether an offering is made available to the public. As shown in the scatter plot below, there is a downward trend in IPO-related fees (excluding underwriter and printing costs and reported as a percentage of offering proceeds) as offering size increases.[559]

558 *See* IPO Task Force, *Rebuilding the IPO On-Ramp*, 9 (Oct. 20, 2011), *available at* http://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf ("IPO Task Force").

559 Fee information is compiled by Capital IQ and is obtained from S-1 filings from 1996 – 2012 which reports six categories of IPO-related fees. The analysis includes four of the fees: legal, accounting, blue sky, and registration, which we collectively refer to as "compliance fees".

Portion of IPO-related fees paid relative to net proceeds after excluding fees paid to underwriters.



For offerings below $50 million, the fixed cost components of legal and accounting-related fees, as a percentage of offering size, are particularly burdensome. In the table below, which reports the six fee types reported in Form S-1, offerings less than $50 million incur compliance related fees that are on average nearly twice those incurred by larger offerings, measured as a percentage of proceeds.

IPO-related fees as a percentage of offering size for offerings completed from 1996 to 2012.

	All Offerings (N=4868)	Offerings $5- $50 million (N = 2017)	Offering > $50million (N = 2851)
Total Fees	9.55%	11.15%	8.44%
Compliance Fees	1.39%	1.91%	1.03%
Registration Fees	0.03%	0.04%	0.02%
Blue Sky Fees	0.03%	0.07%	0.01%
Accounting Fees	0.53%	0.72%	0.40%
Legal Fees	0.80%	1.08%	0.60%
Underwriter Fees	6.45%	6.87%	6.17%

Printing Fees	0.32%	0.47%	0.22%

Analysis excludes offerings from non-Canadian foreign issuers and blank-check companies.

Additional statistical analysis[560] of these fees using regression methodologies shows that fees have increased by approximately six basis points per year since 1996, and that these fees have increased disproportionately more for small offerings than for large offerings. For example, fees related to offerings over $50 million increased by approximately 50 basis points from 2000 to 2010, while fees related to offerings below $50 million increased by 100 basis points over the same period.

In addition to increased compliance costs, there are a number of other possible explanations for the decline in IPOs. For example, one benefit of a public listing is the increased liquidity that results from access to retail investors; however, catering to retail owners can involve investor relations challenges and liability-related costs.[561] A second explanation for the decline of IPOs could result if current offerings are concentrated in high-technology sectors that are sensitive to R&D-related disclosure requirements, which could potentially cause issuers to rely more on private capital sources.[562] Access to capital may also be especially time-sensitive for the types of companies most likely to make small offerings, rendering these companies unwilling to go through a potentially

560 We tested for statistical significance in the relationship between fees and issue size using regression analysis of fees disclosed in S-1 filings. The data is from Capital IQ, which tabulates S-1 and other filings. Due to the abnormal distribution of IPO-related fees, we use quantile regressions. Fees were calculated as described in the table above. The sample eliminates all observations by issuers who would be ineligible for the proposed Regulation A exemption. Finally, we determine that fees have increased more rapidly for smaller issuers by including an interaction term of issuance date with offering size.

561 For instance, the 2011 IPO Task-Force survey results indicate that 88% of CEOs that had completed an IPO listed "Managing Public Communications Restrictions" as one of the most significant challenges brought on by becoming a reporting company.

562 Campbell, Tim S. (1979), *Optimal investment financing decisions and the value of confidentiality*, Journal of Financial and Quantitative Analysis: pp. 913-924.

lengthy registration process. It is also possible that directors and officers of companies looking to raise less than $50 million may not want to subject themselves to the increased liability and takeover threats that come with dispersed ownership.[563] Finally, the decline of public offerings could result from macro-economic effects on investment opportunities in the economy and the cost of capital.[564]

Companies that have completed an IPO often continue to raise capital through follow-on offerings. In 2012, public follow-on offerings accounted for $155 billion, $4 billion of which came from offerings less than $50 million,[565] which is significantly more than the amount raised through IPOs over the same period, suggesting that follow-on offerings (also known as "seasoned equity offerings") comprise a prevalent source of capital for companies.[566]

c. Private debt offerings

Companies with regular cash flows often rely on debt as a source of capital; however, borrowing may not be a cost effective option for many early-stage companies as they may face large information asymmetries with investors, irregular cash-flow projections, insufficient assets to offer as collateral, and high external monitoring costs.[567] For example, an internet start-up company without steady revenues might have trouble

563 Burkart, Mike, Denis Gromb, and Fausto Panunzi (2000), *Agency conflicts in public and negotiated transfers of corporate control,* The Journal of Finance 55.2, pp. 647-677.

564 Lowry, Michelle (2003), *Why does IPO volume fluctuate so much?*, Journal of Financial Economics 67.1, pp. 3-40.

565 There were approximately 211 public follow-on offerings in 2012 according to data from Thompson Reuters SDC.

566 These estimates are based on our analysis of data on seasoned equity offerings from Thompson Financials SDC Platinum and excludes offerings from non-Canadian foreign issuers.

567 Robb, Alicia M., and David T. Robinson, *The capital structure decisions of new firms*, No. w16272, National Bureau of Economic Research, 2010.

securing a loan or a line of credit from a bank because it would have difficulty signaling the quality of its business model and ability to repay. Conversely, an owner of a restaurant franchise could reasonably rely on regular cash flows and its own credit history to support a loan application. Additionally, some companies may find loan requirements imposed by financial institutions difficult to meet. For example, financial institutions generally require a borrower to provide collateral and/or a guarantee by owners,[568] which some companies may not be able to or may be reluctant to provide.[569]

2. Liquidity considerations

As described above, various financing options are available to small companies looking to raise up to $50 million of capital. For many companies, access to liquid markets is an important consideration as they compare the merits of these options.

There are important differences in liquidity for securities issued in a registered offering or under Regulation D or Regulation A. Securities in registered offerings that meet listing requirements benefit from the liquidity of listing on a national securities exchange. Conversely, securities sold under Regulation D are relatively illiquid due to restrictions that prohibit resale in the public market for up to a year. Although securities issued under Regulation A are freely tradable, they typically trade in over-the-counter markets (if at all), as these issuers may not meet listing standards of a national securities

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568 Approximately 92% of all small business debt to financial institutions is secured, and owners of the firm guarantee about 52% of that debt. *See* Berger, Allen N., and Gregory F. Udell. *Relationship lending and lines of credit in small firm finance.* Journal of Business (1995): 351-381.

569 Some of these companies might instead rely on trade credit, which can be an important source of capital for young firms. *See, e.g.* Petersen, Mitchell A., and Raghuram G. Rajan, *Trade credit: theories and evidence*, Review of Financial Studies 10.3 (1997): 661-691; and Murfin, Justin, and Ken Njoroge, *The Implicit Costs of Trade Credit Borrowing by Large Firms.*, working paper.

exchange or be willing or able to bear the costs of ongoing reporting.[570] In fact, a much larger proportion of the qualified Regulation A offerings from 2001 to 2012 are quoted in the OTC market than listed on a national securities exchange; although most of these offerings are not currently quoted on OTC markets.[571]

More generally, OTC-traded securities are significantly less liquid than those listed on a national securities exchange.[572] Existing studies of bid-ask spreads, trading volume, and price volatility find statistically lower liquidity in OTC securities and a comparison group[573] of similar securities listed on a national securities exchange.[574]

There is also evidence that illiquidity is especially expensive for companies that trade on OTC markets.[575] A recent study finds OTC-traded securities differ from listed securities in that they are primarily held by retail investors and have a larger illiquidity return premium.[576] One explanation for the higher liquidity premium is the likelihood of increased asymmetric information,[577] as the cost of illiquidity is largest for securities whose issuers choose not to disclose financial information and that are primarily held by

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570 *See, e.g.*, Sanger and Peterson, 1990; Harris, Panchapagesan, and Werner, 2008; Macey, O'Hara, and Pompilio, 2008.

571 This conclusion is based on a review of three databases with coverage of OTC markets: CapitalIQ, iMetrix, and OTC quote.

572 *See, e.g.*, Sanger and Peterson, 1990; Harris, Panchapagesan, and Werner, 2008; Macey, O'Hara, and Pompilio, 2008.

573 Choosing a comparison set of companies with similar characteristics, such as market capitalization, helps isolate the effect of trading venue on liquidity.

574 Ang, A., Shtauber, A., & Tetlock, P. *Asset pricing in the Dark: The Cross Section of OTC Stocks* (July 1, 2013). Netspar Discussion Paper No. 11/2010-093, *available at* SSRN: http://ssrn.com/abstract=1817542 or http://dx.doi.org/10.2139/ssrn.1817542. Review of Financial Studies, forthcoming. The study analyzes 486 OTC stocks and compares them with a benchmarked (size-based) sample of listed stocks.

575 *Id.*

576 *Id.*

retail investors.[578] The desire of issuers to alleviate this illiquidity discount may explain why many OTC quoted companies that are not required to report financial information under the Exchange Act voluntarily provide limited financial information to investors.[579]

3. Investors in offerings of up to $50 million

The various methods of raising up to $50 million in capital may attract different types of investors. For example, as discussed above, Regulation A and public offerings have no limit on the number of unaccredited investors that can participate. In contrast, offerings under Rule 506(b) of Regulation D are limited to a maximum of 35 unaccredited investors.

Data from Form D filings suggests that unaccredited investors are not significantly involved in Regulation D offerings of up to $50 million. While unaccredited investors can and do participate in Regulation D offerings, offerings involving unaccredited investors are typically smaller than those that do not involve unaccredited investors. In 2012, we estimate that there were approximately 220,000 investor participations in nearly 11,000 Regulation D offerings of below $50 million by issuers that would be eligible for exemption under Regulation A, as proposed to be amended.[580] Of these offerings, approximately 9.4% involved at least one unaccredited

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577 Lev, Baruch. *Toward a theory of equitable and efficient accounting policy.* Accounting Review (1988): 1-22.

578 Ang, A., Shtauber, A., & Tetlock, P. 2011. *Asset pricing in the Dark: The Cross Section of Over-the-Counter Stocks.* Review of Financial Studies, forthcoming. The study analyzes 486 OTC stocks and compares them a benchmark group of listed stocks.

579 Analysis by staff in the Division of Economic and Risk Analysis found that in 2012, there were more than 700 companies quoted through the OTC Markets Group platform that provided limited financial information to qualify as OTC Pink Limited Information securities, which are quoted in a tier above firms that do not provide financial information.

580 These numbers are based on analysis by the Division of Economic and Risk Analysis of initial Form D filings submitted during calendar year 2012. The estimated total number of investor

investor. Offerings to exclusively accredited investors averaged 12 investors per offering and raised an average of $3.7 million per offering. In contrast, an average of 107 investors participated in offerings that involved at least one unaccredited investor and raised an average of $1.5 million.[581]

As of 2010, 8.7 million U.S. households, or 7.4% of all U.S. households, qualified as accredited investors based on the net worth standard in the definition of "accredited investor,"[582] which is substantially larger than the total number of investors that reported as having participated in an unregistered offering, but considerably less than the total number of retail investors, which we estimate could be as high as 33 million.[583] Thus the current pool of investors eligible to participate in Regulation A offerings and public offerings is substantially larger than the estimated total number of accredited investors or current levels of investor participation in the private offering market.

B. Analysis of Proposed Rules

1. General Considerations

The impact of the proposed rules on the level and efficiency of capital formation will depend on the extent to which companies use the new offering method to raise capital that would not otherwise have been available to them. It will also depend on the extent to which companies elect to rely on Regulation A, as proposed to be amended, in place of existing offering methods. As discussed above, many companies finance their

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participations is likely greater than the actual number of Regulation D investors because investors could have participated in more than one offering.

581 Because some investors participate in multiple offerings, these numbers likely overestimate the actual number of unique investors in these reported offerings.

582 *See* analysis presented in SEC Rel. No. 33-9415 (July 10, 2013) [78 FR 44771].

583 *Id.*

operations and investments with credit from banks and other financial entities.[584] Other companies, particularly early-stage and high growth companies, seek capital through equity-based financing because they do not have sufficient collateral or the revenue streams necessary to support the fixed repayment schedule of debt financing.[585] These companies often seek capital from institutional or accredited investors through offerings that are exempt from registration because the minimum fixed costs of going public through a registered offering can be disproportionately large for small issuers.[586] But private offerings impose restrictions on resale, offering amounts, or participating investors in ways that can limit the ability to raise capital and may not be attractive to some small companies or investors.

The proposed amendments to Regulation A are intended to provide small issuers access to sources for capital unavailable through other offering exemptions without imposing the full registration and ongoing reporting requirements of a registered public offering. Hence, it is likely that companies seeking to raise capital through an offering conducted under Regulation A, as proposed to be amended, would have been able to access to capital through private offerings or registered public offerings. In this respect, the impact of the proposed Regulation A amendments on capital formation could be redistributive in nature, but with potentially significant positive effects on capital formation and allocative efficiency by providing the issuers less costly access to capital

584 Berger, Allen N., and Gregory F. Udell, 1998, *The economics of small business finance: The roles of private equity and debt markets in the financial growth cycle*, Journal of Banking & Finance 22.6, pp. 613-673.

585 *Id.*

586 *See* Section I.A. above.

than alternative offering methods and by providing unaccredited (retail) investors with additional investment opportunities.

The potential future use of an amended Regulation A depends largely on the perceived trade-off between the costs of qualification and ongoing disclosure requirements and the potential benefits to issuers from access to a broad investor base and secondary market liquidity.[587] For example, companies considering a traditional IPO may alternatively consider issuing securities pursuant to Regulation A, as amended, if they believe that the benefits of reduced disclosure requirements offset the potential loss of secondary market liquidity that may result from an issuer's inability to have its securities quoted on platforms that are available only for Exchange Act-registered securities. Alternatively, companies considering seeking capital from institutional or accredited investors through a private offering might consider an offering under amended Regulation A if they believe that there is a more dispersed investor base, which could include retail investors, willing to provide capital at a lower cost.

We preliminarily believe that an approach that generally preserves existing Regulation A while also introducing an option that allows issuers to raise greater amounts of capital without state review but with additional disclosure requirements is a prudent first step to adapting Regulation A for larger offerings. We believe this approach balances the trade-offs among compliance costs, investor protection, and benefits

[587] The Commission also recognizes that other important considerations could affect the use of Regulation A as proposed to be amended. In particular, as explained above, the GAO study of Regulation A offerings found that blue sky law compliance was a primary factor in the infrequent reliance on Regulation A. Because we are proposing to define qualified purchasers in a way that has the potential to include a large percentage of Regulation A investors, we believe that compliance costs associated with blue sky laws will be eliminated for most offerings, making them similar to Regulation D offerings and registered offerings in this respect.

associated with liquidity and access to investors. We recognize, however, that this approach may limit the use of Regulation A for certain issuers, and we accordingly are requesting comment on additional considerations for smaller offerings. For example, the ongoing reporting obligations of a Tier 2 offering may be proportionately more burdensome for smaller issuers that are looking to raise substantially less than $50 million, and may not provide the same benefit to smaller issuers that are not pursuing secondary market liquidity. For these issuers, it may also not be reasonable to pursue a Tier 1 offering because the $5 million maximum issuance threshold may be insufficient in light of costs associated with the existing offering process. We recognize that observing market behavior under the proposed approach would provide information that would allow us to assess the need for modifications to the proposed approach, which also could be made when the Commission considers the efficacy of the $50 million threshold, as mandated by Congress every two years.

The disclosure requirements that we are proposing account for the trade-offs identified above and are guided by current and past market experiences. For example, prior to 1999, securities traded over-the-counter (OTC) and quoted on the OTC Bulletin Board (OTCBB) interdealer quotation system were not required to be Exchange Act reporting companies. In January 1999, the SEC approved an OTCBB eligibility rule that required companies whose securities are quoted on OTCBB to file periodic financial reports under the Exchange Act or with their primary regulator if not the SEC.[588] One study evaluating this change found improved liquidity at companies that were already

[588] *See* Order Granting Approval of Proposed Rule Change and Amendment No. 1 from the National Association of Securities Dealers, Inc. Relating to Microcap Initiatives-Amendments to NASD

providing periodic reports, or that chose to comply with Exchange Act reporting requirements to remain eligible for quotation on OTCBB.[589] Approximately three-fourths of the companies that were not already reporting chose not to satisfy the new eligibility requirement by becoming an Exchange Act reporting company and instead entered less regulated and less liquid OTC markets, indicating that, for these companies, the expected costs associated with mandatory public reporting under the Exchange Act outweighed the expected liquidity benefits.[590]

The Tier 2 reporting requirements are substantially less than Exchange Act reporting requirements, but greater than what is currently required for an exemption from registration under the existing Regulation A rules and those under Regulation D. The following table shows a selection of commonly filed reports for Exchange Act registered companies and the analogous form, if any, that would be required for securities issued under Regulation A, as proposed to be amended, or Regulation D.

Overview comparison of differences in reporting requirements for offerings exempt under Regulation D, Regulation A, Regulation A as proposed to be amended and registered offerings.

Common disclosure types	Regulation D	Current Regulation A	Proposed Regulation A Tier 1	Proposed Regulation A Tier 2	Registered[591]

Rules 6530 and 6540, Exchange Act Release No. 34-40878 (Jan. 4, 1999), 64 FR 1255 (Jan. 8, 1999).

589 Bushee, Brian J., and Christian Leuz, (2005), *Economic consequences of SEC disclosure regulation: evidence from the OTC bulletin board*, Journal of Accounting and Economics 39.2 , pp. 233-264.

590 *Id.*

591 This comparison does not cover offerings by foreign private issuers.

Offering document or notice	D[592]	1-A	1-A	1-A	S-1
Auditors	–	–	–	No requirement for a PCAOB-registered Auditor	PCAOB-registered Auditor
Report of material events	–	–	–	1-U	8-K
Interim report	–	–	–	1-SA	10-Q
Annual report	–	–	–	1-K	10-K
Termination of registration	–	2-A	1-Z	1-Z	15

Tier 2 reporting requirements are also greater than what is proposed to be required under Tier 1. We believe that it is appropriate to require some additional disclosure from issuers of larger offerings up to $50 million in order to better protect investors under the new Regulation A regime.

We recognize that even if the proposed rules reduce compliance costs and require sufficient disclosure to enable investors, particularly retail investors, to make informed capital allocation decisions, some issuers may still prefer other offering exemptions. Preferences for other offering exemptions could be particularly strong given that general solicitation is now permissible in certain cases under Rule 506(c). In particular, it is possible that issuers relying on Rule 506(c) may now be in a better position to identify institutional and accredited investors, such that seeking capital from a broader retail investor base is not required or desired. In addition, eliminating the ban on general solicitation for certain Rule 506 offerings may encourage new trading platforms for privately placed securities once their resale restrictions are lifted. While secondary

592 Form D is a notice of sale under Regulation D, not a disclosure document, although certain disclosures are required. Regulation D does not require filing of a disclosure document with the Commission, and does not generally impose disclosure requirements except when sales are made to purchasers that are not accredited investors. *See* Rule 502(b), 17 CFR 230.502(b).

markets for private offerings are unlikely to achieve the same level of liquidity of OTC or other listing venues, it is nonetheless possible that trading platforms could achieve levels of liquidity sufficient to allow certain types of securityholders (like founders and other affiliated owners) to exit once resale restrictions are lifted.

2. Scope of Exemption

a. Eligible Issuers

Under the proposed rules, and consistent with current Regulation A eligibility requirements, eligible issuers include any companies organized and with their principal place of business inside the United States or Canada excluding investment companies, reporting companies, blank check companies, and issuers of claims on natural resources, and certain disqualified "bad actors". We also propose to exclude some issuers that are currently eligible to rely on Regulation A. Specifically, the Commission is proposing to exclude from eligibility issuers that are subject to a denial, suspension, or revocation order by the Commission pursuant to Section 12(j) of the Exchange Act within the five years immediately preceding the filing of the offering statement and issuers that have not filed required ongoing reports pursuant to Regulation A, as proposed to be amended, in the two-year period immediately preceding the filing of a new offering statement.

The proposed changes to the Regulation A eligibility requirements would have benefits and costs. In particular, we believe that the proposed exclusion from eligibility of issuers that have not complied with ongoing reporting requirements in the two-year period immediately preceding the filing of a new offering statement would incentivize issuers that intend to rely on Regulation A in the future to comply with ongoing reporting requirements, which would allow investors to make better informed investment decisions. This exclusion, however, should not impose additional burdens or costs on issuers that would not have already been incurred with the proposed ongoing reporting requirements of Regulation A.

The Commission is also proposing to exclude from eligibility issuers that are subject to a denial, suspension, or revocation order by the Commission pursuant to Section 12(j) of the Exchange Act within the five years immediately preceding the filing of the offering statement. This exclusion may incentivize Exchange Act registrants to comply with their obligations, and would prevent companies with a history of reporting non-compliance from relying on Regulation A. We also recognize that this exclusion could prevent offerings by issuers that intend to comply with Regulation A requirements despite a history of Exchange Act non-compliance, which could limit capital formation in certain situations.

The proposed rules continue to exclude non-Canadian foreign issuers from use of Regulation A, but, as discussed above, we are soliciting comment about the alternative of amending Regulation A to expand eligibility to additional foreign issuers. Allowing participation by non-Canadian foreign issuers could increase competition between foreign and domestic issuers for U.S.-based investor capital. This increased competition could raise the cost of capital for Regulation A issuers to the extent that there is not a commensurate increase in the supply of Regulation A capital. It is also possible, however, that expanding eligibility to use Regulation A to non-Canadian foreign issuers could attract additional investor capital to the market such that the change would not have a material impact on domestic issuers' cost of capital.

The proposed rules also continue to exclude blank-check companies. We believe that this exclusion is appropriate given the potential difficulty for retail investors to evaluate the investment opportunities posed by these issuers, particularly because the issuers do not explicitly identify investment opportunities at the time of offering. The continued exclusion of blank check companies could prevent some legitimate early-stage companies that would otherwise be eligible issuers from relying on Regulation A.

We are not proposing to amend the existing exclusion of companies subject to the ongoing reporting requirements of Section 13 or 15(d) of the Exchange Act ("reporting companies"). As an alternative, we could amend Regulation A to expand the category of eligible issuers to include reporting companies. Although reporting companies do occasionally rely on exemptions for private placements, we believe that many reporting companies generally would not benefit from eligibility to rely on Regulation A as proposed to be amended. In particular, reporting companies are subject to Exchange Act reporting requirements that are more extensive than those proposed for Regulation A, so would not benefit from the reduced disclosure requirements; although reporting companies could potentially benefit from the liability standards conferred by reliance on Regulation A, and such issuers that do not have the class of securities being offered already listed, or are not simultaneously listing, on a national securities exchange could potentially benefit from blue sky law preemption. Nonetheless, we believe that the benefits of amending Regulation A to permit reporting companies to rely on the exemption are minimal.[593]

593 This exemption does not bar reporting companies from suspending or terminating their reporting obligations and then relying on Regulation A. This option could appeal even to large reporting companies if they are not looking to raise more than $50 million of new capital. Many follow-on

The proposed rules also continue to exclude investment companies and BDCs. If, as an alternative, the Commission were to permit investment companies to use Regulation A, offerings from investment companies could increase investment opportunities for retail investors. Additionally, the Commission recognizes that permitting investment companies to rely on Regulation A could enhance capital formation indirectly. Specifically, if the use of proposed Regulation A decreased the cost of capital for investment companies and those savings were passed through to the company recipients of the investment companies' capital, expanding the eligibility for Regulation A to investment companies could potentially enhance capital formation.[594]

b. Eligible Securities and Maximum Offering Size

Consistent with the statute, the proposed rules increase the maximum offering size from $5 million to $50 million of "equity securities, debt securities, and debt securities convertible or exchangeable to equity interests, including any guarantees of such securities." The proposed rules exclude asset-backed securities ("ABS") from eligibility. As discussed above, the Commission does not believe that ABS issuers are the intended beneficiaries of the mandated expansion of Regulation A. ABS are designed to pool the risk of already-issued loans and other financial assets, and, in this respect, do not constitute new capital formation. We recognize, however, that allowing ABS offerings under Regulation A could, in certain cases, lower the cost of capital for underlying

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offerings, for example, are for less than $50 million, as discussed above. This could have both benefits (in the form of reduced transaction costs and compliance costs for issuers) and costs (in the form of reduced accountability and reduced information available to investors).

594 Brewer, Elijah, et al. (1996), *Performance and access to government guarantees: The case of small business investment companies*, Economic Perspectives – Federal Reserve Bank of Chicago 20, pp. 16-30.

borrowers whose loans are eventually securitized by ABS issuers and therefore indirectly facilitate capital formation.[595]

Although there are potential indirect benefits from allowing ABS offerings under Regulation A, we believe that, in practice, Regulation A would have little appeal to ABS issuers if available. Most ABS offerings are much larger than the maximum allowable offer size under the proposed rules. Average ABS offering sizes are generally well over \$50 million.[596] Because of their large size, unregistered ABS offerings—for which Regulation A might be an alternative offering method—currently target Qualified Institutional Buyers (QIBs) under Rule 144A. For these reasons, we do not believe excluding ABS from eligibility for Regulation A will have an adverse effect on capital formation.

As explained above, we are proposing to increase the maximum offering size of Regulation A offerings by introducing two tiers of offerings. Tier 1 offerings may be up to \$5 million and Tier 2 offerings may be up to \$50 million. As compared to the current rules, the increase in the offering limit for some Regulation A offerings should significantly lower issuance costs as a proportion of proceeds to the extent that issuers face certain fixed costs or costs that do not otherwise scale in proportion to offering size.

595 This indirect effect may result because, due to bank accounting standards and capital requirements, securitization allows banks sponsoring ABS issuers to move assets off balance sheet, freeing up capital for additional loans. The resulting increase in capital available for lending could lead to lower borrowing costs for all borrowers down the capital supply chain. *See, e.g.*, Pennacchi, George G. (1995), *Loan sales and the cost of bank capital*, The Journal of Finance 43, no. 2, pp. 375-396.; Carlstrom, Charles T., and Katherine A. Samolyk (1995), *Loan sales as a response to market-based capital constraints*, Journal of Banking & Finance 19, no. 3, pp. 627-646.

596 Our analysis indicates that from 2011-2013, 2.9% of ABS issuances were below \$50 million. This calculation uses the AB Alert and CM Alert databases and includes only private label (non-GSE) ABS deals.

This could make Regulation A, as proposed to be amended, more cost effective and attractive for issuers than existing Regulation A.[597]

Increasing the maximum offering size could lead to improved liquidity of the securities sold in offerings under Regulation A as proposed to be amended, to the extent that larger issuances permit greater breadth of ownership.[598] This would be of particular benefit to companies that have a greater interest in floating their securities in the public market for the purpose of creating liquidity than in raising capital. Greater investor participation, particularly retail investor participation, could increase investors' demand for liquidity, resulting in more frequent trading and further increases in liquidity. As a result of improved liquidity, current and potential investors in larger Regulation A offerings could more easily unwind their investments and at lower cost, thus making such investments more attractive.

The increase in maximum offering size could also increase the potential feasibility and value of intermediation services, such market making and analyst coverage, with respect to Regulation A securities. These services require sufficient investor demand for securities and information following the issuance because market makers and analysts are generally compensated on a per transaction or subscription basis. The presence of these intermediation services could also have a positive impact on

597 Section 401 of the JOBS Act also requires the Commission to review the $50 million offering limit not later than two years after enactment of the JOBS Act and every two years thereafter and, if the Commission decides not to increase the amount, requires that it report its reasoning to Congress. This requirement will benefit issuers and investors by establishing a regular schedule for the Commission to review whether the offering limit remains appropriate or should be increased.

598 Grullon, Gustavo, George Kanatas, and James P. Weston, *Advertising, breadth of ownership, and liquidity*, Review of Financial Studies 17.2, pp. 439-461. The study shows that large issuances permit greater analyst coverage, which leads to higher breadth of ownership.

investor participation and aftermarket liquidity of Regulation A offerings, providing further demand for such services. It is also possible, however, that even the large increase in maximum offering size included in the statute and proposed rules would not be sufficient to make such services economically feasible.[599]

Lastly, the increased maximum offering size could make Regulation A more attractive to larger or more mature companies that are in less need of capital than business start-ups. For these issuers, secondary market liquidity may be the primary goal of an offering, and it is possible that their resulting market capitalization could be much greater than the maximum offering size.[600] It is not clear whether existing OTC markets would be able to supply the liquidity necessary for large issuers.

c. Limitations on secondary sales

We propose to permit sales by selling securityholders of up to $1.5 million in Tier 1 offerings and to $15 million in Tier 2 offerings in any twelve-month period, which represents 30% of the total maximum offering size.[601] This percentage is consistent with the current Regulation A rules, which permit secondary sales of up to $1.5 million, or 30% of the $5 million maximum offering size. The proposed rules would also eliminate current Rule 251(b), which prohibits resales by affiliated parties unless the issuer has had

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599 For instance, one prominent study finds that firm size is an important predictor of analyst coverage. *See* Barth, Mary E., Ron Kasznik, and Maureen F. McNichols., *Analyst coverage and intangible assets.* Journal of Accounting Research 39.1 (2001): 1-34.

600 For instance, an issuer that floats 20% of its shares at $50 million would be valued at $250 million following the issuance. For this issuer, secondary market liquidity may facilitate subsequent offerings by founders, employees, affiliates, and other pre-issuance shareholders who are seeking a partial or full exit of their holdings.

601 So, for example, an offering under $5 million but involving secondary sales in excess of $1.5 million would require exemption under section 3(b)(2) of the Exchange Act and would therefore be a Tier 2 offering.

operating income in at least one of the last two years.[602] As discussed above, selling securityholder access to Regulation A has historically been an important part of the exemptive scheme, and for some issuers, secondary market liquidity and the ability for significant company insiders and affiliates to exit all or a portion of their holdings in the issuer may be a more important consideration than the ability to raise new capital.[603] Hence, we believe that removing the limitation on affiliate resales would have negligible costs and could enhance capital formation and allocative efficiency of capital; however, it is also possible that the limit on resales would not be a constraint on selling securityholders in most instances. The table below shows that if the proposed $15 million resale cap for Regulation A Tier 2 offerings had been applied to registered offerings conducted in 2012, only a small fraction of offerings below $50 million would have been affected.

Overview by offering size of the percent of registered offerings conducted in 2012 that would have been affected by a $15 million limit on secondary sales.

	Initial Public Offerings[604] (millions)			Follow-on Public Offerings[605] (millions)		
	<$5	**$5-$50**	**>$50**	**<$5**	**$5-$50**	**>$50**
Average percentage of proceeds to existing shareholders sales	0.0%	1.4%	13.4%	2.8%	5.1%	21.7%
Percentage offerings with proceeds to existing shareholders > $15 million	n/a	0.8%	26.5%	n/a	0.0%	6.2%

602 Tier 1 offerings may still be subject to state law limitations on secondary sales and sales from affiliates.

603 *For example, see* Rydqvist, Kristian, and Kenneth Högholm (1995), *Going public in the 1980s: evidence from Sweden,* European Financial Management 1.3, pp. 287-315.

604 These estimates use data provided by Capital IQ and are calculated by comparing the total IPO proceeds to the proceeds from the IPO that went to incumbent shareholders as disclosed on Form S-1.

605 These estimates use SCD data provided by Thompson Analytics and, as above, these numbers are calculated by comparing total offering proceeds to the proceeds that went to incumbent shareholders.

Permitting these secondary sales provides exit options for company founders, employees, and institutional investors, such as private equity or venture capital investors, which can have a positive effect on capital formation. For instance, because these investors consider available exit options before participating in a new venture, permitting secondary sales increases the incentives to make the original investment.[606] Allowing these exits could also facilitate an optimal re-allocation of human capital. In particular, entrepreneurs and venture capitalists have valuable talents and allowing them to exit may free their attention for new projects and business ventures, and allow them to make investments not otherwise possible.[607] In turn, their exits facilitate new investment opportunities for investors with different skills and risk preferences, and potentially a more appropriate investor base for an issuer.

As an alternative, we could increase the cap on secondary sales above the proposed \$1.5 million for Tier 1 offerings and \$15 million for Tier 2 offerings. Increasing the cap on secondary sales could provide additional exit options for incumbent shareholders, which could indirectly increase capital formation because exiting investors could more quickly redeploy their capital into new projects and business ventures.

It is also possible that increasing the cap on secondary sales could lead to better monitoring of the underwriter or placement agent if used, as the selling securityholders

606 Cumming, Douglas J., and Jeffrey G. MacIntosh (2003), *Venture-capital exits in Canada and the United States,* The University of Toronto Law Journal 53.2, pp. 101-199.

607 Zhang, Junfu (2011), *The advantage of experienced start-up founders in venture capital acquisition: Evidence from serial entrepreneurs*, Small Business Economics 36.2, pp. 187-208. Also *see*, Gompers, P., A. Kovner, J. Lerner, D. Scharfstein (2006), *Skill vs. luck in entrepreneurship and venture capital: Evidence from serial entrepreneurs,* No. w12592. National Bureau of Economic Research.

have incentives to ensure that the underwriter values the securities and conducts the offering so as to maximize the value of their investment.[608] Finally, increasing the cap on secondary share offerings could result in more dispersed ownership, resulting in better liquidity in the secondary resale market. As described above, an increase in the portion of securities sold to the public generally increases investor participation and the breadth of ownership. The exit of a large shareholder that accounts for an increase in public float has the benefit of changing the composition of shareholders to those that do not have access to non-public information about the issuer's operations and that predominantly trade based on liquidity needs or publicly available information. Studies show that this can result in lower spreads because it minimizes the inventory risk that dealers face.[609]

Increasing the permitted amount of secondary sales could also result in potential costs. In particular, it is often argued that the incentives of company management are better aligned with other shareholders when managers hold a significant equity interest in the company.[610] Specifically, it can be important for insiders to retain some ownership stake to ensure that the incentives of directors and officers are aligned.[611] Hence, it is possible that affiliate sales, if too large, could be detrimental to purchasing investors. However, there is no conclusive evidence that affiliate sales are associated with poor

608 Ljungqvist, Alexander, and William J. Wilhelm (2003), *IPO pricing in the dot-com bubble*, The Journal of Finance 58.2, pp. 723-752.

609 Bharath, S. and Amy Dittmar (2010), *Why Do Firms Use Private Equity to Opt Out of Public Markets?*, Review of Financial Studies 23(5), pp. 1771-1818.

610 *See, e.g.*, Jensen, Michael C., and William H. Meckling (1978), *Theory of the firm: Managerial behavior, agency costs and ownership structure,* Journal of Financial Economics 3.4, pp. 305-360.

611 Core, John E., Robert W. Holthausen, and David F. Larcker (1999), *Corporate governance, chief executive officer compensation, and firm performance*, Journal of Financial Economics 51.3, pp. 371-406.; Mehran, Hamid (1995), *Executive compensation structure, ownership, and firm performance*, Journal of Financial Economics 38.2, pp. 163-184.

post-offering performance in the context of IPOs,[612] and there is some evidence that affiliate sales are associated with positive post-IPO performance, as the selling affiliates have incentives to monitor and limit rent capture by underwriters.[613]

There may also be investor protection benefits in some cases from precluding affiliate sales by limiting transactions between informed investors (affiliates) and uninformed investors, such as retail investors. These potential benefits may be limited, as buyers are aware that they are less informed than affiliates and consequently, security prices should generally reflect these asymmetries at the time of the offering.[614] Investors also may prefer to transact with affiliates in an offering because affiliates assume additional liability for misstatements in the offering documents. Thus affiliates may be sensitive to the risks of exploiting uninformed investors during an offering in which they are selling securities. For example, some empirical evidence suggests venture capitalists avoid reputational consequences of selling over-valued securities to uninformed investors during IPOs.[615] Furthermore, we believe that state oversight of affiliate sales in Tier 1 offerings and the proposed investment limitation and financial statement and disclosure requirements for Tier 2 offerings could provide additional investor protection.

Using an operating income criterion for permitting secondary sales could promote investor confidence with respect to issuer viability by reducing the incidence of insiders

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612 Mikkelson, Wayne H., M. Megan Partch, and Kshitij Shah. *Ownership and operating performance of companies that go public.* Journal of Financial Economics 44.3 (1997): 281-307.

613 Ljungqvist, Alexander, and William J. Wilhelm (2003), *IPO pricing in the dot-com bubble*, The Journal of Finance 58.2, pp. 723-752.

614 Easley, David, and Maureen O'Hara (2004), *Information and the cost of capital*, The Journal of Finance 59.4, 1553-1583.

615 Lin, Timothy H., and Richard L. Smith (1998), *Insider reputation and selling decisions: the unwinding of venture capital investments during equity IPOs*, Journal of Corporate Finance 4.3, pp. 241-263.

offloading investments in companies that are not financially viable. However, the Commission believes that doing so may result in an under- or over-inclusion of companies that are viable investment opportunities because there is no single criterion that would provide an accurate measure of the financial health of all companies that could rely on Regulation A.[616]

d. Investment Limitation

Regulation A currently does not place any limitations on the amount of securities that may be purchased by an investor. As explained above, we are proposing that purchasers of Tier 2 offerings be limited to investing no more than 10% of the greater of the investor's annual income and net worth.[617] By limiting investment size in Tier 2 Regulation A offerings in that way, the proposed rules could limit potential losses to investors; however, they could also limit potential gains.

The proposed rules would permit issuers to rely on investors' representation that they are investing no more than 10% of their net worth and annual income. The ability to rely on investor representations should help to mitigate potential costs that issuers could incur in relation to this requirement. At the same time, we realize that investors might make inaccurate representations, whether intentionally or not, which could expose these investors to the risk of increased losses.

616 Indeed, one study suggests that standard accounting measures are often poor indicators of financial health in small companies. Davila, Antonio, and George Foster (2005), *Management accounting systems adoption decisions: evidence and performance implications from early-stage/startup companies,* The Accounting Review 80.4, pp. 1039-1068.

617 Annual income and net worth would be calculated for individual purchasers as provided in the accredited investor definition in Rule 501 of Regulation D. *See* 17 CFR 230.501. For example, individuals' net worth calculations would exclude the value of their primary residence.

It is also possible that preventing investors from investing more than 10% of the greater of their income and net worth in a Tier 2 Regulation A offering could limit capital formation, particularly if potential purchasers of Tier 2 offerings are not able to meet minimum investment sizes that may be required by some issuers.[618] While these issuers could require smaller minimum investment sizes, doing so may entail searching for, and involving more, investors that contribute to a smaller portion of the offering, which could increase transaction costs. If issuers maintain minimum investment sizes, the proposed rules could limit investor participation in Tier 2 offerings.

Furthermore, in some settings, it may be beneficial for issuers to involve large investments from some types of investors in Regulation A offerings. For example, it could be beneficial to allow company officers to invest a substantial portion of their net worth in an offering as a mechanism to align the officers' incentives with those of the other securityholders. While we recognize that limiting investment size could result in less capital being raised by issuers in Regulation A offerings, we believe that preventing investors from exposing more than 10% of the greater of their income or net worth in a Tier 2 offering could enhance investor protection by limiting potential losses.

As an alternative, we could also require that purchasers of Tier 1 offerings, like purchasers of Tier 2 offerings, be limited to investing no more than 10% of the greater of their annual income and net worth. We believe, however, that because Tier 1 offerings would continue to be subject to additional state oversight, any benefit associated with limiting the investment size in Tier 1 offerings could potentially be eclipsed by state-level

618 For example, in 2012 approximately half of the Regulation D offerings that would have been eligible for reliance on Regulation A included a minimum investment amount; the median minimum investment amount was $20,000.

protections. We also recognize that Tier 1 offerings would be subject to fewer reporting obligations and other investor protections than Tier 2 offerings, which could make investor losses due to fraud more likely under Tier 1.

e. Integration

We are proposing to allow companies to conduct other exempt offerings that would not be integrated with an offering made in reliance on Regulation A under the proposed amendments, as long as the company complies with the requirements of the exemption relied upon for the particular offering. We could have selected an alternative that would have aggregated the amounts offered in reliance on Regulation A with the amounts offered pursuant to other exempt offerings. Under such an alternative, the amounts raised in other exempt offerings would count toward the maximum offering amount under Regulation A. Compared to this alternative, the ability of issuers to conduct other exempt offerings that would not count toward the maximum offering amount under Regulation A would allow issuers to raise more capital.

f. Exclusion from Section 12(g)

As amended by the JOBS Act, Section 12(g) of the Exchange Act requires, among other things, that an issuer with total assets exceeding $10 million and a class of securities held of record by either 2,000 persons, or 500 persons who are not accredited investors, register such class of securities with the Commission.[619] As explained above, the JOBS Act includes a provision regarding the treatment under Section 12(g) of securities issued in securities-based crowdfunding transactions pursuant to Section 4(a)(6) of the Securities Act, but did not provide a similar provision in Section 3(b)(2).

619 *See* Section 501 of the JOBS Act.

We are not proposing to exempt Regulation A securities from the requirements of Section 12(g).

As discussed above and in more detail below, the intent of the proposed rules is to provide sufficient financial disclosure to help investors make informed decisions while limiting the costs imposed on issuers for doing so. We believe that the limited required initial and ongoing disclosures, as proposed, accomplish this objective. If Regulation A issuers cross the shareholder of record threshold described above, however, they would no longer benefit from the limited Regulation A disclosure environment and would be subject to the more comprehensive periodic reporting requirements under the Exchange Act. This may not have significant economic consequences for issuers that are prepared to list on a national securities exchange and would otherwise be required to register with the Commission under Section 12(b) and become subject to Exchange Act reporting requirements. For issuers that do not wish to list on a national securities exchange or do not meet listing requirements, the additional disclosure burden could provide incentive to take actions that would allow them to deregister and cease reporting.[620] In this case, the benefits of the Regulation A environment would be lost to the issuer's securityholders.

Because of the manner in which shareholders of record are tabulated, the likelihood of a Regulation A issuer triggering the 12(g) threshold is low if not triggered at the time of offering. In particular, beneficial owners of Regulation A issuers who hold their shares at a broker are not counted as a record holder. Their shares, held in "street name," are counted at the broker level, so that each brokerage at which there is a least

620 Leuz, Christian, Alexander Triantis, and Tracy Yue Wang (2008), *Why do firms go dark? Causes and economic consequences of voluntary SEC deregistrations*, Journal of Accounting and Economics 45.2, pp. 181-208.

one beneficial owner would constitute one shareholder of record. Because of this treatment, the number of shareholders of record is often significantly less than the number of beneficial owners.[621]

g. Liability under Section 12(a)(2)

Consistent with current Regulation A, sellers of securities under Regulation A as proposed to be amended would be subject to liability to investors under Section 12(a)(2) for any offer or sale by means of an offering circular or an oral communication that includes a material misleading statement or material misstatement of fact. We believe that this would continue to benefit investors by encouraging issuers and selling securityholders to truthfully disclose all relevant facts associated with an offering, which in turn would allow potential investors to better assess the merits of the offering and make informed decisions. We do not expect this requirement to impose any significant costs beyond the liability already incurred by current Regulation A issuers.

In the context of registered transactions, Section 11 liability applies not only to the issuer and underwriter but also, in certain circumstances, to other specified persons, including the accountants, attorneys and other experts involved in preparing the registration statement. In contrast, Section 12(a)(2) liability applies by its terms only to sellers, and does not extend to "those who merely assist in another's solicitation efforts."[622] Therefore, we anticipate that auditors and placement agents may not demand as much compensation for bearing the legal risks associated with participation in Regulation A offerings as they would for offerings subject to Section 11 liability. We

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621 Langevoort, Donald, and Robert Thompson, *'Publicness' in Contemporary Securities Regulation after the JOBS Act*, Georgetown Law Journal, pp. 12-002.

622 Pinter v. Dahl 486 U.S. 622 (1988), at 651 fn. 21.

recognize, however, that Section 12(a)(2) liability may result in lower levels of scrutiny by such intermediaries and may therefore expose investors to additional risks.

3. Offering Statement

We are proposing a number of modifications to the offering statement required under Regulation A. Under current Regulation A, offering materials are submitted to the Commission in paper form. We are proposing to require electronic submission of offering materials so that these materials can more easily be made available to the public.

As discussed in detail above, electronic submission has numerous benefits to issuers and investors. For example, electronic filing allows offering materials to be more easily accessed and analyzed by regulators, investors, and financial market researchers. We anticipate the effect of providing electronic access to offering materials to the public will promote liquidity and pricing efficiency for the issued securities. We also recognize that electronic filing on EDGAR may impose costs on issuers, as discussed below.

We also are proposing a number of modifications to Form 1-A intended to streamline the type of information included in the offering circular. In general, we are proposing to maintain Form 1-A's three-part structure and to make various revisions and updates to the form. For Part I, the substantive additions to Regulation A items are: issuer eligibility, bad actor disqualification and disclosure, and a summary of key issuer financial information and offering details. Since most of this information is already contained in other offering materials, the additional reporting burden in Part I of the Form 1-A should not entail significantly higher costs in terms of time or out-of-pocket expenses.

Regulation A issuers currently are required to file their offering statements on paper. Paper documents are difficult to process both for the Commission and for investors, analysts, and other researchers. The proposed rules require issuer and offering details in Part I of Form 1-A to be reported in XML format that once filed with the Commission will be machine readable. This format will allow for more efficient reviews and the systematic tracking of offering particulars by investors, regulators, and other market participants such as financial market data aggregators.

The rule also proposes eliminating one of the three alternate models for providing narrative disclosure under Part II of the offering statement. Currently, issuers can choose between Model A (for issuers that are corporations only), Model B, and Part 1 of Form S-1 as described in the release. Elimination of Model A, wherein issuers provided disclosure in a question-and-answer format, is unlikely to affect most issuers, as historically, only about 20% of issuers have elected to use Model A. Eliminating Model A also addresses regulators' concerns about possible confusion that could result from the lack of uniformity of information presented in the question-and-answer in the format. Issuers continue to have the option of using Form S-1.

The proposed changes to Model B include statutorily required disclosures and a section containing management discussion and analysis of the issuer's liquidity, capital resources, and business operations. As discussed in more detail below, these additional items may impose costs on the issuer, while providing important information to investors.

Consistent with JOBS Act requirements with regard to ongoing reporting by Regulation A issuers, we are proposing to require offering materials to include audited financial statements, but only for issuers conducting a Tier 2 offering. The benefits of audited financial statements should provide investors with greater confidence in the accuracy and quality of the financial statements of issuers seeking to raise larger amounts of capital. We understand that audited financial statements could entail significant costs to issuers, and that the costs of an audit may discourage the use of Regulation A as proposed to be amended. Based on a compilation of data submitted by reporting companies, the average cost of an audit for offerings of less than $50 million is approximately $114,000.[623] Additionally, the proposed rules do not require that the auditor be PCAOB registered, which could reduce the cost of an audit for some issuers.

The proposed amendments also include a limitation on the age of financial statements at the time of qualification or filing (on these dates, financial statement data must not be older than nine months). This provision ensures that qualification is based on information that closely reflects a company's current financial condition. The additional costs from these changes are somewhat mitigated by decreases in disclosure requirements regarding the issuer's business and transactions with related persons. The higher level of disclosure would, however, enable investors to have better information for making their investment decisions.

The proposed rules would also allow for continuous or delayed offerings of eligible securities by an eligible issuer under Regulation A, on a basis analogous to shelf registration under Rule 415 for registered offerings, although acquisition shelves would not be permitted under Regulation A. Unlike existing Regulation A, the proposed rules also restrict at-the-market shelf offerings. Issuers would need to update their offering

623 *See* Audit Analytics, *Auditor-Fees, available at* http://www.auditanalytics.com/0002/audit-data-company.php. The auditor fee database contains fee data disclosed by SEC reporting companies in electronic filings since January 1, 2001.

circulars annually and after the second fiscal quarter, the same timetable as is proposed to apply for ongoing reporting requirements.

The current Regulation A rules allow for continuous or delayed offerings under Rule 415, but Rule 415 only discusses registered offerings, which may have caused confusion in its application to Regulation A. The provisions in Regulation A as proposed explicitly allow for continuous or delayed offerings and would provide greater clarity. It would now be clear that eligible issuers would have greater flexibility to select the timing of their offerings based on macroeconomic conditions such as interest rates and market volatility, or other company specific factors that may contribute to a successful offering.[624] Issuers would not have to wait for the Commission or a state regulator to complete what can sometimes be a lengthy review process. These factors should contribute to more timely financing decisions and higher capital market efficiency. For example, existing research for Rule 415 offerings in the registered offering market shows that costs of intermediation in shelf offerings, and consequently the cost of raising equity through shelf registration, is lower than through traditional registration.[625]

Excluding at the market offerings will avoid situations where sales at fluctuating market prices result in a breach of the offering ceiling or the cap on secondary sales. Issuers could thus avoid losing their exemption under Regulation A due to unanticipated market factors. While eligible issuers have to file periodic updates and amendments as described above, they have the flexibility to file only a supplement to the offering circular

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624 Bayless, Mark and Susan Chaplinsky, 1996, "*Is there a window of opportunity for seasoned equity issuance*?" Journal of Finance 51, 253–278.

625 Bethel, Jennifer and Laurie Krigman, "*Managing the Cost of Issuing Common Equity: The Role of Registration Choice*", Quarterly Journal of Finance and Accounting, 47 (4) (2008), pp. 57–85.

if there were no fundamental changes. Hence, the cost to issuers of having the flexibility to make a continuous or delayed offering could be minimal.

4. Solicitation of Interest ("Testing the Waters")

Consistent with Title IV of the JOBS Act, the proposed rules permit issuers to "test the waters" by soliciting interest in the offering. Regulation A issuers would be allowed to use all forms of communications with all potential investors in these communications. Under current Regulation A, testing the waters is permitted only until the offering statement is filed with the Commission, and solicitation material is required to be filed prior to or concurrent with first use. Under the proposal, testing the waters would be permitted both before and after filing of the offering statement, and testing the water materials would be required to be filed with the Commission at the time of initial submission of the offering statement, and would be updated thereafter.

In general, allowing issuers to gauge interest through testing the waters may reduce uncertainty regarding whether an offering could be completed successfully. If after testing the waters, the issuer is not confident that it will attract sufficient investment, the issuer can consider alternate methods of raising capital and thereby avoid the costs of an unsubscribed or under-subscribed offering. Allowing solicitation prior to filing enables issuers to determine market interest in their securities before incurring the costs of preparing and filing an offering statement.

By expanding the permissible scope of testing the waters, the proposed rules could have several benefits. In particular, allowing issuers to advertise their intention to raise capital prior to qualification of the offering statement could decrease the time required to raise the desired amount of capital. This option may be useful for smaller companies, especially early-stage companies, which may find it too costly to solicit through intermediaries. Thus, at least for some companies, the proposed rules could lead to lower search costs and therefore lower issuance costs. The expansion of testing the waters could also increase the type and extent of information available to investors, which could lead to more efficient prices for the offered securities.

In addition, to the extent that the proposed rules permit testing the waters for an expanded period of time, investors who previously found it difficult to find investment opportunities in private offerings may be able to find and potentially invest in a larger and more diverse pool of investment opportunities, allowing investors to more efficiently allocate their capital. The net effect would be to enhance both capital formation and allocative efficiency. Further, requiring issuers to attach the offering statement to their testing the waters materials (or providing information about where it can be accessed) would allow investors to be fully aware of the details of the offering material in a timely manner that would support sound investment decisions.

We recognize that there would also be potential costs associated with expanding the use of testing the waters. In particular, to the extent that testing the waters increases under the proposed rules, the proposed rules could result in increased levels of inappropriate and potentially fraudulent activity, because solicitation of these offerings can be directed towards all investors, including non-accredited and unsophisticated investors. To some extent, these costs are mitigated by the application of Section 12(a)(2) and the general antifraud provisions of the federal securities laws. By expanding the scope of permissible testing the waters, the proposed amendments could also lead to investor confusion about how to process the different disclosure materials they receive. For example, investors already aware of an impending offering through testing the waters materials may neglect to read the offering circular, which could be substantively different from the material distributed when testing the waters.

The Commission could require submission of testing the waters materials before or concurrent with first use, allowing regulators to better assess how testing the waters is used to gauge investor interest prior to filing of the offering statement. Requiring initial submission of testing the waters materials could increase costs for issuers that decide not to proceed with the offering after testing the waters. Requiring submission before filing the offering circular could decrease issuers' willingness to test the waters and could potentially limit the overall reliance on Regulation A. Any additional solicitation materials that could result from requiring early submission would also lead to an increase in the amount of material available for investors about the offering, which could increase confusion and the costs incurred by investors evaluating their investment opportunities.

5. Ongoing Reporting Requirements

Requiring limited ongoing disclosure could improve investor decision-making and ultimately benefit issuers by improving the price efficiency of securities issued through an amended Regulation A offering, to the extent that secondary markets for these securities develop. Ongoing financial disclosures and mandatory disclosures of key material events would allow existing and potential future investors to periodically update their expectations of the issuer's prospects and act accordingly. By standardizing the content, timing, and form of these disclosures, the proposed amendments would make it easier for investors to compare information across issuers than if disclosure decisions were otherwise left to voluntary, bilateral arrangements between issuers and investors, as would be the case without mandatory disclosures. Hence, the proposed amendments to require ongoing disclosure under Regulation A would eliminate many potential differences in disclosures between issuers that could otherwise impair the capital allocation decisions of investors,[626] particularly to the extent that such securities trade in OTC markets.

More generally, the proposed ongoing disclosure requirements should result in fewer information asymmetries between issuers and their investors than currently exist for securities offered under the existing Regulation A or other exempt offering methods. The enhanced disclosure requirements should help improve the ability of investors with different risk preferences to identify investment opportunities best suited for their risk tolerance. They will provide investors with a useful benchmark with which to evaluate the performance of other companies, both within and outside of the proposed Regulation A market. This enhanced information environment should improve the allocative efficiency of capital and facilitate the subsequent transfer of issued securities in secondary markets, allowing for more efficient pricing and liquidity. [627]

In addition to the direct costs of preparing the mandatory disclosures, issuers of securities in a Regulation A offering under the proposed rules would be subject to potential indirect disclosure costs by revealing to their competitors and other market

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626 *See, e.g.*, Luigi Zingales (2009), *The Future of Securities Regulation*, Journal of Accounting Review, Vol 47, pp. 391-425.

627 *See* Graham, J., C. Harvey and S. Rajgopal (2005), *The Economic Implications of Corporate Financial Reporting*. Journal of Accounting and Economics 40, pp. 3-73; Durnev, A., R. Morck and B. Yeung (2003), *Value Enhancing Capital Budgeting and Firm-Specific Stock Returns Variation*, Journal of Finance 59, pp. 65-106.

participants information about their business not previously required to be disclosed.[628] For these issuers, ongoing reporting requirements under Regulation A may render alternative offering methods more appealing, such as Rule 506(c) of Regulation D, which allows general solicitation but does not impose any ongoing disclosure requirements.

Nonetheless, the indirect costs of increased disclosures are present for any issuer seeking improved liquidity through access to public capital markets and a broader investor base that includes unaccredited investors. Enhanced disclosure is likely to improve the liquidity of the securities of Regulation A issuers in the secondary market, particularly for securities that are traded in the OTC market.[629] As discussed above, there is a positive feedback effect from increased liquidity, whereby increased trading engenders more accurate pricing by incorporating a greater number of investors' views. More accurate pricing, in turn, encourages greater investor participation and greater liquidity, and provides investors with more accurate information. Increased price efficiency can also facilitate a lower cost of capital by lessening the discount investors otherwise place on illiquid securities and securities for which there is increased risk of asymmetric information. Hence, there would be significant indirect effects of improving capital formation.

a. Periodic Reporting Requirements

Currently, Regulation A issuers do not have ongoing reporting obligations. Under the proposed amendments, issuers that conducted Tier 2 offerings would be required to

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628 Campbell, Tim S (1979), "*Optimal investment financing decisions and the value of confidentiality.*" Journal of Financial and Quantitative Analysis, pp. 913-924.

629 Ang, A., Shtauber, A., & Tetlock, P. (2011). *Asset pricing in the Dark: The Cross Section of Over-the-Counter Stocks.* Review of Financial Studies, forthcoming.

provide annual audited financial statements on Form 1-K. The Commission is further proposing that issuers that conducted Tier 2 offerings provide a semi-annual update on Form 1-SA and current event reporting on Form 1-U. These proposed requirements are more extensive, in terms of breadth and frequency, than those for current Regulation A offerings and those for other exempt offerings.[630] The proposed additional disclosures are intended to reduce the information asymmetries between companies that conduct Tier 2 offerings and their potential investors, both at the time of the offering, through the disclosure document, and on an ongoing basis, via ongoing reporting. While we considered whether we should require certain additional disclosures to be provided in structured data format, the proposed rules do not require these disclosures to be machine readable. Not requiring structured data should help to limit costs to issuers while still providing meaningful information to investors. While not requiring a structured data format could limit the ability for investors, academics, regulators and other market participants to analyze firms relying on Regulation A, as proposed to be amended, we do not believe it is advisable to impose such a requirement on issuers relying on the exemption.

b. Current Event Reporting Requirements

As discussed above, in addition to the proposed annual and semi-annual reporting requirements, the proposed rules include several event-based disclosure requirements, similar to the event-based reporting of reporting companies on Form 8-K. These events, like the ongoing financial performance of a company, can be important determinants in

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630 Small private companies, such as those that might consider a Regulation A offering, typically do not disclose information as frequently or as extensively as public companies, if at all. Moreover,

an investor's capital allocation decision. The direct cost of reporting these events is often minimal, particularly to the extent that the disclosed information is simply the announcement of a new development, such as the sale of an unregistered security. Of the 26 relevant current reporting items on Form 8-K, listed in the table below, eleven are proposed to be required to be reported, in whole or in part, by issuers that conducted Tier 2 offerings.

unlike public companies, small private companies are not required to have their financial statements audited or to hire an independent third party to certify the information disclosed.

8-K item number	Description of event triggering reporting obligation	Proposed Regulation A requirement
	Section 1 - Registrant's Business and Operations	
Item 1.01	Entry into a Material Definitive Agreement.	Sometimes
Item 1.02	Termination of a Material Definitive Agreement.	Sometimes
Item 1.03	Bankruptcy or Receivership.	Yes
Item 1.04	Mine Safety – Reporting of Shutdowns and Patterns of Violations.	No
	Section 2 - Financial Information	
Item 2.01	Completion of Acquisition or Disposition of Assets.	Sometimes
Item 2.02	Results of Operations and Financial Condition.	No
Item 2.03	Creation of a Direct Financial Obligation or an Obligation under an Off-Balance Sheet Arrangement of a Registrant.	No
Item 2.04	Triggering Events That Accelerate or Increase a Direct Financial Obligation or an Obligation under an Off-Balance Shelf Arrangement	No
Item 2.05	Costs Associated with Exit or Disposal Activities.	No
Item 2.06	Material Impairments.	No
	Section 3 - Securities and Trading Markets	
Item 3.01	Notice of Delisting or Failure to Satisfy a Continued Listing Rule or Standard; Transfer of Listing.	N/A
Item 3.02	Unregistered Sales of Equity Securities.	Yes
Item 3.03	Material Modification to Rights of Security Holders	Yes
	Section 4 - Matters Related to Accountants and Financial Statements	
Item 4.01	Changes in Registrant's Certifying Accountant.	Yes
Item 4.02	Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review	Yes
	Section 5 - Corporate Governance and Management	
Item 5.01	Changes in Control of Registrant.	Yes
Item 5.02	Departure of Directors or Certain Officers; Election of Directors; Appointment of Certain Officers; Compensatory Arrangements of Certain Officers	Sometimes[631]
Item 5.03	Amendments to Articles of Incorporation or Bylaws; Change in Fiscal Year.	No
Item 5.04	Temporary Suspension of Trading Under Registrant's Employee Benefit Plans	No
Item 5.05	Amendments to the Registrant's Code of Ethics, or Waiver of a Provision of the Code of Ethics.	No
Item 5.06	Change in Shell Company Status.	No
Item 5.07	Submission of Matters to a Vote of Security Holders.	No
Item 5.08	Shareholder Director Nominations	No
	Section 6 -Asset-Backed Securities (N/A)	
	Sections 7 – 9 - Other	
Item 7.01	Regulation FD Disclosure.	No
Item 8.01	Other Events.	Optional
Item 9.01	Financial Statements and Exhibits.	Sometimes

We have chosen to require the reporting of key current events based on our assessment of their potential usefulness to investors in these types of offerings and issuers and based on the suggestions of commenters. For instance, we are proposing to require the disclosure of certain events that directly affect the rights of securityholders (Items 3.02 and 3.03). Because sales of securities provide important information about an issuer's capital structure and could dilute existing shareholders, these events can have direct securities pricing implications. We are also proposing to require issuers to disclose changes in their certifying accountant or non-reliance on previously issued financial statements or a related audit report (Items 4.01 and 4.02). We believe that these items are relevant information for investors who rely on the information made available to them through the issuer's periodic reporting, and it is important for investors to know if financial statements could be incorrect or compromised in some way.

We also propose requiring disclosure of certain meaningful corporate events. Bankruptcy (Item 1.03) can have direct effects on valuation as it changes a number of obligations of the issuer,[632] the fiduciary duties of executive officers and directors,[633] and can potentially call into question the claims of existing securities to issuer assets and cash flows.[634] Similarly, reorganizations, such as takeovers (Item 5.01), debt restructuring and mergers (Items 1.01, 1.02, and 2.01), change companies' obligations and organizational structure in ways that can have a material impact on security prices.

Finally, we propose requiring the disclosure of changes in issuer management, which can have direct implications on the issuer's future prospects and security prices.[635] Therefore we believe disclosure of management changes would benefit investors.

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631 Form 1-U focuses on officers, as discussed in the release.

632 For example, the automatic stay provision suspends contractual obligations.

633 Firms nearing the "zone of insolvency" have a responsibility to maximize "enterprise value", which is generally not the same as firm value, as it can include the value of providing employment, among other things.

634 Renegotiation plans are subject to approval from a majority of owners of the "fulcrum" security which can be difficult to determine.

635 Murphy, Kevin J., and Jerold L. Zimmerman (1993), *Financial performance surrounding CEO turnover*. Journal of Accounting and Economics 16.1 pp. 273-315.

c. Termination or Suspension of Reporting Requirements

The proposed rules allow for a termination or suspension of an issuer's ongoing reporting obligations if the number of record holders of the class of securities to which the Regulation A offering statement relates falls below 300 persons or suspension upon registration of a class of securities under Section 12 of the Exchange Act or registration of an offering of securities under the Securities Act.

For Tier 2 issuers, which are subject to substantial ongoing reporting requirements, the option for suspending or terminating the Regulation A reporting obligations could be beneficial, especially for issuers that are not seeking secondary market liquidity, and smaller issuers for which the fixed costs of complying with the ongoing disclosure requirements would weigh more heavily.[636] The option to suspend or terminate periodic reporting might be costly for investors because it would decrease the amount of information available about the issuer, making it more difficult to monitor the issuer and accurately price its securities or to find a trading venue that would allow liquidation of the investment. Suspension or termination of reporting might particularly adversely affect minority investors if the lack of current financial or other material information, and/or the presence of large inside or affiliate shareholders could make it easier for controlling shareholders to expropriate capital from minority investors. In most cases we propose to require Tier 2 issuers to notify the Commission upon suspension or termination of reporting requirements through Form 1-Z, which for Tier 2 issuers, will request information regarding the reason for the suspension or termination. To the extent

636 *See* Request for Comment 90 above (seeking comment on, among other things, whether we should exempt some issuers from ongoing reporting on the basis of whether such issuer has taken steps to foster a secondary market for their securities).

that ongoing reporting is suspended due to registration of a class of securities under the Exchange Act, investors may benefit from enhanced reporting under the Exchange Act requirements.

Although Tier 1 issuers are not subject to periodic and current event reporting requirements, we propose to require issuers of Tier 1 offerings to notify the Commission of their terminated reporting obligation using Form 1-Z upon completion of the offering. Under the proposed rules, Form 1-Z would take the place of Form 2-A, which is currently required upon completion of a Regulation A offering. For Tier 1 issuers, Form 1-Z will require issuers to provide updated information regarding some features of the completed offering, such as the final proceeds raised net of fees.[637] This information will allow the Commission to monitor whether issuers can reliably raise the projected amount of capital in Regulation A offerings. Form 1-Z would elicit limited summary information about the completed offering and the issuer, would not require any additional information from issuers that would not have been forecasted and provided in the offering materials of Tier 1 issuers and, therefore, should not impose substantial additional costs on the issuer.

6. Bad Actor Disqualification

We propose to amend Rule 262 to include bad actor disqualification provisions in substantially the same form recently adopted under Rule 506(d), but without the categories of covered persons specific to fund issuers, which are not proposed to be eligible to use Regulation A.[638] We believe that the proposed disqualification provisions are not likely to impose significant incremental costs on issuers and other covered

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637 We do not propose to require notification of the completion of a Tier 2 offering as the information will be included in other ongoing reporting materials required from issuers of Tier 2 offerings.

638 *See* proposed Rule 262.

persons because the proposed rules are substantially similar to the disqualification provisions under existing Regulation A and other exemptions.

The proposed rules likely would induce issuers to implement measures to restrict bad actor participation in offerings made in reliance on Regulation A, which could help reduce the potential for fraud in these types of offerings. If disqualification standards lower the risk premium associated with the presence of bad actors in securities offerings, any resulting reduction in fraud could also reduce the cost of raising capital to issuers that rely on Regulation A as proposed to be amended. In addition, the requirement that issuers determine whether any covered persons are subject to disqualification might reduce the need for investors to do their own investigations and could therefore increase efficiency.

The proposed disqualification provisions likely would also impose costs on issuers, other covered persons and investors. If issuers are disqualified from participating in offerings made in reliance on proposed Regulation A, they may experience increased costs in raising capital through alternative methods. These costs could hinder potential investment opportunities for such issuers, which could have negative effects on capital formation. In addition, issuers may incur personnel costs to avoid the participation of covered persons who are subject to disqualifying events. Issuers also might incur costs by restructuring share ownership to avoid beneficial ownership of more than 20% from individuals subject to disqualifying events. Finally, issuers might incur costs by devoting resources to seeking disqualification waivers.

As discussed above, we are also proposing a reasonable care exception under Regulation A on a basis consistent with Rule 506.[639] We anticipate that the reasonable care exception also would impose benefits and costs. For example, a reasonable care exception could encourage capital formation by enabling Regulation A offerings to go forward, where issuers might have been deterred from relying on Regulation A if they risked potential liability under Section 5 of the Securities Act for unknown disqualifying events. This exception could increase the potential for fraud by limiting issuers' incentive to determine whether bad actors are involved with their offerings. We also recognize that some issuers might incur costs associated with conducting and documenting their factual inquiry into possible disqualifications. The rule's flexibility about the nature and extent of the factual inquiry required could increase these costs because uncertainty could drive issuers to misunderstand requirements for compliance; however, the flexibility would allow an issuer to tailor its factual inquiry as appropriate to its particular circumstance, thereby potentially reducing costs associated with conducting the inquiry.

The proposed requirement that issuers disclose matters that would have triggered disqualification, had such matters occurred after the effective date of proposed Regulation A, also would impose costs and benefits. The proposed disclosure requirement would likely reduce issuer costs, relative to the cost of disqualification. This approach would not preclude the participation of past bad actors, whose disqualifying events occurred prior to the effective date of the proposed rules, which could expose

[639] *See* proposed Rule 262(b)(4).

investors to the risks that arise when bad actors are associated with an offering. Nevertheless, investors would benefit by having access to such information that could inform their investment decisions. Disclosure of triggering events may also make it more difficult for issuers to attract investors, and issuers may experience some or all of the impact of disqualification as a result. Some issuers may, accordingly, choose to exclude involvement from prior bad actors to avoid such disclosures.

We believe the inclusion of Commission cease-and-desist orders in the list of disqualifying events would not impose a significant, incremental cost on issuers and other covered persons because many might already be subject to Commission cease-and-desist orders or may already be disqualified on the basis of orders issued by state regulators, federal banking regulators and the National Credit Union Administration.[640] The inclusion of Commission cease-and-desist orders in the list of disqualifying events might change how settlement negotiations are conducted between respondents and the Commission, and the Commission could grant an appropriate waiver from disqualification.

Under the proposed rules, orders issued by the CFTC would trigger disqualification to the same extent as orders of the regulators enumerated in Section 302(d)(2)(B)(i) of the JOBS Act (*e.g.*, state securities, insurance and banking regulators, federal banking agencies and the National Credit Union Administration). We believe that including orders of the CFTC would result in the similar treatment, for disqualification purposes, of comparable sanctions. In this regard, we note that the conduct that would typically give rise to CFTC sanctions is similar to the type of conduct that would result in

640 *See* SEC Rel. No. 33-9414 (July 10, 2013) [78 FR 44729] ("Bad Actor" adopting release).

disqualification if it were the subject of sanctions by another financial services industry regulator. This provision should enable the disqualification rules to more effectively screen out bad actors.

7. Relationship with State Securities Law

As explained above, Regulation A offerings are subject to registration or qualification under state "blue sky laws," unless the offering is made to "qualified purchasers" (as the Commission may define that term) or is offered or sold on a national securities exchange. Compliance with blue sky law requirements can impose significant costs, predominantly as a result of having to coordinate independent reviews across multiple regulatory regimes when issuers are offering securities to investors in multiple states.[641]

The GAO study of Regulation A offerings found that blue sky law compliance was one of four central factors in the infrequent reliance on Regulation A.[642] Commenters have also raised the importance of state securities law preemption to the utilization of Regulation A.[643] As discussed above, we are concerned that the costs associated with state securities law compliance may deter issuers from using Regulation A, even if the increased cap on offering size and other proposals intended to make Regulation A more workable are implemented. This would limit the possible impact of an amended Regulation A as a tool for capital formation. We believe that

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641 *See* discussion in Section IV.A.1.a. above regarding the determinates of trends in Regulation A issuances.

642 *See* GAO-12-839, "Factors that May Affect Trends in Regulation A Offerings", (July 3, 2012).

643 *See* Fallbrook Letter ("It cannot be understated as to how critical state securities law preemption is to ensuring the Regulation A+ Rules are user-friendly and attractive for utilization by growing companies.").

Regulation A, as we propose to amend it for Tier 2 offerings, would provide substantial protections to purchasers. Under the proposed amendments, a Regulation A offering statement would continue to provide substantive narrative and financial disclosures about the issuer, including an MD&A discussion. We expect that Regulation A offering statements would continue to receive the same level of Commission staff review as registration statements. Additional investor protections would be afforded by Regulation A's limitations on eligible issuers and "bad actor" disqualification provisions, which we are proposing to expand. In addition, the requirements for Tier 2 offerings would provide further protection by requiring the audited financial statements in the offering circular, an obligation for issuers to provide ongoing reporting to purchasers, and a limitation on the percentage of annual income or net worth that an investor could invest in a single offering. Ongoing reporting would assure a continuing flow of information to investors and could support the development of secondary markets for Regulation A securities, offering the prospect of reduced investor risk through liquidity.

Based on these requirements, we are proposing to define the term "qualified purchasers" for purposes of Regulation A to include all offerees in a Regulation A offering and all purchasers in a Tier 2 Regulation A offering. Therefore, as proposed, Tier 1 offerings would be subject to state registration and qualification requirements to the same extent as offerings under current Regulation A, whereas such requirements would be preempted for Tier 2 offerings.

Because state registration requirements were cited as a central factor in the infrequent reliance on Regulation A,[644] we believe that by eliminating these costs of state

[644] *See* GAO-12-839, "Factors that May Affect Trends in Regulation A Offerings", (July 3, 2012).

law compliance for Tier 2 offerings issuers may be more likely to rely on amended Regulation A relative to the current rules under Regulation A, which do not preempt state securities laws.[645] We believe that this definition could facilitate capital formation, as suggested in several comment letters.[646] It is also possible that the preemption of state securities laws for Tier 2 offerings could attract issuers away from offerings conducted under Rule 506, which also provides preemption of state laws, but restricts resales. Given that in 2012 the majority of Rule 506 offerings by eligible issuers were less than $50 million, some shift from Rule 506 to Regulation A is possible; however, we are unable to quantify its magnitude. The infrequent and issuer-specific use of existing Regulation A makes it difficult to identify general findings about the effect of preemption on Regulation A, as proposed to be amended, and to quantify the potential effects of defining qualified purchasers to include all offerees in a Regulation A offering and all purchasers in Tier 2 offerings made under the proposed amendments.

We recognize that the proposal could impose some costs. For example, because the types of issuers and investors that would participate in Regulation A offerings could vary by state, state-specific securities requirements may potentially be tailored to the specific investors and issuers involved in these transactions. It is possible that state securities regulators could provide a meaningful level of investor protection for certain offerings because of greater familiarity with local issuers and investors.

As a policy alternative, we could permit one or a subset of states to qualify certain Regulation A offerings either in place of, or in addition to, federal qualification. This

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645 *See* discussion in Section IV.A.1.a. above.

646 *See, e.g.*,. Campbell Letter, Kaplan Voekler Letter, WR Hambrecht + Co. Letter, and Tresslar Letter,

alternative could allow state securities regulators to provide a comparable level of oversight, while still limiting the costs associated with requiring issuers to undergo multiple review processes. Depending on how this alternative is implemented, it may not result in comparable review. For example, if state review is conducted by a single state, issuers could seek review from the state with the least stringent standards and could therefore increase the level of fraud in Regulation A offerings. A potentially greater risk of fraud could negatively affect both investors and issuers, which may find it more expensive to raise capital using Regulation A, as proposed to be amended, if investors demand higher returns because of any perceived increase in the risk associated with this type of offering. The Commission also recognizes that there are a number of alternative definitions of qualified purchaser that we could propose. One alternative that we could have selected is to define as a "qualified purchaser" any purchaser in any Regulation A offering. Compared to the definition in the proposed rulemaking, such a broad definition would allow Tier 1 Regulation A offerings to qualify for the state law preemption, which in turn would decrease the cost of such offerings and potentially enhance capital formation. However, the resulting loss of state review for Tier 1 offerings, combined with the absence of the additional investor protections included in Tier 2, could increase the likelihood of fraud in these offerings.

Other alternatives can be broadly categorized as relying on attributes of the investor, the issuer, and/or the offering. We discuss these alternatives in greater detail below.

We could have selected a policy alternative that defines as a "qualified purchaser" any purchaser who meets a specified income or net worth standard that is set either lower or higher than the current "accredited investor" definition in Rule 501 of Regulation D. Compared to the definition in the proposed rulemaking, such an alternative could limit the number of offerings that would qualify for state preemption because some investors that purchased securities in Tier 2 offerings would not satisfy these alternative definitions. However, such alternatives might allow the preemption of blue sky law for Tier 1 offerings, which are not subject to the same reporting and other obligations proposed for Tier 2. Limiting eligible investors could result in higher offering costs for potential Regulation A issuers but could also lower the likelihood of fraud in Regulation A offerings compared to the proposed rules.

Another policy alternative that we could have adopted is to define a "qualified purchaser" as any purchaser who purchases securities in a Regulation A offering through a registered broker-dealer. Such an alternative could have limited the number of offerings that would qualify for state preemption because some investors might not use broker-dealers when participating in Tier 2 offerings. Such a limitation could result in higher offering costs for issuers. Additionally, such an alternative could have increased the cost to investors participating in Tier 2 offerings because they would have to pay broker-dealer fees. On the other hand, the presence of registered broker-dealers, who presumably perform due diligence on potential investments, could result in lower likelihood of fraud in this market compared to the proposed rules, and could support blue sky preemption for Tier 1 offerings as well as Tier 2 offerings.

In addition, we could have defined qualified purchasers as investors in a Regulation A offering in which the issuer meets specified conditions. For example, the definition could require that the issuer meet some financial criteria, or that the issuer meet some governance requirements. The potential advantage of defining qualified purchaser according to attributes of the issuer is that indicators of fraud or risky investments are often characteristics of the issuer (e.g. shell companies, financially distressed companies, etc.). Therefore, a definition based on issuer attributes might effectively identify the investments most in need of additional regulatory oversight. However, it may be difficult to identify criteria that effectively distinguish between fraudulent or excessively risky investments and safer investments, given the wide variety of potential issuers. For example, a high degree of leverage would be indicative of financial distress in some companies, but could be optimal in others.

Lastly, we could have used attributes of the offering, other than or in addition to the proposed requirements for Tier 2, to define qualified purchasers. For example, qualified purchasers could be defined in relation to offerings in which issuers and agents of the issuer assume increased liability for material misstatements and omissions, offerings over a certain size, or offerings with a firm commitment underwriting. While some of these factors are correlated with the riskiness of the offering, using a definition based on these factors could prompt issuers to sub-optimally modify features of the offering in order to avoid state regulation.

We considered the policy alternative suggested by one commenter to preempt blue sky laws with respect to secondary sales of Regulation A securities in addition to preempting blue sky laws governing primary offerings.[647] If blue sky laws pertaining to resales affect the ability to conduct or the cost of transactions involving Regulation A securities, preemption of sales in addition to offers could help facilitate liquid secondary

647 *See* Paul Hastings Letter.

markets, and could therefore enhance capital formation. We are currently unaware of any evidence suggesting that blue sky laws inhibit trading in OTC markets; therefore, we are not proposing to preempt blue sky laws with respect to secondary sales of Regulation A securities at this time.

8. Effect of Regulation A on OTC Markets and Dealer Intermediation

For securities issued in Regulation A offerings that end up trading on the OTC market, the proposed new Tier 2 disclosure requirements would provide timely and relevant issuer information to broker-dealers that initiate quotations and make markets in these securities and to investors in these securities. This information would be much more detailed than what is currently required for non-reporting issuers under Rule 15c2-11 and reported on Form 211. Similarly, for issuers with existing securities trading on the OTC market, the disclosure proposed to be required under Tier 2 would supplement the issuer information otherwise used by broker-dealers when relying on the existing piggyback exception of Rule 15c2-11.[648] For Tier 2 issuers, the proposed new periodic reporting requirements, including audited financials, would allow broker-dealers to obtain more current information about these issuers more frequently and at lower cost. Thus, broker-dealers quoting securities for such issuers under Rule 15c2-11 would have a more robust basis for believing that the issuer information is accurate. The availability of more current information about Tier 2 issuers would likely improve the pricing efficiency and reduce the likelihood of fraud in the OTC market for their securities. We expect this

648 Rule 15c2-11(a)(5) currently provides that issuer information must be made available upon request to any person expressing an interest in a transaction in that issuer's security with the broker-dealer. This requirement may have little practical effect because only the first broker-dealer to publish quotations must have the information, and an investor might find it difficult to identify that broker-dealer. In fact, that broker-dealer may no longer be publishing quotations.

effect to be much stronger for issuers that do not currently provide voluntary disclosure to the OTC market. The overall effect of the required disclosure would also depend on what fraction of Regulation A securities eventually trade on the OTC market and on how many current OTC participants decide to make offerings under Regulation A.

A particular set of OTC-listed companies – those that cease reporting and, if necessary, delist from national securities exchanges – might find the proposed rules attractive for raising capital. As mentioned above, the proposed Tier 2 disclosure requirements are less stringent than those applicable to reporting companies. Companies that delist from national exchanges might be able to use Regulation A offerings to raise capital as well as maintain liquid securities in the OTC market. The potential effect of the proposed rules on companies that delist from national securities exchanges is difficult to predict. Companies that would like to maintain liquidity for their securities trading in the OTC market and face a less burdensome disclosure regime than entailed by Exchange Act registration might find Regulation A useful. On the other hand, companies that delist from national securities exchanges because they want to minimize disclosure and cease reporting might find the proposed disclosure requirements under Regulation A too burdensome, and might prefer other offering methods to raise capital (e.g., Regulation D).

The potential future use of Regulation A could also depend on the willingness of financial intermediaries such as placement agents or underwriters to participate in offerings. For example, in registered offerings, underwriters are frequently used to identify potential investors and are primarily responsible for facilitating a successful distribution of the offered securities. Some commenters claim that underwriters are generally unwilling to participate in small offerings because the commissions are not sufficient to warrant their involvement.[649] If the services of financial intermediaries continue to be limited for small offerings under Regulation A as proposed to be amended, it could be difficult for Regulation A issuers to place all offered securities. As noted in the GAO report,[650] increasing the allowed maximum Regulation A offering amount may make placement agents more inclined to participate in offerings because they would be able to collect more compensation from larger offerings. Furthermore, underwriter costs for offerings under Regulation A as proposed to be amended may be lower than for registered public offerings because underwriters would not take on liability under Section 11 of the Securities Act (although they could be liable as sellers under Section 12(a)(2)). Finally, if the requirements for qualification of Regulation A offerings are substantially lighter than the requirements for registered offerings, an underwriting market could develop to provide expedient Regulation A underwriting services.

C. Request for Comment

Throughout this release, we have discussed the anticipated costs and benefits of the proposed rules and their potential impact on efficiency, competition and capital formation. We request and encourage any interested person to submit comments regarding the proposed rules, our analysis of the potential effects of the rules and other matters that may have an effect on the proposed rules. We request comment from the point of view of issuers, investors and other market participants. With regard to any comments, we note that such comments are of particular assistance to us if accompanied

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649 *See, e.g.,* Karr Tuttle Letter.

650 *See* GAO-12-839, "Factors that May Affect Trends in Regulation A Offerings", (July 3, 2012).

by supporting data and analysis of the issues addressed in those comments. We also are interested in comments on the qualitative benefits and costs we have identified and any benefits and costs we may have overlooked. We urge commenters to be as specific as possible.

Request for Comment

128. What types of companies (*e.g.*, in terms of size, industry, age, etc.) would most likely rely on the amended Regulation A exemption? Would Exchange Act reporting companies, which are ineligible to rely on proposed Regulation A, consider raising additional capital through Regulation A by first terminating or suspending their reporting requirements?

129. Are investors in private companies likely to use the amended Regulation A exemption to exit their investments? Would eliminating current Rule 251(b), which prohibits resales by affiliated parties unless the issuer has had operating income in at least one of the last two years, affect fraud in this market?

130. How likely is the amended Regulation A exemption to attract companies that are considering a traditional IPO? What types of companies (*e.g.*, in terms of size, industry, age, etc.) would prefer a Regulation A offering to a traditional IPO? How would the cost of a traditional IPO compare to the cost of a Regulation A offering? Could a Regulation A offering serve as a stepping stone for a future traditional IPO or a national securities exchange listing?

131. How likely is the amended Regulation A exemption to attract companies that are considering offerings relying on Rule 506(b) or Rule 506(c) of Regulation D? What would be the costs and benefits from relying on the amended Regulation A exemption versus Rule 506(b) or Rule 506(c) of Regulation D? Please provide estimates, where possible.

132. What is the economic effect of the proposed investment limitation in Tier 2 Regulation A offerings? What types of issuers and investors are most likely to be affected by this restriction? Will this restriction enhance investor protection? What would be the economic effect of imposing a similar restriction on Tier 1 Regulation A offerings?

133. Would the amended Regulation A exemption attract intermediaries (e.g., broker-dealers or underwriters) to the market for Regulation A offerings? How would the presence of intermediaries change the cost structure for Regulation A issuers? Would the amended Regulation A exemption make it economically feasible for intermediaries to serve as market makers and provide research and analyst coverage? Would the presence of intermediaries likely increase the chances that a wider variety of investors will participate in Regulation A offerings?

134. Do the proposed disclosure requirements help ensure that investors have a reasonable understanding of the risks and costs of investing in Regulation A securities? If not, what additional requirements would further mitigate the associated risks? How would the costs and benefits of the requirements compare to the costs and benefits of the disclosure that currently exists for securities offered under the current Regulation A requirements? How would the costs and benefits compare to other exempt offering methods? Please provide estimates, where possible.

135. How would the proposed preemption of state blue sky laws for offerings made to qualified purchasers, as we propose to define that term, affect the costs and benefits of Tier 1 and Tier 2 Regulation A offerings? Please provide estimates, where possible. Would the proposed blue sky law preemption affect fraud and investor protection and capital formation in this market?

136. The Commission is interested in receiving comments, views, estimates and data on all aspects of the proposal and the following:

- Expected size of the Regulation A market (*e.g.*, number of offerings, number of issuers, size of offerings, number of investors, etc., as well as information comparing these estimates to the current baseline);
- Overall economic impact of the proposed rules; and
- Any other aspect of the economic analysis.

137. What would be the economic impact of the policy alternatives discussed in the proposed rules?

V. PAPERWORK REDUCTION ACT

A. Background

Certain provisions of the proposed rules contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[651]

[651] 44 U.S.C. 3501 *et seq.*

We are submitting the proposal to the Office of Management and Budget ("OMB") for review in accordance with the PRA.[652] The titles for the collections of information are:

(1) "Regulation A (Form 1-A and Form 2-A)" (OMB Control Number 3235-0286);

(2) "Form 1-K" (a proposed new collection of information);

(3) "Form 1-SA" (a proposed new collection of information);

(4) "Form 1-U" (a proposed new collection of information);

(5) "Form 1-Z" (a proposed new collection of information);

(6) "Form ID" (OMB Control Number 3235-0328).

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. We are applying for OMB control numbers for the proposed new collections of information in accordance with 44 U.S.C. 3507(j) and 5 CFR 1320.13, and OMB has not yet assigned a control number to each new collection. Responses to these new collections of information would be mandatory for issuers raising capital under Regulation A.

B. Estimate of Issuers

The number, type and size of the issuers that would participate in offerings of securities under Regulation A, as proposed to be amended, is uncertain, but data regarding current market practices may help identify the number and characteristics of potential issuers that may offer and sell securities in reliance on the proposed rules.[653] We estimate that there are currently approximately 22 Regulation A filings by issuers per

652 44 U.S.C. 3507(d) and 5 CFR 1320.11.

653 *See* Section I.C. above for a discussion of the data regarding current market practices.

year.[654] While it is not possible to predict the number of filings by issuers relating to offerings made in reliance on the proposed amendments to Regulation A, for purposes of this analysis, we estimate that the number would be 250 offerings per year. We base this estimate on (i) the current approximate number of issuers that, on average in recent years, filed a Form 1-A to qualify a Regulation A offering of securities under the existing rules, plus (ii) 95 percent of the estimated number of registered offering of securities of up to $50 million,[655] plus (iii) an additional four offerings that either would not otherwise occur or would have been conducted in reliance on another exemption from Securities Act registration, such as Regulation D.[656] We believe issuers that have either previously relied on Regulation A or have offered securities in amounts up to the revised offering ceiling of $50 million in a twelve-month period would be similar to the potential issuers that may participate in offerings of securities under Regulation A as proposed to be amended.

C. Estimate of Issuer Burdens

1. Regulation A (Form 1-A and Form 2-A)

Currently, Regulation A requires issuers to file a Form 1-A: Offering Statement and a Form 2-A: Report of Sales and Uses of Proceeds with the Commission. Regulation A has 1.00 administrative burden hour associated with it, while current

654 From 2009 through 2012, there were 87 Form 1-As filed with the Commission, and 19 qualified offering statements during this same period. *See also* figures for current use of Regulation A in Section I.C. above.

655 *See* figures and graphs for registered offerings cited in Section IV. above (citing approximately 236 registered initial public offerings or follow-on offerings of up to $50 million in calendar year 2012).

656 *See* figures and graphs for registered and exempt offerings under Regulation D cited in Section IV.A.1.a(2). above (citing approximately 12,000 issuances of up to $50 million in reliance on Regulation D in calendar year 2012).

Form 1-A takes approximately 608.00 hours to prepare and Form 2-A takes approximately 12.00 hours to prepare.[657] We do not anticipate that the 1.00 administrative burden hour associated with Regulation A would change as a result of the proposal. As discussed more fully below, we believe the burden hours associated with Form 1-A would change, while Form 2-A and the associated burden hours would be eliminated as a result of today's proposal.[658]

Under the proposed rules, an issuer conducting a transaction in reliance on Regulation A would be able to conduct either a Tier 1 offering or a Tier 2 offering.[659] In either case, a Regulation A issuer would continue to be required to file with the Commission specified disclosures on a Form 1-A: Offering Statement.[660] An issuer also would file amendments to Form 1-A to reflect comments from Commission staff and to disclose material changes in the disclosure previously provided to the Commission or investors.[661] In light of the proposed electronic filing requirements for Regulation A offering materials discussed above,[662] issuers would no longer be required to file a manually signed copy of the Form 1-A with the Commission.[663] Issuers would, however, be required to manually sign a copy of the offering statement before or at the time of non-public submission or filing that would have to be retained by the issuer for a period

657 *See* Form 1-A at 1; Form 2-A at 1.

658 *See* discussion in Section II.E.1. above.

659 *See* discussion in Section II.B.3. above.

660 *See* 17 CFR 239.91 (Form 1-A) (OMB Control Number 3235-0286) and proposed Rule 252.

661 *See* proposed Rule 252(h).

662 *See* discussion in Section II.C.1. above.

663 *See* discussion in Section II.C.3.d. above.

of five years and produced to the Commission, upon request.[664] As issuers are currently required to manually sign the Form 1-A and file it with the Commission, we do not anticipate the proposed Form 1-A retention requirement would alter an issuer's compliance burden. As proposed, Form 1-A is similar to existing Form 1-A. In some instances, Form 1-A, as proposed, would contain fewer disclosure items than existing Form 1-A (*e.g.*, Part I (Notification) of Form 1-A would not require disclosure of "Affiliate Sales"; Part II (Offering Circular) of Form 1-A would require a description of the issuer's business for a period of three years, rather than five years). Part II of Form 1-A would no longer permit disclosure in reliance on the Model A disclosure format, but direct issuers to follow the provisions of Model B (renamed "Offering Circular") or Part I of Form S-1.[665] In other instances, Form 1-A would contain more disclosure items than existing Form 1-A (*e.g.*, Part I of Form 1-A would require additional disclosure of certain summary information regarding the issuer and the offering; Part II of Form 1-A would require a more detailed management discussion and analysis of the issuer's liquidity and capital resources and results of operations). Form 1-A would require disclosure similar to that required in a Form S-1 registration statement for registered offerings under the Securities Act, but it would require fewer disclosure items (*e.g.*, it would require less disclosure about the compensation of officers and directors, and less detailed management discussion and analysis of the issuer's

[664] *See* Instruction 2. to Signatures in Form 1-A.

[665] *See* discussion at Section II.C.3.b. above.

liquidity and capital resources and results of operations) and, under certain circumstances, not require issuers to file audited financial statements.[666]

We expect that issuers relying on proposed Regulation A for Tier 1 offerings of up to $5 million in a twelve-month period would largely be at a similar stage of development to issuers relying on existing Regulation A and would therefore not experience an increased compliance burden with proposed Form 1-A. Given the increased annual offering threshold of $50 million, however, we expect that issuers conducting Tier 2 offerings pursuant to proposed Regulation A may be at a more advanced stage of development than issuers offering securities at a lower threshold. In such cases, the complexity of the required disclosure and, in turn, the burden of compliance with the requirements of proposed Form 1-A may be greater for some issuers than for issuers relying on existing Form 1-A.[667] We estimate that the total burden to prepare and file proposed Form 1-A, including any amendments to the form, would increase on average across all issuers in comparison to existing Form 1-A to approximately 750.00 hours.[668] We believe that the burden hour response of proposed Form 1-A would be greater than the current estimated 608.00 burden hours per response, but would not be as great as the current estimated 972.32 burden hours per response for Form S-1. We estimate that the issuer would internally carry 75 percent of the burden of

666 *See* discussion in Section II.C.3.b. above.

667 As noted above, we estimate the burden per response for preparing existing Form 1-A to be 608.00 hours. *See* Form 1-A at 1.

668 By comparison, we estimate the burden per response for preparing Form S-1 to be 972.32 hours. *See* Form S-1, at 1.

preparation and that outside professionals[669] retained by the issuer at an average cost of $400 per hour would carry 25 percent.[670]

We estimate that compliance with the requirements of a Form 1-A provided in connection with transactions made in reliance on proposed Regulation A would require 187,500 burden hours (250 offering statements x 750.00 hours/offering statement) in aggregate each year, which corresponds to 140,625 aggregated hours carried by the issuer internally (250 offering statements x 750.00 hours/offering statement x 0.75) and aggregated costs of $18,750,000 (250 offering statements x 750.00 hours/offering statement x 0.25 x $400) for the services of outside professionals. These estimates include the time and cost of collecting the information, preparing and reviewing disclosure, filing documents and retaining records. In deriving our estimates, we recognize that the burdens likely would vary among individual issuers based on a number of factors, including the stage of development of the business, the amount of capital an issuer seeks to raise and the number of years since inception of the business. We believe that some issuers would experience costs in excess of the average and some issuers may experience less than the average costs.

2. Form 1-K: Annual Report

Under the proposed rules, any issuer that conducts a Tier 2 offering in reliance on proposed Regulation A would be required to file an annual report with the Commission

669 For example, an issuer may address certain disclosure requirements internally, but retain an outside professional to assist in the preparation of the financial statements.

670 The costs of retaining outside professionals may vary depending on the nature of the professional services. For purposes of this PRA analysis, however, we estimate that such costs would be an average of $400/hour, which is consistent with the rate we typically estimate for outside legal services used in connection with public company reporting.

on Form 1-K: Annual Report.[671] A manually-signed copy of the Form 1-K would have to be executed by the issuer and related signatories before or at the time of electronic filing, retained by the issuer for a period of five years and, if requested, produced to Commission.[672] We do not anticipate that the proposed requirement to retain a manually-signed copy of the Form 1-K would affect an issuer's compliance burden. We believe the compliance burden on disclosure provided in Form 1-K would be less than the compliance burden associated with reporting required under Exchange Act Section 13 or 15(d). We also believe the burden would be more analogous to the compliance burden attendant to proposed Form 1-A. Unlike the disclosure required in Form 1-A, however, offering-specific disclosure in Form 1-K would not be required. Additionally, under certain circumstances, an issuer would also be required to disclose information similar to the information previously required of issuers on Form 2-A.[673] Unlike the disclosure previously required on Form 2-A, however, an issuer would not be required to provide disclosure about the use of proceeds. We estimate that the burden to prepare and file a Form 1-K would be less than that required to prepare and file a Form 1-A. We estimate that compliance with proposed Form 1-K would result in a burden of 600.00 hours per response.[674] We further estimate that 75 percent of the burden of preparation would be carried by the issuer internally and that 25 percent would be carried by outside

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671 *See* proposed Rule 257(b)(1).

672 *See* General Instruction C. to proposed Form 1-K and related discussion in Section II.E.1.a. above.

673 *See* discussion in Section II.E.1.a. above.

674 We estimate that the burden of preparing the information required by Form 1-K would be approximately 3/4 of the burden for the Form 1-A due to the lack of offering-specific disclosure and an issuer's ability to update previously-provided disclosure.

professionals[675] retained by the issuer at an average cost of $400 per hour.[676] While we do not know the exact number of issuers that will seek to qualify offerings in excess of $5 million in a twelve-month period in reliance on proposed Regulation A, we estimate 75 percent of all issuers filing a Form 1-A (or 188 issuers, 250 issuers x .75) will enter the proposed ongoing reporting regime and therefore be required to file proposed Form 1-K.

We estimate that compliance with the requirements of Form 1-K for issuers with an ongoing reporting obligation under proposed Regulation A would require 112,800 burden hours (188 issuers x 600.00 hours/issuer) in the aggregate each year, which corresponds to 84,600 hours carried by the issuer internally (188 issuers x 600.00 hours/issuer x 0.75) and costs of $11,280,000 (188 issuers x 600.00 hours/issuer x 0.25 x $400) for the services of outside professionals.

3. Form 1-SA: Semiannual Report

Under the proposed rules, any issuer that conducts a Tier 2 offering in reliance on proposed Regulation A would be required to file a semiannual report with the Commission on Form 1-SA: Semiannual Report.[677] A manually-signed copy of the Form 1-SA would have to be executed by the issuer and related signatories before or at the time of electronic filing, retained by the issuer for a period of five years and, if requested, produced to Commission.[678] We do not anticipate that the proposed requirement to retain a manually-signed copy of the Form 1-SA would affect an issuer's compliance burden. Issuers would be required to provide semiannual updates on

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675 *See* fn. 669 above.

676 *See* fn. 670 above.

677 *See* proposed Rule 257(b)(3).

proposed Form 1-SA, which, much like a Form 10-Q,[679] would consist primarily of financial statements and MD&A. Unlike Form 10-Q, Form 1-SA would not require disclosure regarding quantitative and qualitative market risk or controls and procedures.[680] We estimate, however, that on balance the reduction in burden attributable to eliminating these two items in Form 1-SA would be offset by the increased burden associated with requiring financial statement disclosure covering six months, rather than three months. We therefore believe the per response compliance burden of Form 1-SA would be similar to the compliance burden for issuers filing a Form 10-Q under the Exchange Act.[681] Therefore, for purposes of this PRA, we estimate that the burden to prepare and file a Form 1-SA would equal the burden to prepare and file Form 10-Q, which we have previously estimated as 187.43 hours per response.[682] Unlike proposed Form 1-K, Form 1-SA does not require the provision of audited financial statements. We therefore believe, in comparison to Form 1-K, issuers filing a Form 1-SA will be able to handle more of the required disclosures internally. Accordingly, we estimate that 85 percent of the burden of preparation would be carried by the issuer internally and that 15 percent would be carried by outside professionals retained by the issuer at an average cost of $400 per hour.[683]

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678 *See* General Instruction C. to proposed Form 1-SA and related discussion in Section II.E.1.b. above.

679 17 CFR 249.308a.

680 *See* discussion in Section II.E.1.b. above.

681 Issuers would, however, have to file Form 1-SA, a semiannual report, less frequently than Form 10-Q, a quarterly report.

682 *See* Form 10-Q, at 1.

683 *See* fn. 670 above.

We estimate that compliance with the requirements of Form 1-SA for issuers with an ongoing reporting obligation under proposed Regulation A would require 23,428.75 burden hours (188 issuers x 187.43 hours/issuer) in the aggregate each year, which corresponds to 19,914.44 hours carried by the issuer internally (188 issuers x 187.43 hours/issuer x 0.85) and costs of $1,405,725 (188 issuers x 187.43 hours/issuer x 0.15 x $400) for the services of outside professionals.

4. Form 1-U: Current Reporting

Under the proposed rules, any issuer that conducts a Tier 2 offering in reliance on proposed Regulation A would be required to promptly file current reports on proposed Form 1-U with the Commission.[684] A manually-signed copy of the Form 1-U would have to be executed by the issuer and related signatories before or at the time of electronic filing, retained by the issuer for a period of five years and, if requested, produced to Commission.[685] We do not anticipate that the proposed requirement to retain a manually-signed copy of the Form 1-U would affect an issuer's compliance burden. Issuers would be required to file such reports in the event they experience certain corporate events, much the same way as issuers subject to an ongoing reporting obligation under the Exchange Act file current reports on Form 8-K.[686] The requirement to file a Form 1-U, however, would be triggered by significantly fewer corporate events than those that trigger a reporting requirement on a Form 8-K, and, as proposed, the form

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684 *See* proposed Rule 257(b)(4).

685 *See* General Instruction C. to proposed Form 1-U and related discussion in Section II.E.1.c. above.

686 We estimate the burden per response for preparing a Form 8-K to be 5.71 hours. *See* Form 8-K, at 1.

itself would be slightly less burdensome for issuers to fill out.[687] Thus, the frequency of filing the required disclosure and the burden to prepare and file a Form 1-U would be considerably less than for Form 8-K. We estimate that the burden to prepare and file each current report would be 5.00 hours. While we do not know for certain how often an issuer would experience a corporate event that would trigger a current report filing on Form 1-U, we estimate that many issuers may not experience a corporate event that triggers reporting, while others may experience multiple events that trigger reporting. On average, we estimate that an issuer would be required to file one current report annually.[688] Therefore, we estimate that an issuer's compliance with proposed Form 1-U would result in an annual aggregate burden of 5.00 hours (1.00 current report annually x 5.00 hours per current report) per issuer.

As with Form 1-SA, we estimate that 85 percent of the burden of preparation would be carried by the issuer internally and that 15 percent would be carried by outside professionals retained by the issuer at an average cost of $400 per hour.[689] We estimate that compliance with the requirements of Form 1-U would require 940 burden hours (188 issuers x 1 current report annually x 5.00 hours per current report) in aggregate each year, which corresponds to 799 hours carried by the issuer internally (188 issuers x 5.00 hours/issuer/year x 0.85) and costs of $56,400 (188 issuers x 5.00 hours/issuer/year x 0.15 x $400) for the services of outside professionals.

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687 *See* discussion at Section II.E.1.c. above.

688 We have previously estimated that on average issuers file one current report on Form 8-K annually. Although we believe that the frequency of filing a Form 1-U would be considerably less than a Form 8-K, to be conservative, we are estimating that each issuer would be required to file one Form 1-U per year.

689 *See* fn. 670 above.

5. Form 1-Z: Exit Report

Under the proposed rules, all Regulation A issuers would be required to file a notice under cover of Form 1-Z: Exit Report. Issuers conducting Tier 1 offerings would be required to file Part I of Form 1-Z that would disclose information similar to the information previously required of issuers on Form 2-A.[690] Issuers conducting Tier 2 offerings would also be required to disclose the same information as issuers conducting Tier 1 offerings in Part I of Form 1-Z, unless previously reported by the issuer on Form 1-K. Issuers conducting Tier 2 offerings would also be required to fill out Part II of Form 1-Z in order to notify investors and the Commission that it will no longer file and provide annual reports pursuant to the requirements of Regulation A.[691] In Tier 2 offerings, an issuers' obligations to file ongoing reports could be terminated at any time after completion of reporting for the fiscal year in which the offering statement was qualified,[692] if the securities of each class to which the offering statement relates are held of record by fewer than 300 persons and offers and sales made in reliance on a qualified offering statement are not ongoing. A manually-signed copy of the Form 1-Z would have to be executed by the issuer and related signatories before or at the time of electronic filing, retained by the issuer for a period of five years and, if requested, produced to Commission.[693] We do not anticipate that the proposed requirement to retain a manually-signed copy of the Form 1-Z would affect an issuer's compliance burden. We estimate that 50 percent of issuers with an ongoing reporting obligation under proposed

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690 *See* discussion in Section II.E.1.a. above.

691 *See* proposed Rule 257(d).

692 *See* proposed Rule 252(h)(2).

693 *See* Instruction to proposed Form 1-Z and related discussion in Section II.E.4. above.

Regulation A (or 94 issuers, 188 issuers with an ongoing reporting obligation x .50 of issuers filing a Form 1-Z) would file a Form 1-Z in the second fiscal year after qualification of the offering statement. Although we believe that the vast majority of issuers subject to ongoing reporting under Regulation A would qualify for termination in the second fiscal year after qualification, we believe that only half or 50 percent of such issuers would actually choose to terminate their reporting obligations. An issuer may have many reasons, such as a desire to facilitate continued quotations in the over-the-counter ("OTC") markets pursuant to proposed revisions to Exchange Act Rule 15c2-11,[694] to continue reporting even though entitled to terminate reporting.

The Form 1-Z would be similar to the Form 15 that issuers file to provide notice of termination of the registration of a class of securities under Exchange Act Section 12(g) or to provide notice of the suspension of the duty to file reports required by Exchange Act Sections 13(a) or 15(d).[695] Therefore, we estimate that compliance with the proposed Form 1-Z would result in a similar burden as compliance with Form 15, a burden of 1.50 hours per response. We estimate that compliance with proposed Form 1-Z would result in a burden of 141 hours (94 issuers filing Form 1-Z x 1.50 hours/issuer) in the aggregate during the second fiscal year after qualification of the offering statement for issuers terminating their reporting obligations.

694 *See* discussion in Section II.E.2. above.

695 We currently estimate the burden per response for preparing a Form 15 to be 1.50 hours. *See* Form 15 at 1.

6. Form ID Filings

Under the proposed rules, an issuer would be required to file specified disclosures with the Commission on EDGAR.[696] We anticipate that many issuers relying on proposed Regulation A for the first time would not have previously filed an electronic submission with the Commission and so would need to file a Form ID. Form ID is the application form for access codes to permit filing on EDGAR. The proposed rules would not change the form itself, but we anticipate that the number of Form ID filings would increase due to an increase in issuers relying on proposed Regulation A. For purposes of this PRA discussion, we estimate that 75 percent of the issuers who would seek to offer and sell securities in reliance on proposed Regulation A would not have previously filed an electronic submission with the Commission and would, therefore, be required to file a Form ID. As noted above, we estimate that approximately 250 issuers per year would seek to offer and sell securities in reliance on proposed Regulation A, which would correspond to approximately 188 additional Form ID filings. As a result, we estimate the additional annual burden would be approximately 28.20 hours (188 filings x 0.15 hours/filing).[697]

D. Collections of Information are Mandatory

The collections of information required under proposed Rules 251 through 263 would be mandatory for all issuers seeking to rely on the Regulation A exemption. Responses on Form 1-A, Form 1-K, Form 1-SA, Form 1-U and Form 1-Z would not be confidential, although issuers may request confidential treatment for certain materials

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696 *See* proposed Rules 252 and 257.

697 We currently estimate the burden associated with Form ID is 0.15 hours per response. *See* Form ID at 1.

submitted in conjunction with the filings.[698] It is anticipated that most of this material would be made public when the offering is qualified. A Form 1-A that is submitted by an issuer with a confidential treatment request and later abandoned before being publicly filed with the Commission and responses on Form ID would, however, remain non-public, absent a request for such information under the Freedom of Information Act.[699] The hours and costs associated with preparing and filing forms and retaining records constitute reporting and cost burdens imposed by the collection of information requirements.

E. Request for Comment

The Commission invites comment on all of the above estimates. Pursuant to 44 U.S.C. 3506(c)(2)(A), the Commission requests comment in order to: (1) evaluate whether the proposed collections of information are necessary for the proper performance of our functions, including whether the information would have practical utility; (2) evaluate the accuracy of our estimate of the burden of the proposed collections of information; (3) determine whether there are ways to enhance the quality, utility and clarity of the information to be collected; and (4) evaluate whether there are ways to minimize the burden of the proposed collections of information on those who respond, including through the use of automated collection techniques or other forms of information technology.

Persons submitting comments on the proposed collection of information requirements should direct their comments to the Office of Management and Budget,

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698 *See* Commission Rule 83, 17 CFR 200.83.

699 5 U.S.C. 552. The Commission's regulations that implement the Freedom of Information Act are at 17 CFR 200.80 *et seq.*

Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should also send a copy of their comments to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090, with reference to File No. S7-11-13. Requests for materials submitted to OMB by the Commission, with regard to these collections of information, should be in writing, with reference to File No. S7-11-13, and they should be submitted to the Securities and Exchange Commission, Office of FOIA Services, 100 F Street, NE, Washington, DC 20549-2736. As OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication.

VI. INITIAL REGULATORY FLEXIBILITY ACT ANALYSIS

This Initial Regulatory Flexibility Analysis has been prepared in accordance with 5 U.S.C. 603. It relates to the following:

- proposed amendments to Rules 251 through 263 of Regulation A, Form 1-A, Rule 4a-1 under the Trust Indenture Act, Rule 15c2-11 under the Exchange Act, and Item 101 of Regulation S-T;
- proposed new Forms 1-K, 1-SA, 1-U, and 1-Z; and
- the proposed rescission of Form 2-A.

A. Reasons for the Proposed Action

The proposed rule amendments, new forms, and rescission of Form 2-A are designed to implement the requirements of Section 3(b)(2) of the Securities Act and to make certain conforming changes based on our proposed amendments to Regulation A.

Section 3(b)(2) directs the Commission to adopt rules adding a class of securities exempt from the registration requirements of the Securities Act for offerings of up to $50 million of securities within a twelve-month period, subject to various additional terms and conditions set forth in Section 3(b)(2) or as provided for by the Commission as part of the rulemaking process.

B. Objectives

Our primary objective is to implement Section 401 of the JOBS Act, as mandated by Section 3(b)(2), by expanding and updating Regulation A in a manner that makes public offerings of up to $50 million less costly and more flexible while providing a framework for regulatory oversight to protect investors. In so doing, we have endeavored to craft a workable revision of Regulation A that would both promote small company capital formation and provide for meaningful investor protection. We believe that issuers, particularly small businesses, benefit from having a wide range of capital-raising strategies available to them, and that an expanded and updated Regulation A could serve as a valuable option that augments the exemptions more frequently relied upon, thereby facilitating capital formation for small businesses.

C. Legal Basis

The amendments are being proposed under the authority set forth in Sections 3(b), 19 and 28 of the Securities Act of 1933, as amended, and Section 401 of the JOBS Act.[700]

D. Small Entities Subject to the Proposed Rules

For purposes of the Regulatory Flexibility Act, under our rules, an issuer (other than an investment company) is a "small business" or "small organization" if it has total

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[700] Pub. L. No. 112-106, -401, 126 Stat. 307 (April 5, 2012).

assets of $5 million or less as of the end of its most recent fiscal year and is engaged or proposing to engage in an offering of securities which does not exceed $5 million.[701]

While proposed Regulation A would be available for offerings of up to $50 million in securities in a twelve-month period, only offerings up to $5 million in securities in a twelve-month period would be offerings by small entities. It is difficult to predict the number of small businesses that would use proposed Regulation A due to the many variables created by our proposed amendments. Nevertheless, we believe that proposed Regulation A will increase the overall number of Regulation A offerings of $5 million or less due to the ability to non-publicly submit draft offering statements for review by the Commission's staff, the expanded use of solicitation of interest materials, the ability to electronically file and transmit offering statements and offering circulars, the potential for preemption of state regulatory review if the issuer elects to conduct a Tier 2 offering, and other significant changes summarized in Section II.A. above.

Regulation A is currently limited to offerings with an aggregate offering price of $5 million or less.[702] From 2009 through 2012, 87 issuers filed offering statements and 19 offering statements were qualified by the Commission, or an average of approximately 5 qualified offering statements per year. Of the 19 offering statements that were qualified, 12 included financial statements indicating that the issuer had total assets of $5

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701 17 CFR 230.157. We note that currently this rule refers to "the dollar limitation prescribed by Section 3(b) of the Securities Act." As noted earlier in this release, the JOBS Act amended Section 3(b) of the Securities Act. The former Section 3(b) is now Section 3(b)(1), and a new Section 3(b)(2) was added. To retain the meaning of 17 CFR 230.157, we are proposing a technical correction to replace the reference to "Section 3(b)" with a reference to "Section 3(b)(1)."

702 As explained in Section II.B.3. above, the aggregate offering price under existing and proposed Regulation A includes prior sales generated from Regulation A offerings that occurred in the twelve months preceding the current offering.

million or less (as of the most recent balance sheet included in such issuer's offering statement at the time of qualification), or an average of approximately 3 qualified offering statements per year in which the issuer indicated it had total assets of $5 million or less. Based on these data, and for the reasons discussed above, we believe that at least 3 small businesses will conduct offerings under proposed Regulation A per year.

E. Reporting, Recordkeeping, and Other Compliance Requirements

As discussed above in Section II.C., the proposed regulation includes reporting, recordkeeping and other compliance requirements. In particular, the proposed regulation would impose certain reporting requirements on issuers offering and selling securities in a transaction relying on the exemptions provided by Section 3(b) and Regulation A. The proposed rules would require that issuers relying on the exemption file with the Commission certain information specified in Form 1-A about the issuer and the offering, including the issuer's contact information; use of proceeds from the offering; price or method for calculating the price of the securities being offered; business and business plan; property; financial condition and results of operations; directors, officers, significant employees and certain beneficial owners; material agreements and contracts; and past securities sales.[703] Such issuers would also be required to provide information on the material factors that make an investment in the issuer speculative or risky; dilution; the plan of distribution for the offering; executive and director compensation; conflicts of interest and related party transactions; and financial statements. Similar to existing Regulation A, for Tier 1 offerings, Form 1-A would not require the financial

[703] *See* discussion in Section II.C.3. above.

statements to be audited unless the issuer has already had them audited for another purpose.[704]

As discussed above in Section II.E., issuers conducting Tier 2 offerings would also be required to file annual reports on proposed new Form 1-K, semiannual updates on proposed new Form 1-SA, current event reporting on proposed new Form 1-U, and to provide notice to the Commission of the termination of their ongoing reporting obligations on proposed new Form 1-Z. A Tier 1 offering would be limited to $5 million in a twelve-month period. Issuers in a Regulation A offering that would result in exceeding $5 million in a twelve-month period would be required to comply with the requirements for Tier 2 offerings, including being subject to ongoing reporting.

An issuer subject to the Tier 2 periodic and current event reporting described above would be required to provide information annually on Form 1-K, including the issuer's business and business plan; conflicts of interest and related party transactions; executive and director compensation; financial condition and results of operations; and audited financial statements. The semiannual update on Form 1-SA would consist primarily of unaudited, interim financial statements for the issuer's first two fiscal quarters and information regarding the issuer's financial condition and results of operations. The current event reporting on Form 1-U would require issuers to disclose certain major developments, including changes of control; changes in the principal executive officer and principal financial officer; fundamental changes in the nature of business; material transactions or corporate events; unregistered sales of five percent or

[704] The distinction between a Tier 1 offering and Tier 2 offering are discussed in Section II.B.3. above.

more of outstanding equity securities; changes in the issuer's certifying accountant; and non-reliance on previous financial statements.

Unlike the other ongoing reporting requirements, Form 1-Z would only be required for issuers in both Tier 1 and Tier 2 offerings to report summary information about a completed or terminated Regulation A offering. Issuers conducting Tier 2 offerings would, however, be subject to the additional provision in Form 1-Z that relates to the voluntary termination of an issuer's continuous reporting obligations under Tier 2 and thus its use by small entities would be limited. Also, the information that is required in Form 1-Z is minimal.

Although we estimated that approximately 188 issuers under proposed Regulation A would enter the proposed ongoing reporting regime every year, we believe that very few small businesses would do so. A small business under our rules would only be required to file ongoing reports under Regulation A if a Regulation A offering would result in exceeding the Tier 1 annual offering limitation of $5 million in a twelve-month period.

F. Duplicative, Overlapping or Conflicting Federal Rules

We believe that there are no federal rules that conflict with or duplicate the proposed rules.

G. Significant Alternatives

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish the stated objective of our proposals, while minimizing any significant adverse impact on small entities. In connection with the proposed amendments and rules, we considered the following alternatives: (1) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (2) the clarification, consolidation or simplification of compliance and reporting requirements under the rule for small entities; (3) the use of performance rather than design standards; and (4) an exemption from coverage of the rules, or any parts of the rules, for small entities.

We considered whether it is necessary or appropriate to establish different compliance or reporting requirements, timetables, or to clarify, consolidate, or simplify compliance and reporting requirements under the proposed rules for small entities. With respect to using performance rather than design standards, we used performance standards to the extent appropriate under the statute. For example, issuers have the flexibility to customize the presentation of certain disclosures in their offering statements.[705] We also considered whether there should be an exemption from coverage of the rules, or any parts of the rule for small entities. As discussed above, we do propose different compliance reporting requirements for issuers of less than $5 million that conduct an offering under Tier 1. For example, we are not proposing to subject entities likely to be small entities to ongoing reporting requirements and the requirement to provide audited financial statements. We also considered providing additional reductions in the disclosures required by Form 1-A for issuers of less than $5 million, but we believe that different compliance requirements for Form 1-A users may lead to investor confusion or reduced investor confidence in Regulation A offerings, especially considering that the disclosure requirements are already less than what is required by Form S-1 for registered offerings. Further, we anticipate that the burden for filling out a

705 *See* Section II.C. above.

Form 1-A should be less for companies at an earlier stage of development and with less extensive operations that are likely to be small entities.[706] For these reasons, we believe that small entities should be covered by the proposed rules to the extent specified above. We believe that the proposed rules should have limited impact on small entities and we are not proposing to establish different compliance requirements for small entities other than what we have proposed. We do, however, seek comment on alternatives that may reduce any potential adverse impact on small entities but accomplish similar objectives.

H. Request for Comment

We encourage comments with respect to any aspect of this initial regulatory flexibility analysis. In particular, we request comments regarding:

- The number of small entities that may be affected by the proposals;
- The existence or nature of the potential impact of the proposals on small entities discussed in the analysis; and
- How to quantify the impact of the proposed rules.

We request members of the public to submit comments and ask them to describe the nature of any impact on small entities they identify and provide empirical data supporting the extent of the impact. Such comments will be considered in the preparation of the final regulatory flexibility analysis, if the proposals are adopted, and will be placed in the same public file as comments on the proposed amendments themselves.

706 *See* discussion in Section V.C.1. above.

VII. SMALL BUSINESS REGULATORY ENFORCEMENT FAIRNESS ACT

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,[707] a rule is "major" if it has resulted, or is likely to result in:

- An annual effect on the economy of $100 million or more;
- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effects on competition, investment or innovation.

We request comment on whether our proposals would be a "major rule" for purposes of SBREFA. We solicit comment and empirical data on:

- The potential effect on the U.S. economy on an annual basis;
- Any potential increase in costs or prices for consumers or individual industries; and
- Any potential effect on competition, investment or innovation.

We request those submitting comments to provide empirical data and other factual support for their views if possible.

VIII. STATUTORY BASIS AND TEXT OF PROPOSED AMENDMENTS

The amendments and forms contained in this document are being proposed under the authority set forth in Sections 3(b), 19 and 28 of the Securities Act of 1933, as amended, and Section 401 of the JOBS Act.[708]

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707 Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996).

708 Pub. L. No. 112-106, -401, 126 Stat. 307 (April 5, 2012).

TEXT OF PROPOSED AMENDMENTS

List of Subjects

17 CFR Part 230, 232, 239, 240 and 260

Reporting and recordkeeping requirements, Securities.

In accordance with the foregoing, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 230 – GENERAL RULES AND REGULATIONS, SECURITIES ACT OF 1933

1. The authority citation for part 230 is revised 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, 78*l*, 78m, 78n, 78o, 78o–7 note, 78t, 78w, 78*ll*(d), 78mm, 80a–8, 80a–24, 80a–28, 80a–29, 80a–30, and 80a–37, and Pub. L. No. 112-106, § 201(a), § 401, 126 Stat. 313 (2012), unless otherwise noted.

* * * * *

2. § 230.157(a) is revised to read as follows:

§ 230.157 Small entities under the Securities Act for purposes of the Regulatory Flexibility Act.

* * * * *

(a) When used with reference to an issuer, other than an investment company, for purposes of the Securities Act of 1933, means an issuer whose total assets on the last day of its most recent fiscal year were $5 million or less and that is engaged or proposing to engage in small business financing. An issuer is considered to be engaged or proposing to engage in small business financing under this section if it is conducting or proposes to conduct an offering of securities which does not exceed the dollar limitation prescribed by section 3(b)(1) of the Securities Act.

* * * * *

3. Revise the undesignated center heading and §§ 230.251 through 230.263 to read as follows:

Regulation A

Sec.	
230.251	Scope of exemption.
230.252	Offering statement.
230.253	Offering circular.
230.254	Preliminary offering circular.
230.255	Solicitation of interest communications.
230.256	Definition of "qualified purchaser."
230.257	Periodic and current reporting; exit report.
230.258	Suspension of the exemption.
230.259	Withdrawal or abandonment of offering statements.
230.260	Insignificant deviations from a term, condition or requirement of Regulation A.
230.261	Definitions.
230.262	Disqualification provisions.
230.263	Consent to service of process.

* * * * *

4. §§ 230.251 through 230.263 are revised to read as follows:

§ 230.251 Scope of exemption.

(a) *Tier 1 and Tier 2.* A public offer or sale of eligible securities, as defined in Rule 261 (§ 230.261), that meets the following terms and conditions shall be exempt under section 3(b) from the registration requirements of the Securities Act of 1933 (the "Securities Act") (15 U.S.C. 77a *et seq.*):

(1) Offerings pursuant to Regulation A in which the sum of all cash and other consideration to be received for the securities being offered ("aggregate offering price")

plus the aggregate offering price for all securities sold pursuant to other Regulation A offering statements within the twelve months before the start of and during the current offering of securities does not exceed \$5,000,000, including not more than \$1,500,000 offered by all selling securityholders ("Tier 1 offerings"); and

(2) Offerings pursuant to Regulation A in which such sum does not exceed \$50,000,000, including not more than \$15,000,000 offered by all selling securityholders ("Tier 2 offerings").

NOTE: Where a mixture of cash and non-cash consideration is to be received, the aggregate offering price must be based on the price at which the securities are offered for cash. Any portion of the aggregate offering price attributable to cash received in a foreign currency must be translated into United States currency at a currency exchange rate in effect on or at a reasonable time before the date of the sale of the securities. If securities are not offered for cash, the aggregate offering price must be based on the value of the consideration as established by bona fide sales of that consideration made within a reasonable time, or, in the absence of sales, on the fair value as determined by an accepted standard. Valuations of non-cash consideration must be reasonable at the time made. If convertible securities or warrants are being offered, the underlying securities must also be qualified and the aggregate offering price must include the conversion, exercise, or exchange price of such securities.

(b) *Issuer.* The issuer of the securities:

(1) Is an entity organized under the laws of the United States or Canada, or any State, Province, Territory or possession thereof, or the District of Columbia, with its

principal place of business in the United States or Canada;

(2) Is not subject to section 13 or 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act") (15 U.S.C. 78a *et seq.*) immediately before the offering;

(3) Is not a development stage company that either has no specific business plan or purpose, or has indicated that its business plan is to merge with an unidentified company or companies;

(4) Is not an investment company registered or required to be registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1 *et seq.*) or a business development company as defined in section 2(a)(48) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(48));

(5) Is not issuing fractional undivided interests in oil or gas rights, or a similar interest in other mineral rights;

(6) Is not, and has not been, subject to any order of the Commission entered pursuant to Section 12(j) of the Exchange Act (15 U.S.C. 78*l*(j)) within five years before the filing of the offering statement;

(7) Has filed with the Commission all the reports it was required to file, if any, pursuant to Rule 257 (§ 230.257) during the two years before the filing of the offering statement (or for such shorter period that the issuer was required to file such reports); and

(8) Is not disqualified under Rule 262 (§ 230.262).

(c) *Integration with other offerings.* Offers and sales made in reliance on this Regulation A will not be integrated with:

(1) Prior offers or sales of securities; or

(2) Subsequent offers or sales of securities that are:

(i) Registered under the Securities Act, except as provided in Rule 255(e) (§ 230.255(e));

(ii) Made pursuant to Rule 701 (§ 230.701);

(iii) Made pursuant to an employee benefit plan;

(iv) Made pursuant to Regulation S (§ 230.901-905);

(v) Made more than six months after the completion of the Regulation A offering; or

(vi) Made in reliance on Regulation Crowdfunding (§ 230.XX-XX).

NOTE: If these safe harbors do not apply, whether subsequent offers and sales of securities will be integrated with the Regulation A offering will depend on the particular facts and circumstances. See Securities Act Release No. 4552 (November 6, 1962) [27 FR 11316].

(d) *Offering conditions*—(1) *Offers*.

(i) Except as allowed by Rule 255 (§ 230.255), no offer of securities may be made unless a Form 1-A offering statement has been filed with the Commission.

(ii) After the Form 1-A offering statement has been filed, but before it is qualified:

(A) Oral offers may be made;

(B) Written offers pursuant to Rule 254 (§ 230.254) may be made; and

(C) Communications pursuant to Rule 255 (§ 230.255) may be made.

(iii) After the Form 1-A offering statement has been qualified, any written offers must be accompanied with or preceded by the most recent offering circular filed with the Commission for such offering.

(2) *Sales.*

(i) No sale of securities may be made until:

(A) The Form 1-A offering statement has been qualified;

(B) A Preliminary Offering Circular is delivered at least 48 hours before the sale to any person that before qualification of the offering statement had indicated an interest in purchasing securities in the offering, including those persons that responded to an issuer's solicitation of interest materials; and

(C) For Tier 2 offerings, no sale may be made to a purchaser if the aggregate purchase price paid by such purchaser for securities in the offering (including any conversion, exercise, or exchange price for securities that are convertible, exercisable or exchangeable for other securities) is more than ten percent (10%) of the greater of such purchaser's annual income and net worth, based on the representations of the purchaser (with annual income and net worth for natural person purchasers determined as provided in Rule 501 (§ 230.501), provided that the issuer does not know, at the time of sale, that any such representation is untrue.

(ii) In a transaction that represents a sale by the issuer or an underwriter, or a sale where there is not an exclusion or exemption from the requirement to deliver a Final Offering Circular pursuant to paragraph 251(d)(2)(iii) of this rule, each underwriter or dealer selling in such transaction must deliver to each purchaser from it, not later than two business days following the completion of such sale, a copy of the Final Offering Circular or, in lieu of such Final Offering Circular, a notice to the effect that the sale was made pursuant to a qualified offering statement that includes the uniform resource locator ("URL") where the Final Offering Circular, or the offering statement of which such Final

Offering Circular is part, may be obtained on EDGAR and contact information sufficient to notify a purchaser where a request for a Final Offering Circular can be sent and received in response. If the sale was by the issuer and was not effected by or through an underwriter or dealer, the issuer is responsible for sending the Final Offering Circular or notice.

(iii) Sales by a dealer (including an underwriter no longer acting in that capacity for the security involved in such transaction) that take place within 90 calendar days after the qualification of the Regulation A offering statement may be made only if the dealer delivers a copy of the current offering circular to the purchaser before or with the confirmation of sale, provided that where an offering statement relates to offerings to be made from time to time pursuant to paragraph (d)(3) of this rule, such 90 calendar day period shall commence on the day of the first bona fide offering of securities under such offering statement; and

(3) *Continuous or delayed offerings.* (i) Continuous or delayed offerings may be made under this Regulation A, so long as the offering statement pertains only to:

(A) Securities that are to be offered or sold solely by or on behalf of a person or persons other than the issuer, a subsidiary of the issuer, or a person of which the issuer is a subsidiary;

(B) Securities that are to be offered and sold pursuant to a dividend or interest reinvestment plan or an employee benefit plan of the issuer;

(C) Securities that are to be issued upon the exercise of outstanding options, warrants, or rights;

(D) Securities that are to be issued upon conversion of other outstanding securities;

(E) Securities that are pledged as collateral; or

(F) Securities the offering of which will be commenced within two calendar days after the qualification date, will be made on a continuous basis, may continue for a period in excess of 30 days from the date of initial qualification, and will be offered in an amount that, at the time the offering statement is qualified, is reasonably expected to be offered and sold within two years from the initial qualification date. These securities may be offered and sold only if not more than three years have elapsed since the initial qualification date of the offering statement under which they are being offered and sold; provided, however, that if a new offering statement has been filed pursuant to this paragraph (d)(3)(i)(F), securities covered by the prior offering statement may continue to be offered and sold until the earlier of the qualification date of the new offering statement or 180 days after the third anniversary of the initial qualification date of the prior offering statement. Before the end of such three-year period, an issuer may file a new offering statement covering the securities. The new offering statement must include all the information that would be required at that time in an offering statement relating to all offerings that it covers. Before the qualification date of the new offering statement, the issuer may include as part of such new offering statement any unsold securities covered by the earlier offering statement by identifying on the cover page of the new offering circular or the latest amendment the amount of such unsold securities being included. The offering of securities on the earlier offering statement will be deemed terminated as of the date of qualification of the new offering statement. Securities may be sold pursuant this paragraph (d)(3)(i)(F) only if the issuer is current in its annual and semiannual filings pursuant to Rule 257(b) (§230.257(b)), at the time of such sale.

(ii) At the market offerings, by or on behalf of the issuer or otherwise, are not permitted under this Regulation A. As used in this paragraph (d)(3)(ii), the term *at the market offering* means an offering of equity securities into an existing trading market for outstanding shares of the same class at other than a fixed price.

§ 230.252 Offering statement.

(a) *Documents to be included.* The offering statement consists of the contents required by Form 1-A (§ 239.90 of this chapter) and any other material information necessary to make the required statements, in light of the circumstances under which they are made, not misleading.

(b) *Paper, printing, language and pagination.* Except as otherwise specified in this rule, the requirements for offering statements are the same as those specified in Rule 403 (§ 230.403) for registration statements under the Act. No fee is payable to the Commission upon either the submission or filing of an offering statement on Form 1-A, or any amendment to an offering statement.

(c) *Confidential treatment.* A request for confidential treatment may be made under Rule 406 (§ 230.406) for information required to be filed, and Rule 83 (§ 200.83) for information not required to be filed.

(d) *Signatures.* The issuer, its principal executive officer, principal financial officer, principal accounting officer, and a majority of the members of its board of directors or other governing body, must sign the offering statement. If a signature is by a person on behalf of any other person, evidence of authority to sign must be filed, except where an executive officer signs for the issuer.

(e) *How to file.* The offering statement must be filed with the Commission in electronic format by means of the Commission's Electronic Data Gathering, Analysis and Retrieval System ("EDGAR") in accordance with the EDGAR rules set forth in Regulation S-T (17 CFR Part 232). The offering statement must be signed in the manner prescribed by Form 1-A.

(f) *Non-public submission.* An issuer whose securities have not been previously sold pursuant to a qualified offering statement under this Regulation A or an effective registration statement under the Securities Act may submit under Rule 83 (§ 200.83) a draft offering statement to the Commission for non-public review by the staff of the Commission before public filing, provided that the offering statement shall not be qualified less than 21 calendar days after the public filing of (1) the initial non-public submission, (2) all non-public amendments with the Commission, and (3) all non-public correspondence submitted by or on behalf of the issuer to the Commission staff regarding such submissions (subject to any separately approved confidential treatment request under paragraph (c) of this rule). Draft offering statements must be submitted to the Commission in electronic format by means of EDGAR in accordance with the EDGAR rules set forth in Regulation S-T (17 CFR Part 232).

(g) *Qualification.* An offering statement and any amendment thereto can be qualified only by order of the Commission.

(h) *Amendments.* (1) (i) Amendments to an offering statement must be signed and filed in the same manner as the initial filing. The amendment must be filed with the Commission in the manner set forth in paragraph (e) of this rule. Amendments to an offering statement must be filed under cover of Form 1-A and must be numbered consecutively in the order in which filed.

(ii) Every amendment that includes audited financial statements must include the consent of the certifying accountant to the use of such accountant's certificate in connection with the amended financial statements in the offering statement or offering circular and to being named as having audited such financial statements.

(iii) Amendments solely relating to Part III of Form 1-A must comply with the requirements of paragraph (h)(1)(i) of this rule, except that such amendments may be limited to the Part I of Form 1-A, an explanatory note, and all of the information required by Part III of Form 1-A.

(2) Post-qualification amendments must be filed in the following circumstances for ongoing offerings:

(i) At least every 12 months after the qualification date to include the financial statements that would be required by Form 1-A as of such date; or

(ii) To reflect any facts or events arising after the qualification date of the offering statement (or the most recent post-qualification amendment thereof) which, individually or in the aggregate, represent a fundamental change in the information set forth in the offering statement.

§ 230.253 Offering circular.

(a) *Contents.* An offering circular must include the information required by Form 1-A for offering circulars.

(b) Notwithstanding paragraph (a) of this section, the offering circular may omit information with respect to the public offering price, underwriting syndicate (including any material relationships between the issuer or selling securityholders and the unnamed underwriters, brokers or dealers), underwriting discounts or commissions, discounts or commissions to dealers, amount of proceeds, conversion rates, call prices and other items dependent upon the offering price, delivery dates, and terms of the securities dependent upon the offering date; provided, that the following conditions are met:

(1) The securities to be qualified are offered for cash.

(2) The outside front cover page of the offering circular includes a bona fide estimate of the range of the maximum offering price and the maximum number of shares or other units of securities to be offered or a bona fide estimate of the principal amount of debt securities offered, subject to the following conditions:

(i) The range must not exceed $2 for offerings where the upper end of the range is $10 or less and 20% if the upper end of the price range is over $10; and

(ii) The upper end of the range must be used in determining the aggregate offering price under Rule 251(a) (§ 230.251(a)).

(3) The offering statement does not relate to securities to be offered by competitive bidding.

(4) The volume of securities (the number of equity securities or aggregate principal amount of debt securities) to be offered may not be omitted in reliance on this paragraph (b).

NOTE: A decrease in the volume of securities offered or a change in the bona fide estimate of the offering price range from that indicated in the offering circular filed as part of a qualified offering statement may be disclosed in the offering circular filed with the Commission pursuant to Rule 253(g) (§ 230.253(g)), so long as the decrease in the volume of securities offered or change in the price range would not materially change the disclosure contained in the offering statement at qualification. Notwithstanding the foregoing, any decrease in the volume of securities offered and any deviation from the low or high end of the price range may be reflected in the offering circular supplement filed with the Commission pursuant to Rule 253(g)(1) (§ 230.253(g)(1)) if, in the aggregate, the decrease in volume and/or change in price represent no more than a 20% change from the maximum aggregate offering price calculable using the information in the qualified offering statement. In no circumstances may this paragraph be used to offer securities where the maximum aggregate offering price would result in the offering exceeding the limit set forth in Rule 251(a) (§ 230.251(a)) for offerings under Regulation A or if the change would result in a Tier 1 offering becoming a Tier 2 offering. An offering circular supplement may not be used to increase the volume of securities being offered. Additional securities may only be offered pursuant to a new offering statement or post-qualification amendment qualified by the Commission.

(c) The information omitted from the offering circular in reliance upon paragraph (b) of this rule must be contained in an offering circular filed with the Commission pursuant to Rule 252(e) (§ 230.252(e)) and paragraph (g) of this rule; except that if such offering circular is not so filed by the later of 15 business days after the qualification date of the offering statement or 15 business days after the qualification of a post-qualification amendment thereto that contains an offering circular, the information omitted in reliance upon paragraph (b) of this rule must be contained in a qualified post-qualification amendment to the offering statement.

(d) *Presentation of information.*

(1) Information in the offering circular must be presented in a clear, concise and understandable manner and in a type size that is easily readable. Repetition of information should be avoided; cross-referencing of information within the document is permitted.

(2) Where an offering circular is distributed through an electronic medium, issuers may satisfy legibility requirements applicable to printed documents by presenting all required information in a format readily communicated to investors.

(e) *Date.* An offering circular must be dated approximately as of the date it was filed with the Commission.

(f) *Cover page legend.* The cover page of every offering circular must display the following statement highlighted by prominent type or in another manner:

> The United States Securities and Exchange Commission does not pass upon the merits of or give its approval to any securities offered or the terms of the offering, nor does it pass upon the accuracy or completeness of any offering circular or other solicitation materials. These securities are offered pursuant to an exemption from registration with the Commission; however, the Commission has not made an independent determination that the securities offered are exempt from registration.

(g) *Offering circular supplements.*

(1) An offering circular that discloses information previously omitted from the offering circular in reliance upon Rule 253(b) (§ 230.253(b)) must be filed with the

Commission no later than two business days following the earlier of the date of determination of the offering price or the date such offering circular is first used after qualification in connection with a public offering or sale.

(2) An offering circular that reflects information other than that covered in paragraph (g)(1) of this rule that constitutes a substantive change from or addition to the information set forth in the last offering circular filed with the Commission must be filed with the Commission no later than five business days after the date it is first used after qualification in connection with a public offering or sales. If an offering circular filed pursuant to this paragraph (g)(2) consists of an offering circular supplement attached to an offering circular that (i) previously had been filed or (ii) was not required to be filed pursuant to paragraph (g) of this rule because it did not contain substantive changes from an offering circular that previously was filed, only the offering circular supplement need be filed under paragraph (g) of this rule, provided that the cover page of the offering circular supplement includes a cross reference to the date(s) of the related offering circular and any offering circular supplements thereto that together constitute the offering circular with respect to the securities currently being offered or sold.

(3) An offering circular that discloses information, facts or events covered in both paragraphs (g)(1) and (2) must be filed with the Commission no later than two business days following the earlier of the date of the determination of the offering price or the date it is first used after qualification in connection with a public offering or sales.

(4) An offering circular required to be filed pursuant to paragraph (g) of this rule that is not filed within the time frames specified in paragraph (g) must be filed pursuant to this paragraph (4) as soon as practicable after the discovery of such failure to file.

(5) Each offering circular must be filed with the Commission in electronic format by means of EDGAR in accordance with the EDGAR rules set forth in Regulation S-T (17 CFR Part 232).

(6) Each offering circular filed under this rule must contain in the upper right corner of the cover page the paragraph and subparagraph of this rule under which the filing is made, and the file number of the offering statement to which the offering circular relates.

§ 230.254 Preliminary offering circulars.

Before qualification of the required offering statement, but after its filing, a written offer of securities may be made if it meets the following requirements:

(a) The outside front cover page of the material bears the caption *Preliminary Offering Circular*, the date of issuance, and the following legend, which must be highlighted by prominent type or in another manner:

> An offering statement pursuant to Regulation A relating to these securities has been filed with the Securities and Exchange Commission. Information contained in this Preliminary Offering Circular is subject to completion or amendment. These securities may not be sold nor may offers to buy be accepted before the offering statement filed with the Commission is qualified. This Preliminary Offering Circular shall not constitute an offer to sell or the solicitation of an offer to buy nor may there be any sales of these securities in any state in which such offer, solicitation or sale would be unlawful before registration or qualification under the laws of any such state. We may elect to satisfy our obligation to deliver a Final Offering Circular by sending you a notice within two business days after

the completion of our sale to you that contains the URL where the Final Offering Circular or the offering statement in which such Final Offering Circular was filed may be obtained.

(b) The Preliminary Offering Circular contains substantially the information required in an offering circular by Form 1-A (§ 239.90 of this chapter), except that information that may be omitted under Rule 253(b) (§ 230.253(b)) may be omitted if the conditions set forth in Rule 253(b) are met.

(c) The Preliminary Offering Circular is filed as a part of the offering statement.

§ 230.255 Solicitation of interest communications.

(a) At any time before the qualification of an offering statement, including before the non-public submission or public filing of such offering statement, an issuer or any person authorized to act on behalf of an issuer may communicate orally or in writing to determine whether there is any interest in a contemplated securities offering. Such communications are deemed to be an offer of a security for sale for purposes of the antifraud provisions of the federal securities laws. No solicitation or acceptance of money or other consideration, nor of any commitment, binding or otherwise, from any person is permitted until qualification of the offering statement.

(b) The communications must:

(1) State that no money or other consideration is being solicited, and if sent in response, will not be accepted;

(2) State that no offer to buy the securities can be accepted and no part of the purchase price can be received until the offering statement is qualified, and any such offer may be withdrawn or revoked, without obligation or commitment of any kind, at

any time before notice of its acceptance given after the qualification date;

(3) State that a person's indication of interest involves no obligation or commitment of any kind; and

(4) After the public filing of the offering statement:

(i) State from whom a copy of the most recent version of the Preliminary Offering Circular may be obtained, including a phone number and address of such person;

(ii) Provide the URL where such Preliminary Offering Circular or to the offering statement in which such Preliminary Offering Circular was filed may be obtained; or

(iii) Include a complete copy of the Preliminary Offering Circular.

(c) Any written communication under this rule may include a means by which a person may indicate to the issuer that such person is interested in a potential offering. This issuer may require the name, address, telephone number, and/or e-mail address in any response form included pursuant to this paragraph (c).

(d) If solicitation of interest materials are used after the public filing of the offering statement and such solicitation of interest materials contain information that is inaccurate or inadequate in any material respect, revised solicitation of interest materials must be redistributed in a manner substantially similar to the manner in which such materials were originally distributed. Notwithstanding the foregoing in this paragraph (d), if the only information that is inaccurate or inadequate is contained in a Preliminary Offering Circular provided with the solicitation of interest materials pursuant to paragraphs (b)(4)(i) or (b)(4)(ii) of this rule, no such redistribution is required in the following circumstances:

(1) in the case of paragraph (b)(4)(i) of this rule, the revised Preliminary Offering Circular will be provided to any persons making new inquiries and will be recirculated to any persons making any previous inquiries; or

(2) in the case of paragraph (b)(4)(ii) of this rule, the URL continues to link directly to the most recent Preliminary Offering Circular or to the offering statement in which such revised Preliminary Offering Circular was filed.

(e) Where an issuer decides to register an offering under the Securities Act after soliciting interest in a contemplated, but abandoned, Regulation A offering, the Regulation A exemption for offers would not be subject to integration with the registered offering, unless the issuer engaged in solicitations of interest pursuant to this rule to persons other than qualified institutional buyers and institutional accredited investors permitted by Section 5(d) of the Securities Act. In such circumstances, the issuer (and any underwriter, broker, dealer, or agent used by the issuer in connection with the proposed offering) must wait at least 30 calendar days between the last such solicitation of interest in the Regulation A offering and the filing of the registration statement with the Commission.

§ 230.256 Definition of "qualified purchaser."

For purposes of Section 18(b)(3) of the Securities Act [15 USC 77r(b)(3)], a "qualified purchaser" of a security offered or sold pursuant to Regulation A means any offeree of such security and, in a Tier 2 offering, any purchaser of such security.

§ 230.257 Periodic and current reporting; exit report.

(a) *Tier 1: Exit report.* Each issuer that has filed an offering statement for a Tier

1 offering that has been qualified pursuant to this Regulation A must file an exit report on Form 1-Z (§ 239.94) not later than 30 calendar days after the termination or completion of the offering.

(b) *Tier 2: Periodic and current reporting.* Each issuer that has filed an offering statement for a Tier 2 offering that has been qualified pursuant to this Regulation A must file with the Commission the following periodic and current reports in electronic format by means of EDGAR in accordance with the EDGAR rules set forth in Regulation S-T (17 CFR Part 232):

(1) *Annual reports.* An annual report on Form 1-K (§ 239.91) for the fiscal year in which the offering statement became qualified and for any fiscal year thereafter, unless the issuer's obligation to file such annual report is suspended under paragraph (d) of this rule. Annual reports must be filed within the period specified in Form 1-K.

(2) *Special financial report.* (i) A special financial report if the offering statement did not contain the following:

(A) audited financial statements for the issuer's last full fiscal year (or for the life of the issuer if less than a full fiscal year) preceding the fiscal year in which the issuer's offering statement became qualified; or

(B) financial statements covering the first half of the issuer's current fiscal year if the offering statement was qualified during the second half of that fiscal year.

(ii) The special financial report described in paragraph (a)(2)(i)(A) of this rule must be filed under cover of Form 1-K within 120 calendar days after the qualification date of the offering statement and must include audited financial statements for such last full fiscal year or other period, as the case may be. The special financial report described in paragraph (a)(2)(i)(B) of this rule must be filed under cover of Form 1-SA within 90 calendar days after the qualification date of the offering statement and must include the semiannual financial statements for the first half of the issuer's fiscal year, which may be unaudited.

(iii) A special financial report must be signed in accordance with the requirements of the form on which it is filed.

(3) *Semiannual report.* A semiannual report on Form 1-SA (§ 239.92) within the period specified in Form 1-SA. Semiannual reports must cover the first half of each fiscal year of the issuer, commencing with the first half of the fiscal year following the most recent fiscal year for which full financial statements were included in the offering statement, or, if the offering statement included financial statements for the first half of the fiscal year following the most recent full fiscal year, for the first half of the following fiscal year.

(4) *Current reports.* Current reports on Form 1-U (§ 239.93) with respect to the matters and within the period specified in that form, unless substantially the same information has been previously reported to the Commission by the issuer under cover of Form 1-K or 1-SA.

(5) *Reporting by successor issuers.* Where in connection with a succession by merger, consolidation, exchange of securities, acquisition of assets or otherwise, securities of any issuer that is not required to file reports pursuant to paragraph (b) of this rule are issued to the holders of any class of securities of another issuer that is required to file such reports, the duty to file reports pursuant to paragraph (b) of this rule shall be deemed to have been assumed by the issuer of the class of securities so issued. The

successor issuer must, after the consummation of the succession, file reports in accordance with paragraph (b) of this rule, unless that issuer is exempt from filing such reports or the duty to file such reports is suspended under paragraph (d).

(c) *Amendments.* All amendments to the reports described in paragraphs (a) and (b) of this rule must be filed under cover of the form amended, marked with the letter "A" to designate the document as an amendment, *e.g.*, "1-K/A," and in compliance with pertinent requirements applicable to such reports. Amendments filed pursuant to this paragraph (c) must set forth the complete text of each item as amended, but need not include any items that were not amended. Amendments must be numbered sequentially and be filed separately for each report amended. Amendments must be signed on behalf of the issuer by a duly authorized representative of the issuer. An amendment to any report required to include certifications as specified in the applicable form must include new certifications by the appropriate persons.

(d) *Termination or suspension of duty to file reports.* (1) The duty to file reports under this rule shall be automatically suspended if and so long as the issuer is subject to the duty to file reports required by section 13 or 15(d) of the Exchange Act (15 U.S.C. 78m or 15 U.S.C. 78o).

(2) The duty to file reports under paragraph (b) of this rule with respect to a class of securities held of record (as defined in Rule 12g5-1 (§ 240.12g5-1)) by less than 300 persons shall be suspended for such class of securities immediately upon filing with the Commission an exit report on Form 1-Z (§ 239.94) if the issuer of such class has filed all reports due pursuant to this rule before the date of such Form 1-Z filing for the shorter of (i) the period since the issuer became subject to such reporting obligation, or (ii) its most

recent three fiscal years and the portion of the current year preceding the date of filing Form 1-Z. For the purposes of this subsection, the term "class" shall be construed to include all securities of an issuer that are of substantially similar character and the holders of which enjoy substantially similar rights and privileges. If the Form 1-Z is subsequently withdrawn or denied, the issuer must, within 60 days, file with the Commission all reports which would have been required if such exit report had not been filed. If the suspension resulted from the issuer's merger into, or consolidation with, another issuer or issuers, the notice must be filed by the successor issuer.

(3) The ability to suspend reporting, as described in paragraph (d)(2) of this rule, is not available for any class of securities if (i) during that fiscal year an offering statement was qualified or (ii) at the time of filing of Form 1-Z, offers or sales of securities of that class are being made pursuant to Regulation A.

(e) *Termination of suspension of duty to file reports.* If the duty to file reports is suspended pursuant to paragraph (d)(1) of this rule and such suspension ends because the issuer is no longer subject to the duty to file reports under the Exchange Act, the issuer's obligation to file reports under paragraph (b) of this rule shall:

(1) automatically terminate if the issuer is eligible to suspend its duty to file reports under paragraph (d)(2)-(3); or

(2) recommence with the report covering any financial period after that included in any registration statement or Exchange Act report.

§ 230.258 Suspension of the exemption.

(a) The Commission may at any time enter an order temporarily suspending a Regulation A exemption if it has reason to believe that:

(1) No exemption is available or any of the terms, conditions or requirements of Regulation A have not been complied with;

(2) The offering statement, any sales or solicitation of interest material, or any report filed pursuant to Rule 257 (§ 230.257) contains any untrue statement of a material fact or omits to state a material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading;

(3) The offering is being made or would be made in violation of section 17 of the Securities Act;

(4) An event has occurred after the filing of the offering statement that would have rendered the exemption hereunder unavailable if it had occurred before such filing;

(5) Any person specified in Rule 262(a) (§ 230.262(a)) has been indicted for any crime or offense of the character specified in Rule 262(a)(1) (§ 230.262(a)(1)), or any proceeding has been initiated for the purpose of enjoining any such person from engaging in or continuing any conduct or practice of the character specified in Rule 262(a)(2) (§ 230.262(a)(2)), or any proceeding has been initiated for the purposes of Rule 262(a)(3)-(8) (§ 230.262(a)(3)-(8)); or

(6) The issuer or any promoter, officer, director or underwriter has failed to cooperate, or has obstructed or refused to permit the making of an investigation by the Commission in connection with any offering made or proposed to be made in reliance on Regulation A.

(b) Upon the entry of an order under paragraph (a) of this rule, the Commission will promptly give notice to the issuer, any underwriter and any selling securityholder:

(1) That such order has been entered, together with a brief statement of the

reasons for the entry of the order; and

(2) That the Commission, upon receipt of a written request within 30 calendar days after the entry of the order, will within 20 calendar days after receiving the request, order a hearing at a place to be designated by the Commission.

(c) If no hearing is requested and none is ordered by the Commission, an order entered under paragraph (a) of this rule shall become permanent on the 30th calendar day after its entry and shall remain in effect unless or until it is modified or vacated by the Commission. Where a hearing is requested or is ordered by the Commission, the Commission will, after notice of and opportunity for such hearing, either vacate the order or enter an order permanently suspending the exemption.

(d) The Commission may, at any time after notice of and opportunity for hearing, enter an order permanently suspending the exemption for any reason upon which it could have entered a temporary suspension order under paragraph (a) of this rule. Any such order shall remain in effect until vacated by the Commission.

(e) All notices required by this rule must be given by personal service, registered or certified mail to the addresses given by the issuer, any underwriter and any selling securityholder in the offering statement.

§ 230.259 Withdrawal or abandonment of offering statements.

(a) If none of the securities that are the subject of an offering statement have been sold and such offering statement is not the subject of a proceeding under Rule 258 (§ 230.258), the offering statement may be withdrawn with the Commission's consent. The application for withdrawal must state the reason the offering statement is to be withdrawn, must be signed by an authorized representative of the issuer and must be filed with the Commission in electronic format by means of EDGAR in accordance with the EDGAR rules set forth in Regulation S-T (17 CFR Part 232). Any withdrawn document will remain in the Commission's files, as well as the related request for withdrawal.

(b) When an offering statement has been on file with the Commission for nine months without amendment and has not become qualified, the Commission may, in its discretion, declare the offering statement abandoned. If the offering statement has been amended, the nine-month period shall be computed from the date of the latest amendment.

§ 230.260 Insignificant deviations from a term, condition or requirement of Regulation A.

(a) A failure to comply with a term, condition or requirement of Regulation A will not result in the loss of the exemption from the requirements of section 5 of the Securities Act for any offer or sale to a particular individual or entity, if the person relying on the exemption establishes that:

(1) The failure to comply did not pertain to a term, condition or requirement directly intended to protect that particular individual or entity;

(2) The failure to comply was insignificant with respect to the offering as a whole, provided that any failure to comply with paragraphs (a), (b), (d)(1) and (3) of Rule 251 (§ 230.251) shall be deemed to be significant to the offering as a whole; and

(3) A good faith and reasonable attempt was made to comply with all applicable terms, conditions and requirements of Regulation A.

(b) A transaction made in reliance upon Regulation A must comply with all applicable terms, conditions and requirements of the regulation. Where an exemption is established only through reliance upon paragraph (a) of this rule, the failure to comply shall nonetheless be actionable by the Commission under section 20 of the Securities Act.

(c) This provision provides no relief or protection from a proceeding under Rule 258 (§ 230.258).

§ 230.261 Definitions.

As used in this Regulation A, all terms have the same meanings as in Rule 405 (§ 230.405), except that all references to *registrant* in those definitions shall refer to the issuer of the securities to be offered and sold under Regulation A. In addition, these terms have the following meanings:

(a) *Business day.* Any day except Saturdays, Sundays or United States federal holidays.

(b) *Eligible securities.* Equity securities, debt securities, and debt securities convertible or exchangeable to equity interests, including any guarantees of such securities, but not including asset-backed securities as such term is defined in Item 1101(c) of Regulation AB.

(c) *Final offering circular.* The more recent of (1) the current offering circular contained in a qualified offering statement and (2) the offering circular filed pursuant to Rule 253(g) (§ 230.253(g)), or if the issuer is relying on Rule 253(b), the Final Offering Circular is the offering circular filed pursuant to Rule 253(g)(1) or (3) (§ 230.253(g)(1) or (3)).

(d) *Preliminary offering circular.* The offering circular described in Rule 254 (§ 230.254).

§ 230.262 Disqualification provisions.

(a) No exemption under this Regulation A shall be available for a sale of securities if the issuer; any predecessor of the issuer; any affiliated issuer; any director, executive officer, other officer participating in the offering, general partner or managing member of the issuer; any beneficial owner of 20% or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power; any promoter connected with the issuer in any capacity at the time of filing, any offer after qualification, or such sale; any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with such sale of securities; any general partner or managing member of any such solicitor; or any director, executive officer or other officer participating in the offering of any such solicitor or general partner or managing member of such solicitor:

(1) Has been convicted, within ten years before the filing of the offering statement (or five years, in the case of issuers, their predecessors and affiliated issuers), of any felony or misdemeanor:

(i) In connection with the purchase or sale of any security;

(ii) Involving the making of any false filing with the Commission; or

(iii) Arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities;

(2) Is subject to any order, judgment or decree of any court of competent jurisdiction, entered within five years before the filing of the offering statement, that, at the time of such filing, restrains or enjoins such person from engaging or continuing to engage in any conduct or practice:

(i) In connection with the purchase or sale of any security;

(ii) Involving the making of any false filing with the Commission; or

(iii) Arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities;

(3) Is subject to a final order of a state securities commission (or an agency or officer of a state performing like functions); a state authority that supervises or examines banks, savings associations, or credit unions; a state insurance commission (or an agency or officer of a state performing like functions); an appropriate federal banking agency; the U.S. Commodity Futures Trading Commission; or the National Credit Union Administration that:

(i) At the time of the filing of the offering statement, bars the person from:

(A) Association with an entity regulated by such commission, authority, agency, or officer;

(B) Engaging in the business of securities, insurance or banking; or

(C) Engaging in savings association or credit union activities; or

(ii) Constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct entered within ten years before such sale;

(4) Is subject to an order of the Commission entered pursuant to section 15(b) or 15B(c) of the Securities Exchange Act of 1934 (15 U.S.C. 78 *o* (b) or 78 *o* -4(c)) or section 203(e) or (f) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3(e) or (f)) that, at the time of the filing of the offering statement:

(i) Suspends or revokes such person's registration as a broker, dealer, municipal securities dealer or investment adviser;

(ii) Places limitations on the activities, functions or operations of such person; or

(iii) Bars such person from being associated with any entity or from participating in the offering of any penny stock;

(5) Is subject to any order of the Commission entered within five years before the filing of the offering statement that, at the time of such filing, orders the person to cease and desist from committing or causing a violation or future violation of:

(i) Any scienter-based anti-fraud provision of the federal securities laws, including without limitation section 17(a)(1) of the Securities Act of 1933 (15 U.S.C. 77q(a)(1)), section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78j(b)) and 17 CFR 240.10b-5, section 15(c)(1) of the Securities Exchange Act of 1934 (15 U.S.C. 78 *o* (c)(1)) and section 206(1) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-6(1)), or any other rule or regulation thereunder; or

(ii) Section 5 of the Securities Act of 1933 (15 U.S.C. 77e).

(6) Is suspended or expelled from membership in, or suspended or barred from association with a member of, a registered national securities exchange or a registered national or affiliated securities association for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade;

(7) Has filed (as a registrant or issuer), or was or was named as an underwriter in, any registration statement or Regulation A offering statement filed with the Commission that, within five years before the filing of the offering statement, was the subject of a

refusal order, stop order, or order suspending the Regulation A exemption, or is, at the time of such filing, the subject of an investigation or proceeding to determine whether a stop order or suspension order should be issued; or

(8) Is subject to a United States Postal Service false representation order entered within five years before the filing of the offering statement, or is, at the time of such filing, subject to a temporary restraining order or preliminary injunction with respect to conduct alleged by the United States Postal Service to constitute a scheme or device for obtaining money or property through the mail by means of false representations.

(b) Paragraph (a) of this rule shall not apply:

(1) With respect to any order under § 230.262(a)(3) or (a)(5) that occurred or was issued before **[effective date of rule]**;

(2) Upon a showing of good cause and without prejudice to any other action by the Commission, if the Commission determines that it is not necessary under the circumstances that an exemption be denied;

(3) If, before the filing of the offering statement, the court or regulatory authority that entered the relevant order, judgment or decree advises in writing (whether contained in the relevant judgment, order or decree or separately to the Commission or its staff) that disqualification under paragraph (a) of this rule should not arise as a consequence of such order, judgment or decree; or

(4) If the issuer establishes that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed under paragraph (a) of this rule.

Instruction to paragraph (b)(4). An issuer will not be able to establish that it has exercised reasonable care unless it has made, in light of the circumstances, factual inquiry into whether any disqualifications exist. The nature and scope of the factual inquiry will vary based on the facts and circumstances concerning, among other things, the issuer and the other offering participants.

(c) For purposes of paragraph (a) of this rule, events relating to any affiliated issuer that occurred before the affiliation arose will be not considered disqualifying if the affiliated entity is not:

(1) In control of the issuer; or

(2) Under common control with the issuer by a third party that was in control of the affiliated entity at the time of such events.

(d) *Disclosure of prior "bad actor" events.* The issuer must include in the offering circular a description of any matters that would have triggered disqualification under paragraph (a) of this rule but occurred before **[effective date]**. The failure to provide such information shall not prevent an issuer from relying on Regulation A if the issuer establishes that it did not know and, in the exercise of reasonable care, could not have known of the existence of the undisclosed matter or matters.

NOTE: An issuer will not be able to establish that it has exercised reasonable care unless it has made, in light of the circumstances, factual inquiry into whether any disqualifications exist. The nature and scope of the factual inquiry will vary based on the facts and circumstances concerning, among other things, the issuer and the other offering participants.

§ 230.263 Consent to service of process.

(a) If the issuer is not organized under the laws of any of the states of or the United States of America, it shall at the time of filing the offering statement required by

Rule 252 (§ 230.252), furnish to the Commission a written irrevocable consent and power of attorney on Form F-X (§ 239.42 of this chapter).

(b) Any change to the name or address of the agent for service of the issuer shall be communicated promptly to the Commission through amendment of the requisite form and referencing the file number of the relevant offering statement.

* * * * *

5. § 230.505(b)(2)(iii)(A) and (B) are revised, in part, to read as follows:

§ 230.505 Exemption for limited offers and sales of securities not exceeding $5,000,000.

* * * * *

(b) * * *

(2) * * *

(iii) * * *

(A) The term "filing of the offering statement" as used in § 230.262 shall mean the first sale of securities under this section;

(B) The term "underwriter" as used in § 230.262(a) shall mean a person that has been or will be paid directly or indirectly remuneration for solicitation of purchasers in connection with sales of securities under this section; and

* * * * *

PART 232 – REGULATION S-T—GENERAL RULES AND REGULATIONS FOR ELECTRONIC FILINGS

6. The authority citation for part 232 is revised to read in part as follows:

Authority: 15 U.S.C. 77c, 77f, 77g, 77h, 77j, 77s(a), 77z-3, 77sss(a), 78c(b), 78*l*, 78m, 78n, 78o(d), 78w(a), 78*ll*, 80a-6(c), 80a-8, 80a-29, 80a-30, 80a-37, 7201 et seq.; 18 U.S.C. 1350; and Pub. L. No. 112-106, § 401, 126 Stat. 313 (2012), unless otherwise noted.

* * * * *

7. § 232.101 is amended by:

a. Revising paragraph (a)(1)(vii) and (c)(6);

b. Adding paragraph (a)(1)(xvii); and

c. Reserving paragraph (b)(8).

The revisions, additions and reservations read as follows:

§ 232.101 Mandated electronic submissions and exceptions.

* * * * *

(a) * * *

(1) * * *

(vii) Form F-X (§ 239.42 of this chapter) when filed in connection with a Form CB (§§ 239.800 and 249.480 of this chapter) or a Form 1-A (§ 239.90);

* * * * *

(xvii) Filings made pursuant to Regulation A (§§ 230.251-230.263 of this chapter).

* * * * *

(b) * * *

(8) [Reserved]

* * * * *

(c) * * *

(6) Filings on Form 144 (§ 239.144 of this chapter) where the issuer of the securities is not subject to the reporting requirements of section 13 or 15(d) of the Exchange Act (15 U.S.C. 78m or 78o(d), respectively).

* * * * *

PART 239 – FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

8. The authority citation for Part 239 is revised to read, in part, as follows:

Authority: 15 U.S.C. 77c, 77f, 77g, 77h, 77j, 77s, 77z–2, 77z–3, 77sss, 78c, 78 l, 78m,78n, 78 o (d), 78o–7 note, 78u–5, 78w(a), 78 ll, 78mm, 80a–2(a), 80a–3, 80a–8, 80a–9, 80a–10, 80a–13, 80a–24, 80a–26, 80a–29, 80a–30, and 80a–37, and Pub. L. No. 112-106, § 401, 126 Stat. 313 (2012), unless otherwise noted.

* * * * *

9. Amend Form 1-A (referenced in § 239.90) by revising it to read as follows:

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 1-A
REGULATION A OFFERING STATEMENT UNDER THE SECURITIES ACT OF 1933

GENERAL INSTRUCTIONS

I. Eligibility Requirements for Use of Form 1-A.

This Form is to be used for securities offerings made pursuant to Regulation A (17 CFR 230.251 *et seq.*). Careful attention should be directed to the terms, conditions and requirements of Regulation A, especially Rule 251, because the exemption is not available to all issuers or to every type of securities transaction. Further, the aggregate offering price of securities in any 12 month period is strictly limited to $5 million for Tier 1 offerings and $50 million for Tier 2 offerings, including no more than $1.5 million offered by all selling securityholders for Tier 1 offerings and $15 million for Tier 2 offerings. Please refer to Rule 251 of Regulation A for more details.

II. Preparation, Submission and Filing of the Offering Statement.

An offering statement must be prepared by all persons seeking exemption under the provisions of Regulation A. Parts I, II and III must be addressed by all issuers. Part II, which relates to the content of the required offering circular, provides two alternative formats, of which the issuer must choose one. General information regarding the preparation, format, content, and submission or filing of the offering statement is contained in Rule 252. Information regarding non-public submission of the offering statement is contained in Rule 252(f). Requirements relating to the offering circular are contained in Rules 253 and 254. The offering statement must be submitted or filed with the Securities and Exchange Commission in electronic format by means of the Commission's Electronic Data Gathering, Analysis and Retrieval System (EDGAR) in accordance with the EDGAR rules set forth in Regulation S-T (17 CFR Part 232) for such submission or filing.

III. Incorporation by Reference.

An issuer may incorporate by reference to other documents previously submitted or filed on EDGAR pursuant to Regulation A, subject to the following additional conditions:

(a) The use of incorporation by reference in Part II of this Form is limited to the following items:

(1) Items 2-14 of Part II if following the Offering Circular format; or

(2) Items 3-11 of Form S-1 if following the Part I of Form S-1 format.

(b) Descriptions of where the information incorporated by reference can be found must be specific and must clearly identify the relevant document and portion thereof where such information can be found. For exhibits, this description must be noted in the exhibits index for each relevant exhibit. All such descriptions must be accompanied by a separate hyperlink to the incorporated document on EDGAR, which hyperlink need not remain active after the filing of the offering statement. Inactive hyperlinks must be updated in any amendment to the offering statement otherwise required. Reference may not be made to any document that incorporates another document by reference if the pertinent portion of the document containing the information to be incorporated by reference includes an incorporation by reference to another document. Incorporation by reference to documents not available on EDGAR is not permitted. Matter shall not be incorporated by reference in any case where such incorporation would render the statement or report incomplete, unclear, or confusing.

(c) If any substantive modification has occurred in the text of any document incorporated by reference since such document was filed, the issuer must file with the reference a statement containing the text and date of such modification.

IV. Supplemental Information.

The following information must be furnished to the Commission as supplemental information, if applicable:

(a) A statement as to whether or not the amount of compensation to be allowed or paid to the underwriter has been cleared with the Financial Industry Regulatory Authority (FINRA);

(b) Any engineering, management, market, or similar report referenced in the offering circular; and

(c) Such other information as requested by the staff in support of statements, representations and other assertions contained in the offering statement or any correspondence to the staff.

Correspondence appropriately responding to any staff comments made on the offering statement must also be furnished. When applicable, such correspondence must clearly indicate where changes responsive to the staff's comments may be found in the offering statement.

PART I—NOTIFICATION

The following information must be provided in the XML-based portion of Form 1-A available through the EDGAR portal and must be completed or updated before uploading each offering statement or amendment thereto. The format of Part I shown below may differ from the electronic version available on EDGAR. The electronic version of Part I will allow issuers to attach Part II and Part III for filing by means of EDGAR. All items must be addressed, unless otherwise indicated.

* * * * * *

☐ No changes to the information required by Part I have occurred since the last filing of this offering statement.

ITEM 1. Issuer Information

Exact name of issuer as specified in the issuer's charter: ______________________

State or other jurisdiction of incorporation: ______________________

Year of incorporation: ______________________

CIK: ______________________

Primary Standard Industrial Classification Code: ______________________

I.R.S. Employer Identification Number:____________________

Total number of full time employees:____________________

Total number of part time employees:____________________

Contact Information

Address of Principal Executive Offices: ____________________

____

Telephone: ( ) ____________________

Provide the following information for the person the Securities and Exchange Commission's staff should call in connection with any pre-qualification review of the offering statement:

Name:____________________
Address:____________________
Telephone: ( ) ____________________

Optional: Provide up to two e-mail addresses to which the Securities and Exchange Commission's staff may send any comment letters relating to the offering statement. After qualification of the offering statement, such e-mail addresses are not required to remain active. Regardless of whether you provide this information here, you may be asked to provide such e-mail addresses by the staff member reviewing your filing:______

____

Financial Statements

Use the financial statements for the most recent fiscal period contained in this offering statement to provide the following information about the issuer:

Balance Sheet Information

Total Assets:	__________
Cash and Cash Equivalents:	__________
Accounts Receivable:	__________
Investment Assets:	__________
Property, Plant and Equipment:	__________
Total Liabilities:	__________
Accounts Payable:	__________
Short Term Liabilities:	__________
Long Term Liabilities:	__________

Income Statement Information

Total Revenues: ______________________

Total Expenses: ______________________

Research and Development Expenses: ______________________

Interest Expense: ______________________

Investment Income: ______________________

Name of Auditor (if any):______________________

Outstanding Securities

	Units Outstanding	CUSIP (if any)	Units Publicly Traded
Common Equity			
Preferred Equity			
Debt Securities			

ITEM 2. Issuer Eligibility

☐ Check this box to certify that all of the following statements are true for the issuer:

- Organized under the laws of the United States or Canada, or any State, Province, Territory or possession thereof, or the District of Columbia.
- Principal place of business is in the United States or Canada.
- Not subject to section 13 or 15(d) of the Securities Exchange Act of 1934.
- Not a development stage company that either (a) has no specific business plan or purpose, or (b) has indicated that its business plan is to merge with an unidentified company or companies.
- Not an investment company registered or required to be registered under the Investment Company Act of 1940.
- Not issuing fractional undivided interests in oil or gas rights, or a similar interest in other mineral rights.
- Not issuing asset-backed securities as defined in Item 1101(c) of Regulation AB.

- Not, and has not been, subject to any order of the Commission entered pursuant to Section 12(j) of the Exchange Act (15 U.S.C. 78*l*(j)) within five years before the filing of this offering statement.

- Has filed with the Commission all the reports it was required to file, if any, pursuant to Rule 257 during the two years immediately before the filing of the offering statement (or for such shorter period that the issuer was required to file such reports).

ITEM 3. Application of Rule 262

☐ Check this box to certify that, as of the time of this filing, none of the persons described in Rule 262 of Regulation A are disqualified under that rule.

☐ Check this box if "bad actor" disclosure under Rule 262(d) is provided in Part II of the offering statement.

ITEM 4. Summary Information Regarding the Offering and Other Current or Proposed Offerings

Check the appropriate box to indicate whether you are conducting a Tier 1 or Tier 2 offering:

☐ Tier 1 ☐ Tier 2

Types of Securities Offered in this Offering Statement (select all that apply):

☐ Equity (common or preferred stock)

☐ Debt

☐ Option, warrant or other right to acquire another security

☐ Security to be acquired upon exercise of option, warrant or other right to acquire security

☐ Tenant-in-common securities

☐ Other (describe) ______________________________

Does the issuer intend to offer the securities on a delayed or continuous basis pursuant to Rule 251(d)(3)?

Yes ☐ No ☐

Does the issuer intend this offering to last more than one year?
Yes ☐ No ☐

Does the issuer intend to price this offering after qualification pursuant to Rule 253(b)?

Yes ☐ No ☐

Will the issuer be conducting a best efforts offering?
Yes ☐ No ☐

Has the issuer used solicitation of interest communications in connection with the proposed offering?

Yes ☐ No ☐

Does the proposed offering involve the resale of securities by affiliates of the issuer?
Yes ☐ No ☐

Number of securities offered:______________________________

Number of securities of that class already outstanding:______________________

The information called for by this item below may be omitted if undetermined at the time of filing or submission, except that if a price range has been included in the offering statement, the midpoint of that range must be used to respond. Please refer to Rule 251(a) for the definition of "aggregate offering price" as used in this item.

Price per security: $______________________________

The aggregate offering price for the securities being offered on behalf of the issuer:
$________________ ☐ N/A

The aggregate offering price for the securities being offered on behalf of selling securityholders:
$________________ ☐ N/A

The aggregate offering price for all securities of the issuer sold pursuant to a qualified offering statement within the 12 months before the qualification of this offering statement:
$________________ ☐ N/A

The estimated aggregate offering price of any securities that may be sold pursuant to any other qualified offering statement concurrently with securities being sold under this offering statement:
$________________ ☐ N/A

Total: $________________ (the sum of the aggregate offering prices in the four preceding paragraphs).

Anticipated fees in connection with this offering and names of service providers:

Name of Service Provider	Fees

Underwriters:	____________	$ ____________
Sales Commissions:	____________	$ ____________
Finders' Fees:	____________	$ ____________
Auditor:	____________	$ ____________
Legal:	____________	$ ____________
Promoters:	____________	$ ____________
Blue Sky Compliance:	____________	$ ____________

CRD Number of any broker or dealer listed: ____________
Estimated net proceeds to the issuer: $____________

Clarification of responses (if necessary): ____________

ITEM 5. Jurisdictions in Which Securities are to be Offered

Check the appropriate box for each jurisdiction in which the issuer intends to offer the securities:

☐ All States

☐ AL	☐ AK	☐ AZ	☐ AR	☐ CA	☐ CO	☐ CT	☐ DE	☐ DC	☐ FL	☐ GA	☐ HI	☐ ID
☐ IL	☐ IN	☐ IA	☐ KS	☐ KY	☐ LA	☐ ME	☐ MD	☐ MA	☐ MI	☐ MN	☐ MS	☐ MO
☐ MT	☐ NE	☐ NV	☐ NH	☐ NJ	☐ NM	☐ NY	☐ NC	☐ ND	☐ OH	☐ OK	☐ OR	☐ PA
☐ RI	☐ SC	☐ SD	☐ TN	☐ TX	☐ UT	☐ VT	☐ VA	☐ WA	☐ WV	☐ WI	☐ WY	☐ PR

Check the appropriate box for each jurisdiction in which the securities are to be offered by underwriters, dealers or sales persons:

☐ None

☐ Same as the jurisdictions in which the issuer intends to offer the securities.

☐ AL	☐ AK	☐ AZ	☐ AR	☐ CA	☐ CO	☐ CT	☐ DE	☐ DC	☐ FL	☐ GA	☐ HI	☐ ID
☐ IL	☐ IN	☐ IA	☐ KS	☐ KY	☐ LA	☐ ME	☐ MD	☐ MA	☐ MI	☐ MN	☐ MS	☐ MO
☐ MT	☐ NE	☐ NV	☐ NH	☐ NJ	☐ NM	☐ NY	☐ NC	☐ ND	☐ OH	☐ OK	☐ OR	☐ PA
☐ RI	☐ SC	☐ SD	☐ TN	☐ TX	☐ UT	☐ VT	☐ VA	☐ WA	☐ WV	☐ WI	☐ WY	☐ PR

ITEM 6. Unregistered Securities Issued or Sold Within One Year

☐ None

As to any unregistered securities issued by the issuer or any of its predecessors or affiliated issuers within one year before the filing of this Form 1-A, state:

(a) Name of such issuer;

(b) Title and amount of securities issued; and

(c) Aggregate consideration for which they were issued and basis for computing the amount thereof.

____

As to any unregistered securities of the issuer or any of its predecessors or affiliated issuers that were sold within one year before the filing of this Form 1-A by or for the account of any person who at the time was a director, officer, promoter or principal securityholder of the issuer of such securities, or was an underwriter of any securities of such issuer, furnish the information specified in subsections (a) through (c) of the preceding paragraph: ____

Indicate the section of the Securities Act or Commission rule or regulation relied upon for exemption from the registration requirements of such Act and state briefly the facts relied upon for such exemption: ____

PART II — INFORMATION REQUIRED IN OFFERING CIRCULAR

(a) The narrative disclosure contents of offering circulars are specified as follows:

(1) The information required by the Offering Circular format described below; or

(2) The offering circular must describe any matters that would have triggered disqualification under Rule 262(a) but for the provisions set forth in Rule 262(b)(1);

(3) The legend required by Rule 253(f) of Regulation A must be included on the offering circular cover page (for issuers following the S-1 disclosure model this legend must be included instead of the legend required by Item 501(b)(7) of Regulation S-K);

(4) For preliminary offering circulars, the legend required by Rule 254(a) must be included on the offering circular cover page (for issuers following the S-1

disclosure model, this legend must be included instead of the legend required by Item 501(b)(10) of Regulation S-K); and

(5) For Tier 2 offerings, the offering circular cover page must include the following legend highlighted by prominent type or in another manner:

> No sale may be made to you in this offering if the aggregate purchase price you pay is more than 10% of the greater of your annual income and net worth. Before making any representation that your investment does not exceed this threshold, we encourage you to refer to Rule 251(d)(2)(i)(C) of Regulation A, which provides additional details. For general information on investing, we encourage you to refer to www.investor.gov.

(c) The Commission encourages the use of management's projections of future economic performance that have a reasonable basis and are presented in an appropriate format. See Rule 175, 17 CFR 230.175.

(d) Offering circulars need not follow the order of the items or the order of other requirements of the disclosure form except to the extent otherwise specifically provided. Such information may not, however, be set forth in such a fashion as to obscure any of the required information or any information necessary to keep the required information from being incomplete or misleading. Information requested to be presented in a specified tabular format must be given in substantially the tabular format specified. For incorporation by reference, please refer to General Instruction III of this Form.

OFFERING CIRCULAR

Item 1. Cover Page of Offering Circular

The cover page of the offering circular must be limited to one page and must include the information specified in this item.

(a) Name of the issuer.

Instruction to Item 1(a):

> *If your name is the same as, or confusingly similar to, that of a company that is well known, include information to eliminate any possible confusion with the other company. If your name indicates a line of business in which you are not engaged or you are engaged only to a limited extent, include information to eliminate any misleading inference as to your business. In some circumstances, disclosure may not be sufficient and you may be required to change your name. You will not be required to change your name if you are an established company, the character of your business has changed, and the investing public is generally aware of the change and the character of your current business.*

(b) Full mailing address of the issuer's principal executive offices and the issuer's telephone number (including the area code) and, if applicable, website address.

(c) Date of the offering circular.

(d) Title and amount of securities offered. Separately state the amount of securities offered by selling securityholders, if any. Include a cross-reference to the section where the disclosure required by Item 14 of this Form 1-A has been provided;

(e) The information called for by the applicable table below as to all the securities being offered, in substantially the tabular format indicated. If necessary, you may estimate any underwriting discounts and commissions and the proceeds to the issuer or other persons.

	Price to public	Underwriting discount and commissions	Proceeds to issuer	Proceeds to other persons
Per share/unit:	______	______	______	______
Total:	______	______	______	______

If the securities are to be offered on a best efforts basis, the cover page must set forth the termination date, if any, of the offering, any minimum required sale and any arrangements to place the funds received in an escrow, trust, or similar arrangement. The following table must be used instead of the preceding table.

	Price to public	Underwriting discount and commissions	Proceeds to issuer	Proceeds to other persons
Per share/unit:	______	______	______	______
Total Minimum:	______	______	______	______
Total Maximum:	______	______	______	______

Instructions to Item 1(e):

> *1. The term "commissions" includes all cash, securities, contracts, or anything else of value, paid, to be set aside, disposed of, or understandings with or for the benefit of any other persons in which any underwriter is interested, made in connection with the sale of such security.*

2. Only commissions paid by the issuer in cash are to be indicated in the table. Commissions paid by other persons or any form of non-cash compensation must be briefly identified in a footnote to the table with a cross-reference to a more complete description elsewhere in the offering circular.

3. Before the commencement of sales pursuant to Regulation A, the issuer must inform the Commission whether or not the amount of compensation to be allowed or paid to the underwriters, as described in the offering statement, has been cleared with FINRA.

4. If the securities are not to be offered for cash, state the basis upon which the offering is to be made.

5. Any finder's fees or similar payments must be disclosed on the cover page with a reference to a more complete discussion in the offering circular. Such disclosure must identify the finder, the nature of the services rendered and the nature of any relationship between the finder and the issuer, its officers, directors, promoters, principal stockholders and underwriters (including any affiliates of such persons).

6. The amount of the expenses of the offering borne by the issuer, including underwriting expenses to be borne by the issuer, must be disclosed in a footnote to the table.

(f) The name of the underwriter or underwriters.

(g) Any legend or information required by the law of any state in which the securities are to be offered.

(h) A cross-reference to the risk factors section, including the page number where it appears in the offering circular. Highlight this cross-reference by prominent type or in another manner.

(i) Approximate date of commencement of proposed sale to the public.

(j) If the issuer intends to rely on Rule 253(b) and a preliminary offering circular is circulated, provide (1) a bona fide estimate of the range of the maximum offering price and the maximum number of securities offered or (2) a bona fide estimate of the principal amount of the debt securities offered. The range must not exceed $2 for offerings where the upper end of the range is $10 or less and 20% if the upper end of the price range is over $10.

Instruction to Item 1(j):

The upper limit of the price range must be used in determining the aggregate offering price for purposes of Rule 251(a).

Item 2. Table of Contents

On the page immediately following the cover page of the offering circular, provide a reasonably detailed table of contents. It must show the page number of the various sections or subdivisions of the offering circular. Include a specific listing of the risk factors section required by Item 3 of this Form 1-A.

Item 3. Summary and Risk Factors

(a) An issuer may provide a summary of the information in the offering circular where the length or complexity of the offering circular makes a summary useful. The summary should be brief and must not contain all of the detailed information in the offering circular.

(b) Immediately following the Table of Contents required by Item 2 or the Summary, there must be set forth under an appropriate caption, a carefully organized series of short, concise paragraphs, summarizing the most significant factors that make the offering speculative or substantially risky. Issuers should avoid generalized statements and include only factors that are specific to the issuer.

Item 4. Dilution

Where there is a material disparity between the public offering price and the effective cash cost to officers, directors, promoters and affiliated persons for shares acquired by them in a transaction during the past year, or that they have a right to acquire, there must be included a comparison of the public contribution under the proposed public offering and the average effective cash contribution of such persons.

Item 5. Plan of Distribution and Selling Securityholders

(a) If the securities are to be offered through underwriters, give the names of the principal underwriters, and state the respective amounts underwritten. Identify each such underwriter having a material relationship to the issuer and state the nature of the relationship. State briefly the nature of the underwriters' obligation to take the securities.

Instructions to Item 5(a):

> *1. All that is required as to the nature of the underwriters' obligation is whether the underwriters are or will be committed to take and to pay for all of the securities if any are taken, or whether it is merely an agency or the type of best efforts arrangement under which the underwriters are required to take and to pay for only such securities as they may sell to the public. Conditions precedent to the*

underwriters' taking the securities, including market-outs, need not be described except in the case of an agency or best efforts arrangement.

2. It is not necessary to disclose each member of a selling group. Disclosure may be limited to those underwriters who are in privity of contract with the issuer with respect to the offering.

(b) State briefly the discounts and commissions to be allowed or paid to dealers, including all cash, securities, contracts or other consideration to be received by any dealer in connection with the sale of the securities.

(c) Outline briefly the plan of distribution of any securities being issued that are to be offered through the selling efforts of brokers or dealers or otherwise than through underwriters.

(d) If any of the securities are to be offered for the account of securityholders, identify each selling securityholder, state the amount owned by the securityholder, the amount offered for his or her account and the amount to be owned after the offering. Provide such disclosure in a tabular format. At the bottom of the table, provide the total number of securities being offered for the account of all securityholders and describe what percent of the outstanding securities of such class the offering represents.

Instruction to Item 5(d):

The term "securityholder" in this paragraph refers to beneficial holders, not nominee holders or other such holders of record. If the selling securityholder is an entity, disclosure of the persons who have sole or shared voting or investment power must be included.

(e) Describe any arrangements for the return of funds to subscribers if all of the securities to be offered are not sold. If there are no such arrangements, so state.

(f) If there will be a material delay in the payment of the proceeds of the offering by the underwriter to the issuer, the salient provisions in this regard and the effects on the issuer must be stated.

(g) Describe any arrangement to (1) limit or restrict the sale of other securities of the same class as those to be offered for the period of distribution, (2) stabilize the market for any of the securities to be offered, or (3) withhold commissions, or otherwise to hold each underwriter or dealer responsible for the distribution of its participation.

(h) Identify any underwriter that intends to confirm sales to any accounts over which it exercises discretionary authority and include an estimate of the amount of securities so intended to be confirmed:

Instruction to Item 5:

Attention is directed to the provisions of Rules 10b-9 [17 CFR 240.10b-9] and 15c2-4 [17 CFR 240.15c2-4] under the Securities Exchange Act of 1934. These rules outline, among other things, antifraud provisions concerning the return of funds to subscribers and the transmission of proceeds of an offering to a seller.

Item 6. Use of Proceeds to Issuer

State the principal purposes for which the net proceeds to the issuer from the securities to be offered are intended to be used and the approximate amount intended to be used for each such purpose. If the issuer will not receive any of proceeds from the offering, so state.

Instructions to Item 6:

1. If any substantial portion of the proceeds has not been allocated for particular purposes, a statement to that effect must be made together with a statement of the amount of proceeds not so allocated.

2. State whether or not the proceeds will be used to compensate or otherwise make payments to officers or directors of the issuer or any of its subsidiaries.

3. For best efforts offerings, describe any anticipated material changes in the use of proceeds if all of the securities being qualified on the offering statement are not sold.

4. If an issuer must provide the disclosure described in Item 9(c) the use of proceeds and plan of operations should be consistent.

5. If any material amounts of other funds are to be used in conjunction with the proceeds, state the amounts and sources of such other funds.

6. If any material part of the proceeds is to be used to discharge indebtedness, describe the material terms of such indebtedness. If the indebtedness to be discharged was incurred within one year, describe the use of the proceeds arising from such indebtedness.

7. If any material amount of the proceeds is to be used to acquire assets, otherwise than in the ordinary course of business, briefly describe and state the cost of the assets. If the assets are to be acquired from affiliates of the issuer or their associates, give the names of the persons from whom they are to be acquired and set forth the basis used in determining the purchase price to the issuer.

8. The issuer may reserve the right to change the use of proceeds, so long as the reservation is prominently disclosed in the section where the use of proceeds is discussed. It is not necessary to describe the possible alternative uses of proceeds *unless the issuer believes that a change in circumstances leading to an alternative use of proceeds is likely to occur.*

Item 7. Description of Business

(a) Narrative description of business.

(1) Describe the business done and intended to be done by the issuer and its subsidiaries and the general development of the business during the past three years or such shorter period as the issuer may have been in business. Such description must include, but not be limited to, a discussion of the following factors if such factors are material to an understanding of the issuer's business:

(i) The principal products and services of the issuer and the principal market for and method of distribution of such products and services.

(ii) The status of a product or service if the issuer has made public information about a new product or service that would require the investment of a material amount of the assets of the issuer or is otherwise material.

(iii) The estimated amount spent during each of the last two fiscal years on company- sponsored research and development activities determined in accordance with generally accepted accounting principles. In addition, state the estimated dollar amount spent during each of such years on material customer-sponsored research activities relating to the development of new products, services or techniques or the improvement of existing products, services or techniques.

(iv) The total number of persons employed by the issuer, indicating the number employed full time.

(v) Any bankruptcy, receivership or similar proceeding.

(vi) Any legal proceedings material to the business or financial condition of the issuer.

(vii) Any material reclassification, merger, consolidation, or purchase or sale of a significant amount of assets not in the ordinary course of business.

(2) The issuer must also describe those distinctive or special characteristics of the issuer's operation or industry that may have a material impact upon the issuer's future financial performance. Examples of factors that might be discussed include dependence on one or a few major customers or suppliers (including suppliers of raw materials or financing), existing or probable governmental regulation

(including environmental regulation), material terms of and/or expiration of material labor contracts or patents, trademarks, licenses, franchises, concessions or royalty agreements, unusual competitive conditions in the industry, cyclicality of the industry and anticipated raw material or energy shortages to the extent management may not be able to secure a continuing source of supply.

(3) Any engineering, management or similar reports that have been prepared or provided for external use by the issuer or by a principal underwriter in connection with the proposed offering must be furnished to the Commission at the time of filing the offering statement or as soon as practicable thereafter. There must also be furnished at the same time a statement as to the actual or proposed use and distribution of such report or memorandum. Such statement must identify each class of persons who have received or will receive the report or memorandum, and state the number of copies distributed to each such class. If no such report or memorandum has been prepared, the Commission must be so informed in writing at the time the report or memorandum would otherwise have been submitted.

(b) Segment Data. If the issuer is required to include segment information in its financial statements, an appropriate cross-reference must be included in the description of business.

(c) Industry Guides. The disclosure guidelines in all Securities Act Industry Guides must be followed. To the extent that the industry guides are codified into Regulation S-K, the Regulation S-K industry disclosure items must be followed.

(d) For offerings of limited partnership or limited liability company interests, an issuer must comply with the Commission's interpretive views on substantive disclosure requirements set forth in Securities Act Release No. 6900 (June 17, 1991).

Item 8. Description of Property

State briefly the location and general character of any principal plants or other material physical properties of the issuer and its subsidiaries. If any such property is not held in fee or is held subject to any major encumbrance, so state and briefly describe how held. Include information regarding the suitability, adequacy, productive capacity and extent of utilization of the properties and facilities used in the issuer's business.

Instruction to Item 8:

Detailed descriptions of the physical characteristics of individual properties or legal descriptions by metes and bounds are not required and should not be given.

Item 9. Management's Discussion and Analysis of Financial Condition and Results of Operations

Discuss the issuer's financial condition, changes in financial condition and results of operations for each year and interim period for which financial statements are required, including the causes of material changes from year to year or period to period in financial statement line items, to the extent necessary for an understanding of the issuer's business as a whole. Information provided also must relate to all separate segments of the issuer. Provide the information specified below as well as such other information that is necessary for an investor's understanding of the issuer's financial condition, changes in financial condition and results of operations.

(a) Operating results. Provide information regarding significant factors, including unusual or infrequent events or new developments, materially affecting the issuer's income from operations, indicating the extent to which income was so affected. Describe any other significant component of revenue or expenses necessary to understand the issuer's results of operations. To the extent that the financial statements disclose material changes in net sales or revenues, provide a narrative discussion of the extent to which such changes are attributable to changes in prices or to changes in the volume or amount of products or services being sold or to the introduction of new products or services.

(b) Liquidity and capital resources. Provide information regarding the following:

(1) the issuer's liquidity (both short and long term), including a description and evaluation of the internal and external sources of liquidity and a brief discussion of any material unused sources of liquidity. Include a statement by the issuer that, in its opinion, the working capital is sufficient for the issuer's present requirements, or, if not, how it proposes to provide the additional working capital needed.

(2) the level of borrowings at the end of the period under review, the seasonality of borrowing requirements and the maturity profile of borrowings and committed borrowing facilities, with a description of any restrictions on their use.

(3) the type of financial instruments used, the maturity profile of debt, currency and interest rate structure, the extent to which borrowings are at fixed rates, and the use of financial instruments for hedging purposes.

(4) the issuer's material commitments for capital expenditures as of the end of the latest financial year and any subsequent interim period and an indication of the general purpose of such commitments and the anticipated sources of funds needed to fulfill such commitments.

(c) Plan of Operations. Issuers (including predecessors) that have not received revenue from operations during each of the three fiscal years immediately before the filing of the offering statement must describe, if formulated, their plan of operation for the twelve months following the commencement of the proposed offering. If such information is not available, the reasons for its unavailability must be stated. Disclosure relating to any plan must include, among other things, a statement indicating whether, in the issuer's opinion, the proceeds from the offering will satisfy its cash requirements or whether it anticipates it will be necessary to raise additional funds in the next six months to implement the plan of operations.

(d) Trend information. The issuer must identify the most significant recent trends in production, sales and inventory, the state of the order book and costs and selling prices since the latest financial year. The issuer also must discuss, for at least the current financial year, any known trends, uncertainties, demands, commitments or events that are reasonably likely to have a material effect on the issuer's net sales or revenues, income from continuing operations, profitability, liquidity or capital resources, or that would cause reported financial information not necessarily to be indicative of future operating results or financial condition.

Item 10. Directors, Executive Officers and Significant Employees

(a) For each of the directors, persons nominated or chosen to become directors, executive officers, persons chosen to become executive officers, and significant employees, provide the information specified below in substantially the following tabular format:

Name	Position	Age	Term of Office(1)	Approximate hours per week(2)
Executive Officers:				
Directors:				
Significant Employees:				

(1) Provide the month and year of the start date and, if applicable, the end date. To the extent you are unable to provide specific dates, provide such other description in the table or in an appropriate footnote clarifying the term of office. If the person is a nominee or chosen to become a director or executive officer, it must be indicated in this column or by footnote.

(2) For executive officers and significant employees that are working part-time, indicate approximately the average number of hours per week or month such person works or is anticipated to work. This column may be left blank for directors. The entire column may be omitted if all those listed in the table work full time for the issuer.

In a footnote to the table, briefly describe any arrangement or understanding between the persons described above and any other persons (naming such persons) pursuant to which the person was or is to be selected to his or her office or position.

Instructions to Item 10(a):

1. No nominee or person chosen to become a director or person chosen to be an executive officer who has not consented to act as such may be named in response to this item.

2. The term "executive officer" means the president, secretary, treasurer, any vice-president in charge of a principal business function (such as sales, administration, or finance) and any other person who performs similar policy making functions for the issuer.

3. The term "significant employee" means persons such as production managers, sales managers, or research scientists, who are not executive officers, but who make or are expected to make significant contributions to the business of the issuer.

(b) Family relationships. State the nature of any family relationship between any director, executive officer, person nominated or chosen by the issuer to become a director or executive officer or any significant employee.

Instruction to Item 10(b):

The term "family relationship" means any relationship by blood, marriage, or adoption, not more remote than first cousin.

(c) Business experience. Give a brief account of the business experience during the past five years of each director, executive officer, person nominated or chosen to become a director or executive officer, and each significant employee, including his or her principal occupations and employment during that period and the name and principal business of any corporation or other organization in which such occupations and employment were carried on. When an executive officer or significant employee has been employed by the issuer for less than five years, a brief explanation must be included as to the nature of the responsibilities undertaken by the individual in prior positions to provide adequate disclosure of this prior business experience. What is required is information relating to the level of the employee's professional competence, which may include, depending upon the circumstances, such specific information as the size of the operation supervised.

(d) Involvement in certain legal proceedings. Describe any of the following events which occurred during the past five years and which are material to an evaluation of the ability or integrity of any director, person nominated to become a director or executive officer of the issuer:

(1) A petition under the federal bankruptcy laws or any state insolvency law was filed by or against, or a receiver, fiscal agent or similar officer was appointed by a court for the business or property of such person, or any partnership in which he was general partner at or within two years before the time of such filing, or any

corporation or business association of which he was an executive officer at or within two years before the time of such filing; or

(2) Such person was convicted in a criminal proceeding (excluding traffic violations and other minor offenses).

Item 11. Compensation of Directors and Officers

(a) Provide, in substantially the tabular format indicated, the annual compensation of each of the three highest paid persons who were officers or directors during the issuer's last completed fiscal year.

Name	Capacities in which compensation was received (e.g., Chief Executive Officer, director, etc.)	Cash compensation ($)	Other compensation ($)	Total compensation ($)

(b) Provide the aggregate annual compensation of the issuer's directors as a group for the issuer's last completed fiscal year.

(c) Briefly describe all proposed compensation to be made in the future pursuant to any ongoing plan or arrangement to the individuals specified in paragraphs (a) and (b) of this item. The description must include a summary of how each plan operates, any performance formula or measure in effect (or the criteria used to determine payment amounts), the time periods over which the measurements of benefits will be determined, payment schedules, and any recent material amendments to the plan. Information need not be furnished with respect to any group life, health, hospitalization, or medical reimbursement plans that do not discriminate in scope, terms or operation in favor of officers or directors of the issuer and that are available generally to all salaried employees.

Instructions to Item 11:

1. In case of compensation paid or to be paid otherwise than in cash, if it is impracticable to determine the cash value thereof, state in a note to the table the nature and amount thereof.

2. This item is to be answered on an accrual basis if practicable; if not so answered, state the basis used.

Item 12. Security Ownership of Management and Certain Securityholders

(a) Include the information specified in paragraph (b) of this item as of the most recent practicable date (stating the date used), in substantially the tabular format indicated, with respect to voting securities beneficially owned by:

(1) all officers and directors as a group, individually naming each director or officer who beneficially owns more than 10% of any class of the issuer's voting securities;

(2) any other shareholder who beneficially owns more than 10% of any class of the issuer's voting securities as such beneficial ownership would be calculated if the issuer were subject to Rule 13d-3(d)(1) of the Securities Exchange Act of 1934.

(b) Beneficial Ownership Table:

Title of Class	Name and address of beneficial owner[(1)]	Amount and nature of beneficial ownership	Amount and nature of beneficial ownership acquirable[(2)]	Percent of Class[(3)]

(1) The address given in this column may be a business, mailing, or residential address. The address may be included in an appropriate footnote to the table rather than in this column.

(2) This column must include the amount of equity securities each beneficial owner has the right to acquire using the manner specified in Rule 13d-3(d)(1) of the Securities Exchange Act of 1934. An appropriate footnote must be included if the column heading does not sufficiently describe the circumstances upon which such securities could be acquired.

(3) This column must use the amounts contained in the two preceding columns to calculate the percent of class owned by such beneficial owner.

Item 13. Interest of Management and Others in Certain Transactions

(a) Describe briefly any transactions or any currently proposed transactions during the issuer's last two completed fiscal years and the current fiscal year, to which the issuer or any of its subsidiaries was or is to be a participant and the amount involved exceeds the lesser of $120,000 or one percent of the average of the issuer's total assets at year end for the last two completed fiscal years, and in which any of the following persons had or is to have a direct or indirect material interest, naming the person and stating his or her relationship to the issuer, the nature of the person's interest in the transaction and, where practicable, the amount of such interest:

(1) Any director or officer of the issuer;

(2) Any nominee for election as a director;

(3) Any securityholder named in answer to Item 12(a)(2);

(4) If the issuer was incorporated or organized within the past three years, any promoter of the issuer; or

(5) Any immediate family member of the above persons. An "immediate family member" of a person means such person's child, stepchild, parent, stepparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, sister-in-law, or any person (other than a tenant or employee) sharing such person's household.

Instructions to Item 13(a):

1. For purposes of calculating the amount of the transaction described above, all periodic installments in the case of any lease or other agreement providing for periodic payments must be aggregated to the extent they occurred within the time period described in this item.

2. No information need be given in answer to this item as to any transaction where:

(a) The rates of charges involved in the transaction are determined by competitive bids, or the transaction involves the rendering of services as a common or contract carrier fixed in conformity with law or governmental authority;

(b) The transaction involves services as a bank depositary of funds, transfer agent, registrar, trustee under a trust indenture, or similar services;

(c) The interest of the specified person arises solely from the ownership of securities of the issuer and the specified person receives no extra or special benefit not shared on a pro-rata basis by all of the holders of securities of the class.

3. This item calls for disclosure of indirect as well as direct material interests in transactions. A person who has a position or relationship with a firm, corporation, or other entity which engages in a transaction with the issuer or its subsidiaries may have an indirect interest in such transaction by reason of the *position or relationship. However, a person is deemed not to have a material indirect interest in a transaction within the meaning of this item where:*

> *(a) the interest arises only (i) from the person's position as a director of another corporation or organization (other than a partnership) that is a party to the transaction, or (ii) from the direct or indirect ownership by the person and all other persons specified in paragraphs (1) through (5) of this item, in the aggregate, of less than a 10 percent equity interest in another person (other than a partnership) that is a party to the transaction, or (iii) from both such position and ownership;*
>
> *(b) the interest arises only from the person's position as a limited partner in a partnership in which the person and all other persons specified in paragraphs (1) through (5) of this item had an interest of less than 10 percent; or*
>
> *(c) the interest of the person arises solely from the holding of an equity interest (unless the equity interest confers management rights similar to a general partner interest) or a creditor interest in another person that is a party to the transaction with the issuer or any of its subsidiaries and the transaction is not material to the other person.*

4. Include the name of each person whose interest in any transaction is described and the nature of the relationships by reason of which such interest is required to be described. The amount of the interest of any specified person must be computed without regard to the amount of the profit or loss involved in the transaction. Where it is not practicable to state the approximate amount of the interest, the approximate amount involved in the transaction must be disclosed.

5. Information must be included as to any material underwriting discounts and commissions upon the sale of securities by the issuer where any of the specified persons was or is to be a principal underwriter or is a controlling person, or member, of a firm which was or is to be a principal underwriter. Information need not be given concerning ordinary management fees paid by underwriters to a managing underwriter pursuant to an agreement among underwriters, the parties to which do not include the issuer or its subsidiaries.

6. As to any transaction involving the purchase or sale of assets by or to any issuer or any subsidiary, otherwise than in the ordinary course of business, state the cost of the assets to the purchaser and, if acquired by the seller within two years before the transaction, the cost to the seller.

7. Information must be furnished in answer to this item with respect to transactions not excluded above which involve compensation from the issuer or its subsidiaries, directly or indirectly, to any of the specified persons for services in any capacity unless the interest of such persons arises solely from the *ownership individually and in the aggregate of less than 10 percent of any class of equity securities of another corporation furnishing the services to the issuer or its subsidiaries.*

(b) If any expert named in the offering statement as having prepared or certified any part of the offering statement was employed for such purpose on a contingent basis or, at the time of such preparation or certification or at any time thereafter, had a material interest in the issuer or any of its parents or subsidiaries or was connected with the issuer or any of its subsidiaries as a promoter, underwriter, voting trustee, director, officer or employee, describe the nature of such contingent basis, interest or connection.

Item 14. Securities Being Offered

(a) If capital stock is being offered, state the title of the class and furnish the following information regarding all classes of capital stock outstanding:

(1) Outline briefly: (i) dividend rights; (ii) voting rights; (iii) liquidation rights; (iv) preemptive rights; (v) conversion rights; (vi) redemption provisions; (vii) sinking fund provisions; (viii) liability to further calls or to assessment by the issuer; (ix) any classification of the Board of Directors, and the impact of classification where cumulative voting is permitted or required; (x) restrictions on alienability of the securities being offered; (xi) any provision discriminating against any existing or prospective holder of such securities as a result of such securityholder owning a substantial amount of securities; and (xii) any rights of holders that may be modified otherwise than by a vote of a majority or more of the shares outstanding, voting as a class.

(2) Briefly describe potential liabilities imposed on shareholders under state statutes or foreign law, for example, to employees of the issuer, unless such disclosure would be immaterial because the financial resources of the issuer are such as to make it unlikely that the liability will ever be imposed.

(3) If preferred stock is to be offered or is outstanding, describe briefly any restriction on the repurchase or redemption of shares by the issuer while there is any arrearage in the payment of dividends or sinking fund installments. If there is no such restriction, so state.

(b) If debt securities are being offered, outline briefly the following:

(1) Provisions with respect to interest, conversion, maturity, redemption, amortization, sinking fund or retirement.

(2) Provisions with respect to the kind and priority of any lien securing the issue, together with a brief identification of the principal properties subject to such lien.

(3) Material affirmative and negative covenants.

Instruction to Item 14(b):

In the case of secured debt there must be stated: (i) the approximate amount of unbonded property available for use against the issuance of bonds, as of the most recent practicable date, and (ii) whether the securities being issued are to be issued against such property, against the deposit of cash, or otherwise.

(c) If securities described are to be offered pursuant to warrants, rights, or convertible securities, state briefly:

(1) the amount of securities issuable upon the exercise or conversion of such warrants, convertible securities or rights;

(2) the period during which and the price at which the warrants, convertible securities or rights are exercisable;

(3) the amounts of warrants, convertible securities or rights outstanding; and

(4) any other material terms of such securities.

(d) In the case of any other kind of securities, appropriate information of a comparable character.

Part F/S

(a) General Rules

(1) The appropriate financial statements set forth below of the issuer, or the issuer and its predecessors or any businesses to which the issuer is a successor must be filed as part of the offering statement and included in the offering circular that is distributed to investors.

(2) Unless the issuer is a Canadian company, financial statements must be prepared in accordance with generally accepted accounting principles in the United States (US GAAP). If the issuer is a Canadian company, such financial statements must be prepared in accordance with either US GAAP or International Financial Reporting Standards as issued by the International Accounting Standards Board. If the financial statements comply with International Financial Reporting Standards as issued by the International Accounting Standards Board, such compliance must be unreservedly and explicitly stated in the notes to the financial statements and the auditor's report must include an opinion on whether the financial statements comply with International Financial Reporting Standards as issued by the International Accounting Standards Board.

(3) The following requirements apply to all financial statements filed on this Form 1-A:

(i) The most recent balance sheet must be as of a date within nine months before filing the offering statement. For filings made more than three months after the end of the issuer's most recent fiscal year, the balance sheet must be dated as of the end of the most recent fiscal year. For filings made more than nine months after the end of the issuer's most recent fiscal year, the balance sheet must be dated no earlier than as of six months after the end of the most recent fiscal year.

(ii) The date of the most recent balance sheet included pursuant to this Part F/S must be used to determine which fiscal years must be covered by the statements of income and cash flows and any other financial statement disclosure dependent on such date.

(iii) Financial statements for the two most recently completed fiscal years are required for the issuer. Financial statements for no more than the two most recently completed fiscal years are required for any businesses acquired or to be acquired.

(iv) Interim financial statements, which may be unaudited (in which case that fact must be stated), must cover at least the first six months of the issuer's fiscal year and the corresponding period of the preceding fiscal year.

(v) If the day that the financial statements included in the offering statement become stale falls on a Saturday, Sunday, or holiday, such offering statement may be filed on the first business day following the last day of the specified period.

(vi) *Financial Statements of Guarantors and Issuers of Guaranteed Securities.* Financial statements of a subsidiary of an issuer that issues securities guaranteed by the issuer or guarantees securities issued by the issuer must be presented as required by Rule 3-10 of Regulation S-X, except that the periods presented are those required by this paragraph (a)(3) of this Part F/S and that no audit is required for Tier 1 offerings unless paragraph (b)(7) applies.

(vii) *Financial Statements of Affiliates Whose Securities Collateralize an Issuance.* Financial statements for an issuer's affiliates whose securities constitute a substantial portion of the collateral for any class of securities being offered must be presented as required by Rule 3-16 of Regulation S-X, except that the periods presented are those required by this paragraph (a)(3) of this Part F/S and that no audit is required for Tier 1 offerings unless paragraph (b)(7) applies.

(viii) *Oil and Gas Producing Activities.* Issuers engaged in oil and gas producing activities must follow the financial accounting and reporting standards specified in Rule 4-10 of Regulation S-X.

(ix) Additional financial statement requirements depend on whether the offering is a Tier 1 or Tier 2 offering and those requirements are set forth in paragraphs (b) and (c) below.

(4) Issuers should refer to Rule 257(b)(2) to determine whether a special financial report will be required after qualification of the offering statement.

(b) Financial Statements for Tier 1 Offerings

(1) In addition to the general rules in paragraph (a), the rules in (2) through (8) of this paragraph should be followed in the preparation of the issuer's financial statements. Regulation S-X does not apply to the financial statements, except as otherwise specifically provided below.

(2) *Balance Sheet.* There must be filed consolidated balance sheets for the issuer and its subsidiaries as of the end of each of the two most recent fiscal years. If the issuer has been in existence for less than one fiscal year, the issuer must file a balance sheet as of a date within nine months of the date of the filing of the offering statement.

(3) *Statements of income, cash flows, and other stockholders equity.* File consolidated statements of income, cash flows, and other stockholders equity for each of the two fiscal years preceding the date of the most recent balance sheet being filed, and for any interim period between the end of the most recent of such fiscal years and the date of the most recent balance sheet being filed, and the corresponding period of the preceding fiscal year, or for the period of the issuer's existence if less than the period above.

(4) Income statements must be accompanied by a statement that in the opinion of management all adjustments necessary for a fair statement of results for the interim period have been included. If all such adjustments are of a normal recurring nature, a statement to that effect must be made.

(5) *Financial Statements of Businesses Acquired or to be Acquired.* File the financial statements described in Rule 8-04 of Regulation S-X. The requirements of such rules apply as if the issuer were conducting a registered offering, except as otherwise provided in paragraph (a)(3) of this Part F/S and except that no audit is required unless paragraph (b)(7) applies.

(6) *Pro Forma Financial Information.*

(i) Pro forma information must be furnished if any of the following conditions exist:

(A) During the most recent fiscal year or subsequent interim period for which a balance sheet of the issuer is required, a significant business combination has occurred; or

(B) After the date of the issuer's most recent balance sheet, consummation of a significant business combination has occurred or is probable.

(ii) Pro forma statements must ordinarily be in columnar form showing condensed historical statements, pro forma adjustments, and the pro forma results and must include the following:

(A) If the transaction was consummated during the most recent fiscal year or in the subsequent interim period, pro forma statements of income reflecting the combined operations of the entities for the latest fiscal year and interim period, if any, or

(B) If consummation of the transaction has occurred or is probable after the date of the most recent balance sheet, a pro forma balance sheet giving effect to the combination as of the date of the most recent balance sheet required and pro forma statements of income reflecting the combined operations of the entities for the latest fiscal year and interim period, if any.

(7) The financial statements prepared pursuant to this paragraph (b) need not be audited. However, if an audit of these financial statements is obtained for other purposes and that audit was performed in accordance with either U.S. generally accepted auditing standards or the Standards of the Public Company Accounting Oversight Board by an auditor that is independent pursuant to Rule 2-01 of Regulation S-X, those audited financial statements must be filed, and an audit opinion complying with Article 2 of Regulation S-X must be filed along with such financial statements. The auditor may, but need not, be registered with the Public Company Accounting Oversight Board.

(8) As an alternative, an issuer may—but need not—elect to comply with the provisions of paragraph (c).

(c) Financial Statement Requirements for Tier 2 Offerings

(1) In addition to the general rules in paragraph (a), the rules in (2) through (4) of this paragraph should be followed in the preparation of the issuer's financial statements.

(2) Audited financial statements are required for Tier 2 offerings.

(3) An issuer must comply with Article 8 of Regulation S-X as if it was conducting a registered offering on Form S-1, except as otherwise provided in paragraph (a)(3) of this Part F/S.

(4) The audit must be conducted in accordance with standards of the Public Company Accounting Oversight Board (United States). Accounting firms conducting audits for the financial statements included in the offering circular may, but need not, be registered with the Public Company Accounting Oversight Board.

PART III—EXHIBITS

Item 16. Index to Exhibits

(a) An exhibits index must be presented at the beginning of Part III.

(b) Each exhibit must be listed in the exhibit index according to the number assigned to it under Item 17 below.

(c) For incorporation by reference, please refer to General Instruction III of this Form.

Item 17. Description of Exhibits

As appropriate, the following documents must be filed as exhibits to the offering statement.

1. *Underwriting agreement*—Each underwriting contract or agreement with a principal underwriter or letter pursuant to which the securities are to be distributed; where the terms have yet to be finalized, proposed formats may be provided.

2. *Charter and bylaws*—The charter and bylaws of the issuer or instruments corresponding thereto as currently in effect and any amendments thereto.

3. *Instruments defining the rights of securityholders*—

(a) All instruments defining the rights of any holder of the issuer's securities, including but not limited to (i) holders of equity or debt securities being issued; (ii) holders of long-term debt of the issuer, and of all subsidiaries for which consolidated or unconsolidated financial statements are required to be filed.

(b) The following instruments need not be filed if the issuer agrees to file them with the Commission upon request: (i) instruments defining the rights of holders of long-term debt of the issuer and all of its subsidiaries for which consolidated financial statements are required to be filed if such debt is not being issued pursuant to this Regulation A offering and the total amount of such authorized issuance does not exceed 5% of the total assets of the issuer and its subsidiaries on a consolidated basis; (ii) any instrument with respect to a class of securities that is to be retired or redeemed before the issuance or upon delivery of the securities being issued pursuant to this Regulation A offering and appropriate steps have been taken to assure such retirement or redemption; and (iii) copies of instruments evidencing scrip certificates or fractions of shares.

4. *Subscription agreement*—The form of any subscription agreement to be used in connection with the purchase of securities in this offering.

5. *Voting trust agreement*—Any voting trust agreements and amendments.

6. *Material contracts*

(a) Every contract not made in the ordinary course of business that is material to the issuer and is to be performed in whole or in part at or after the filing of the offering statement or was entered into not more than two years before such filing. Only contracts need be filed as to which the issuer or subsidiary of the issuer is a party or has succeeded to a party by assumption or assignment or in which the issuer or such subsidiary has a beneficial interest.

(b) If the contract is such as ordinarily accompanies the kind of business conducted by the issuer and its subsidiaries, it is made in the ordinary course of business and need not be filed unless it falls within one or more of the following categories, in which case it must be filed except where immaterial in amount or significance: (i) any contract to which directors, officers, promoters, voting trustees, securityholders named in the offering statement, or underwriters are parties, except where the contract merely involves the purchase or sale of current assets having a determinable market price, at such market price; (ii) any contract upon which the issuer's business is substantially dependent, as in the case of continuing contracts to sell the major part of the issuer's products or services or to purchase the major part of the issuer's requirements of goods, services or raw materials or any franchise or license or other agreement to use a patent, formula, trade secret, process or trade name upon which the issuer's business depends to a material extent; (iii) any contract calling for the acquisition or sale of any property, plant or equipment for a consideration exceeding 15% of such fixed assets of the issuer on a consolidated basis; or (iv) any material lease under which a part of the property described in the offering statement is held by the issuer.

(c) Any management contract or any compensatory plan, contract or arrangement including, but not limited to, plans relating to options, warrants or rights, pension, retirement or deferred compensation or bonus, incentive or profit sharing (or if not set forth in any formal document, a written description) is deemed material and must be filed except for the following: (i) ordinary purchase and sales agency agreements; (ii) agreements with managers of stores in a chain organization or similar organization; (iii) contracts providing for labor or salesperson's bonuses or payments to a class of securityholders, as such; (iv) any compensatory plan, contract or arrangement that pursuant to its terms is available to employees generally and that in operation provides for the same method of allocation of benefits between management and non-management participants.

7. *Plan of acquisition, reorganization, arrangement, liquidation, or succession*—Any material plan of acquisition, disposition, reorganization, readjustment, succession, liquidation or arrangement and any amendments thereto described in the offering statement. Schedules (or similar attachments) to these exhibits must not be filed unless such schedules contain information that is material to an investment decision and that is not otherwise disclosed in the agreement or the offering statement. The plan filed must contain a list briefly identifying the contents of all omitted schedules, together with an agreement to furnish supplementally a copy of any omitted schedule to the Commission upon request.

8. *Escrow agreements*—Any escrow agreement or similar arrangement which has been executed in connection with the Regulation A offering.

9. *Letter re change in certifying accountant*—A letter from the issuer's former independent accountant regarding its concurrence or disagreement with the statements made by the issuer in the current report concerning the resignation or dismissal as the issuer's principal accountant.

10. *Power of attorney*—If any name is signed to the offering statement pursuant to a power of attorney, signed copies of the power of attorney must be filed. Where the power of attorney is contained elsewhere in the offering statement or documents filed therewith, a reference must be made in the index to the part of the offering statement or document containing such power of attorney. In addition, if the name of any officer signing on behalf of the issuer is signed pursuant to a power of attorney, certified copies of a resolution of the issuer's board of directors authorizing such signature must also be filed. A power of attorney that is filed with the Commission must relate to a specific filing or an amendment thereto. A power of attorney that confers general authority may not be filed with the Commission.

11. *Consents*—

(a) Experts: The written consent of (i) any accountant, counsel, engineer, geologist, appraiser or any persons whose profession gives authority to a statement made by them and who is named in the offering statement as having prepared or certified any part of the document or is named as having prepared or certified a report or evaluation whether or not for use in connection with the offering statement; (ii) the expert that authored any portion of a report quoted or summarized as such in the offering statement, expressly stating their consent to the use of such quotation or summary; (iii) any persons who are referenced as having reviewed or passed upon any information in the offering statement, and that such information is being included on the basis of their authority or in reliance upon their status as experts.

(b) All written consents must be dated and signed.

12. *Opinion re legality*—An opinion of counsel as to the legality of the securities covered by the Offering Statement, indicating whether they will when sold, be legally issued, fully paid and non-assessable, and if debt securities, whether they will be binding obligations of the issuer.

13. *"Test the waters" materials*—Any written communication or broadcast script used under the authorization of Rule 255. Such materials need not be filed if they are substantively the same as materials previously filed with the offering statement.

14. *Appointment of agent for service of process*—A Canadian issuer must file Form F-X.

15. *Additional exhibits*—

(a) Any non-public, draft offering statement previously submitted pursuant to Rule 252(f) and any related, non-public correspondence submitted by or on behalf of the issuer.

(b) Any additional exhibits which the issuer may wish to file, which must be so marked as to indicate clearly the subject matters to which they refer.

SIGNATURES

Pursuant to the requirements of Regulation A, the issuer certifies that it has reasonable grounds to believe that it meets all of the requirements for filing on Form 1-A and has duly caused this offering statement to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of __________, State of _________________, on___ __________ *(date)*.

(Exact name of issuer as specified in its charter) ____________________________

By (Signature and Title) ____

This offering statement has been signed by the following persons in the capacities and on the dates indicated.

(Signature)____

(Title)____

(Date)____

Instructions to Signatures:

1. The offering statement must be signed by the issuer, its principal executive officer, principal financial officer, principal accounting officer, and a majority of the members of its board of directors or other governing body. If a signature is by a person on behalf of any other person, evidence of authority to sign must be filed with the offering statement, except where an executive officer signs on behalf of the issuer.

2. The offering statement must be signed using a typed signature. Each signatory to the filing must also manually sign a signature page or other document authenticating, acknowledging or otherwise adopting his or her signature that appears in the filing. Such document must be executed before or at the time the filing is made and must be retained by the issuer for a period of five years. Upon request, the issuer must furnish to the Commission or its staff a copy of any or all documents retained pursuant to this section.

3. The name and title of each person signing the offering statement must be typed or printed beneath the signature.

Note: The text of Form 1-A will not appear in the Code of Federal Regulations.

* * * * *

10. Revise § 239.91 to read as follows:

§ 239.91 Form 1-K

This form shall be used for filing annual reports under Regulation A (§§ 230.251-230.263 of this chapter).

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 1-K

GENERAL INSTRUCTIONS

A. Rules as to Use of Form 1-K.

(1) This Form shall be used for annual reports pursuant to Rule 257(b)(1) of Regulation A (§§ 230.251-230.263).

(2) Annual reports on this Form shall be filed within 120 days after the end of the fiscal year covered by the report.

(3) This Form also shall be used for special financial reports filed pursuant to Rule 257(b)(2)(i)(A) of Regulation A. Such special financial reports shall be filed and signed in the manner set forth in this Form, but otherwise need only provide Part I and the financial statements required by Rule 257(b)(2)(i)(A). Special financial reports filed using this Form shall be filed within 120 calendar days after the qualification date of the offering statement.

B. Preparation of Report.

(1) Regulation A contains certain general requirements that are applicable to reports on any form, including amendments to reports. These general requirements should be carefully read and observed in the preparation and filing of reports on this Form.

(2) This Form is not to be used as a blank form to be filled in, but only as a guide in the preparation of the report.

(3) Except where information is required to be given for the fiscal year or as of a specified date, it shall be given as of the latest date reasonably practicable.

(4) References in this Form to the items in Form 1-A are to the items set forth in Part II and Part III of Form 1-A, not Part I.

(5) In addition to the information expressly required to be included in this Form, there shall be added such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading.

C. Signature and Filing of Report.

(1) The report must be filed with the Commission in electronic format by means of the Commission's Electronic Data Gathering, Analysis and Retrieval System ("EDGAR") in accordance with the EDGAR rules set forth in Regulation S-T (17 CFR Part 232).

(2) The report must be signed by the issuer, its principal executive officer, principal financial officer, principal accounting officer, and at least a majority of the members of its board of directors or other governing body. If a signature is by a person on behalf of any other person, evidence of authority to sign must be filed with the report, except where an executive officer signs on behalf of the issuer.

(3) The report must be signed using a typed signature. Each signatory to the filing must also manually sign a signature page or other document authenticating, acknowledging or otherwise adopting his or her signature that appears in the filing. Such document must be executed before or at the time the filing is made and must be retained by the issuer for a period of five years. Upon request, the issuer must furnish to the Commission or its staff a copy of any or all documents retained pursuant to this paragraph.

D. Incorporation by Reference.

(1) An issuer may incorporate by reference to other documents previously submitted or filed on EDGAR pursuant to Regulation A. Descriptions of where the information incorporated by reference can be found must be specific and must clearly identify the relevant document and portion thereof where such information can be found. For exhibits, this description must be noted in the exhibits index for each relevant exhibit. All such descriptions must be accompanied by a separate hyperlink to the incorporated document on EDGAR. A hyperlink need not remain active after the filing of the report, except that amendments to the report must update any hyperlinks referred to in the amendment that are inactive. If any substantive modification has occurred in the text of any document incorporated by reference since such document was filed, the issuer must file with the reference a statement containing the text and date of such modification.

(2) Reference may not be made to any document which incorporates another document by reference if the pertinent portion of the document containing the information to be incorporated by reference includes an incorporation by reference to another document. Incorporation by reference to documents not available on EDGAR is not permitted. Matter shall not be incorporated by reference in any case where such incorporation would render the statement or report incomplete, unclear, or confusing.

PART I
NOTIFICATION

The following information must be provided in the XML-based portion of Form 1-K available through the EDGAR portal and must be completed or updated before uploading each offering statement or amendment thereto. The format of Part I shown below may differ from the electronic version available on EDGAR. The electronic version of Part I will allow issuers to attach Part II for filing by means of EDGAR. All items must be addressed, unless otherwise indicated.

* * * * * *

This Form 1-K is to provide an ☐ Annual Report ***OR*** ☐ Special Financial Report for the fiscal year ended ______________________________

Exact name of issuer as specified in the issuer's charter: ______________________

State or other jurisdiction of incorporation: ______________________

I.R.S. Employer Identification Number: ______________________

Address of Principal Executive Offices: ______________________

____

Telephone: ( ) ____________________

Title of each class of securities issued pursuant to Regulation A: ____________________
____

Summary Information Regarding Prior Offerings and Proceeds

The following information must be provided for any Regulation A offering that has terminated or completed prior to the filing of this Form 1-K, unless such information has been previously reported in a manner permissible under Rule 257. If such information has been previously reported, check this box ☐ and leave the rest of Part I blank.

Date of qualification of the offering statement: ____________________

Date of commencement of the offering: ____________________

Number of securities qualified to be sold in the offering: ____________________

Number of securities sold in the offering: ____________________

Price per security: $____________________

The aggregate offering price for securities sold on behalf of the issuer:
$____________________ ☐ N/A

The aggregate offering price for the securities sold on behalf of selling securityholders:
$____________________ ☐ N/A

Fees in connection with this offering and names of service providers:

	Name of Service Provider	Fees
Underwriters:		$
Sales Commissions:		$
Finders' Fees:		$
Auditor:		$
Legal:		$
Promoters:		$
Blue Sky Compliance:		$

CRD Number of any broker or dealer listed: ____________________

Net proceeds to the issuer: $____________________

Clarification of responses (if necessary): ____________________

PART II

INFORMATION TO BE INCLUDED IN REPORT

Item 1. **Business**

Set forth the information required by Item 7 of Form 1-A.

Item 2. **Management's Discussion and Analysis of Financial Condition and Results of Operations**

Set forth the information required by Item 9 of Form 1-A for the previous two completed fiscal years.

Item 3. **Directors and Officers**

Set forth the information required by Items 10 and 11 of Form 1-A.

Item 4. **Security Ownership of Management and Certain Securityholders**

Set forth the information required by Item 12 of Form 1-A.

Item 5. **Interest of Management and Others in Certain Transactions**

Set forth the information required by Item 13 of Form 1-A.

Item 6. **Other Information**

Set forth any information required to be disclosed in a report on Form 1-U during the second half of the fiscal year covered by this Form 1-K, but not reported, whether or not otherwise required by this Form 1-K. If disclosure of such information is made under this item, it need not be repeated in a report on Form 1-U that would otherwise be required to be filed with respect to such information or in a subsequent report on Form 1-U.

Item 7. **Financial Statements**

(a) At the beginning of the section where you provide the financial statements required by this Form, provide a list of the financial statements included.

(b) Include annual financial statements of the issuer that would meet the requirements of Part F/S of Form 1-A if included in an offering statement being qualified on the due date of the report.

Item 8. **Exhibits**

(a) An exhibits index must be presented immediately preceding the first signature page of the report.

(b) File, as exhibits to this Form, the exhibits required by Form 1-A, except for the exhibits required by paragraphs 1, 12, and 13 of Item 17.

SIGNATURES

Pursuant to the requirements of Regulation A, the issuer has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

(Exact name of issuer as specified in its charter)______________________________
____

By (Signature and Title)______________________________

Date______________________________

Pursuant to the requirements of Regulation A, this report has been signed below by the following persons on behalf of the issuer and in the capacities and on the dates indicated.

By (Signature and Title)______________________________

Date______________________________

By (Signature and Title)______________________________

Date______________________________

Note: The text of Form 1-K will not appear in the Code of Federal Regulations.

* * * * *

12. Revise § 239.92 to read as follows:

§ 230.92 Form 1-SA

This form shall be used for filing semiannual reports under Regulation A

(§§ 230.251-230.263 of this chapter).

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 1-SA

[ ] SEMIANNUAL REPORT PURSUANT TO REGULATION A
or
[ ] SPECIAL FINANCIAL REPORT PURSUANT TO REGULATION A

For the fiscal semiannual period ended ______________________________

____
(Exact name of issuer as specified in its charter)

____________________ State or other jurisdiction of incorporation or organization	____________________ (I.R.S. Employer Identification No.)

____
(Full mailing address of principal executive offices)

____
(Issuer's telephone number, including area code)

GENERAL INSTRUCTIONS

A. Rules as to Use of Form 1-SA.

(1) This Form shall be used for semiannual reports pursuant to Rule 257(b)(3) of Regulation A (§§ 230.251-230.263).

(2) Semiannual reports on this Form shall be filed within 90 days after the end of the semiannual period covered by the report.

(3) This Form also shall be used for special financial reports filed pursuant to Rule 257(b)(2)(i)(B) of Regulation A. Such special financial reports shall be filed and signed in the manner set forth in this Form, but otherwise need only provide the cover page and financial statements required by Rule 257(b)(2)(i)(B). Special financial reports filed using this Form shall be filed within 90 calendar days after the qualification date of the offering statement.

B. Preparation of Report.

(1) Regulation A contains certain general requirements that are applicable to reports on any form, including amendments to reports. These general requirements should be carefully read and observed in the preparation and filing of reports on this Form.

(2) This Form is not to be used as a blank form to be filled in, but only as a guide in the preparation of the report.

(3) In addition to the information expressly required to be included in this Form, there shall be added such further material information, if any, as may be necessary to make the

required statements, in light of the circumstances under which they are made, not misleading.

C. Signature and Filing of Report.

(1) The report must be filed with the Commission in electronic format by means of the Commission's Electronic Data Gathering, Analysis and Retrieval System ("EDGAR") in accordance with the EDGAR rules set forth in Regulation S-T (17 CFR Part 232).

(2) The report must be signed by the issuer, its principal executive officer, principal financial officer and principal accounting officer. If a signature is by a person on behalf of any other person, evidence of authority to sign must be filed with the report, except where an executive officer signs on behalf of the issuer.

(3) The report must be signed using a typed signature. Each signatory to the filing must also manually sign a signature page or other document authenticating, acknowledging or otherwise adopting his or her signature that appears in the filing. Such document must be executed before or at the time the filing is made and must be retained by the issuer for a period of five years. Upon request, the issuer must furnish to the Commission or its staff a copy of any or all documents retained pursuant to this paragraph.

D. Incorporation by Reference.

(1) An issuer may incorporate by reference to other documents previously submitted or filed on EDGAR pursuant to Regulation A. Descriptions of where the information incorporated by reference can be found must be specific and must clearly identify the relevant document and portion thereof where such information can be found. For exhibits, this description must be noted in the exhibits index for each relevant exhibit. All such descriptions must be accompanied by a separate hyperlink to the incorporated document on EDGAR. A hyperlink need not remain active after the filing of the report, except that amendments to the report must update any hyperlinks referred to in the amendment that are inactive. If any substantive modification has occurred in the text of any document incorporated by reference since such document was filed, the issuer must file with the reference a statement containing the text and date of such modification.

(2) Reference may not be made to any document which incorporates another document by reference if the pertinent portion of the document containing the information to be incorporated by reference includes an incorporation by reference to another document. Incorporation by reference to documents not available on EDGAR is not permitted. Matter shall not be incorporated by reference in any case where such incorporation would render the statement or report incomplete, unclear, or confusing.

INFORMATION TO BE INCLUDED IN REPORT

Item 1. Management's Discussion and Analysis of Financial Condition and Results of Operations

Set forth the information required by Item 9 of Form 1-A.

Item 2. Other Information

Set forth any information required to be disclosed in a report on Form 1-U during the semiannual period covered by this Form 1-SA, but not reported, whether or not otherwise required by this Form 1-SA. If disclosure of such information is made under this item, it need not be repeated in a report on Form 1-U that would otherwise be required to be filed with respect to such information or in a subsequent report on Form 1-U.

Item 3. Financial Statements

The appropriate financial statements set forth below of the issuer, or the issuer and its predecessors or any businesses to which the issuer is a successor must be filed as part of the Form 1-SA.

Unless the issuer is a Canadian company, financial statements must be prepared on a consolidated basis in accordance with generally accepted accounting principles in the United States (US GAAP). If the issuer is a Canadian company, such financial statements must be prepared in accordance with either US GAAP or International Financial Reporting Standards as issued by the International Accounting Standards Board. If the financial statements comply with International Financial Reporting Standards as issued by the International Accounting Standards Board, such compliance must be unreservedly and explicitly stated in the notes to the financial statements.

The financial statements included pursuant to this item may be unaudited and are not required to be reviewed. The financial statements must include the following:

(a) An interim balance sheet as of the end of the six month period covered by this report and a balance sheet as of the end of the preceding fiscal year. An interim balance sheet as of the end of the corresponding six month interim period of the preceding fiscal year need not be provided unless necessary for an understanding of the impact of seasonal fluctuations on the issuer's financial condition.

(b) Interim statements of income must be provided for the six month interim period covered by this report and for the corresponding period of the preceding fiscal year. Income statements must be accompanied by a statement that in the opinion of management all adjustments necessary for a fair statement of results for the interim period have been included. If all such adjustments are of a normal recurring nature, a statement to that effect must be made.

(c) Interim statements of cash flows must be provided for the six month interim period covered by this report and for the corresponding period of the preceding fiscal year.

(d) Interim statements of changes in financial position shall be provided for the period between the end of the preceding fiscal year and the end of the interim period covered by this report, and for the corresponding period of the preceding fiscal year.

(e) *Financial Statements of Guarantors and Issuers of Guaranteed Securities.* Financial statements of a subsidiary of an issuer that issues securities guaranteed by the issuer or guarantees securities issued by the issuer must be presented as required by Rule 3-10 of Regulation S-X, except that the periods presented are those required by this item and the financial statements need not be audited.

(f) *Financial Statements of Affiliates Whose Securities Collateralize an Issuance.* Financial statements for an issuer's affiliates whose securities constitute a substantial portion of the collateral for any class of securities being offered must be presented as required by Rule 3-16 of Regulation S-X, except that the periods presented are those required by this item and the financial statements need not be audited.

(g) *Oil and Gas Producing Activities.* Issuers engaged in oil and gas producing activities must follow the financial accounting and reporting standards specified in Rule 4-10 of Regulation S-X.

Item 4. Exhibits

(a) An exhibits index must be presented immediately preceding the first signature page of the report.

(b) File, as exhibits to this Form, the exhibits required by Form 1-A, except for the exhibits required by paragraphs 1, 12, and 13 of Item 17.

SIGNATURES

Pursuant to the requirements of Regulation A, the issuer has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

(Exact name of issuer as specified in its charter)__________________________

By (Signature and Title)____

Date____

Pursuant to the requirements of Regulation A, this report has been signed below by the following persons on behalf of the issuer and in the capacities and on the dates indicated.

By (Signature and Title)____

Date____

By (Signature and Title)________________________________

Date____

Note: The text of Form 1-SA will not appear in the Code of Federal Regulations.

* * * * *

13. Revise § 239.93 to read as follows:

§ 230.93 Form 1-U

This form shall be used for filing current reports under Regulation A (§§ 230.251-230.263 of this chapter).

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 1-U

CURRENT REPORT PURSUANT TO REGULATION A

Date of Report (Date of earliest event reported)________________________

____
(Exact name of issuer as specified in its charter)

____
State or other jurisdiction of
incorporation or organization

____
(I.R.S. Employer
Identification No.)

____
(Full mailing address of principal executive offices)

____
(Issuer's telephone number, including area code)

Title of each class of securities issued pursuant to Regulation A: ________________
____

GENERAL INSTRUCTIONS

A. Rules as to Use of Form 1-U.

(1) This Form shall be used for current reports pursuant to Rule 257(b)(4) of Regulation A (§§ 230.251-230.263).

(2) A report on this Form is required to be filed, as applicable, upon the occurrence of any one or more of the events specified in Items 1 – 9 of this Form. Unless otherwise specified, a report is to be filed within four business days after occurrence of the event. If the event occurs on a Saturday, Sunday, or holiday on which the Commission is not open for business, then the four business day period shall begin to run on, and include, the first business day thereafter.

(3) If the issuer previously has provided substantially the same information as required by this Form in a report required by Rule 257(b) of Regulation A, the issuer need not make an additional report of the information on this Form. To the extent that an item calls for disclosure of developments concerning a previously reported event or transaction, any information required in the new report or amendment about the previously reported event or transaction may be provided by incorporation by reference to the previously filed report, if a hyperlink to such report as filed with the Commission is included.

(4) Copies of agreements, amendments or other documents or instruments required to be filed pursuant to Form 1-U are not required to be filed or furnished as exhibits to the Form 1-U unless specifically required to be filed or furnished by the applicable item. This instruction does not affect the requirement to otherwise file such agreements, amendments or other documents or instruments, including as exhibits to offering statements and periodic reports pursuant to the requirements of Regulation A.

B. Preparation of Report.

(1) Regulation A contains certain general requirements which are applicable to reports on any form, including amendments to reports. These general requirements should be carefully read and observed in the preparation and filing of reports on this Form.

(2) This Form is not to be used as a blank form to be filled in, but only as a guide in the preparation of the report. Nevertheless, the report shall contain the number and caption of the applicable item, but the text of such item may be omitted. All items that are not required to be answered in a particular report may be omitted and no reference thereto need be made in the report. All instructions should also be omitted.

(3) In addition to the information expressly required to be included in this Form, there shall be added such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading.

C. Signature and Filing of Report.

(1) The report must be filed with the Commission in electronic format by means of the Commission's Electronic Data Gathering, Analysis and Retrieval System ("EDGAR") in accordance with the EDGAR rules set forth in Regulation S-T (17 CFR Part 232).

(2) The report must be signed by an officer duly authorized to sign on behalf of the issuer. The report must be signed using a typed signature. The signatory to the filing must also manually sign a signature page or other document authenticating, acknowledging or otherwise adopting his or her signature that appears in the filing. Such document must be executed before or at the time the filing is made and must be retained by the issuer for a period of five years. Upon request, the issuer must furnish to the Commission or its staff a copy of any or all documents retained pursuant to this paragraph.

D. Incorporation by Reference.

(1) An issuer may incorporate by reference to other documents previously submitted or filed on EDGAR pursuant to Regulation A. Descriptions of where the information incorporated by reference can be found must be specific and must clearly identify the relevant document and portion thereof where such information can be found. For exhibits, this description must be noted in the exhibits index for each relevant exhibit. All such descriptions must be accompanied by a separate hyperlink to the incorporated document on EDGAR. A hyperlink need not remain active after the filing of the report, except that amendments to the report must update any hyperlinks referred to in the amendment that are inactive. If any substantive modification has occurred in the text of any document incorporated by reference since such document was filed, the issuer must file with the reference a statement containing the text and date of such modification.

(2) Reference may not be made to any document which incorporates another document by reference if the pertinent portion of the document containing the information to be incorporated by reference includes an incorporation by reference to another document. Incorporation by reference to documents not available on EDGAR is not permitted. Matter shall not be incorporated by reference in any case where such incorporation would render the statement or report incomplete, unclear, or confusing.

INFORMATION TO BE INCLUDED IN THE REPORT

Item 1. Fundamental Changes

(a) If the issuer has entered into or terminated a material definitive agreement that has resulted in or would reasonably be expected to result in a fundamental change to the nature of its business or plan of operations, disclose the following information to the extent applicable:

> (1) the date on which the agreement was entered into, amended, or terminated, the identity of the parties to the agreement or amendment, and a brief description of any material relationship between the issuer or its affiliates and any of the parties

(other than the relationship created by the material definitive agreement or amendment);

(2) a brief description of the material terms and conditions of the agreement;

(3) a brief description of the material circumstances surrounding the termination; and

(4) any material early termination penalties incurred by the issuer due to a termination.

(b) For purposes of this item, a material definitive agreement means an agreement that provides for obligations that are material to and enforceable against the issuer, or rights that are material to the issuer and enforceable by the issuer against one or more other parties to the agreement, in each case whether or not subject to conditions.

(c) File any material definitive agreement disclosed pursuant to this item as an exhibit to the report on this Form.

Instructions to Item 1:

1. A material definitive agreement that is not made in the ordinary course of business is not necessarily required to be disclosed under this item if it does not result in, and would not reasonably be expected to result in, a fundamental change to the nature of the issuer's business or plan of operations.

2. Without limiting the generality of the foregoing, a material definitive agreement is deemed to result in a fundamental change if it involves any of the following:

a. A transaction that would exceed the significance thresholds in Rule 8-04 of Regulation S-X (17 CFR 210.8-04) if such rule applied;

b. A merger, consolidation, acquisition or similar transaction that requires approval by the issuer's securityholders;

c. Any contract upon which the issuer's business is substantially dependent, as in the case of continuing contracts to sell the major part of the issuer's products or services or to purchase the major part of the issuer's requirements of goods, services or raw materials or any franchise or license or other agreement to use a patent, formula, trade secret, process or trade name upon which the issuer's business is substantially dependent; or

3. An issuer must provide disclosure under this item if the issuer succeeds as a party to the agreement or amendment to the agreement by assumption or *assignment (other than in connection with a merger or acquisition or similar transaction that is otherwise reported pursuant to this item).*

4. No disclosure under this item is required regarding the termination of a material definitive agreement if:

a. The agreement terminated on its stated termination date, or as a result of all parties completing their obligations under such agreement.

b. Only negotiations or discussions regarding termination of a material definitive agreement are being conducted and the agreement has not been terminated.

c. The issuer believes in good faith that the material definitive agreement has not been terminated, unless the issuer has received a notice of termination pursuant to the terms of agreement.

Item 2. Bankruptcy or Receivership

(a) If a receiver, fiscal agent or similar officer has been appointed for an issuer or its parent, in a proceeding under the U.S. Bankruptcy Code or in any other proceeding under state, federal, or Canadian laws, in which a court or governmental authority has assumed jurisdiction over substantially all of the assets or business of the issuer or its parent, or if such jurisdiction has been assumed by leaving the existing directors and officers in possession but subject to the supervision and orders of a court or governmental authority, disclose the following information:

(1) the name or other identification of the proceeding;

(2) the identity of the court or governmental authority;

(3) the date that jurisdiction was assumed; and

(4) the identity of the receiver, fiscal agent or similar officer and the date of his or her appointment.

(b) If an order confirming a plan of reorganization, arrangement or liquidation has been entered by a court or governmental authority having supervision or jurisdiction over substantially all of the assets or business of the issuer or its parent, disclose the following:

(1) the identity of the court or governmental authority;

(2) the date that the order confirming the plan was entered by the court or governmental authority;

(3) a summary of the material features of the plan;

(4) the number of shares or other units of the issuer or its parent issued and outstanding, the number reserved for future issuance in respect of claims and interests filed and allowed under the plan, and the aggregate total of such numbers; and

(5) information as to the assets and liabilities of the issuer or its parent as of the date that the order confirming the plan was entered, or a date as close thereto as practicable.

Instruction to Item 2:

The information called for in paragraph (b)(5) of this item may be presented in the form in which it was furnished to the court or governmental authority.

Item 3. Material Modification to Rights of Securityholders

(a) If the constituent instruments defining the rights of the holders of any class of securities of the issuer that were issued pursuant to Regulation A have been materially modified, disclose the date of the modification, the title of the class of securities involved and briefly describe the general effect of such modification upon the rights of holders of such securities.

(b) If the rights or benefits evidenced by any class of securities issued pursuant to Regulation A have been materially limited or qualified by the issuance or modification of any other class of securities by the issuer, briefly disclose the date of the issuance or modification, the general effect of the issuance or modification of such other class of securities upon the rights or benefits of the holders of the securities issued pursuant to Regulation A.

Instruction to Item 3:

Working capital restrictions and other limitations upon the payment of dividends must be reported pursuant to this item.

Item 4. Changes in Issuer's Certifying Accountant

(a) If an independent accountant who was previously engaged as the principal accountant to audit the issuer's financial statements, or an independent accountant upon whom the principal accountant expressed reliance in its report regarding a significant subsidiary, resigns (or indicates that it declines to stand for re-appointment after completion of the current audit) or is dismissed, disclose the information that would be required under Item 304(a)(1) of Regulation S-K (17 CFR 229.304(a)(1)), including compliance with Item 304(a)(3) of Regulation S-K (17 CFR 229.304(a)(3)) if the issuer were a "registrant."

(b) If a new independent accountant has been engaged as either the principal accountant to audit the issuer's financial statements or as an independent accountant on whom the principal accountant is expected to express reliance in its report regarding a significant subsidiary, the issuer must disclose the information that would be required by Item 304(a)(2) of Regulation S-K (17 CFR 229.304(a)(2)) if the issuer were a "registrant."

Instructions to Item 4:

> *1. Information under this Item 4 is only required if the issuer's most recent qualified offering statement on Form 1-A or report on Form 1-K, whichever is most recent, contains audited financial statements.*
>
> *2. The resignation or dismissal of an independent accountant, or its refusal to stand for re-appointment, is a reportable event separate from the engagement of a new independent accountant. On some occasions, two reports on Form 1-U are required for a single change in accountants, the first on the resignation (or refusal to stand for re-appointment) or dismissal of the former accountant and the second when the new accountant is engaged. Information required in the second Form 1-U in such situations need not be provided to the extent that it has been reported previously in the first Form 1-U.*

Item 5. Non-reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review

(a) If the issuer's board of directors, a committee of the board of directors or the officer or officers of the issuer authorized to take such action if board action is not required, concludes that any previously issued financial statements, covering one or more years or interim periods for which the issuer is required to provide financial statements under Regulation A, including Form 1-A, should no longer be relied upon because of an error in such financial statements as addressed in FASB Accounting Standards Codification Topic 250, as may be modified, supplemented or succeeded, disclose the following information:

> (1) the date of the conclusion regarding the non-reliance and an identification of the financial statements and years or periods covered that should no longer be relied upon;
>
> (2) a brief description of the facts underlying the conclusion to the extent known to the issuer at the time of filing;
> and
>
> (3) a statement of whether the audit committee, or the board of directors in the absence of an audit committee, or authorized officer or officers, discussed with the issuer's independent accountant the matters disclosed in the filing pursuant to this paragraph (a).

(b) If the issuer is advised by, or receives notice from, its independent accountant that disclosure should be made or action should be taken to prevent future reliance on a previously issued audit report or completed interim review related to previously issued financial statements, disclose the following information:

(1) the date on which the issuer was so advised or notified;

(2) identification of the financial statements that should no longer be relied upon;

(3) a brief description of the information provided by the accountant; and

(4) a statement of whether the audit committee, or the board of directors in the absence of an audit committee, or authorized officer or officers, discussed with the independent accountant the matters disclosed in the filing pursuant to paragraph (b) of this item.

(c) If the issuer receives advisement or notice from its independent accountant requiring disclosure under paragraph (b) of this item, the issuer must:

(1) provide the independent accountant with a copy of the disclosures it is making in response to this item that the independent accountant shall receive no later than the day that the disclosures are filed with the Commission;

(2) request the independent accountant to furnish to the issuer as promptly as possible a letter addressed to the Commission stating whether the independent accountant agrees with the statements made by the issuer in response to this item and, if not, stating the respects in which it does not agree; and

(3) amend the issuer's previously filed Form 1-U by filing the independent accountant's letter as an exhibit to the filed Form 1-U no later than two business days after the issuer's receipt of the letter.

Item 6. Changes in Control of Issuer

(a) If, to the knowledge of the issuer's board of directors, a committee of the board of directors, governing body similar to a board of directors, or authorized officer or officers of the issuer, a change in control of the issuer has occurred, furnish the following information:

(1) the identity of the persons who acquired such control;

(2) the date and a description of the transactions which resulted in the change in control;

(3) the basis of the control, including the percentage of voting securities of the issuer now beneficially owned directly or indirectly by the persons who acquired control;

(4) the amount of the consideration used by such persons;

(5) the sources of funds used by the persons, unless all or any part of the consideration used is a loan made in the ordinary course of business by a bank as defined by Section 3(a)(6) of the Securities Exchange Act of 1934.

(6) the identity of the persons from whom control was assumed; and

(7) any arrangements or understandings among members of both the former and new control groups and their associates with respect to election of directors or other matters.

(b) Describe any arrangements, known to the issuer, including any pledge by any person of securities of the issuer or any of its parents, the operation of which may at a subsequent date result in a change in control of the issuer. It is not necessary to describe ordinary default provisions contained in the charter, trust indentures, or other governing instruments relating to securities of the issuer in response to this paragraph.

Item 7. Departure of Certain Officers

If the issuer's principal executive officer, principal financial officer, principal accounting officer, or any person performing similar functions, retires, resigns or is terminated from that position, disclose the fact that the event has occurred and the date of the event.

Instruction to Item 7:

The disclosure requirements of this item do not apply to an issuer that is a wholly-owned subsidiary of an issuer with a class of securities registered under Section 12 of the Exchange Act (15 U.S.C. 78l), or that is required to file reports under Section 15(d) of the Exchange Act (15 U.S.C. 78o(d)) or under Regulation A.

Item 8. Unregistered Sales of Equity Securities

(a) If the issuer sells equity securities in a transaction that is not registered under the Securities Act or qualified under Regulation A, furnish the information set forth in Item 6 of Part I of Form 1-A. For purposes of determining the required filing date for the Form 1-U under this item, the issuer has no obligation to disclose information under this item until the issuer enters into an agreement enforceable against the issuer, whether or not subject to conditions, under which the equity securities are to be sold. If there is no such agreement, the issuer must provide the disclosure within four business days after the occurrence of the closing or settlement of the transaction or arrangement under which the equity securities are to be sold.

(b) No report need be filed if the equity securities sold, in the aggregate since its last report filed under this item or its last periodic report, whichever is more recent, constitute less than 5% of the number of shares outstanding of the class of equity securities sold.

Instructions to Item 8:

> *1. For purposes of this item, "the number of shares outstanding" refers to the actual number of shares of equity securities of the class outstanding and does not include outstanding securities convertible into or exchangeable for such equity securities.*
>
> *2. It is not necessary to follow the format of Item 6 of Part I of Form 1-A when providing the information required by this item.*

Item 9. Other Events

The issuer may, at its option, disclose under this item any events, with respect to which information is not otherwise called for by this Form, that the issuer deems of importance to securityholders.

SIGNATURES

Pursuant to the requirements of Regulation A, the issuer has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

(Exact name of issuer as specified in its charter)______________________________

By (Signature and Title)____

Date____

Note: The text of Form 1-U will not appear in the Code of Federal Regulations.

* * * * *

13. Revise § 239.94 to read as follows:

§ 230.94 Form 1-Z

This form shall be used to file an exit report under Regulation A (§§ 230.251-230.263 of this chapter).

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 1-Z

EXIT REPORT UNDER REGULATION A

GENERAL INSTRUCTIONS

(1) The following information must be provided in the XML-based Form 1-Z available through the EDGAR portal. The format shown below may differ from the electronic version available on EDGAR.

(2) An issuer filing this Form pursuant to Rule 257(a) must only complete the Preliminary Information and Part I.

(3) An issuer filing this Form to suspend its duty to file reports under Rule 257(d) must complete the Preliminary Information and Part II. Such issuer must also provide Part I if it has not previously provided the Part I information in a Form 1-K filing.

* * * * * *

PRELIMINARY INFORMATION

Exact name of issuer as specified in the issuer's charter: ______________________

Address of Principal Executive Offices: ______________________

____

Telephone: ( ) ______________________

Commission File Number(s): ______________________

PART I
Summary Information Regarding the Offering and Proceeds

Date of qualification of the offering statement: ______________________

Date of commencement of the offering:______________________________________

Number of securities qualified to be sold in the offering:___________________________

Number of securities sold in the offering:______________________________________

Price per security: $____

The aggregate offering price for securities sold on behalf of the issuer:
$________________ ☐ N/A

The aggregate offering price for the securities sold on behalf of selling securityholders:
$________________ ☐ N/A

Fees in connection with this offering and names of service providers:

	Name of Service Provider	Fees
Underwriters:	________________	$ ________________
Sales Commissions:	________________	$ ________________
Finders' Fees:	________________	$ ________________
Auditor:	________________	$ ________________
Legal:	________________	$ ________________
Promoters:	________________	$ ________________
Blue Sky Compliance:	________________	$ ________________

CRD Number of any broker or dealer listed:_____________________________________

Net proceeds to the issuer: $____

Clarification of responses (if necessary): _____________________________________

PART II
Certification of Suspension of Duty to File Reports

Title of each class of securities covered by this Form___________________________

Commission File Number(s)____

Approximate number of holders of record as of the certification date:________________

Pursuant to the requirements of Regulation A, ______________________ *(Name of issuer as specified in charter)* certifies that it meets all of the conditions for termination of Regulation A reporting specified in Rule 257(d) and that there are no classes of securities other than those that are the subject of this Form 1-Z regarding which the issuer has Regulation A reporting obligations. ______________________ *(Name of issuer as* *specified in charter)* has caused this certification to be signed on its behalf by the undersigned duly authorized person.

By: ______________________________ Date: ______________________________
Title: ______________________________

Instruction: This Part II of Form 1-Z is required by Rule 257(d) of Regulation A. An officer of the issuer or any other duly authorized person may sign, and must do so by typed signature. The name and title of the person signing the form must be typed or printed under the signature. The signatory to the filing must also manually sign a signature page or other document authenticating, acknowledging or otherwise adopting his or her signature that appears in the filing. Such document must be executed before or at the time the filing is made and must be retained by the issuer for a period of five years. Upon request, the issuer must furnish to the Commission or its staff a copy of any or all documents retained pursuant to this instruction.

Note: The text of Form 1-Z will not appear in the Code of Federal Regulations.

* * * * *

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

14. The authority citation for Part 240 is amended by revising the sectional authority for § 240.15c2-11 to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78c-3, 78c-5, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78*l*, 78m, 78n, 78n-1, 78o, 78o-4, 78o-10, 78p, 78q, 78q-1, 78s, 78u-5, 78w, 78x, 78*ll*, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, 7201 et. seq., and 8302; 7 U.S.C. 2(c)(2)(E); 12 U.S.C. 5221(e)(3); 18 U.S.C. 1350; and Pub. L. 111-203, 939A, 124 Stat. 1376, (2010), unless otherwise noted.

* * * * *

Section 240.15c2-11 also issued under 15 U.S.C. 78j(b), 78 o (c), 78q(a), 78w(a), and Pub. L. No. 112-106, § 401, 126 Stat. 313 (2012).

* * * * *

15. § 240.15c2-11 is amended by revising paragraphs (a)(3) and (d)(2)(i) to read as follows:

§ 240.15c2-11 Initiation or resumption of quotations without specific information.

* * * * *

(a) * * *

(3) A copy of the issuer's most recent annual report filed pursuant to section 13 or 15(d) of the Act or pursuant to Regulation A ((§§ 230.251-230.263 of this chapter), or a copy of the annual statement referred to in section 12(g)(2)(G)(i) of the Act in the case of an issuer required to file reports pursuant to section 13 or 15(d) of the Act or an issuer of a security covered by section 12(g)(2)(B) or (G) of the Act, together with any semiannual, quarterly and current reports that have been filed under the provisions of the Act or Regulation A by the issuer after such annual report or annual statement; *provided, however,* that until such issuer has filed its first annual report pursuant to section 13 or 15(d) of the Act or pursuant to Regulation A, or annual statement referred to in section 12(g)(2)(G)(i) of the Act, the broker or dealer has in its records a copy of the prospectus specified by section 10(a) of the Securities Act of 1933 included in a registration statement filed by the issuer under the Securities Act of 1933, other than a registration statement on Form F-6, or a copy of the offering circular specified by Regulation A included in an offering statement filed by the issuer under Regulation A, that became effective or was qualified within the prior 16 months, or a copy of any registration

statement filed by the issuer under section 12 of the Act that became effective within the prior 16 months, together with any semiannual, quarterly and current reports filed thereafter under section 13 or 15(d) of the Act or Regulation A; and *provided further,* that the broker or dealer has a reasonable basis under the circumstances for believing that the issuer is current in filing annual, semiannual, quarterly, and current reports filed pursuant to section 13 or 15(d) of the Act or Regulation A, or, in the case of an insurance company exempted from section 12(g) of the Act by reason of section 12(g)(2)(G) thereof, the annual statement referred to in section 12(g)(2)(G)(i) of the Act; or

* * * * *

(d) * * *

(2) * * *

(i) A broker-dealer shall be in compliance with the requirement to obtain current reports filed by the issuer if the broker-dealer obtains all current reports filed with the Commission by the issuer as of a date up to five business days in advance of the earlier of the date of submission of the quotation to the quotation medium and the date of submission of the paragraph (a) information pursuant to the applicable rule of the Financial Industry Regulatory Authority, Inc. or its successor organization; and

* * * * *

PART 260 - GENERAL RULES AND REGULATIONS, TRUST INDENTURE ACT OF 1939

16. The authority citation for Part 260 is revised to read, in part, as follows:

Authority: 15 U.S.C. 77c, 77eee, 77ggg, 77nnn, 77sss, 78 ll (d), 80b-3, 80b-4, 80b-11 and Pub. L. No. 112-106, § 401, 126 Stat. 313 (2012), unless otherwise noted.

* * * * *

17. § 260.4a-1 is revised to read as follows:

§ 260.4a-1 Exempted securities under section 304(a)(8).

The provisions of the Trust Indenture Act of 1939 shall not apply to any security that has been or will be issued otherwise than under an indenture. The same issuer may not claim this exemption within a period of twelve consecutive months for more than $50,000,000 aggregate principal amount of any securities.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy

Secretary

Dated: December 18, 2013

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 71126 / December 18, 2013

INVESTMENT COMPANY ACT OF 1940
Release No. 30838 / December 18, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15652

In the Matter of **Jonathan Samuel Daspin,** **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 Jonathan Samuel Daspin ("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. Respondent admits to the facts set forth in Sections III.B. and C. below, acknowledges that his conduct violated the federal securities laws, admits the Commission's jurisdiction over him and the subject matter of these proceedings and 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:

A. <u>Summary</u>

These proceedings arise out of Respondent's participation in a fraudulent scheme to conceal his employer's practice of charging undisclosed mark-ups and mark-downs in addition to disclosed commissions on certain global trading and transition management customer orders. G-Trade Services LLC ("G-Trade") and ConvergEx Execution Solutions LLC ("CES") are broker-dealers that held themselves out to the public as conflict-free agency brokers that charged explicit commissions for equity order execution. In addition to charging explicit commissions, however, G-Trade and CES routinely routed customer orders to their offshore affiliate, ConvergEx Global Markets Limited ("CGM"), which took undisclosed "trading profits" ("TP") from global trading and transition management customers by executing orders on a riskless basis and opportunistically adding a mark-up or mark-down to the price of the security. Respondent was the global head of trading for CGM, a Bermuda broker-dealer. He often consulted with the client-facing brokers to assess whether and how much TP to take, in order to minimize the risk of detection by the customer.

Respondent and other employees feared that they would lose business if customers became aware of the practice of taking TP. As a result, Respondent participated in a scheme to intentionally or recklessly conceal the practice of taking TP from customers. Respondent and others engaged in specific acts to hide CGM's practice of taking TP from customers, including opportunistically taking TP only when they believed that the risk of detection by the customer was low, using technological tools to conceal CGM's identity in otherwise transparent markets, intentionally delaying the implementation of real-time trade reporting and utilizing proprietary software applications to quickly fabricate false execution prices. In addition, with the knowledge and approval of his direct supervisor, Respondent falsified trading data to cover up the fact that CGM had taken TP on trades, knowing that those falsified documents would likely be provided to customers.

By virtue of his conduct, Respondent willfully violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; willfully aided and abetted and caused another person's violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; and willfully aided and abetted and caused CES's and G-Trade's violations of Section 15(c)(1) of the Exchange Act.

[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.

B. Respondent and Other Relevant Entities and Individuals

1. **Jonathan Samuel Daspin** was the global head of trading of ConvergEx Global Markets Limited from 2006 until his discharge in 2011. From 1992 through 2004, Respondent was a registered representative associated with broker-dealers registered with the Commission. Respondent held securities licenses from 1992 until 2004. Respondent is a resident of New Jersey.

2. **ConvergEx Global Markets Limited** was a Bermuda broker-dealer and a wholly-owned subsidiary of ConvergEx Group, LLC ("ConvergEx").[2] CGM is not registered with the Commission in any capacity. The CGM trading model at issue in these proceedings predated the formation of ConvergEx in October 2006.

3. **G-Trade Services LLC** is a registered broker-dealer and a wholly-owned subsidiary of ConvergEx. G-Trade is headquartered in New York. G-Trade is currently and was at all times relevant to these proceedings registered as a broker-dealer with the Commission. ConvergEx Global Markets Division (the "CGM Division") was an unincorporated business division of G-Trade and other offshore affiliates of ConvergEx, which offered global trading services from 2006 until 2011.

4. **ConvergEx Execution Solutions LLC** is a registered broker-dealer and a wholly-owned subsidiary of ConvergEx. CES is headquartered in New York. CES is currently and was at all times relevant to these proceedings registered with the Commission as a broker-dealer and as an investment adviser and was a member of the New York Stock Exchange. Global Transition Management ("GTM") is an unincorporated business division of CES and other offshore affiliates of ConvergEx, which offers transition management services.

C. Facts

5. From 2006 through 2011, the CGM Division offered customers global trading services, and GTM provided global transition management services. The CGM Division's global trading services involved handling large non-electronic orders for either a single stock or a basket of stocks in markets around the world, including the United States. GTM's global transition management services generally involved handling large orders to buy and sell stocks for customers who were changing fund managers or investment strategies. Customers seek out transition management services in order to minimize risks to their portfolios and preserve the value of their stocks while in transition.

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[2] ConvergEx, formerly known as BNY ConvergEx Group, LLC, is a global investment services and technology firm that was established in October 2006 through the combination of an institutional trade execution business and an investment technology company. ConvergEx is headquartered in New York and is not registered with the Commission in any capacity.

6. GTM and the CGM Division of G-Trade acted as agents on behalf of customers and charged a disclosed commission. In this capacity, sales traders received customer orders and entered them into CGM's order management system, which allowed them to automatically route the orders to CGM in Bermuda.[3]

7. The CGM Division of G-Trade, GTM and CGM were not market makers, and they generally did not commit their own capital to facilitate customer executions or offer customers guaranteed prices. Thus, they assumed little, if any, market risk when they executed customer orders.

8. From 2006 until his discharge in 2011, Respondent was employed as CGM's global head of trading. When Respondent and other CGM traders received orders originating from GTM or the CGM Division of G-Trade, they acted in a riskless principal capacity and bought or sold the securities for CGM's own account through a local broker in the relevant market.[4]

9. At the direction and with the approval of senior management, if Respondent and the other CGM traders believed that they could add a mark-up or mark-down without detection by a customer, they added one to the price that CGM had received from the local broker and kept the difference for CGM as trading profits or "TP." CGM then delivered the execution back to the CGM Division of G-Trade (which, in the case of an order for a transition management customer, would send the execution on to GTM). The trade would then be confirmed to the customer at a price that included TP. As a result, when Respondent took TP on a customer's trade, the price reported to the customer was worse than the price that CGM had received from the local broker.

10. Respondent or other CGM traders often took TP on orders to buy or sell stocks listed on U.S. exchanges. Most of these orders were received in the New York office of GTM or the CGM Division, and instead of routing those orders to CES, which was ConvergEx's U.S. trading arm and a member of U.S. exchanges, GTM or the CGM Division of G-Trade unnecessarily routed those orders to CGM in Bermuda in order to take TP. Respondent or other CGM traders in Bermuda would then in turn execute the orders with third-party U.S. broker-dealers and add TP to the price received before delivering the execution back to GTM or the CGM Division of G-Trade.

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[3] For orders executed in Asian markets, GTM and the CGM Division routed customer orders to an affiliated broker in Hong Kong wholly owned by ConvergEx, which functioned in a similar capacity to CGM in Bermuda.

[4] In general, a "riskless principal" trade occurs when a broker-dealer, after receiving a customer order to buy (or sell) a security, buys (or sells) the security for its own account from (or to) another person in a contemporaneous offsetting transaction and then allocates the shares to the customer order.

11. Each customer's trade confirmation disclosed the commission charged by CES or G-Trade, but did not state that CGM also had taken a mark-up or mark-down on the price at which the local broker filled the order.

Marketing Materials and Disclosures

12. From 2006 to 2011, GTM and the CGM Division marketed themselves as "conflict free" agency-only brokers offering global execution services.

13. GTM and the CGM Division used several versions of customer disclosures during the relevant period, and the relevant disclosures expanded over time. These disclosures generally stated, "Client authorizes ConvergEx, in its sole discretion and without notice, to use the services of one or more other persons or entities (including its affiliates) in connection with the execution, clearance and/or settlement of any Order and/or Transaction, or otherwise to service Client or perform its obligations, and that such persons or entities may act as principal and earn a spread[.]"

14. These disclosures did not state the regularity with which GTM and the CGM Division of G-Trade routed orders to CGM and took TP. These disclosures also did not state that GTM and the CGM Division routed orders for securities listed on U.S. exchanges to their affiliate in Bermuda, which took a mark-up or mark-down, instead of CES, their "U.S. trading arm" and a member of U.S. exchanges. Furthermore, the disclosures did not inform customers of the amount of TP that CGM took on trades or indicate to customers that, in many instances, they were paying several times more than the agreed-upon commission amount.

Concealing TP from Customers

15. Respondent and his superiors understood that customers likely were unaware of CGM's practice of taking TP, and they feared customers would withdraw their business if they learned of the practice. As a result, from at least 2006 until his discharge in 2011, as described herein, Respondent participated in a fraudulent scheme by taking steps to intentionally or recklessly conceal TP from customers.

TP Taken Opportunistically

16. With the knowledge and approval of CGM senior management, Respondent concealed the practice of taking TP by doing so on an opportunistic basis. In other words, Respondent's decision whether to take TP and the amount of TP to take depended largely on whether Respondent thought that CGM could take TP and how much TP it could take without the customer detecting it. Respondent also instructed other CGM traders to take TP in an opportunistic manner. For example, on one occasion, Respondent sent an instant message to a CGM trader in Hong Kong, directing, "You must take TP, take as much as you can get away with."

17. Respondent was often able to take TP without detection because the customers whose orders he traded were often asleep during market trading hours due to time zone

differences. Conversely, Respondent did not take TP from customers who actively monitored executions throughout the day through the receipt of real-time trade information.

18. To further avoid potentially revealing the practice of taking TP, Respondent instructed sales traders that they needed to give Respondent notice prior to trading if the sales traders' customers were going to ask for time and sales reports. If prior to trading, the sales traders advised that a customer might request time and sales reports, Respondent would refrain from taking TP on those trades.

19. Respondent also suspended the practice of taking TP at times when he knew customers were scrutinizing their executions, in order to impress those customers and secure future business. In one instance, at the direction of his supervisor, Respondent suspended the practice of taking TP when a customer requested time and sales reports to analyze execution prices and then resumed taking TP after his supervisor was told that the customer was no longer conducting the analysis.

20. Respondent also determined the amount of TP that he could take from customers based on his perception of the likelihood that the customer would detect the charge. In certain instances when Respondent perceived the risk of detection to be low, he took TP in an amount that caused some customers to buy at a price equal to the market high of the day and sell at a price equal to the market low of the day, where better prices could have been provided. Senior management of CGM was aware of these practices, and when consulted, directed and approved of setting customer prices in this manner.

21. At the encouragement of certain members of senior management, Respondent consulted with sales traders at GTM and the CGM Division regarding the sales traders' assessment of the "sensitivity" of their customers to determine whether a particular customer was paying close attention to execution prices. The end result of this practice was that certain customers received worse execution prices than they would have received if they had been more "sensitive."

Preventing Customers from Monitoring Their Executions in Real Time

22. It became more difficult for Respondent to take TP without detection when advances in technology prompted an increased number of customers to request intraday execution price information on their trades in "real time." Respondent and senior management of CGM understood that CGM would not be able to take TP if the customers received a live data feed that revealed the prices that CGM itself had received in the local markets for the customers' trades.

23. As a result, Respondent, his supervisor and CGM Division sales traders discussed possible steps they could take to delay implementing real-time trade reporting for one highly profitable customer. After the customer requested real-time reporting, and even though CGM had the ability to deliver this service to the customer at the time, Respondent and employees in the CGM Division took steps to delay providing real-time trade reporting to that customer for approximately one year in order for CGM to be able to continue to take TP on that customer's

trades. Beyond that, even after the customer began receiving real-time trading data, Respondent and other CGM traders, with the knowledge and approval of CGM senior management, disabled the real-time service from time-to-time, enabling CGM to continue taking TP on at least some of that customer's trades.

Falsified Time and Sales Reports

24. Certain customers requested time and sales reports for trades on which CGM had taken TP. Because CGM had added a mark-up or mark-down to the price received from the local broker in order to take TP, the average of the prices reflected on the actual time and sales reports did not match the price that had already been reported to the customer on the trade confirmation. Due to these discrepancies and the risk that the inquiring customers would discover TP had been taken on their trades, Respondent, with the approval of the CEO of CGM, created false trade execution data and provided that false data to client-facing sales traders to provide to customers, rather than having the sales traders acknowledge to the customer that mark-ups or mark-downs had been taken.

25. In some instances, Respondent and senior management of CGM directed sales traders to tell customers that the time and sales reports no longer existed. In other instances, Respondent altered the time and sales data reflecting CGM's actual execution prices, so that the prices and volumes on the altered time and sales reports would average to the price, inclusive of TP, that had appeared on the customers' confirmation. Respondent also taught some of the other CGM traders to create these false time and sales reports. Once a false report was prepared, Respondent would provide it to sales traders in a format that would make it difficult for the customer to analyze. Senior management of CGM was aware that these false reports were provided to customers who asked for prints for their trades.

26. On one occasion, a customer requested a time and sales report for orders of a U.S. equity on which CGM had taken TP. Respondent altered the actual time and sales data so that the prices reflected on the report he provided to the sales trader servicing the customer would average to the price, inclusive of TP, that had previously been provided to the customer. Respondent then sent the falsified time and sales report to the client-facing sales trader and the CEO of CGM, knowing that the sales trader would likely forward the falsified report to the customer. Respondent sent the report as an image file so that the customer would not be able to easily analyze the data.

Technological Tools

27. Respondent employed technological tools to conceal CGM's practice of taking TP from customers. On at least one occasion when Respondent believed that there might be market transparency on trades that were part of a transition, with the approval of certain members of senior management, he used an anonymous broker code and an algorithmic tool provided by G-Trade to reduce that transparency in order to take TP without detection by the customer. Using G-Trade's algorithmic tool enabled Respondent to hide CGM's identity in the market so that the customer would not be able to identify the entities with whom CGM traded or the prices it received. Although this algorithmic tool could be used for legitimate purposes, such as promoting

market anonymity in order to minimize market impact of trades, Respondent used this anonymity on this occasion to take TP without risking detection by the customer.

28. In addition, Respondent provided guidance on the development and implementation of software known as "AutoTP" that allowed him and other CGM traders to quickly compare actual execution prices to market highs, lows and various benchmarks. This tool helped Respondent and other traders maximize TP and arrive at a customer price that minimized the likelihood of detection by the customer. Respondent on at least one occasion also used this software to create plausible execution prices for an altered time and sales report.

Advice of Counsel

29. Respondent was advised by ConvergEx's in-house legal counsel that the general practice of taking TP had been approved by outside legal counsel and that the disclosure language was adequate. Legal counsel, however, was never advised and was unaware of the full extent of CGM's and Respondent's practices regarding the taking of TP. For example, Respondent and other CGM traders made false statements to customers in order to conceal CGM's practice of taking TP and took numerous other steps to intentionally or recklessly conceal TP from customers. Thus, Respondent did not receive legal advice that his participation in a scheme to conceal from customers CGM's practice of taking TP was permissible.

D. <u>Violations</u>

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

31. As a result of the conduct described above, Respondent willfully aided and abetted and caused another person's violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

32. As a result of the conduct described above, Respondent willfully aided and abetted and caused G-Trade's and CES's violations of Section 15(c)(1) of the Exchange Act, which prohibits fraudulent conduct by a broker-dealer in effecting, inducing or attempting to induce any securities transaction.

E. <u>Respondent's Cooperation</u>

In determining to accept the Offer, the Commission considered the cooperation Respondent afforded the Commission staff.

IV.

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

Accordingly, pursuant to 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 cease and desist from committing or causing any violations and any future violations of Sections 10(b) and 15(c) of the Exchange Act and Rule 10b-5 thereunder.

B. Respondent 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.

C. Any reapplication for association by 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 Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

D. Respondent shall pay disgorgement of $1,000,000 and prejudgment interest of $111,550 to the Securities and Exchange Commission. Respondent shall pay $150,000 within 30 days of the entry of this Order and pay the remainder within 365 days of the entry of this Order. 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;[5]
(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

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[5] The minimum threshold for transmission of payment electronically is $1,000,000.00 as of December 31, 2012. For amounts below the threshold, respondents must make payments pursuant to option (2) or (3) above.

(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 Jonathan Samuel Daspin as the 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 Stephen L. Cohen, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549-5553.

E. Such disgorgement and prejudgment interest may be combined with the funds paid in In the Matter of G-Trade Services LLC, ConvergEx Global Markets Limited and ConvergEx Execution Solutions LLC, to be filed contemporaneously with these proceedings, for distribution to harmed customers.

F. Respondent acknowledges that the Commission is not imposing a civil penalty based upon his entry into a Cooperation Agreement with the Commission in which he agrees to cooperate fully and truthfully in these proceedings and any other related enforcement litigation or proceeding to which the Commission is a party. If at any time following the entry of the Order, the Division of Enforcement ("Division") obtains information indicating that Respondent has failed to comply with the obligations set forth in the Cooperation Agreement to cooperate fully and truthfully in these proceedings or any other related enforcement litigation or proceeding to which the Commission is a party, the Division may, at its sole discretion and with 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 contest by way of defense in any resulting administrative proceeding whether he failed to comply with his obligations to cooperate fully and truthfully, but may not: (1) contest the findings in the Order; or (2) assert any defense to liability or remedy, including, but not limited to, any statute of limitations defense.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 71127 / December 18, 2013

INVESTMENT COMPANY ACT OF 1940
Release No. 30839 / December 18, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15653

In the Matter of **Thomas Lekargeren,** **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 Thomas Lekargeren ("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. Respondent admits to the facts set forth in Sections III.B. and C. below, acknowledges that his conduct violated the federal securities laws, admits the Commission's jurisdiction over him and the subject matter of these proceedings and 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:

A. Summary

These proceedings arise out of Respondent's participation in a fraudulent scheme to conceal his employer's practice of charging undisclosed mark-ups and mark-downs in addition to disclosed commissions on certain global trading and transition management customer orders. G-Trade Services LLC ("G-Trade") and ConvergEx Execution Solutions LLC ("CES") are broker-dealers that held themselves out to the public as conflict-free agency brokers that charged explicit commissions for equity order execution. In addition to charging explicit commissions, however, G-Trade and CES routinely routed customer orders to their offshore affiliate, ConvergEx Global Markets Limited ("CGM"), which took undisclosed "trading profits" ("TP") from global trading and transition management customers by executing orders on a riskless basis and opportunistically adding a mark-up or mark-down to the price of the security. At all times relevant to these proceedings, Respondent was a sales trader for the CGM Division of G-Trade.

Respondent and other employees feared that they would lose business if customers became aware of the practice of taking TP. As a result, Respondent participated in a scheme to intentionally or recklessly conceal the practice of taking TP from customers. In furtherance of this scheme, Respondent engaged in specific acts to hide CGM's practice of taking TP from one of G-Trade's most profitable customers, which in turn helped to conceal the practice of taking TP more generally. These acts included making misleading statements to the customer regarding the delay in providing the customer with implementation of real-time trade reporting, reporting trades to the customer in a manner that concealed TP and providing falsified documents related to the customer's executed orders.

By virtue of his conduct, Respondent willfully violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; willfully aided and abetted and caused G-Trade's violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; and willfully aided and abetted and caused G-Trade's violations of Section 15(c)(1) of the Exchange Act.

B. Respondent and Other Relevant Entities

1. **Thomas Lekargeren**, at all times relevant to these proceedings, was a sales trader for the CGM Division of G-Trade. In this capacity, Respondent was a registered representative with G-Trade from 2007 until 2010, and with ConvergEx Execution Solutions from

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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.

2010 until he was discharged in 2011. Respondent has held securities licenses since 1997. Respondent, 43 years old, is a resident of New York.

2. **ConvergEx Global Markets Limited** was a Bermuda broker-dealer and a wholly-owned subsidiary of ConvergEx Group, LLC ("ConvergEx").[2] CGM is not registered with the Commission in any capacity.

3. **G-Trade Services LLC** is a registered broker-dealer and a wholly-owned subsidiary of ConvergEx. G-Trade is headquartered in New York. G-Trade is currently and was at all times relevant to these proceedings registered as a broker-dealer with the Commission. ConvergEx Global Markets Division (the "CGM Division") was an unincorporated business division of G-Trade and other offshore affiliates of ConvergEx, which offered global trading services from 2006 until 2011.

4. **ConvergEx Execution Solutions LLC** is a registered broker-dealer and a wholly-owned subsidiary of ConvergEx. CES is headquartered in New York. CES is currently and was at all times relevant to these proceedings registered with the Commission as a broker-dealer and as an investment adviser and was a member of the New York Stock Exchange. Global Transition Management ("GTM") is an unincorporated business division of CES and other offshore affiliates of ConvergEx, which offers transition management services.

C. Facts

5. From 2006 through 2011, the CGM Division offered customers global trading services, and GTM provided global transition management services. The CGM Division's global trading services involved handling large non-electronic orders for either a single stock or a basket of stocks in markets around the world, including the United States. GTM's global transition management services generally involved handling large orders to buy and sell stocks for customers who were changing fund managers or investment strategies. Customers seek out transition management services in order to minimize risks to their portfolios and preserve the value of their stocks while in transition.

6. From 2008 until his discharge in 2011, Respondent was a sales trader for G-Trade's global trading business line, the CGM Division. In this capacity, Respondent's primary responsibility was to serve as the sales trader and point of contact with respect to order execution for one of the CGM Division's most lucrative customers.

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[2] ConvergEx, formerly known as BNY ConvergEx Group, LLC, is a global investment services and technology firm that was established in October 2006 through the combination of an institutional trade execution business and an investment technology company. ConvergEx is headquartered in New York and is not registered with the Commission in any capacity.

7. GTM and the CGM Division of G-Trade acted as agents on behalf of customers and charged a disclosed commission. In this capacity, sales traders received customer orders and released them to CGM in Bermuda.

8. The CGM Division of G-Trade, GTM and CGM were not market makers, and they generally did not commit their own capital to facilitate customer executions or offer customers guaranteed prices. Thus, they assumed little, if any, market risk when they executed customer orders.

9. If CGM traders believed that they could add a mark-up or mark-down without detection by a customer, they added one to the price that CGM had received from the local broker and kept the difference for CGM as trading profits or "TP." CGM then delivered the execution back to the CGM Division of G-Trade (which, in the case of an order for a transition management customer, would send the execution on to GTM). The trade would then be confirmed to the customer at a price that included TP. As a result, when TP was taken, the price reported to the customer was worse than the price that CGM had received from the local broker.

10. Each customer's trade confirmation disclosed the commission charged by CES or G-Trade, but did not state that CGM also had taken a mark-up or mark-down on the price at which the local broker filled the order.

Concealing TP

11. Respondent and his superiors understood that customers likely were unaware of CGM's practice of taking TP, and they feared customers would withdraw their business if they learned of the practice.

12. As a result, from at least 2009 until his discharge in 2011, Respondent participated in a fraudulent scheme by taking steps to intentionally or recklessly conceal TP from customers.

False Statements and Steps to Prevent a Highly Lucrative Customer from Monitoring its Executions

13. Over time, it became more difficult for CGM to take TP when advances in technology prompted an increased number of customers to request intraday execution price information on their trades in "real time." Respondent and senior management of CGM understood that CGM would not be able to take TP if the customers received a live data feed that revealed the prices that CGM itself had received in the local markets for the customers' trades.

14. As a result, when a highly lucrative customer in the global trading business line requested real-time reporting of its trades, Respondent made misleading statements to the customer with respect to the availability of that service to delay implementing that service for the customer for approximately one year so that CGM could continue to take TP.

15. Furthermore, even after the customer started receiving real-time data, traders at CGM and the CGM Division of G-Trade, in consultation with Respondent, intentionally disabled the service from time to time in order to enable CGM to continue taking TP on at least some of that customer's trades. In those instances, Respondent communicated to executing traders that they could report trades to the customer in batches, instead of in real time, thereby permitting the taking of TP without the customer detecting the charge. Conversely, Respondent instructed traders to process trades in real-time when the customer's trade did not present an opportunity to take TP.

16. On some occasions, Respondent falsely told the customer that it was not receiving real-time reporting of its trade executions because the traders were accessing dark pools to execute the customer's orders. On other occasions, Respondent falsely told the customer that it was not receiving real-time reporting of its trade executions because the company was experiencing technological difficulties with respect to its real-time reporting capabilities.

Falsified Time and Sales Reports

17. On another occasion, the same highly lucrative customer that requested real-time trade reporting also requested a time and sales report for orders of a U.S. equity on which CGM had taken TP. Because CGM had added a mark-up to the price received from the local broker in order to take TP, the average of the prices reflected on the actual time and sales report did not match the price that had already been reported to the customer on the trade confirmation.

18. In order to conceal TP from the customer, a trader at CGM altered the actual time and sales data, so that the prices reflected on the report given to the customer would average to the price, inclusive of TP, that had previously been provided to the customer. Respondent, believing that the data had been altered, then transmitted the false data to the customer.

D. <u>Violations</u>

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

20. As a result of the conduct described above, Respondent willfully aided and abetted and caused G-Trade's violations of Section 10(b) of the Exchange Act and Rule 10b-5.

21. As a result of the conduct described above, Respondent willfully aided and abetted and caused G-Trade's violations of Section 15(c)(1) of the Exchange Act, which prohibits fraudulent conduct by a broker-dealer in effecting, inducing or attempting to induce any securities transaction.

E. **Respondent's Cooperation**

In determining to accept the Offer, the Commission considered the cooperation Respondent afforded the Commission staff.

IV.

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

Accordingly, pursuant to 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 cease and desist from committing or causing any violations and any future violations of Sections 10(b) and 15(c) of the Exchange Act and Rule 10b-5 thereunder.

B. Respondent 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.

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 $110,089 and prejudgment interest of $6,953 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 make direct payment from a bank account via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm; or
(2) 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 Thomas Lekargeren as the 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 Stephen L. Cohen, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549-5553.

E. Such disgorgement and prejudgment interest may be combined with the funds paid in In the Matter of G-Trade Services LLC, ConvergEx Global Markets Limited and ConvergEx Execution Solutions LLC, to be filed contemporaneously with these proceedings, for distribution to harmed customers.

F. Respondent acknowledges that the Commission is not imposing a civil penalty based upon his entry into a Cooperation Agreement with the Commission in which he agrees to cooperate fully and truthfully in these proceedings and any other related enforcement litigation or proceeding to which the Commission is a party. If at any time following the entry of the Order, the Division of Enforcement ("Division") obtains information indicating that Respondent has failed to comply with the obligations set forth in the Cooperation Agreement to cooperate fully and truthfully in these proceedings or any other related enforcement litigation or proceeding to which the Commission is a party, the Division may, at its sole discretion and with 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 contest by way of defense in any resulting administrative proceeding whether he failed to comply with his obligations to cooperate fully and truthfully, but may not: (1) contest the findings in the Order; or (2) assert any defense to liability or remedy, including, but not limited to, any statute of limitations defense.

By the Commission.

Elizabeth M. Murphy
Secretary

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

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 71128 / December 18, 2013

INVESTMENT ADVISERS ACT OF 1940
Release No. 3744 / December 18, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15654

In the Matter of **G-Trade Services LLC,** **ConvergEx Global Markets Limited,** **and** **ConvergEx Execution Solutions LLC,** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTIONS 15(b) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTION 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 Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") and Section 203(e) of the Investment Advisers Act of 1940 ("Advisers Act") against G-Trade Services LLC ("G-Trade"), ConvergEx Global Markets Limited ("CGM"), and ConvergEx Execution Solutions LLC ("CES") (collectively, "Respondents").

II.

In anticipation of the institution of these proceedings, Respondents have submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Respondents admit the facts set forth in Sections III.B. and C. below, acknowledge that their conduct violated the federal securities laws, admit the Commission's jurisdiction over them and the subject matter of these proceedings and consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 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 Respondents' Offers, the Commission finds[1] that:

A. Summary

These proceedings arise out of a fraudulent scheme to conceal Respondents' practice of unnecessarily routing certain global trading and transition management customer orders to an offshore affiliate in order to charge undisclosed mark-ups and mark-downs in addition to disclosed commissions on those orders. Respondents held themselves out to the public as a unified conflict-free agency broker that charged explicit commissions for equity order execution. In addition to explicit commissions, however, Respondents routinely took undisclosed "trading profits" ("TP") from global trading and transition management customers by routing customer orders to an offshore affiliate, which executed orders on a riskless basis and opportunistically added a mark-up or mark-down to the price of the security. Often the offshore affiliate consulted with the client-facing brokers to assess whether and how much TP to take, in order to minimize the risk of detection by the customer. TP often greatly exceeded the disclosed commissions, which resulted in many customers paying more than double the amount that they thought they were paying to execute orders. The practice of executing orders through the offshore affiliate and taking TP was not adequately disclosed to customers and was inconsistent with Respondents' purported conflict-free agency model. In addition, through this practice, Respondents failed to seek to obtain best execution.

Respondents believed that they would lose business if customers became aware of this practice. As a result, Respondents orchestrated a scheme to intentionally or recklessly conceal TP from customers. The foundation of the scheme was Respondents' multiple-broker corporate structure that included the offshore affiliate, which was necessary to add an additional layer of execution charges while maintaining the appearance of technical compliance with regulatory requirements. Respondents also engaged in specific acts to hide TP from customers, including opportunistically taking TP only when they believed that the risk of detection by the customer was low, using technological tools to conceal their identity in otherwise transparent markets, intentionally delaying the implementation of real-time trade reporting and utilizing proprietary software applications to quickly fabricate false execution prices. In addition, Respondents made false and misleading statements to customers who inquired about Respondents' overall compensation, including providing certain customers with falsified trading data to cover up the fact that the offshore affiliate had taken TP on their orders.

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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.

Customers with large orders, including those arising out of the global trading and transition management services at issue here, typically rely on their brokers to execute orders on their behalf at the most favorable terms reasonably available under the circumstances. Monitoring the execution of these orders and assessing the quality of a broker's services can be difficult for even the most sophisticated customers – particularly given the complex nature of today's markets, where brokers often need to choose from a variety of order types, routing strategies, and trading venues to execute large orders. Customers rely on the honesty and expertise of their brokers and are ill-positioned to decipher disclosures that may be technically accurate but are materially misleading.[2] Often, as in this case, customers ask their brokers for general information on how their orders are handled, as well as request specific data to enable more detailed tracking of execution quality. In such cases, brokers must provide accurate information, without material misstatements or omissions, including by responding to customer inquiries in a transparent and complete manner, in order for customers to be able to assess the quality and overall costs of the broker's services.

By virtue of their conduct, Respondents willfully violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and G-Trade and CES willfully violated Section 15(c)(1) of the Exchange Act.

After commencement of the Commission's investigation, Respondents provided substantial cooperation to the Commission staff and undertook significant remedial measures. For example, the Audit and Risk Committee of Respondents' ultimate parent company retained separate counsel, who conducted an internal investigation and, together with company counsel, promptly reported to the staff the factual information developed in counsel's witness interviews and document review. Counsel consistently responded to staff requests in a timely fashion and in a useful format, and on several occasions identified significant evidence for the staff, which accelerated the progress of the investigation. Respondents also closed down the offshore affiliate, discharged a number of employees, including employees in management positions, and ceased the routing of U.S. securities offshore for order handling. Moreover, in 2012, Respondents augmented disclosures related to global trading and transition management, enhanced relevant policies, procedures and compliance programs and hired a new general counsel.

B. <u>Respondents</u>

1. **G-Trade Services LLC** is a registered broker-dealer and a wholly-owned subsidiary of ConvergEx Group, LLC ("ConvergEx").[3] G-Trade is headquartered in New York

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[2] *See SEC v. Gabelli*, 653 F.3d 49, 57 (2d Cir. 2011), *rev'd on other grounds*, — U.S. —, 133 S.Ct. 1216, 185 L.Ed.2d 297 (2013) ("The law is well settled . . . that so-called 'half-truths'—literally true statements that create a materially misleading impression—will support claims for securities fraud").

[3] ConvergEx, formerly known as BNY ConvergEx Group, LLC, is a global investment services and technology firm that was established in October 2006 through the combination of an

and has been registered as a broker-dealer with the Commission since October 2006. ConvergEx Global Markets Division (the "CGM Division") was an unincorporated business division of G-Trade and other offshore affiliates of ConvergEx, which offered global trading services from 2006 until 2011.

2. **ConvergEx Global Markets Limited** was a Bermuda broker-dealer and is a wholly-owned subsidiary of ConvergEx. CGM is not registered with the Commission in any capacity. CGM ceased all trading activities in early 2012 and voluntarily relinquished its securities license with the Bermuda Monetary Authority in 2012. The CGM trading model at issue in these proceedings predated the formation of ConvergEx in October 2006.

3. **ConvergEx Execution Solutions LLC** is a registered broker-dealer and a wholly-owned subsidiary of ConvergEx. CES is headquartered in New York. CES has been registered with the Commission as a broker-dealer since January 1994, and as an investment adviser since September 2006. CES has been a member of the New York Stock Exchange since January 1994. Global Transition Management ("GTM") is an unincorporated business division of CES and other offshore affiliates of ConvergEx, which offers transition management services.

C. Facts

Order Routing Practices and Customer Charges

4. From 2006 through 2011, Respondents executed equity orders for institutional customers, including funds managed on behalf of charities, religious organizations, retirement plans, universities and governments.

5. The CGM Division offered customers global trading services, and GTM provided global transition management services.[4] The CGM Division's global trading services involved handling large non-electronic orders for either a single stock or a basket of stocks in markets around the world, including the United States. GTM's global transition management services involved handling large orders to buy and sell stocks for customers who were changing fund managers or investment strategies. Customers seek out transition management services in order to minimize risks to their portfolios and preserve the value of their stocks while in transition.

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institutional trade execution business and an investment technology company. ConvergEx is headquartered in New York and is not registered with the Commission in any capacity.

[4] The conduct that is the subject of this Order involves certain segments of the businesses operated by CES and G-Trade from 2006 through 2011. These proceedings do not involve the following businesses of CES, G-Trade or their affiliates: U.S. Program and Sales Trading, Options Services, Prime Services, ATSs, Commission Management and Recapture Services, Clearing, or Technology. These proceedings also do not involve orders executed through ConvergEx's electronic Direct Market Access ("DMA") platform.

6. Respondents are not market makers, and they generally do not commit their own capital to facilitate customer executions or offer customers guaranteed prices. Thus, Respondents assume little, if any, market risk when they execute customer orders.

7. GTM and the CGM Division of G-Trade acted as agent on behalf of customers and charged a disclosed commission. In this capacity, sales traders received customer orders and entered them into CGM's order management system, which allowed them to automatically route the orders to CGM in Bermuda. With a customer order in hand, CGM acted in a riskless principal capacity and bought or sold the security for CGM's own account through a local broker in the relevant market.[5] If CGM employees believed that they could add a mark-up or mark-down without detection by a non-fiduciary customer, they added one to the price received from the local broker and kept the difference for Respondents as trading profits or "TP."[6] CGM then delivered the execution back to GTM or the CGM Division of G-Trade, which confirmed the trade to the customer at a price that included TP. As a result, when CGM took TP on a customer's trade, the price reported to the customer by GTM or the CGM Division was worse than the price that CGM had received from the local broker.

8. CGM often took TP on orders to buy or sell stocks listed on U.S. exchanges. Most of these orders were received in the New York office of GTM or the CGM Division, and instead of routing those orders to CES, which was ConvergEx's U.S. trading arm and a member of U.S. exchanges, Respondents unnecessarily routed those orders to CGM in Bermuda in order to take TP. CGM traders in Bermuda would then in turn execute the orders with third-party U.S. broker-dealers and add TP to the price received before delivering the execution back to GTM or the CGM Division of G-Trade.

9. Each customer's trade confirmation disclosed the commission charged by CES or G-Trade, but did not state that CGM also had taken a mark-up or mark-down on the price at which the local broker filled the order.

10. The amount of TP taken on trades often was more than the disclosed commission. It was not uncommon for the amount of TP to be several times the amount of the commission that the customer had paid CES or G-Trade. For example, GTM conducted a transition for a university, which paid GTM approximately $93,000 in disclosed commissions, but also paid approximately $543,000 in TP. Similarly, GTM conducted a transition on behalf of a

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[5] In general, a "riskless principal" trade occurs when a broker-dealer, after receiving a customer order to buy (or sell) a security, buys (or sells) the security for its own account from (or to) another person in a contemporaneous offsetting transaction and then allocates the shares to the customer order.

[6] Some customers asked Respondents to handle their trades on a fiduciary basis. When customers requested fiduciary treatment, Respondents did not take TP on those customers' trades and typically charged those customers higher disclosed commission rates.

charitable organization, which paid approximately $33,000 in disclosed commissions, but also paid approximately $283,000 in TP. In both cases, the transitions involved trades only in securities listed on U.S. exchanges, yet GTM unnecessarily routed the customers' orders offshore to CGM in order to take TP.

11. TP was an important revenue source for Respondents, and the profitability of CGM and GTM in large part depended on it.

Concealing TP from Customers

12. Many employees of Respondents, including certain members of their senior management, understood that customers likely were unaware of CGM's practice of taking TP and would fire them if they learned of the practice. As a result, from 2006 through 2011, as described herein, Respondents engaged in a fraudulent scheme by taking steps to intentionally or recklessly conceal from customers the practice of taking TP.

Marketing Materials and Disclosures

13. From 2006 to 2011, Respondents marketed themselves as a "conflict free" agency-only broker offering global execution services.

14. Some of Respondents' marketing materials described Respondents' global trading services under the "BNY ConvergEx Group" brand as a "conflict-free" solution with access to global markets "all through one organization." With respect to these services, Respondents stated that "[o]ur interests are aligned with yours." Likewise, Respondents stated, "[o]ur primary interest is putting your interests first."

15. GTM at times marketed its transition management services by stating, "with our agency-only platform, our interests are always fully aligned with yours." GTM also at times promoted its transition management services as the customer's "conflict-free advocate." GTM at times further advertised that it eliminated "unnecessary transactions" and promised "full transparency." For these services, GTM at times represented to customers that the commission schedule included "all of our charges."

16. In light of the practice of taking TP described herein, these statements were untrue with respect to Respondents' order handling practices for non-fiduciary orders.

17. Respondents used several versions of customer disclosures during the relevant period, and the relevant disclosures expanded over time. These disclosures generally stated, "Client authorizes ConvergEx, in its sole discretion and without notice, to use the services of one or more other persons or entities (including its affiliates) in connection with the execution, clearance and/or settlement of any Order and/or Transaction, or otherwise to service Client or perform its obligations, and that such persons or entities may act as principal and earn a spread[.]"

18. These disclosures did not state the regularity with which GTM and the CGM Division of G-Trade routed orders to CGM and took TP. These disclosures also did not state that GTM and the CGM Division routed orders for securities listed on U.S. exchanges to their affiliate in Bermuda, which took a mark-up or mark-down, instead of CES, their "U.S. trading arm" and a member of U.S. exchanges. Furthermore, Respondents did not disclose the amount of TP that they took on trades or indicate to customers that, in many instances, they were paying several times more than the agreed-upon commission amount.

19. Certain members of CGM's and G-Trade's senior management were aware that these disclosures did not inform customers of their routine practice of taking TP or the magnitude of the TP in comparison to the commission.

Multiple-Broker Structure

20. G-Trade and CES unnecessarily used CGM, which was established prior to the formation of ConvergEx, to execute certain customer orders. This multiple-broker structure was critical to the practice of taking TP. Specifically, GTM and the CGM Division of G-Trade received orders worldwide through sales traders located in New York and elsewhere, but maintained their global traders in a separate broker entity, CGM, which was located in Bermuda.[7]

21. CGM in Bermuda and the CGM Division (which included New York-based global sales traders registered with G-Trade) were operated as one business. For example, CGM's Bermuda operation was managed jointly with the CGM Division of G-Trade in New York, and TP generated in Bermuda was credited or "shadow posted" to CES and G-Trade for various business reasons, including for employee compensation determinations. In addition, CGM's TP and commission revenues were regularly discussed with senior management of ConvergEx.

22. There was no benefit to customers arising from the fact that the services were provided in Bermuda by a separate broker. Rather, CGM's Bermuda operation was used as a means to take TP. Particularly with respect to U.S. equities, GTM and the CGM Division routed certain orders to CGM in order to take TP, knowing that many trades would be more profitable for Respondents at customers' expense. CGM did not provide additional necessary services in handling these orders and routed them back to brokers in the U.S. for execution. Respondents thus improperly interpositioned CGM between the customer and the relevant market and failed to seek to obtain best execution on customer orders.

23. In 2007, certain members of senior management approved GTM's decision to increase the routing of orders for U.S. equities to CGM in Bermuda. CGM could generate more profits by adding TP to the customer's price than CES could generate by charging commissions alone. Significantly, because there were increased settlement costs associated with routing trades

[7] For orders executed in Asian markets, GTM and the CGM Division routed customer orders to an affiliated broker in Hong Kong wholly owned by ConvergEx, which functioned in a similar capacity to CGM in Bermuda.

to Bermuda, certain members of senior management directed that customer orders not be routed to CGM unless there was an opportunity to take TP from customers.

TP Taken Opportunistically

24. Respondents concealed their practice of charging customers both commissions and TP by making decisions regarding TP on an opportunistic basis. In other words, Respondents' decision whether to take TP, and the amount of TP to take, depended largely on whether Respondents thought that CGM could take TP without the customer detecting it. On one occasion, CGM's then head trader directed another trader, "You must take TP, take as much as you can get away with."

25. To this end, the CGM Division and GTM generally assessed the "sensitivity" of their customers to determine whether a particular customer was paying attention to execution quality. The CGM Division of G-Trade and GTM communicated that information to CGM in Bermuda, and CGM did not take TP on trades for "sensitive" customers.

26. Similarly, CGM often took TP when customers were asleep during market trading hours because of time zone differences. On the other hand, CGM did not take TP from customers who actively monitored executions throughout the day through the receipt of real-time trade information.

27. Likewise, CGM, with the knowledge and approval of its senior management, did not take TP on trades if customers, prior to trading, requested a "time and sales" report that would detail the times of execution and prices received on the individual executions underlying a customer's order, and thus expose any TP taken by CGM.

28. The CGM Division also suspended the practice of taking TP at times when it knew customers were scrutinizing their executions, in order to impress those customers and secure future business. In at least one instance, CGM suspended the practice of taking TP when a customer requested time and sales reports to analyze execution prices and then resumed taking TP after they were told that the customer was no longer conducting the analysis.

29. Respondents also determined the amount of TP that they could take from customers based on their perception of the likelihood that the customer would detect the charge. For example, in certain instances when Respondents perceived the risk of detection to be low, CGM took TP in an amount that resulted in customers buying at a price equal to the market high of the day and selling at a price equal to the market low of the day, where better prices could have been provided. Senior management of CGM was aware of these practices, and when consulted, directed and approved of setting customer prices in this manner.

30. The end result of this practice was that certain customers received worse execution prices from Respondents than they would have received if they had been more "sensitive." Certain members of Respondents' senior management encouraged employees to

communicate information regarding customers' perceived "sensitivity" to CGM to maximize the amount of TP taken by CGM.

Preventing Customers from Monitoring Their Executions

31. To conceal TP, Respondents took steps to prevent their customers from monitoring their trade executions. For example, certain customers were told that they needed to give Respondents prior notice in order to receive time and sales reports.

32. Likewise, the practice of taking TP became threatened when advances in market technology prompted an increased number of customers to request intraday execution price information on their trades in "real-time." Respondents understood that they would not be able to take TP if the customers received a live data feed that revealed the prices that CGM itself had received in the local markets for the customers' trades.

33. As a result, CGM took steps to delay implementing real-time trade reporting for one highly profitable customer. After the customer requested real-time reporting, the CGM Division made misleading statements to the customer indicating that it did not have the capability, and it delayed implementing the service for approximately a year in order to take TP. To continue to take TP even after the customer started receiving real-time data, CGM, working in coordination with employees of the CGM Division of G-Trade, disabled the service periodically in order to take TP and falsely told the customer that they were experiencing technological difficulties.

Misrepresentations Regarding Compensation

34. Respondents believed that customers generally did not understand Respondents' business model with respect to TP and would fire them if they learned the truth. As a result, Respondents further concealed their practice of taking TP by making misrepresentations and misleading statements to customers who inquired about how Respondents were compensated for their order execution services.

Compensation on Transitions

35. In response to one customer's inquiry into whether GTM could act in a principal capacity and take a spread, GTM employees first attempted to avoid answering the question, and then provided a misleading response with respect to the circumstances under which orders would be executed on a principal basis. GTM employees also stated falsely that it was "difficult, if not impossible" to determine the amount of the mark-ups or mark-downs under such circumstances.

36. At times, GTM also provided untrue responses to requests for pre-transition proposals for some customers. For example, one customer's request for proposal for transition management services asked GTM directly: "Describe your revenue source. How transparent is your revenue?" A GTM employee responded: "All of our revenue sources are commission based,

and are fully disclosed. Other than explicit commissions, we do not charge any additional fees." While this response was technically accurate from the narrow perspective of GTM, the response omitted the fact that the customer would pay TP in addition to the explicit commissions charged by GTM, and was thus misleading.

37. In response to another customer's inquiry regarding the spread disclosure language in the transition management agreement, a GTM employee falsely stated that principal trading is "rarely used in our transition business" and "we can assure you that no principal trading has been carried out in any transition for [the customer.]" The GTM employee further stated that "[s]hould it ever be necessary, prudent or strategically important" to engage in principal trading for the customer, GTM "would always discuss and seek your approval." This statement was approved expressly by a senior manager of GTM, who knew that the statement was untrue.

Falsified Time and Sales Reports

38. Certain customers requested time and sales reports for trades on which CGM had taken TP. Because CGM had added a mark-up or mark-down to the price received from the local broker in order to take TP, the average of the prices reflected on the time and sales reports would not match the price previously reported to the customer on the trade confirmation. Due to these discrepancies and the risk of the inquiring customers finding out about TP, certain employees of CGM and G-Trade's CGM Division lied to customers rather than acknowledge the undisclosed mark-ups and mark-downs.

39. In some instances, customers were falsely told that the time and sales reports no longer existed. On at least six occasions involving at least four different customers, CGM employees altered the time and sales data reflecting CGM's actual execution prices, so that the prices given to the customers would average to the price, inclusive of TP, previously reported on the customers' confirmations. Once these reports were prepared, CGM or CGM Division employees transmitted the data to customers in a format that made it difficult for the customer to analyze. Senior management of CGM was aware that these false reports were provided to customers who asked for prints for their trades.

Technological Tools

40. Respondents employed technological tools to conceal their practice of taking TP from their customers.

41. On at least one occasion, when the now former head trader for CGM believed that there might be market transparency on trades that were part of a transition, with the approval of certain members of senior management, he used algorithmic tools and anonymous broker codes to hide CGM's identity in the market so that the customer could not identify with whom CGM traded or the prices it received. Although this algorithmic tool could be used for legitimate purposes, such as promoting market anonymity in order to minimize market impact of trades, the former CGM head trader used this anonymity on this occasion to add a mark-up or

mark-down on the prices that CGM had received on the customer's trades in order to take TP without the customer knowing it.

42. In addition, Respondents developed and implemented software known as "AutoTP" that allowed traders to quickly compare actual execution prices to market highs, lows and various benchmarks. This tool helped traders to maximize TP and arrive at a customer price that minimized the likelihood of detection by the customers.

Inadequacy of Procedures

43. Throughout the relevant period, Respondents lacked adequate policies and procedures related to monitoring execution quality for orders routed to CGM. Indeed, until November 2008, Respondents had no formal policies and procedures in place to evaluate CGM's execution quality. Even after Respondents adopted such policies, Respondents failed to effectively implement and review compliance with those policies. Respondents also ignored a number of red flags related to the concealment of TP.

Advice of Counsel

44. On certain occasions, ConvergEx and a predecessor entity retained outside law firms in the United States and elsewhere to advise on the adequacy of certain disclosures in light of CGM's taking of TP on trades in global securities. Many of Respondents' employees were generally aware of these reviews. None of these employees, however, was told that outside counsel had approved concealing the practice from clients. Indeed, these law firms were not advised that Respondents sometimes routed trades consisting solely of U.S. securities to Bermuda, nor were they told that CGM and GTM deliberately concealed TP from customers, that CGM routinely took TP in an opportunistic manner, or that CGM and GTM employees made false statements to customers in order to conceal their practice of taking TP.

D. Violations

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

46. As a result of the conduct described above, Respondents G-Trade and CES willfully violated Section 15(c)(1) of the Exchange Act, which prohibits fraudulent conduct by a broker-dealer in effecting, inducing or attempting to induce any securities transaction.

E. Respondents' Remedial Efforts and Cooperation

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

F. Undertakings

G-Trade and CES undertake to:

48. Retain, at the expense of G-Trade and CES and within thirty (30) days of the issuance of this Order, a qualified independent ethics and compliance consultant (the "Consultant") with extensive experience in developing, implementing and overseeing organizational compliance and ethics programs, not unacceptable to the staff, to conduct an ethics and compliance program assessment. G-Trade and CES shall cause the Consultant to analyze whether the components of G-Trade's and CES's ethics and compliance program set forth below are having the desired effects, determine whether the culture is supportive of ethical and compliant conduct and provide advice and recommendations to strengthen the program and enhance the culture of compliance. G-Trade and CES shall cause the Consultant to:

a. review the creation, administration and implementation of the compliance and ethics program, including but not limited to reviewing key documents (e.g., business principles, Code of Conduct, policies and procedures, risk assessments, performance evaluation forms, relevant internal training materials and internal communications), conducting an assessment survey and interviewing relevant personnel;

b. review and evaluate G-Trade's and CES's policies, practices and procedures related to best execution and the provision of information to customers concerning order handling and compensation for trade execution, including but not limited to related written disclosures, advertising materials and other communications with customers and prospective customers;

c. evaluate the structure and functioning of the Legal and Compliance Department, including a review of the corporate culture of compliance; and

d. report to the Commission staff and G-Trade's and CES's General Counsel and Chief Compliance Officer, as described below, regarding the Consultant's findings and recommendations;

49. Provide a copy of the engagement letter detailing the Consultant's responsibilities to Jennifer S. Leete, Assistant Director, Division of Enforcement, U.S. Securities and Exchange Commission, 100 F Street, N.E., Washington, D.C. 20549-5546;

50. Cooperate fully with the Consultant, including providing the Consultant with access to its files, books, records and personnel as reasonably requested for the above-described review;

51. Require the Consultant to report to the Commission staff on his/her activities as the staff shall request;

52. Permit the Consultant to engage such assistance, clerical, legal or expert, as necessary and at reasonable cost, to carry out his/her activities, and the cost, if any, of such assistance shall be borne exclusively by G-Trade and CES;

53. Within one hundred and fifty (150) days of the issuance of this Order, unless otherwise extended by the Commission staff for good cause, G-Trade and CES shall require the Consultant to complete the review and report to the Commission staff and G-Trade's and CES's General Counsel and Chief Compliance Officer concerning:

a. the scope and methodologies used by the Consultant in order to complete the review;

b. G-Trade's and CES's compliance with the review;

c. the adequacy of G-Trade's and CES's existing policies, practices and procedures regarding the matters assessed; and

d. the Consultant's recommendations, if necessary, regarding modification or supplementation of G-Trade's and CES's policies, practices and procedures related to the matters assessed (the "Recommendations");

54. Within one hundred and twenty (120) days of G-Trade's and CES's receipt of the Recommendations, G-Trade and CES shall adopt and implement all of the Recommendations; provided, however, that as to any Recommendation that G-Trade and CES consider to be, in whole or in part, unduly burdensome or impractical, G-Trade and CES may submit in writing to the Consultant and the Commission staff (at the address set forth above), within sixty (60) days of receiving the Recommendations, an alternative policy, practice or procedure designed to achieve the same objective or purpose. G-Trade and CES shall then attempt in good faith to reach an agreement with the Consultant relating to each Recommendation that G-Trade and CES consider to be unduly burdensome or impractical and G-Trade and CES shall cause the Consultant to reasonably evaluate any alternative policy, practice or procedure proposed by G-Trade and CES. Such discussion and evaluation by G-Trade, CES and the Consultant shall conclude within ninety (90) days after G-Trade's and CES's receipt of the Recommendations, whether or not G-Trade, CES and the Consultant have reached an agreement. Within fourteen (14) days after the conclusion of the discussion and evaluation by G-Trade, CES and the Consultant, G-Trade and CES shall require that the Consultant inform G-Trade, CES and the staff (at the address set forth above) of his/her final determination concerning any Recommendation that G-Trade and CES consider to be unduly burdensome or impractical. G-Trade and CES shall abide by the determinations of the Consultant and, within sixty (60) days after final agreement between G-Trade, CES and the Consultant or final determination by the Consultant, whichever occurs first, G-Trade and CES shall adopt and implement all of the Recommendations that the Consultant deems appropriate;

55. Within fourteen (14) days of G-Trade's and CES's adoption of all of the Recommendations that the Consultant deems appropriate, G-Trade's and CES's General Counsel and Chief Compliance Officer shall certify in writing to the staff (at the address set forth above) that G-Trade and CES have adopted and implemented all of the Consultant's Recommendations and that G-Trade and CES have established policies, practices and procedures that are consistent with the findings of this Order;

56. G-Trade and CES may apply to the Commission staff for an extension of the deadlines described above before their expiration, and upon a showing of good cause by G-Trade and CES, the Commission staff may, in its sole discretion, grant such extensions for whatever time period it deems appropriate;

57. To ensure the independence of the Consultant, G-Trade and CES shall not have the authority to terminate the Consultant without prior written approval of the Commission's staff and shall compensate the Consultant and persons engaged to assist the Consultant for services rendered pursuant to this Order at their reasonable and customary rates;

58. G-Trade and CES shall require the Consultant to enter into an agreement that provides that, for the period of engagement and for a period of two years from completion of the engagement, the Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with G-Trade and CES or any of their present or former affiliates, directors, officers, employees or agents acting in their capacity as such. The agreement will also provide that the Consultant will require that any firm with which he/she is affiliated or of which he/she is a member, and any person engaged to assist the Consultant in the performance of his/her duties under this Order shall not, without the prior written consent of the Commission staff, enter into any employment, consultant, attorney-client, auditing or other professional relationship with G-Trade and CES, or any of their present or former affiliates, directors, officers, employees or agents acting in their capacity as such, for the period of the engagement and for a period of two years after the engagement;

59. G-Trade and CES agree to certify in writing to the Commission staff (at the address set forth above), in the second year following the issuance of this Order, that G-Trade and CES have established and continue to maintain policies, practices and procedures consistent with the findings of this Order;

60. The Commission's acceptance of G-Trade's and CES's offer of settlement and entry of this Order shall not be construed as its approval of any policy or practice reviewed by the Consultant and/or implemented based on the Consultant's Recommendation.

IV.

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

Accordingly, pursuant to Sections 15(b) and 21C of the Exchange Act and Section 203(e) of the Advisers Act, it is hereby ORDERED that:

A. Respondents 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. CES and G-Trade cease and desist from committing or causing any violations and any future violations of Section 15(c) of the Exchange Act.

C. CES and G-Trade are censured.

D. Respondents shall, within 10 days of the entry of this Order, pay, jointly and severally, disgorgement of $79,802,448, prejudgment interest of $7,621,981 and a civil money penalty of $20,000,000, into an escrow account acceptable to the Commission's staff and provide evidence of such deposit in a form acceptable to the Commission's staff. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. If timely deposit of the civil penalty is not made by the required payment date, additional interest shall accrue pursuant to 31 U.S.C. § 3717.

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 Section IV.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, 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 Section, a "Related Investor Action" means a private damages action brought against Respondents by or on behalf of one or more customers based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

F. The disgorgement, interest, civil penalties and any other funds which may be paid to the Fair Fund through this action, or as the result of any related Commission actions, shall be aggregated in the Fair Fund in accordance with any orders issued in those other actions. The Commission will appoint a Fund Administrator who will develop a distribution plan (the "Plan") with the assistance and cooperation of Respondents. The Plan will include a methodology to identify and compensate affected current and former customers of Respondents from whom TP was taken between October 2, 2006, and December 31, 2011. The Fund Administrator will administer the Plan in accordance with the Commission Rules on Fair Fund and Disgorgement Plans. Respondents shall be responsible for any and all costs associated with developing and administering the Plan. Respondents shall also be responsible for any and all tax compliance responsibilities associated with the Fair Fund and may retain any professional services necessary or appropriate. The costs and expenses of any such tax compliance responsibilities and professional services, including the payment of any taxes, penalties, and interest due, shall be borne by Respondents and shall not be paid out of the Fair Fund. The Respondents have informed the Commission staff that the Fair Fund will constitute a Qualified Settlement Fund ("QSF") under Section 468B(g) of the Internal Revenue Code, 26 U.S.C. §468B(g), and related regulations, 26 C.F.R. §§1.468B-1 through 1.468B-5. Respondents shall be the "administrators" of the QSF identified in 26 C.F.R. §1.468B-2(k)(3) for tax reporting and compliance purposes. Any amount remaining in the Fair Fund after all distributions have been made and costs have been paid shall be transmitted to the Commission for transfer to the U.S. Treasury. Under no circumstances shall any part of the Fair Fund be returned to Respondents.

G. Respondents acknowledge that the Commission is not imposing a civil penalty in excess of $20 million based upon their cooperation in the Commission investigation and their agreement to cooperate in related enforcement actions. If at any time following the entry of the Order, the Division of Enforcement ("Division") obtains information indicating that Respondents knowingly failed to provide full, truthful and continuing cooperation, the Division may, at its sole discretion and with prior notice to the Respondents, petition the Commission to reopen this matter and seek an order directing that the Respondents pay an additional civil penalty. Respondents may contest by way of defense in any resulting administrative proceeding whether it knowingly failed to provide full, truthful and continuing cooperation, but may not: (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.

H. G-Trade and CES shall comply with the Undertakings enumerated in Section III.F. above.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 71135 / December 19, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15655

In the Matter of **China Dongfang Healthcare Group, Inc.,** **China Golf Group, Inc.,** **OMA Enterprises Corp., and** **Startec Global Communications Corp.,** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents China Dongfang Healthcare Group, Inc., China Golf Group, Inc., OMA Enterprises Corp., and Startec Global Communications Corp.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. China Dongfang Healthcare Group, Inc. (CIK No. 1491496) is a revoked Nevada corporation located in Guangzhou City, China with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). China Dongfang 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, 2010, which reported a net loss of $52,057 for the prior nine months.

2. China Golf Group, Inc. (CIK No. 1444183) is a void Delaware corporation located in Shanghai, China with a class of securities registered with the Commission

pursuant to Exchange Act Section 12(g). China Golf 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, 2010, which reported a net loss of $307,313 for the prior three months.

3. OMA Enterprises Corp. (CIK No. 1438575) is a defaulted Nevada corporation located in Vancouver, British Columbia, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). OMA Enterprises 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, 2010, which reported a net loss of $2,593 for the prior three months.

4. Startec Global Communications Corp. (CIK No. 1043310) is a withdrawn Delaware corporation located in Potomac, Maryland with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Startec 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, 2001, which reported a net loss of over $76 million for the prior nine months.

B. DELINQUENT PERIODIC FILINGS

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

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

7. As a result of the foregoing, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and/or 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 them upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondents personally or by certified, registered, or Express Mail, or by other means 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. 71136 / December 19, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15656

In the Matter of **Bank of Florida Corp.,** **CLS Capital Group, Inc.,** **FGBC Bancshares, Inc.,** **Global Resource Corp.,** **Tritec Industries, Inc., and** **UTG Communications International, 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 Bank of Florida Corp., CLS Capital Group, Inc., FGBC Bancshares, Inc., Global Resource Corp., Tritec Industries, Inc., and UTG Communications International, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Bank of Florida Corp. (CIK No. 1082368) is a dissolved Florida corporation located in Naples, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Bank of Florida 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, 2010, which reported a net loss of $38 million for the prior nine months.

2. CLS Capital Group, Inc. (CIK No. 1444143) is a void Delaware corporation located in Toledo, Ohio with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). CLS Capital 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, 2010, which reported a net loss of $237,057 for the prior three months.

3. FGBC Bancshares, Inc. (CIK No. 1360581) is a Georgia corporation located in Franklin, Georgia with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). FGBC 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, 2010, which reported a net loss of over $9.2 million for the prior nine months.

4. Global Resource Corp. (CIK No. 1128949) is a revoked Nevada corporation located in Morrisville, North Carolina with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Global Resource 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, 2010, which reported a net loss of over $5.7 million for the prior nine months. As of October 15, 2013, the company's stock (symbol "GBRC") was traded on the over-the-counter markets.

5. Tritec Industries, Inc. (CIK No. 1053244) is a permanently revoked Nevada corporation located in Eden Prairie, Minnesota with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Tritec is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10 registration statement on February 13, 1998, which reported a net loss of $611,263 for the year ended December 30, 1996.

6. UTG Communications International, Inc. (CIK No. 1018402) is a void Delaware corporation located in Geroldswil, Switzerland with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). UTG 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 December 31, 2002, which reported a net loss of $406,034 for the prior nine months.

B. DELINQUENT PERIODIC FILINGS

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

8. Exchange Act Section 13(a) and the rules promulgated thereunder require issuers of securities registered pursuant to Exchange Act Section 12 to file with the Commission current and accurate information in periodic reports, even if the registration

is voluntary under Section 12(g). Specifically, Rule 13a-1 requires issuers to file annual reports, and Rule 13a-13 requires domestic issuers to file quarterly reports.

9. As a result of the foregoing, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and/or 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 them upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondents personally or by certified, registered, or Express Mail, or by other means 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

December 19, 2013

In The Matter Of	:	
	:	**ORDER DENYING PETITION FOR TERMINATION OF TRADING SUSPENSION**
Guar Global Ltd.	:	
	:	
File No. 500-1	:	

On December 16, 2013, Guar Global Ltd ("GGBL") submitted a petition pursuant to SEC Rule of Practice 550, 17 CFR 201.550, requesting termination of the Commission's December 6, 2013 Order suspending trading in the securities of GGBL for a period of 10 days ("Petition").[1] On December 18, GGBL submitted a supplemental statement ("Supplemental Statement") for Commission consideration in connection with the Petition. The Commission has reviewed the Petition, the exhibits to the Petition, the Supplemental Statement and its exhibits, and other relevant facts, including the trading pattern for GGBL. The Commission remains of the opinion that the public interest and the protection of investors require suspension of trading in the securities of GGBL for the full period covered by, and for the reasons stated in, the Commission's December 6, 2013 Order. Accordingly, GGBL's Petition is denied.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

[1] http://www.sec.gov/litigation/suspensions/2013/34-71002-o.pdf.

DEPARTMENT OF THE TREASURY
OFFICE OF THE COMPTROLLER OF THE CURRENCY
[Docket ID OCC-2013-0014]

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
[Docket No. OP-1465]

FEDERAL DEPOSIT INSURANCE CORPORATION

NATIONAL CREDIT UNION ADMINISTRATION

BUREAU OF CONSUMER FINANCIAL PROTECTION
[Docket No. CFPB-2013-0029]

SECURITIES AND EXCHANGE COMMISSION
[Release No. 34-71134; File No. S7-08-13]

EXTENSION OF COMMENT PERIOD FOR PROPOSED INTERAGENCY POLICY STATEMENT ESTABLISHING JOINT STANDARDS FOR ASSESSING THE DIVERSITY POLICIES AND PRACTICES OF ENTITIES REGULATED BY THE AGENCIES

AGENCIES: Office of the Comptroller of the Currency ("OCC"); Board of Governors of the Federal Reserve System ("Board"); Federal Deposit Insurance Corporation ("FDIC"); National Credit Union Administration ("NCUA"); Bureau of Consumer Financial Protection ("CFPB"); and Securities and Exchange Commission ("SEC").

ACTION: Proposed interagency policy statement; extension of comment period.

SUMMARY: On October 25, 2013, the OCC, Board, FDIC, NCUA, CFPB, and SEC (collectively, the "Agencies") published in the Federal Register a joint notice of a proposed interagency policy statement establishing standards for assessing the diversity

policies and practices of the entities they regulate.[1] To allow the public more time to consider the proposed assessment standards, the Agencies have determined that an extension of the comment period to February 7, 2014, is appropriate. This action will allow interested persons additional time to analyze the interagency policy statement and prepare their comments.

DATES: Comments must be received on or before February 7, 2014.

ADDRESSES: You may submit comments by any of the methods identified in the proposed interagency policy statement. To avoid duplication, the Agencies request that commenters not submit the same comment to more than one Agency. The Agencies will share comments with each other, as appropriate.

FOR FURTHER INFORMATION CONTACT:

OCC: Joyce Cofield, Executive Director, Office of Minority and Women Inclusion, at (202) 649-6460 or Karen McSweeney, Counsel, Law Department, at (202) 649-6295, Office of the Comptroller of the Currency, 400 7th Street, SW., Washington, DC 20219.

BOARD: Sheila Clark, Director, Office of Diversity and Inclusion, at (202) 452-2883; or Katherine Wheatley, Associate General Counsel, Legal Division, at (202) 452-3779.

FDIC: Melodee Brooks, Senior Deputy Director, Office of Minority and Women Inclusion, (703) 562-6090; Henry R.F. Griffin, Assistant General Counsel, (703) 562-6404; or Michelle M. Borzillo, Senior Counsel, (703) 562-6083; or Robert Lee, Counsel,

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[1] 78 FR 64052 (October 25, 2013).

(703) 562-2020, Legal Division, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429-0002.

NCUA: Tawana James, Director, Office of Minority and Women Inclusion, at (703) 518-1650, or Cynthia Vaughn, Diversity Outreach Program Analyst, Office of Minority and Women Inclusion, at (703) 518-1653, or Steven W. Widerman, Senior Staff Attorney, Office of General Counsel, at (703) 518-6540.

CFPB: Stuart Ishimaru, Director, Office of Minority and Women Inclusion, at (202) 435-9012, or To-Quyen Truong, Deputy General Counsel, Legal Division at (202) 435-7434, Bureau of Consumer Financial Protection, 1700 G Street, NW., Washington, DC 20552.

SEC: Pamela A. Gibbs, Director, Office of Minority and Women Inclusion, (202) 551-6046, or Tracey L. McNeil, Counsel, Office of Minority and Women Inclusion, (202) 551-3392, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549.

SUPPLEMENTARY INFORMATION:

On October 25, 2013, the proposed interagency policy statement was published in the Federal Register, 78 FR 64052 (October 25, 2013). The proposed interagency policy statement would establish joint standards for assessing the diversity policies and practices of entities regulated by the Agencies. The Agencies sought comment on all aspects of the proposed policy statement and requested that commenters respond to numerous questions. The proposed policy statement stated that the public comment period would close after 60 days, on December 24, 2013.

The Agencies have received requests from the public for an extension of the comment period. The Agencies believe that the additional time will facilitate public comment on the policy statement and the questions posed by the Agencies. Therefore, the Agencies are extending the comment period for the proposed interagency policy statement by 45 days, from December 24, 2013 to February 7, 2014.

[THIS SIGNATURE PAGE RELATES TO THE EXTENSION OF THE COMMENT PERIOD FOR THE JOINT NOTICE ENTITLED "PROPOSED INTERAGENCY POLICY STATEMENT ESTABLISHING JOINT STANDARDS FOR ASSESSING THE DIVERSITY POLICIES AND PRACTICES OF ENTITIES REGULATED BY THE AGENCIES"]

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Thomas J. Curry
Comptroller of the Currency

BILLING CODE: OCC 4810-33-P

[THIS SIGNATURE PAGE RELATES TO THE EXTENSION OF THE COMMENT PERIOD FOR THE JOINT NOTICE ENTITLED "PROPOSED INTERAGENCY POLICY STATEMENT ESTABLISHING JOINT STANDARDS FOR ASSESSING THE DIVERSITY POLICIES AND PRACTICES OF ENTITIES REGULATED BY THE AGENCIES"]

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Robert deV. Frierson,
Secretary of the Board.

BILLING CODE: FRB 6210-01-P

[THIS SIGNATURE PAGE RELATES TO THE EXTENSION OF THE COMMENT PERIOD FOR THE JOINT NOTICE ENTITLED "PROPOSED INTERAGENCY POLICY STATEMENT ESTABLISHING JOINT STANDARDS FOR ASSESSING THE DIVERSITY POLICIES AND PRACTICES OF ENTITIES REGULATED BY THE AGENCIES"]

Robert E. Feldman,
Executive Secretary.

BILLING CODE: FDIC 6741-01-P

[THIS SIGNATURE PAGE RELATES TO THE EXTENSION OF THE COMMENT PERIOD FOR THE JOINT NOTICE ENTITLED "PROPOSED INTERAGENCY POLICY STATEMENT ESTABLISHING JOINT STANDARDS FOR ASSESSING THE DIVERSITY POLICIES AND PRACTICES OF ENTITIES REGULATED BY THE AGENCIES"]

By the National Credit Union Administration Board on December __, 2013

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Gerard Poliquin
Secretary of the Board

BILLING CODE: NCUA 7590-01 P

[THIS SIGNATURE PAGE RELATES TO THE EXTENSION OF THE COMMENT PERIOD FOR THE JOINT NOTICE ENTITLED "PROPOSED INTERAGENCY POLICY STATEMENT ESTABLISHING JOINT STANDARDS FOR ASSESSING THE DIVERSITY POLICIES AND PRACTICES OF ENTITIES REGULATED BY THE AGENCIES"]

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Richard Cordray,
Director, Bureau of Consumer Financial Protection.

BILLING CODE: CFPB 4810-AMP

[THIS SIGNATURE PAGE RELATES TO THE EXTENSION OF THE COMMENT PERIOD FOR THE JOINT NOTICE ENTITLED "PROPOSED INTERAGENCY POLICY STATEMENT ESTABLISHING JOINT STANDARDS FOR ASSESSING THE DIVERSITY POLICIES AND PRACTICES OF ENTITIES REGULATED BY THE AGENCIES"]

Thomas J. Curry
Comptroller of the Currency

BILLING CODE: OCC 4810-33-P

[THIS SIGNATURE PAGE RELATES TO THE EXTENSION OF THE COMMENT PERIOD FOR THE JOINT NOTICE ENTITLED "PROPOSED INTERAGENCY POLICY STATEMENT ESTABLISHING JOINT STANDARDS FOR ASSESSING THE DIVERSITY POLICIES AND PRACTICES OF ENTITIES REGULATED BY THE AGENCIES AND REQUEST FOR COMMENT"]

By order of the Board of Governors of the Federal Reserve System, acting through the Secretary under delegated authority, December 5, 2013.

Robert deV. Frierson

Robert deV. Frierson,
Secretary of the Board.

BILLING CODE: FRB 6210-01-P

[THIS SIGNATURE PAGE RELATES TO THE EXTENSION OF THE COMMENT PERIOD FOR THE JOINT NOTICE ENTITLED "PROPOSED INTERAGENCY POLICY STATEMENT ESTABLISHING JOINT STANDARDS FOR ASSESSING THE DIVERSITY POLICIES AND PRACTICES OF ENTITIES REGULATED BY THE AGENCIES AND REQUEST FOR COMMENT"]

Valerie J. Best

Valerie J. Best,
Assistant Executive Secretary.

BILLING CODE: FDIC 6741-01-P

[THIS SIGNATURE PAGE RELATES TO THE EXTENSION OF THE COMMENT PERIOD FOR THE JOINT NOTICE ENTITLED "PROPOSED INTERAGENCY POLICY STATEMENT ESTABLISHING JOINT STANDARDS FOR ASSESSING THE DIVERSITY POLICIES AND PRACTICES OF ENTITIES REGULATED BY THE AGENCIES"]

By the National Credit Union Administration Board on December 16, 2013

Gerard Poliquin
Secretary of the Board

BILLING CODE: NCUA 7590-01 P

[THIS SIGNATURE PAGE RELATES TO THE EXTENSION OF THE COMMENT PERIOD FOR THE JOINT NOTICE ENTITLED "PROPOSED INTERAGENCY POLICY STATEMENT ESTABLISHING JOINT STANDARDS FOR ASSESSING THE DIVERSITY POLICIES AND PRACTICES OF ENTITIES REGULATED BY THE AGENCIES"]

Richard Cordray

Richard Cordray,
Director, Bureau of Consumer Financial Protection.

BILLING CODE: CFPB 4810-AMP

[THIS SIGNATURE PAGE RELATES TO THE EXTENSION OF THE COMMENT PERIOD FOR THE JOINT NOTICE ENTITLED "PROPOSED INTERAGENCY POLICY STATEMENT ESTABLISHING JOINT STANDARDS FOR ASSESSING THE DIVERSITY POLICIES AND PRACTICES OF ENTITIES REGULATED BY THE AGENCIES"]

By the Securities and Exchange Commission.

Kevin M. O'Neill

Kevin M. O'Neill
Deputy Secretary

Dated: December 19, 2013

BILLING CODE: SEC 8011–01–p

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
December 20, 2013

In the Matter of **CompuSonics Video Corporation,** **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 CompuSonics Video Corporation because it has not filed any periodic reports since the period ended April 30, 2006.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above-listed company. Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed company is suspended for the period from 9:30 a.m. EST on December 20, 2013, through 11:59 p.m. EST on January 6, 2014.

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. 71151 / December 20, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15657

In the Matter of **CompuSonics Video Corporation,** **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 CompuSonics Video Corporation.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENT

CompuSonics Video Corporation (CIK No. 777844) is an active Colorado corporation located in Farmington Hills, Michigan with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). CompuSonics is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it last filed a Form 10-QSB for the period ended April 30, 2006, which reported a net loss of $174,007 for the prior nine months. As of November 27, 2013, the company's stock (symbol "CPVD") is publicly quoted on the 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

As discussed in more detail above, Respondent is delinquent in its periodic filings with the Commission, has repeatedly failed to meet its obligations to file timely periodic reports, and failed to heed a delinquency letter sent to it by the Division of Corporation Finance requesting compliance with their periodic filing obligations.

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.

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

III.

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

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

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

IV.

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

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

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

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

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

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Gallagher
Commissioner Piwowar
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 71154 / December 20, 2013

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3520 / December 20, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15658

In the Matter of JOHN KINROSS-KENNEDY, CPA, Respondent.	ORDER MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS PURSUANT TO SECTIONS 4C AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934 AND RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE AND A CEASE-AND-DESIST ORDER

I.

On September 30, 2013, the Securities and Exchange Commission ("Commission") instituted public administrative and cease-and-desist proceedings against John Kinross-Kennedy, CPA ("Respondent" or "Kinross") pursuant to Sections 4C[1] and 21C of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 102(e)(1)(ii) and (iii) of the Commission's Rules of Practice.[2]

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

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

[2] Rule 102(e)(1)(ii) provides, in pertinent part, that:

> The Commission may . . . deny, temporarily or permanently, the privilege of appearing or practicing before it . . . to any person who is found . . . to have engaged in unethical or improper professional conduct.

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

> The Commission may . . . deny, temporarily or permanently, the privilege of appearing or practicing before it . . . to any person who is found...to have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws or the rules and regulations thereunder.

II.

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 Making Findings and Imposing Remedial Sanctions Pursuant to Sections 4C and 21C of the Exchange Act and Rule 102(e) and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds[3] that:

A. SUMMARY

These proceedings arise out of John Kinross-Kennedy's improper professional conduct in connection with audit and review engagements for issuers for fiscal periods beginning on or after December 15, 2009. During this period, Kinross issued audit reports in which he falsely represents that he conducted his audits in accordance with Public Company Accounting Oversight Board ("PCAOB") standards. This matter also involves Kinross's willful violations of Sections 10A(j) and 10A(k) of the Exchange Act and Rules 2-02(b)(1) and 2-07 of Regulation S-X.

B. RESPONDENT

John Kinross-Kennedy, age 85, of Irvine, California, is a certified public accountant licensed in California. Kinross has operated as an unincorporated sole proprietor since 1993 and has been registered with the PCAOB since 2005. As of July 15, 2013, Kinross is the independent public accountant for six public companies. Since 2009, at any one time, he has been the independent accountant for as many as 23 public companies.

C. RELEVANT ISSUERS

At all relevant times Issuer A's common stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act and was traded on the OTC Bulletin Board, and its fiscal year ended on the last day of March.

At all relevant times, Issuer B filed reports with the Commission pursuant to Section 15(d) of the Exchange Act, its common stock was traded on the OTC Market, and its fiscal year ended on the last day of August.

At all relevant times, Issuer C's common stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act and was traded on the OTC Market, and its fiscal year ended on the last day of September.

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

At all relevant times, Issuer D's common stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act and was traded on the OTC Bulletin Board, and its fiscal year ended on the last day of December.

At all relevant times, Issuer E filed reports with the Commission pursuant to Section 15(d) of the Exchange Act, its common stock was traded on the OTC Bulletin Board, and its fiscal year ended on the last day of December.

D. FACTS

1. During 2011 and 2012, Kinross issued six audit reports containing unqualified opinions listed in the table below in connection with his audits of the financial statements of five issuers (the "Issuer Audits"), as well as audit reports for approximately 20 other issuers. In each of these six audit reports, Kinross represents that he conducted his audits in accordance with PCAOB standards. Kinross failed, however, to conduct each of the six audits of the five issuer's financial statements in accordance with PCAOB standards, as described below.

Issuer	Report Date	Fiscal Periods
Issuer A	June 21, 2011	Periods from inception, March 31, 2009, to March 31, 2010 and 2011
Issuer A	June 25, 2012	Periods from inception, March 31, 2009, to March 31, 2011 and 2012
Issuer B	Oct. 31, 2011	Years ended and periods from inception, August 22, 2008, to August 31, 2011 and 2010
Issuer C	Dec. 22, 2011	Years ended and periods from inception, August 2, 2005, to September 30, 2011 and 2010
Issuer D	March 26, 2012	Years ended and periods from inception, December 22, 2006, to December 31, 2011 and 2010
Issuer E	Feb. 29, 2012	Years ended December 31, 2011 and 2010

<u>AU §230, Due Professional Care in the Performance of Work</u>

2. Kinross failed to exercise due professional care in each of the six Issuer Audits. *See* AU §230.02-.06. Kinross does not possess the degree of skill commonly possessed by other auditors and failed to exercise reasonable care and diligence. AU §230.02-.05. Kinross's lack of knowledge and skill is demonstrated by his admitted unfamiliarity with PCAOB requirements to perform certain auditing procedures, e.g. annual written confirmation of his independence (*See* PCAOB Rule 3526), and his failure to communicate with the predecessor auditor (*See* AU §315) and communicate with the audit committee (*See* AU §380). He also was unaware of certain changes in GAAP, such as the 2001 shift from amortization of goodwill to non-amortization of goodwill (changed by Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets* (June 2001)).

3. Kinross also failed to exercise due professional care on fundamental aspects of the audits by using outdated audit templates to document his audit planning and performance of certain audit procedures on each of the audits without any apparent effort to adapt those templates for subsequent changes in auditing standards. Kinross relied upon checklists published in 1993, the

year he formed his audit practice and ten years before the creation of the PCAOB, for client acceptance, internal control evaluation, and transactional audit plans for small organizations. Kinross's audit work papers for Issuer D's December 31, 2011 financial statements included a copy of the cover page and an index of a 1993-checklist, but did not include the checklist itself. Not only was the checklist outdated, the cover page indicated that it pertained to GAAP disclosure requirements for financial statements of a *nonpublic* commercial business.

4. Kinross's inappropriate use of client personnel to perform audit steps also illustrates his lack of due professional care. For example, for Issuer E's December 31, 2011 audit, Kinross instructed client personnel to select one invoice per month for the sample to be subjected to audit testing. Even though he was present at the time the client made the selection, Kinross should have made sure that all items were available for selection, selected the items, and made sure that the sample was expected to be representative of the population.[4]

<u>AU §326, Evidential Matter and Auditing Standard No. 15, Audit Evidence</u>

5. Under AU §326, *Evidential Matter*, which was in effect for the pertinent periods beginning before December 15, 2010, an auditor was required to obtain sufficient competent evidential matter to afford a reasonable basis for his opinion. *See* AU §326.01 and 22-24; and AU §150.02, *Generally Accepted Auditing Standards*. Auditing Standard No. 15, *Audit Evidence* ("AS 15"), which is effective for fiscal periods beginning on or after December 15, 2010, requires that an auditor plan and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for his opinion. *See* AS 15, ¶4. For each of the six Issuer Audits, Kinross failed to obtain the requisite level of evidential matter or audit evidence to support his opinion.

6. For the three audits of fiscal years beginning before December 15, 2010, Kinross failed to obtain sufficient competent evidential matter to afford a reasonable basis for his opinion. For issuer A, Kinross issued an audit report containing an unqualified opinion on Issuer A's financial statements as of March 31, 2010 and 2011 and the periods from inception (March 31, 2009), despite the fact that he had performed no audit procedures as of March 31, 2010 or for the period from inception (March 31, 2009) to March 31, 2010. Kinross issued an audit report containing an unqualified opinion on Issuer B's August 31, 2011 financial statements. Issuer B's sole operating subsidiary accounted for 100 percent of Issuer B's revenues and cost of revenues and 15 percent of its expenses. Yet, Kinross performed no audit procedures on the subsidiary's revenues or its expenses. Instead, Kinross conducted a "balance sheet audit," relying on the change in net equity to validate the subsidiary's net income and limiting the testing of Issuer B's expenses. With respect to Issuer C, which recorded a $42 million gain upon deconsolidation of Issuer B and a corresponding $42 million investment in Issuer B (*See* FASB ASC 810-10-40-5, *Consolidation: Derecognition*), Kinross failed to consider potential impairment of Issuer C's $42

[4] AU §350.03 *Audit Sampling*, "[R]equire[s] that the auditor use professional judgment in planning, performing, and evaluating a sample and in relating the evidential matter produced by the sample to other evidential matter when forming a conclusion about the related account balance or class of transactions." Additionally, AU §350.39 provides that the sample should be selected in such a way that the sample can be expected to be representative of the population and that all items in the population should have an opportunity to be selected.

million investment in Issuer B despite Issuer B's stock price having declined by 94 percent by Issuer C's fiscal year end.

7. For the three audits of fiscal years beginning on or after December 15, 2010, Kinross failed to plan and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for his opinion. For issuer A, Kinross issued an audit report containing an unqualified opinion on Issuer A's financial statements as of March 31, 2011 and 2012 and the periods from inception (March 31, 2009), despite the fact that he had performed no audit procedures as of March 31, 2010 or for the period from inception (March 31, 2009) to March 31, 2010. With respect to his audit of Issuer D's December 31, 2011 financial statements, Kinross inadequately tested revenues and cost of goods sold. Despite Issuer D having only one customer and relatively few transactions, Kinross did not review sales contracts or purchase orders with customers or suppliers to identify terms that might affect the timing of revenue recognition or cost of goods sold. Additionally, Kinross inappropriately relied upon documents that he could not read, either because the documents were written in Chinese or because the copies were illegible. With respect to Issuer E, Kinross inadequately tested revenues and failed to investigate material, differences between schedules detailing sales transactions and the amount of recorded sales revenue.

Auditing Standard No. 8, Audit Risk

8. Kinross failed to obtain sufficient audit evidence by failing to conduct three audits in compliance with Auditing Standard No. 8, *Audit Risk* ("AS 8"), which was effective for audits of fiscal years beginning on or after December 15, 2010. AS 8 requires an auditor to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to error or fraud. An auditor obtains reasonable assurance by reducing audit risk to an appropriately low level through applying due professional care, including obtaining sufficient appropriate audit evidence. *See* AS 8, ¶3. Kinross did not exercise due professional care and did not obtain sufficient appropriate audit evidence for Issuer D's and Issuer E's December 31, 2011 audits or Issuer A's March 31, 2012 audit. Consequently, Kinross did not conduct these audits in a manner designed to reduce audit risk to an appropriately low level.

AU §333, Management Representations

9. Under AU §333, *Management Representations*, an independent auditor must obtain written representations from management for all financial statements and all periods covered by the audit report. Kinross failed to satisfy this auditing standard for each of the Issuer Audits because he issued audit reports on both the current and prior year's financial statements even though he obtained written representations from management only for the current year's financial statements. *See* AU §333.05.

Auditing Standard No. 3, Audit Documentation

10. For each of the Issuer Audits, Kinross's audit documentation was deficient. Auditing Standard No. 3, *Audit Documentation* ("AS 3") establishes the requirements for documentation that the auditor should prepare and retain in connection with engagements to support the auditor's conclusions and representations contained in the auditor's report. *See* AS 3,

¶2. Audit documentation must contain sufficient information to enable an experienced auditor, having no previous connection with the engagement to i) understand the nature, timing, extent, and results of the procedures performed, evidence obtained, and conclusions reached; and ii) determine who performed the work and the date such work was completed as well as the person who reviewed the work and the date of such review. *See* AS 3 ¶6. Kinross failed to prepare documentation that sufficiently described the procedures he performed, the evidence he obtained, and the conclusions he reached. Kinross's documentation also did not identify the person who performed the work and the date such work was completed, or the person who reviewed the work and the date of the review. Kinross performed substantially all of the audit procedures, but he frequently did not sign or initial and date his audit work papers. Additionally, Kinross did not include written audit programs or document the conclusions he reached for most audit areas other than cash. *See* AS 3, ¶¶4-6. Finally, he did not prepare an engagement completion document identifying significant findings or issues. *See* AS 3, ¶13.

11. Kinross added information to his audit work papers after the documentation completion date without identifying who prepared the additional documentation and explaining why it was added. In some instances, he failed to specify the date he added the information. *See* AS 3, ¶16.

12. Kinross did not retain audit documentation for the required seven years. Kinross was unable to locate documentation to support his audit reports on Issuer B's fiscal year 2008 and Issuer C's fiscal year 2008 financial statements, the earliest years covered by his initial audit reports for these issuers. *See* AS 3, ¶14.

Auditing Standard No. 7, Engagement Quality Review

13. Kinross failed to obtain required Engagement Quality Reviews ("EQR") for the vast majority of his audit engagements, and he engaged an unqualified person to perform the few EQRs that he did obtain. Under Auditing Standard No. 7, *Engagement Quality Review* ("AS 7"), an auditor must obtain an EQR and concurring approval of issuance for each audit and interim review engagement.[5] Kinross engaged Wilfred W. Hanson to conduct EQRs on the engagements for five of the 40 audit reports he issued on financial statements for fiscal years beginning on or after December 15, 2009.[6] For the same period, however, Kinross did not obtain the required EQRs for any of the other 35 audits he conducted or for any reviews of interim financial information. *See* AS 7, ¶1.

14. Kinross engaged Hanson to conduct an EQR on the audits of Issuer A's March 31, 2012 financial statements, Issuer B's August 31, 2011 financial statements, Issuer C's September 30, 2011 financial statements, Issuer D's December 30, 2011 financial statements, and Issuer E's December 31, 2011 financial statements. In connection with these audits, Kinross did not ascertain whether Hanson was qualified to perform the review. An engagement quality reviewer must be, among other things, competent, i.e., possessing the level of knowledge and competence related to

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5 AS 7 is effective for audits and interim reviews for fiscal years beginning on or after December 15, 2009.

6 On September 30, 2013, the Commission brought a settled action against Hanson for his role as EQR on certain Kinross engagements. *In the Matter of Wilfred W. Hanson, CPA,* (Accounting and Auditing Enforcement Release No. 3503).

accounting, auditing and financial reporting required to serve as the engagement partner on the engagement under review. *See* AS 7, ¶¶4-5. Additionally, Kinross did not establish quality control policies and procedures to provide him with reasonable assurance that the engagement quality reviewer has sufficient competence, among other things, to perform the EQR. *See* AS 7, ¶4.[7] Finally, Kinross did not ensure that his audit documentation included adequate documentation of Hanson's EQRs. *See* AS 7, ¶¶19-21.

15. With respect to Issuer D, Kinross requested that Hanson act as the engagement quality reviewer but did not request him to provide concurring approval of issuance of Kinross's audit report. Instead, Kinross improperly signed as the engagement quality reviewer and provided concurring approval to issue the audit report, even though Kinross was the engagement partner responsible for supervising the audit.

AU §508, Reports on Audited Financial Statements

16. Under AU §508, *Reports on Audited Financial Statements*, an auditor may express an unqualified opinion on historical financial statements only when the auditor has formed such an opinion on the basis of an audit performed in accordance with PCAOB standards. *See* AU §508.07. Kinross failed to conduct each of the Issuer Audits in accordance with PCAOB standards. Kinross should not have issued audit reports expressing an unqualified opinion and asserting he had conducted his audits in accordance with PCAOB standards.

Communications with Audit Committees

17. For each of the Issuer Audits, Kinross failed to make required communications to the audit committee or to others responsible for the oversight of the issuer's financial reporting process. *See* AU §380, *Communication With Audit Committees*, Section 10A(k) of the Exchange Act, Rule 2-07 of Regulation S-X, and PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence*. Kinross did not make or document that he had made the required communications to the audit committee (or board of directors for the entities without an audit committee), including, where applicable: i) the auditor's responsibility under PCAOB standards, ii) significant accounting policies, iii) management's judgments and accounting estimates, iv) audit adjustments, v) the auditor's judgment about the quality of the company's accounting principles, vi) other information in documents containing audited financial statements, vii) disagreements with management, viii) consultation with other accountants, ix) major issues discussed with management prior to retention, and x) difficulties encountered in performing the audit. *See* AU §380.03-.16.

18. For each of the Issuer Audits, Kinross neglected to report information regarding: i) all critical accounting policies and practices to be used, ii) all alternative treatments of financial information within GAAP for policies and practices related to material items that have been discussed with management, including ramifications of the use of such alternative disclosures and

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[7] PCAOB standard QC §40, *The Personnel Management Element of a Firm's System of Quality Control-Competencies Required by a Practitioner-in-Charge of an Attest Engagement* states, in part, that policies and procedures should be established to provide the firm with reasonable assurance that "those hired possess the appropriate characteristics to enable them to perform competently" and "[w]ork is assigned to personnel having the degree of technical training and proficiency required in the circumstances." QC §40, ¶.02.

treatments, and the treatment preferred by the registered public accounting firm, and iii) other material written communications between the registered public accounting firm and management (management letter, schedule of unadjusted differences). *See* Section 10A(k) of the Exchange Act and Rule 2-07 of Regulation S-X.

19. With respect to Issuer A, Kinross failed to affirm to the audit committee,[8] in writing, prior to accepting his initial engagement pursuant to standards of the PCAOB that he was in compliance with PCAOB Rule 3520, *Auditor Independence*. Similarly, with respect to continuation of engagements for Issuers A, B, C, D, and E, Kinross failed to affirm to the audit committee, in writing, at least annually that he was in compliance with PCAOB Rule 3520. (*See* PCAOB Rule 3526, Communication With Audit Committees Concerning Independence.)

AU §315, Communications Between Predecessor and Successor Auditors

20. Kinross failed to make required communications with the predecessor auditor or obtain sufficient competent evidential matter to afford a reasonable basis for his opinion on Issuer A's fiscal year 2010 financial statements, which were included in his audit report on Issuer A's financial statements for the fiscal years ending March 31, 2011 and March 31, 2010. As the successor auditor, Kinross was required to obtain sufficient competent evidential matter to afford a reasonable basis for expressing an opinion on Issuer A's financial statements, including making an inquiry of the predecessor auditor and requesting to review its work papers. *See* AU §315, *Communications Between Predecessor and Successor Auditors*, ¶¶.03 and ¶¶.07-.13. For the fiscal year ending March 31, 2010, Kinross never contacted Issuer A's predecessor auditor. Instead, he relied exclusively on the predecessor's audit report on Issuer A's March 31, 2010 financial statements as the basis for his opinion on Issuer A's March 31, 2010 financial statements, even though he had not spoken with the predecessor auditor or reviewed the predecessor auditor's work papers. Because Kinross performed no audit procedures as of March 31, 2010 or for the period then ended, he failed to obtain sufficient competent evidential matter to afford a reasonable basis for his opinion on Issuer A's March 31, 2010 and 2011 financial statements. *See* AU §326 and AU §315.12.

AU § 330, The Confirmation Process

21. With respect to Issuer A, and consistent with his practice, Kinross did not control the confirmation process. The purpose of the confirmation process, which includes communicating the confirmation request to the appropriate third party, is to obtain evidence from a third party about financial statement assertions made by management. *See* AU §§ 330.04, 330.06, and 330.28. Kinross failed to maintain control over the confirmation requests and did not establish direct communication with the intended recipients. Kinross knew that the auditor should control the confirmation process, but he instructed his clients to prepare and mail confirmation requests on his behalf.

[8] Section 3(a)(58) of the Exchange Act states, in part, that the term "audit committee" means the entire board of directors if the issuer does not have an audit committee.

AU §334, Related Parties

22. With respect to Issuer D, Kinross failed to evaluate and assess the adequacy of the issuer's disclosure of related party transactions. Kinross knew that Issuer D derived 100 percent of its revenues and cost of revenues from a company that owned 93 percent of Issuer D's common stock, and with which Issuer D shared its officers and its principal place of business. Kinross also knew or should have known that the transactions with its parent company were material and required disclosure. *See* FASB ASC 850-10-50, *Related Party Disclosures*. Kinross failed to consider whether he had obtained sufficient appropriate evidential matter to understand the relationship of the parties and the effects of the transactions on the financial statements. Similarly, he failed to evaluate all the information available and satisfy himself that Issuer D adequately disclosed related party transactions in its financial statements. *See* AU §334.11. In fact, Issuer D did not make required disclosures regarding related party transactions in its December 31, 2011 financial statements.

Auditing Standard No. 14, Evaluating Audit Results

23. For Issuers C and D, Kinross failed to aggregate uncorrected differences that were clearly not inconsequential, and evaluate whether they were material, either individually or in combination with other misstatements. AS 14, *Evaluating Audit Results,* ("AS 14").[9] Kinross determined planning materiality based on an amount equal to five percent of total expenses. During the audit, Kinross identified, but did not address differences that exceeded five percent of total expenses, i.e., planning materiality. Kinross failed to evaluate whether the uncorrected differences were material, individually or in combination with other misstatements. *See* AS 14, ¶¶11-18.

Section 10A(j) of the Exchange Act, Audit Partner Rotation

24. Kinross was Issuer D's registered public accounting firm from 2007 until he resigned in November 2012. During this period, Kinross issued audit reports for Issuer D's financial statements for each of the five years in the period ended December 31, 2011. Kinross continued to provide audit services in connection with reviews of Issuer D's interim financial information for the quarters ended March 31, June 30, and September 30, 2012.[10] As a result, Kinross was not independent with respect to the audit services he provided in connection with his review of Issuer D's 2012 interim financial statements.[11] *See* Section 10A(j) of the Exchange Act.

E. VIOLATIONS

1. As a result of the conduct described above, Kinross willfully violated Sections 10A(j) and 10A(k) of the Exchange Act.

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[9] AS 14 is effective for audits of fiscal years beginning on or after December 15, 2010.

[10] PCAOB Rule 1001(a)(vii) defines audit services, in part, as "professional services rendered for the audit of an issuer's annual financial statements, and (if applicable) for the reviews of an issuer's financial statements included in the issuer's quarterly reports."

[11] Kinross does not qualify for the audit partner rotation exemption pursuant to Rule 2-01(c)(6)(ii) of Regulation S-X because Kinross was the auditor for five or more issuer clients at all relevant times.

2. As a result of the conduct described above, Kinross willfully violated Rule 2-02(b)(1) and Rule 2-07 of Regulation S-X.

3. As a result of the conduct described above, Kinross engaged in improper professional conduct as defined in Rule 102(e)(1)(iv)(B)(2) in that his conduct constituted negligent conduct, consisting of repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission.

4. As a result of the conduct described above, Kinross willfully violated certain provisions of the Federal securities laws and the rules and regulations thereunder pursuant to Rule 102(e)(1)(iii) of the Commission's Rules of Practice.

F. Findings

1. Based on the foregoing, the Commission finds that Kinross willfully violated Sections 10A(j) and 10A(k) of the Exchange Act and Rules 2-02(b)(1) and 2-07 of Regulation S-X.

2. Based on the foregoing, the Commission finds that Kinross engaged in improper professional conduct pursuant to Section 4C(a)(2) of the Exchange Act and Rule 102(e)(1)(ii) of the Commission's Rules of Practice and willfully violated certain provisions of the federal securities laws, pursuant to 4C(a)(3) of the Exchange Act and Rule 102(e)(1)(iii) of the Commission's Rules of Practice.

IV.

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

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

A. Kinross shall cease and desist from committing or causing any violations and any future violations of Sections 10A(j) and 10A(k) of the Exchange Act and Rules 2-02(b)(1) and 2-07 of Regulation S-X.

B. Kinross is denied the privilege of appearing or practicing before the Commission as an accountant.

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

1. a preparer or reviewer, or a person responsible for the preparation or review, of any public company's financial statements that are filed with the Commission. Such an application must satisfy the Commission that Respondent's work in his practice before the Commission will be reviewed either by the independent audit committee of the

public company for which he works or in some other acceptable manner, as long as he practices before the Commission in this capacity; and/or

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

(a) Respondent, or the public accounting firm with which he is associated, is registered with the PCAOB in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective;

(b) Respondent, or the registered public accounting firm with which he is associated, has been inspected by the PCAOB and that inspection did not identify any criticisms of or potential defects in the respondent's or the firm's quality control system that would indicate that the respondent will not receive appropriate supervision;

(c) Respondent has resolved all disciplinary issues with the PCAOB, and has complied with all terms and conditions of any sanctions imposed by the PCAOB (other than reinstatement by the Commission); and

(d) Respondent acknowledges his responsibility, as long as Respondent appears or practices before the Commission as an independent accountant, to comply with all requirements of the Commission and the PCAOB, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews and quality control standards.

D. The Commission will consider an application by Respondent to resume appearing or practicing before the Commission provided that his state CPA license is current and he has resolved all other disciplinary issues with the applicable state boards of accountancy. However, if state licensure is dependent on reinstatement by the Commission, the Commission will consider an application on its other merits. The Commission's review may include consideration of, in addition to the matters referenced above, any other matters relating to Respondent's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

By the Commission.

Elizabeth M. Murphy
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. 71161 / December 20, 2013

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3521 / December 20, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15659

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

I.

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

II.

The Commission finds that:

A. RESPONDENT

1. Thomas D. Melvin, 46 years old, is and has been a certified public accountant ("CPA") licensed to practice in the State of Georgia. He has been a partner in the accounting firm of Melvin, Rooks and Howell in Griffin, Georgia, for a number of years.

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

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

B. CIVIL INJUNCTION

2. On August 14, 2013 the U.S. District Court for the Northern District of Georgia entered a final judgment against Melvin, permanently enjoining him from future violations, direct or indirect, of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. Securities and Exchange Commission v. Melvin, et al., Civil Action Number 1:12-cv-2984-CAP (N.D. Ga.).

3. The Commission's complaint alleged that Melvin and others engaged in a fraudulent insider trading scheme in which Melvin misappropriated confidential information from one of his clients regarding an imminent merger involving a company of which the client was a director. The complaint alleges that Melvin tipped four friends and business associates about the merger in violation of his fiduciary duties to his clients, and then those tippees purchased shares of the target company, realizing large profits.

III.

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

IT IS HEREBY ORDERED that Melvin 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 Melvin 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 Melvin personally or by certified mail at his last known address.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 71174 / December 23, 2013

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3522 / December 23, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-13709

	:	ORDER GRANTING APPLICATION FOR
In the Matter of	:	REINSTATEMENT TO APPEAR AND PRACTICE
	:	BEFORE THE COMMISSION AS AN ACCOUNTANT
Clinton Ronald Greenman,	:	RESPONSIBLE FOR THE PREPARATION OR
CPA	:	REVIEW OF FINANCIAL STATEMENTS REQUIRED
	:	TO BE FILED WITH THE COMMISSION

On December 10, 2009, Clinton Ronald Greenman, CPA ("Greenman") was suspended from appearing or practicing before the Commission as an accountant as a result of settled public administrative proceedings instituted by the Commission against Greenman pursuant to Rule 102(e)(3)(i) of the Commission's Rules of Practice.[1] This order is issued in response to Greenman's application for reinstatement to appear and practice before the Commission as an accountant responsible for the preparation or review of financial statements required to be filed with the Commission.

The Commission found that Greenman had been permanently enjoined by a United States District Court from future violations of Section 17(a)(2) and (3) of the Securities Act of 1933 and Rules 13b2-1 and 13b2-2 Under the Securities Exchange Act of 1934 ("Exchange Act") and from aiding and abetting violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act, and Rules 12b-20, 13a-1, 13a-11, and 13a-13 thereunder. In a complaint filed on November 12, 2009, the Commission alleged that SafeNet, Inc. ("SafeNet") engaged in a scheme to meet or exceed quarterly earnings per share targets through the use of improper accounting adjustments from the third quarter of 2004 through the second quarter of 2005. Greenman served as SafeNet's Corporate Controller from December 2002 through December 2004 and as the Director for the Americas Regional Operating Center from December 2004 through May 26, 2005. The complaint alleged that Greenman and others made, or caused others to make, certain

[1] *See* Accounting and Auditing Enforcement Release No. 3076 dated December 10, 2009. Greenman was permitted, pursuant to the order, to apply for reinstatement after two years upon making certain showings.

improper accounting adjustments in SafeNet's books and records. The complaint further alleged that, as a result of these inappropriate adjustments, SafeNet's periodic reports, registration statements, and press releases contained materially misstated financial results and materially false and misleading information concerning SafeNet's financial condition.

In his capacity as a preparer or reviewer, or as a person responsible for the preparation or review, of financial statements of a public company to be filed with the Commission, Greenman attests that he will undertake to have his work reviewed by the independent audit committee of any company for which he works, or in some other manner acceptable to the Commission, while practicing before the Commission in this capacity. Greenman is not, at this time, seeking to appear or practice before the Commission as an independent accountant. If he should wish to resume appearing and practicing before the Commission as an independent accountant, he will be required to submit an application to the Commission showing that he has complied and will comply with the terms of the original suspension order in this regard. Therefore, Greenman's suspension from practice before the Commission as an independent accountant continues in effect until the Commission determines that a sufficient showing has been made in this regard in accordance with the terms of the original suspension order.

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

On the basis of information supplied, representations made, and undertakings agreed to by Greenman, it appears that he has complied with the terms of the December 10, 2009 order suspending him from appearing or practicing before the Commission as an accountant, that no information has come to the attention of the Commission relating to his character, integrity, professional conduct or qualifications to practice before the Commission that would be a basis for adverse action against him pursuant to Rule 102(e) of the Commission's Rules of Practice, and that Greenman, by undertaking to have his work reviewed by the independent audit committee of any company for which he works, or in some other manner acceptable to the Commission, in his practice before the Commission as a preparer or reviewer of financial statements required to be filed with the Commission, has shown good cause for reinstatement.

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

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

Therefore, it is accordingly,

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

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Chair White
Commissioner Gallagher
not participating
Commissioner Piwowar
Disapproved

UNITED STATES OF AMERICA
BEFORE THE
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT COMPANY ACT OF 1940
Release No. 30842 / December 23, 2013

In the Matter of

RBS SECURITIES INC.
600 Washington Boulevard
Stamford, CT 06901

CITIZENS INVESTMENT ADVISORS,
a separately identifiable department of RBS Citizens, N.A.
Mail Stop RC 03-30
One Citizens Plaza
Providence, RI 02903

(812-14232)

ORDER PURSUANT TO SECTION 9(c) OF THE INVESTMENT COMPANY ACT OF 1940 GRANTING A PERMANENT EXEMPTION FROM SECTION 9(a) OF THE ACT

RBS Securities Inc. ("RBS Securities") and Citizens Investment Advisors, a separately identifiable department of RBS Citizens, N.A. ("Citizens IA," and with RBS Securities, the "Applicants") filed an application on November 7, 2013, and an amendment to the application on November 25, 2013, requesting temporary and permanent orders under section 9(c) of the Investment Company Act of 1940 ("Act") exempting Applicants and any other company of which RBS Securities is or hereafter becomes an affiliated person (together with Applicants, "Covered Persons") from section 9(a) of the Act with respect to an injunction entered by the United States District Court for the District of Connecticut on November 25, 2013.

On November 25, 2013, the Commission simultaneously issued a notice of the filing of the application and a temporary conditional order exempting the Covered Persons from section 9(a) of the Act (Investment Company Act Release No. 30808) until the Commission takes final action on the application for a permanent order. The notice gave interested persons an opportunity to request a hearing and stated that an order disposing of the application would be issued unless a hearing was ordered. No request for a hearing has been filed, and the Commission has not ordered a hearing.

The matter has been considered and it is found that the conduct of the Applicants has been such as not to make it against the public interest or protection of investors to grant the permanent exemption from the provisions of section 9(a) of the Act.

Accordingly,

IT IS ORDERED, pursuant to section 9(c) of the Act, on the basis of the representations contained in the application, as amended and filed by RBS Securities and Citizens IA (File No. 812-14232) that Covered Persons be and hereby are permanently exempted from the provisions of section 9(a) of the Act, operative solely as a result of an injunction, described in the application, as amended, entered by the United States District Court for the District of Connecticut on November 25, 2013.

By the Commission.

Elizabeth M. Murphy
Secretary

Kevin M. O'Neill
By: Kevin M. O'Neill
Deputy Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9501 / December 23, 2013

INVESTMENT ADVISERS ACT OF 1940
Release No. 3746 / December 23, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15660

In the Matter of

WEST COAST ASSET MANAGEMENT, INC. AND LANCE W. HELFERT

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 A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") against West Coast Asset Management, Inc. ("WCAM") and Lance W. Helfert ("Helfert" and collectively with WCAM, "Respondents").

II.

In anticipation of the institution of these proceedings, each Respondent has submitted an Offer of Settlement (the "Offers") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over 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 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. This matter involves untrue statements by WCAM and Helfert to an advisory client regarding a hedge fund WCAM managed, the West Coast Opportunity Fund ("WCOF" or the "Fund"). In September and October 2008, as the financial crisis was unfolding, the client was considering an additional $4 million investment in the Fund. In response to a question from the client's representative, Respondents stated that there had been only two minor redemptions from WCOF, and that there had been net inflows into the Fund, neither of which was true. In reality, a WCAM affiliate had requested a $5 million redemption from WCOF just a month before that resulted in net outflows from the Fund. As a result, Respondents violated Section 17(a)(2) of the Securities Act and Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8(a)(1) thereunder as set forth below.

Respondents

2. **West Coast Asset Management, Inc. ("WCAM")**, is a California corporation with its principal place of business in Montecito, CA. WCAM is registered with the Commission as an investment adviser and currently has approximately $190 million in assets under management. WCAM is also the managing member of and investment adviser to WCOF.

3. **Lance W. Helfert ("Helfert")**, age 40, resides in Thousand Oaks, CA. Helfert is the president, director and 40% owner of WCAM.

Facts

4. On November 4, 2008, a family trust (the "Fund Investor") invested $4 million into WCOF. This was the Fund Investor's second investment in the Fund, having invested $2 million in the Fund earlier in 2008. The Fund Investor also had a separately managed account with WCAM, over which WCAM had discretionary control. In connection with both of its investments in WCOF, the Fund Investor was represented by an individual (the "Investor's Representative") who performed due diligence regarding the investment opportunity, provided a summary of his thoughts to the Fund Investor, and ultimately recommended that it make each of its two investments in the Fund.

5. In conducting his due diligence, the Investor's Representative regularly communicated with Helfert and others at WCAM regarding the Fund. Helfert understood that the

[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.

Investor's Representative was representing the Fund Investor and that the information Helfert provided the Investor's Representative was for his assessment of whether the Fund Investor should invest in WCOF.

6. WCAM marketed the Fund, in part, by emphasizing that WCAM's principals had "skin in the game," accounting for approximately 40% of WCOF's assets.

7. On October 31, 2008, as the financial crisis unfolded, the Investor Representative sent an email to Helfert inquiring about redemption activity in WCOF. Specifically, he posed the following question: "One thing that we didn't touch on was how your investors are reacting. Are funds being pulled to any large extent, from their SMA's, or the early investors in WCOF who are out of their lockups?"

8. Helfert responded by email on November 3, 2008: "We have had net inflow in both the SMA's and the WCOF the past couple of months. We have had no full redemptions in the WCOF, just 2 minor partial redemptions that we were informed of months ago."

9. This response, however, was not true because it did not include a redemption by a WCAM affiliate. In particular, it excluded the WCAM affiliate's $5 million redemption request made on September 30, 2008 (and that was deemed effective on October 31, 2008—the same day as the Investor Representative's inquiry). Second, when including the $5 million redemption, there was actually a net outflow from the Fund since July 1, 2008 of over $3.4 million. The $5 million redemption represented approximately 5% of WCOF's total value.

10. Minutes after Helfert sent his November 3, 2008 email, the Investor Representative confirmed to Helfert that the Fund Investor would invest an additional $4 million into WCOF. The Fund received the $4 million the next day.

Violations

11. By offering and selling interests in WCOF through the untrue statements in the November 3, 2008 email described above, Respondents willfully violated Section 17(a)(2) of the Securities Act, which makes it unlawful, in the offer or sale of securities, to obtain 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)(2) of the Securities Act does not require a showing of scienter; negligence is sufficient. *Aaron v. SEC*, 446 U.S. 680, 701-02 (1980).

12. As a result of the untrue statements in the November 3, 2008 email described above, Respondents willfully violated Section 206(2) of the Advisers Act, which prohibits investment advisers - such as Respondents - from, directly or indirectly, engaging 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 does not require a showing of scienter; negligence is sufficient. *SEC v. Steadman*, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992) (citing *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963)).

13. As a result of the untrue statements in the November 3, 2008 email described above, Respondents willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-8(a)(1) thereunder. Section 206(4) prohibits investment advisers from engaging in "any act, practice, or course of business which is fraudulent, deceptive or manipulative," as defined by the Commission by rule. Rule 206(4)-8(a)(1) prohibits an investment adviser to a "pooled investment vehicle" - such as Respondents with respect to WCOF - from, directly or indirectly, making false or misleading statements to investors or prospective investors in those pools. Section 206(4) of the Advisers Act and Rule 206(4)-8(a)(1) thereunder do not require a showing of scienter; negligence is sufficient. *Steadman*, 967 F.2d at 647.

IV.

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

Accordingly, pursuant to 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. Respondents WCAM and Helfert cease and desist from committing or causing any violations and any future violations of Section 17(a)(2) of the Securities Act and Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 promulgated thereunder.

B. Respondents WCAM and Helfert are censured.

C. Respondent WCAM shall, within ten days of the entry of this Order, pay disgorgement of $51,113 and prejudgment interest of $5,073.32 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 WCAM 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

(2) Respondent WCAM 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 WCAM 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 Marshall S. Sprung, Co-Chief, Asset Management Unit, Division of Enforcement, Securities and Exchange Commission, 5670 Wilshire Blvd., 11th Floor, Los Angeles, CA 90036.

D. Respondent WCAM shall, within ten days of the entry of this Order, pay a civil money penalty in the amount of $100,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Payment must be made in one of the following ways:

(1) Respondent WCAM 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

(2) Respondent WCAM 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 WCAM 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 Marshall S. Sprung, Co-Chief, Asset Management Unit, Division of Enforcement, Securities and Exchange Commission, 5670 Wilshire Blvd., 11th Floor, Los Angeles, CA 90036.

E. Respondent Helfert shall, within ten days of the entry of this Order, pay a civil money penalty in the amount of $32,500 to the United States Treasury. 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:

(1) Respondent Helfert 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

(2) Respondent Helfert 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 Helfert 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 Marshall S. Sprung, Co-Chief, Asset Management Unit, Division of Enforcement, Securities and Exchange Commission, 5670 Wilshire Blvd., 11th Floor, Los Angeles, CA 90036.

F. After receipt of all payments of civil money penalties and disgorgement, the Commission shall pay the disgorgement and additional interest accrued pursuant to SEC Rule of Practice 600 to the Fund Investor.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Gallagher
Commissioner Piwowar
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 3747 / December 24, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15661

In the Matter of **JIM POE AND ASSOCIATES, INC. AND JAMES EMORY POE** **Respondents.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 15(b)(6) OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTIONS 203(e), 203(f), AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 15(b)(6) of the Securities Exchange Act of 1934 ("Exchange Act") and Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") against Jim Poe and Associates, Inc. ("JPA") and James Emory Poe ("Poe"), (collectively "Respondents").

II.

In anticipation of the institution of these proceedings, Respondents have submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 15(b)(6) of the Securities Exchange Act of 1934 and Sections 203(e), 203(f), and 203(k), of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

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

Summary

1. These proceedings arise as a result of performance fees being improperly charged by JPA, a registered investment adviser based in Fort Worth, Texas. Between 2009 and 2011, JPA, at the direction of its founder and principal James Emory Poe, improperly charged three private funds that it manages a performance fee for clients who did not satisfy the requirements of a "qualified client" under the Advisers Act.

Respondents

2. Jim Poe and Associates, Inc. is a Texas corporation based in Fort Worth, Texas. JPA has been registered with the Commission as an investment adviser since September 15, 2010 and as an adviser with the Texas State Securities Board from August 31, 2006 through September 27, 2010.

3. James Emory Poe, age 67, resides in Benbrook Texas. Poe is the sole officer and majority owner of JPA. Poe was registered representative with Commission registered broker-dealer from 2008 to 2012. Poe has completed the series 62, 63, and 65 examinations.

Background

4. Generally, Section 205(a)(1) of the Advisers Act prohibits investment advisers that are registered or required to be registered with the Commission from entering into advisory contracts or providing advisory services pursuant to contracts that provide for compensation based on a share of capital gains upon or capital appreciation of the assets or any portion of the assets of a client ("performance fee"). Rule 205-3 provides that the provisions of Section 205(a)(1) shall not apply if the client with whom the adviser is entering into such contract is a "qualified client" as defined in Rule 205-3(d)(1).

5. In 2009, Poe formed a fund that was designed to invest in closed-end bond and REIT funds. As of October 31, 2010, this fund had $16.5 million in assets and 97 investors, 23 of which were non-accredited based on information in their subscription agreements. In June 2010, Poe formed a second fund to provide income and capital gains utilizing an income and rotation strategy. As of October 31, 2010, this fund had $4.3 million in assets and 23 investors, five of which were non-accredited based on information in their subscription agreements. In December 2010, Poe formed a third fund to invest in ETFs and periodic indexed options to hedge the portfolio. As of February 2011, this fund had $3.6 million in assets and 19 investors, one of which was non-accredited based on information in his subscription agreement.

6. Investors in any of the funds managed by JPA received a Private Placement Memorandum ("PPM"). Each PPM is identical, except as to fund objective, and contains standard

disclosures, an investor questionnaire, a subscription agreement, and a limited partnership agreement. The limited partnership agreement served as the advisory agreement between JPA and the respective fund, as well as the advisory contract between the investor, the fund, and JPA. Pursuant to the partnership agreement, JPA as fund manager would receive a fixed asset-based fee, plus a performance fee based on the capital appreciation of the fund. The partnership agreement was executed by the investor, and by Poe on behalf of JPA.

7. The subscription agreement includes an accreditation questionnaire and a qualified client questionnaire for each investor to review and complete. The former tracks the accreditation requirements under Regulation D of the Securities Act, and the latter tracts the language of Rule 205-3 of the Advisers Act. Nearly all of the subscription agreements submitted by investors in the JPA funds did not have the qualified client section completed.

8. JPA and Poe failed to determine at the time that the advisory contract was entered into, whether any investors satisfied the requirements of Advisers Act Rule 205-3. That is, whether any investors were "qualified clients." As a result, JPA charged all investors in its funds, including those who were non-qualified clients, a performance fee. Between 2009 and 2012, JPA received $637,843 in performance fees from investors who were not qualified clients.

9. However, during this time period, the language and application of the performance fee proscriptions in the Advisers Act changed due to enactment of the Dodd Frank Act and to amendments of certain Advisers Act rules. When enacted on July 22, 2010, the Dodd Frank Act amended Section 205 of the Advisers Act so that Section 205(a)(1) applied only to investment advisers registered or required to be registered with the Commission. Because JPA did not register with the Commission until September 15, 2010, Section 205(a)(1) did not apply to it from July 22 to September 14, 2010.

10. In addition, the Commission proposed and then adopted changes to Advisers Act Rule 205-3, which became effective on May 22, 2012. The changes included a "grandfathering" provision that stated, in pertinent part, that Section 205(a)(1) "will not apply ~~to~~...an account of an equity owner of a private investment company advised by the adviser if the account was established when the adviser was not required to register and was not registered." As a result, performance fees earned by JPA from accounts established by non-qualified clients between July 22 (the effective date of the Dodd Frank Act amendments to Section 205(a)) and September 15, 2010 (the date JPA registered with the Commission), were not earned in violation of Advisers Act Section 205(a)(1) between May 10, 2011 until the relevant conduct ceased in 2012.

11. Taking into consideration the enactment of the Dodd Frank Act and the adoption of changes to Advisers Act Rule 205-3, JPA received $610,762 in performance fees in violation of Section 205(a)(1) of the Advisers Act.

12. As a result of the conduct described above, JPA willfully[1] violated, and Poe willfully aided and abetted and caused JPA's violations of, Section 205(a) of the Advisers Act, which prohibits an investment adviser from entering into an advisory contract that provides for performance-based compensation.

13. As of the date of this Order, JPA has reimbursed all non-qualified clients the amount each improperly paid in performance fees.

Remedial Efforts

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

IV.

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

Accordingly, pursuant to Section 15(b)(6) of the Exchange Act and Sections 203(e), 203(f), 203(k), and 203(i) of the Advisers Act, it is hereby ORDERED that:

A. Respondents JPA and Poe cease and desist from committing or causing any violations and any future violations of Section 205(a) of the Advisers Act.

B. Respondents JPA and Poe are censured.

C. Respondents JPA and Poe shall, within ten days of the entry of this Order, pay jointly and severally civil money penalties in the amount of $35,000 to the United States Treasury. 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:

(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:

[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)).

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 JPA and Poe as a Respondents 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 David Peavler, Associate Regional Director, Division of Enforcement, Fort Worth Regional Office, Securities and Exchange Commission, Burnett Plaza, Suite 1900, 801 Cherry Street, Unit #18, Fort Worth, Texas 76102-6882.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Aguilar
Commissioner Piwowar
not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 71185 / December 24, 2013

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3523 / December 24, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15662

In the Matter of **KEVIN BRENNAN, CPA,** **Respondent.**	**ORDER OF SUSPENSION PURSUANT TO RULE 102(e)(2) OF THE COMMISSION'S RULES OF PRACTICE**

I.

The Securities and Exchange Commission deems it appropriate to issue an order of forthwith suspension of Kevin Brennan pursuant to Rule 102(e)(2) of the Commission's Rules of Practice [17 C.F.R. Section 201.102(e)(2)].[1]

II.

The Commission finds that:

1. Brennan, 60, is a certified public accountant holding inactive licenses in Florida and Pennsylvania.

2. On June 27, 2013, a judgment of conviction was entered against Brennan in *United States v. Brennan, et al*, Case No. 12-60064-CR, in the United States District Court for the Southern District of Florida, finding him guilty of two counts of securities fraud and one count of conspiracy to commit securities fraud.

[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."

3. As a result of this conviction, Brennan was sentenced to 75 months imprisonment in a federal penitentiary and ordered to forfeit $4,770.

III.

In view of the foregoing, the Commission finds that Brennan has been convicted of a felony within the meaning of Rule 102(e)(2) of the Commission's Rules of Practice.

Accordingly, it is ORDERED that Kevin Brennan is forthwith suspended from appearing or practicing before the Commission pursuant to Rule 102(e)(2) of the Commission's Rules of Practice.

By the Commission.

Elizabeth M. Murphy
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9505 / December 26, 2013

SECURITIES EXCHANGE ACT OF 1934
Release No. 71192 / December 26, 2013

Administrative Proceeding
File No. 3-15663

In the Matter of **NOMURA HOLDINGS, 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**

I.

Nomura Holdings, Inc. ("Respondent") has submitted a letter on behalf of itself and its affiliates, dated November 27, 2013, requesting a waiver of the disqualification provisions of Section 27A(b)(1)(A)(ii) of the Securities Act of 1933 ("Securities Act") and Section 21E(b)(1)(A)(ii) of the Securities Exchange Act of 1934 ("Exchange Act") arising from the settlement of a cease-and-desist administrative proceeding instituted by the Commission against Instinet, LLC ("Instinet"), a broker-dealer subsidiary of Respondent.

II.

On December 26, 2013, pursuant to Instinet's Offer of Settlement, the Commission issued an Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934 and Section 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"). Under the Order, the Commission found that Instinet willfully aided and abetted and caused violations by J.S. Oliver Capital Management, L.P. ("JS Oliver") of Sections 206(2) and 206(4) of the Advisers Act of 1940 ("Advisers Act") and Rule 206(4)-8 thereunder by engaging in the following conduct: From January 2009 through July 2010, Instinet paid approximately $430,000 in client commission credits called "soft dollars" as requested by its customer, JS Oliver, a San Diego-based investment adviser, for expenses that JS Oliver had not properly disclosed to its clients. The improper payments included $329,365 to the ex-wife of JS Oliver's president, Ian O. Mausner; thirteen months of increased rent payments totaling $65,000 for JS Oliver's offices at Mausner's home; and two payments totaling $40,094.54 for upkeep on Mausner's New York City timeshare. Instinet made the payments pursuant to JS Oliver's requests even though the information JS Oliver had provided Instinet presented significant red flags and clear suggestions of irregular conduct that each payment was improper. The Order required Instinet to 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 thereunder, censured Instinet, required that Instinet pay disgorgement of $378,673.76, prejudgment interest of $59,607.66, and a civil money penalty of $375,000. Instinet also was ordered to comply with certain undertakings enumerated in the Order.

III.

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.

IV.

Based on the representations set forth in Respondent'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 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 Respondent and its affiliates resulting from the Commission's Order is hereby granted.

By the Commission.

Elizabeth M. Murphy
Secretary

By: Lynn M. Powalski
Deputy Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9504 / December 26, 2013

Administrative Proceeding
File No. 3-15663

In the Matter of **INSTINET, LLC,** **Respondent.**	**ORDER UNDER RULE 602(e) OF THE SECURITIES ACT OF 1933 GRANTING A WAIVER OF THE RULE 602(c)(3) DISQUALIFICATION PROVISION**

I.

Instinet, LLC ("Instinet") has submitted a letter, dated December 11, 2013, requesting a waiver for itself and affiliates of the Rule 602(c)(3) disqualification from relying on the exemption from registration under Regulation E arising from Instinet's settlement of administrative and cease-and-desist proceedings instituted by the Commission.

II.

On December 26, 2013, pursuant to Instinet's Offer of Settlement, the Commission issued an Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934 and Section 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"). Under the Order, the Commission found that Instinet willfully aided and abetted and caused violations by J.S. Oliver Capital Management, L.P. ("JS Oliver") of Sections 206(2) and 206(4) of the Advisers Act of 1940 ("Advisers Act") and Rule 206(4)-8 thereunder by engaging in the following conduct: From January 2009 through July 2010, Instinet paid approximately $430,000 in client commission credits called "soft dollars" as requested by its customer, JS Oliver, a San Diego-based investment adviser, for expenses that JS Oliver had not properly disclosed to its clients. The improper payments included $329,365 to the ex-wife of JS Oliver's president, Ian O. Mausner; thirteen months of increased rent payments totaling $65,000 for JS Oliver's offices at Mausner's home; and two payments totaling $40,094.54 for upkeep on Mausner's New York City timeshare. Instinet made the payments pursuant to JS Oliver's requests even though the information JS Oliver had provided Instinet presented significant red flags and clear suggestions of irregular conduct that each payment was improper. The Order required Instinet to 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 thereunder, censured Instinet, required that Instinet pay disgorgement of $378,673.76, prejudgment interest of $59,607.66, and a civil money penalty of $375,000. Instinet also was ordered to comply with certain undertakings enumerated in the Order.

III.

The Regulation E exemption is unavailable for the securities of small business investment company issuers or business development company issuers if any investment adviser or any underwriter of the securities to be offered is subject to an order of the Commission pursuant to Section 15(b) of the Securities Exchange Act of 1934. 17 C.F.R. § 230.602(c)(3). The Order is such an order. Rule 602(e) of the Securities Act of 1933 ("Securities Act") provides, however, that the disqualification "shall not apply . . . if the Commission determines, upon a showing of good cause, that it is not necessary under the circumstances that the exemption be denied." 17 C.F.R. § 230.602(e).

IV.

Based upon the representations set forth in Instinet's request, the Commission has determined that pursuant to Rule 602(e) under the Securities Act a showing of good cause has been made that it is not necessary under the circumstances that the exemption be denied as a result of the entry of the Order.

Accordingly, **IT IS ORDERED**, pursuant to Rule 602(e) under the Securities Act, that a waiver from the application of the disqualification provision of Rule 602(c)(3) under the Securities Act resulting from the entry of the Order is hereby granted.

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

SECURITIES EXCHANGE ACT OF 1934
Release No. 71191 / December 26, 2013

INVESTMENT ADVISERS ACT OF 1940
Release No. 3748 / December 26, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15663

In the Matter of **INSTINET, LLC** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTION 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 Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Section 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") against Instinet, LLC ("Instinet" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934 and Section 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[1] that

Summary

1. From January 2009 through July 2010, Instinet paid approximately $430,000 in client commission credits called "soft dollars" as requested by its customer, J.S Oliver Capital Management, L.P. ("JS Oliver"), a San Diego-based investment adviser, for expenses that JS Oliver had not properly disclosed to its clients. The improper payments included $329,365 to the ex-wife of JS Oliver's president, Ian O. Mausner; thirteen months of increased rent payments totaling $65,000 for JS Oliver's offices at Mausner's home; and two payments totaling $40,094.54 for upkeep on Mausner's New York City timeshare. Instinet made the payments pursuant to JS Oliver's requests even though the information JS Oliver had provided to Instinet when requesting approval of the payments presented significant red flags and clear suggestions of irregular conduct that each payment was improper.

Respondent

2. **Instinet, LLC** is a Delaware limited liability company with its principal place of business in New York, NY. Instinet is a broker-dealer registered with the Commission.

Other Relevant Entity and Individual

3. **J.S. Oliver Capital Management, L.P.** is a California limited partnership with its principal place of business in San Diego, California. JS Oliver registered with the Commission as an investment adviser in 2004 and has approximately $115 million in assets under management. **Ian O. Mausner** has been the president, head portfolio manager, and control person of JS Oliver since 2004. On August 30, 2013, the Commission instituted an administrative and cease-and-desist proceeding against JS Oliver and Mausner alleging that they violated the antifraud and other provisions of the federal securities laws for engaging in cherry-picking and soft dollar schemes. See *In the Matter of J.S. Oliver Capital Management, L.P., et al.*, Advisers Act Rel. No. 3658 (Aug. 30, 2013).

Factual Background

4. In January 2009, Instinet and JS Oliver entered into an agreement whereby JS Oliver could accumulate commission credits called "soft dollars" on its clients' equity

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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.

and option trades executed through Instinet. Pursuant to the arrangement, Instinet generally agreed to give JS Oliver a soft dollar credit of $0.0225 for every $0.03 of brokerage commissions generated per share by JS Oliver clients' equity trades; soft dollar credits for option trades varied. JS Oliver, through Instinet, used soft dollar credits for expenses that fell both within and outside the safe harbor provided in Section 28(e) of the Exchange Act ("Section 28(e) safe harbor") for the use of commission credits for certain research and brokerage expenses.

5. Instinet's commission management services ("CMS") department was in charge of administering soft dollar arrangements with its customers, including the approval of all soft dollar payments. Before approving a soft dollar payment that a customer requested, the CMS department's practice included reviewing the related invoice, any relevant back-up documentation or information in support of the payment request, and the adviser's soft dollar disclosures for non-Section 28(e) safe harbor payment requests.

6. The soft dollar disclosures JS Oliver provided to Instinet included, among other things, that soft dollars may be used for "evaluating potential investment opportunities (including travel, meals and lodging related to such evaluation) ... and may even include such 'overhead' expenses as office rent, salaries, benefits and other compensation of employees or of consultants to the Investment Manager ...."

Payment To Mausner's Ex-Wife

7. In June 2009, Instinet, pursuant to JS Oliver's request, paid JS Oliver $329,365 using soft dollar credits for a payment to Mausner's ex-wife based on JS Oliver's representations to Instinet that the payment was for employee compensation. The payment was not employee compensation and was not properly disclosed to JS Oliver's clients. As a result, JS Oliver's use of soft dollars to make this payment violated (among other provisions) Sections 206(2) and 206(4) of the Advisers Act, and Rule 206(4)-8 thereunder.

8. An Instinet CMS employee knew of significant red flags that the payment to Mausner's ex-wife was improper because it was not compensation to a JS Oliver employee but rather was to satisfy Mausner's personal obligation. These red flags included that (1) the recipient of the payment was Mausner's ex-wife; (2) the payment was purportedly relating to the Mausners' parting ways professionally after their divorce; (3) JS Oliver gave Instinet a series of inconsistent justifications for the payment, first stating that Mausner's ex-wife would provide future work as a consultant to JS Oliver for tax and compliance issues, then stating that the payment was to terminate a pre-existing employment agreement for her advice on organizational and accounting issues; (4) despite Instinet's requests, JS Oliver never provided Instinet with the purported employment agreement or a legal opinion from outside counsel stating that the use of soft dollars for the payment was proper; and (5) JS Oliver provided Instinet only an excerpt of the purported employment agreement that, although materially altered by JS Oliver in an attempt to hide that the payment was Mausner's personal obligation, did not indicate that Mausner's ex-wife had conducted any work for JS Oliver after 2006 and did not substantiate the amount of JS Oliver's request to pay $329,365.

9. Despite these red flags, that Instinet CMS employee approved the payment.

Payments For Increased Rent

10. In July 2009, Instinet, pursuant to JS Oliver's request, agreed to use soft dollars to pay a 50% increase in rent (from $10,000 to $15,000) on JS Oliver's behalf for its offices in Mausner's home. Since January 2009, Instinet had paid JS Oliver's rent of $10,000 per month using soft dollars. The increased rent payments of $15,000 continued through July 2010. The rent payments were inflated, made for Mausner's personal financial benefit, and not properly disclosed to JS Oliver's clients. As a result, JS Oliver's use of soft dollars for these payments violated (among other provisions) Sections 206(2) and 206(4) of the Advisers Act, and Rule 206(4)-8 thereunder.

11. An Instinet CMS employee knew of significant red flags that the increased rent payment was improper because it was for Mausner's personal financial benefit. These red flags included that (1) JS Oliver rented office space in Mausner's personal residence; (2) the lease agreement requested by Instinet clearly indicated that Mausner owned the company to which Instinet paid the rent; (3) JS Oliver had already provided Instinet with invoices for all of 2009 that indicated monthly rent of $10,000; (4) the increase in rent was a significant, 50% increase; and (5) JS Oliver's business address had not changed at the time JS Oliver sought the rent increase.

12. Despite these red flags, that Instinet CMS employee approved the payments.

Payments For Mausner's Personal Timeshare Property

13. In January and December 2009, Instinet, pursuant to JS Oliver's request, used soft dollars to make two payments totaling $40,094.54 on JS Oliver's behalf that were purportedly for Mausner's travel expenses related to evaluating "potential investment opportunities." In fact, these payments were for maintenance, taxes and fees on Mausner's personal timeshare in New York City, and thus were for Mausner's own financial benefit and were not properly disclosed to JS Oliver's clients. As a result, JS Oliver's use of soft dollars to make these payments violated (among other provisions) Sections 206(2) and 206(4) of the Advisers Act, and Rule 206(4)-8 thereunder.

14. An Instinet CMS employee knew of significant red flags that the timeshare payments were improper because they satisfied Mausner's personal expenses. These red flags included that (1) only the invoice JS Oliver prepared for each payment request indicated that the expenses were related to travel; (2) the January 2009 bill JS Oliver provided to Instinet was in Mausner's name from the St. Regis New York, payable to Fifth & Fifty-Fifth Residence Club Association, Inc., and described the expenses as "2009 Maintenance Fee" and "2009 Real Estate Taxes"; and (3) the December 2009 bill JS Oliver provided to Instinet was in Mausner's name from the Fifth & Fifty-Fifth Residence Club Association, Inc., described the expenses as "2010 Maintenance Fee" and "2010 Replacement Reserves" and provided that "owners delinquent in the payment of maintenance fees may be denied use of their fractional interest."

15. Despite these red flags, that Instinet CMS employee approved the payment.

VIOLATIONS

16. As a result of the conduct described above, Instinet willfully aided and abetted and caused JS Oliver's violations of Sections 206(2) of the Advisers Act, which prohibits an investment adviser from engaging in any transaction, practice, or course of business which operates as a fraud or deceit upon a client or prospective client, and Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, which prohibit fraudulent conduct by an investment adviser to pooled investment vehicles.

UNDERTAKINGS

Respondent has undertaken to:

17. Retain, not later than thirty (30) days after the date of this Order, at its expense, an independent consultant not unacceptable to the Commission's staff (the "Independent Consultant"). Instinet shall require the Independent Consultant to (a) conduct a comprehensive review of Instinet's policies, procedures, and practices related to its payment of soft dollars as part of its client commission services (collectively, "Policies and Procedures"); and (b) make recommendations for changes in or improvements to the Policies and Procedures to prevent Instinet from aiding and abetting and causing an investment adviser's violations of Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder with respect to soft dollars.

18. No later than ten (10) days following the date of the Independent Consultant's engagement, provide to the Commission staff a copy of an engagement letter detailing the Independent Consultant's responsibilities pursuant to paragraph 16 above. To ensure independence, Instinet shall not have the authority to terminate the Independent Consultant without prior written approval of the Commission's staff.

19. Arrange for the Independent Consultant to issue its report within one hundred twenty (120) days after the date of this Order. Within ten (10) days after the issuance of the report, Instinet shall require the Independent Consultant to submit to C. Dabney O'Riordan of the Commission's Los Angeles Regional Office a copy of the Independent Consultant's report. The Independent Consultant's report shall describe the review performed and the conclusions reached and shall include any recommendations deemed necessary to make the Policies and Procedures adequate and address the findings set forth in Section III of the Order.

20. Within thirty (30) days of receipt of the Independent Consultant's report, adopt all recommendations contained in the report and remedy any deficiencies in its Policies and Procedures; provided, however, that as to any recommendation that Instinet believes is unnecessary or inappropriate, Instinet may, within fifteen (15) days of receipt of the report, advise the Independent Consultant in writing of any recommendations that it considers to be unnecessary or inappropriate and propose in writing an alternative policy or procedure designed to achieve the same objective or purpose.

21. With respect to any recommendation with which Instinet and the Independent Consultant do not agree, attempt in good faith to reach an agreement with the

Independent Consultant within thirty (30) days of receipt of the report. In the event that Instinet and the Independent Consultant are unable to agree on an alternative proposal acceptable to the Commission's staff, Instinet will abide by the original recommendation of the Independent Consultant.

22. Cooperate fully with the Independent Consultant and provide the Independent Consultant with access to its files, books, records and personnel as reasonably requested for the Independent Consultant's review.

23. Require the Independent Consultant to enter into an agreement that provides that for the period of engagement and for a period of two years from completion of the engagement, the Independent Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with Instinet, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity. The agreement will also provide that the Independent Consultant will require that any firm with which he/she is affiliated or of which he/she is a member, and any person engaged to assist the Independent Consultant in performance of his/her duties under this Order shall not, without prior written consent of the Commission staff, enter into any employment, consultant, attorney-client, auditing or other professional relationship with Instinet, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement.

24. Certify, in writing, compliance with the undertaking(s) set forth above. The certification shall identify the undertaking(s), provide written evidence of compliance in the form of a narrative, and be supported by exhibits sufficient to demonstrate compliance. The Commission staff may make reasonable requests for further evidence of compliance, and Respondent agrees to provide such evidence. The certification and supporting material shall be submitted to C. Dabney O'Riordan, Assistant Regional Director, with a copy to the Office of Chief Counsel of the Enforcement Division, no later than sixty (60) days from the date of the completion of the undertakings.

IV.

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

Accordingly, pursuant to Section 15(b) of the Exchange Act and Section 203(k) of the Advisers Act, it is hereby ORDERED that:

A. Respondent Instinet shall 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 thereunder.

B. Respondent Instinet is censured.

C. Respondent Instinet shall, within ten (10) days of the entry of this Order, pay disgorgement of $378,673.76, prejudgment interest of $59,607.66, and a civil money penalty in the amount of $375,000 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600 and 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 Instinet 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 Marshall S. Sprung, Co-Chief of the Asset Management Unit, Division of Enforcement, Securities and Exchange Commission, 5670 Wilshire Blvd., 11th Floor, Los Angeles, CA 90036.

D. 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 Paragraph 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, 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 thirty (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. Respondent shall comply with the undertakings enumerated in Paragraphs 17-24 above.

By the Commission.

Elizabeth M. Murphy
Secretary

Lynn M. Powalski

By: Lynn M. Powalski
Deputy Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 240 and 249

Release No. 34-71194; File No. S7-15-11

RIN 3235-AL14

REMOVAL OF CERTAIN REFERENCES TO CREDIT RATINGS UNDER THE SECURITIES EXCHANGE ACT OF 1934

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission (the "Commission") is adopting amendments that remove references to credit ratings in certain rules and one form under the Securities Exchange Act of 1934 (the "Exchange Act") relating to broker-dealer financial responsibility and confirmations of securities transactions. This action implements a provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

EFFECTIVE DATES: The amendments will become effective on [insert date 180 days after the date of 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, at (202) 551-5729, Office of Financial Responsibility (Net Capital, Customer Protection, and Books and Records Requirements); and Joseph M. Furey, Assistant Chief Counsel; and Brice D. Prince, Special Counsel, Office of the Chief Counsel, at (202) 551-5550 (Confirmations of Securities Transactions); Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-7010.

SUPPLEMENTARY INFORMATION: The Commission is adopting amendments to Rules 10b-10,[1] 15c3-1,[2] 15c3-1a,[3] 15c3-1e,[4] 15c3-1f,[5] 15c3-3,[6] and 17a-4[7] under the Exchange Act and corresponding amendments to the General Instructions to Form X-17A-5, Part IIB.[8]

I. INTRODUCTION

On July 21, 2010, the President signed the Dodd-Frank Act into law.[9] This legislation was enacted to, among other things, promote the financial stability of the United States by improving accountability and transparency in the financial system.[10] Section 939A of the Dodd-Frank Act requires each Federal agency, including the Commission, 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.[11] The section further provides that each such agency shall "modify any such regulations identified by the review . . . to remove any reference to or requirement of reliance on credit ratings, and to substitute in such regulations such standard of creditworthiness as each respective agency shall determine as appropriate for such regulations."[12]

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1 17 CFR 240.10b-10.

2 17 CFR 240.15c3-1.

3 17 CFR 240.15c3-1a.

4 17 CFR 240.15c3-1e.

5 17 CFR 240.15c3-1f.

6 17 CFR 240.15c3-3.

7 17 CFR 240.17a-4.

8 See the General Instructions to Form X-17A-5, Part IIB (referenced in 17 CFR 249.617).

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

10 Id. at Preamble.

11 Pub. L. No. 111-203 § 939A(a)(1)-(2). In July 2011, the Commission published a report on the staff's review of Commission regulations that relied on credit ratings. See Commission Staff, 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 (July 2011). Section 939A of the Dodd-Frank Act applies to all federal agencies.

12 See Pub. L. No. 111-203 § 939A(b).

II. DISCUSSION

A. Background

Prior to and after enactment of the Dodd-Frank Act, the Commission has taken a number of steps toward removing references to credit ratings from its regulations under the federal securities laws.[13] These steps include a 2011 proposal to remove references to credit ratings of nationally recognized statistical rating organizations ("NRSROs") from certain rules under the Exchange Act relating to broker-dealer financial responsibility (Rule 15c3-1, Rule 15c3-3, and Form X-17A-5, Part IIB), confirmations of securities transactions (Rule 10b-10), and distributions of securities (Rules 101 and 102 of Regulation M).[14] Today the Commission is adopting amendments to remove references to credit ratings in the broker-dealer financial responsibility and confirmations of transactions rules. In doing so, the Commission considered its prior actions in this area. Regarding its proposal to remove credit ratings from its rules under

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13 See, e.g., Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34616 (Aug. 31, 1994), 59 FR 46314 (Sep. 7, 1994) (soliciting comment on, among other things, whether references to NRSRO credit ratings should be eliminated from Commission rules); Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws, Exchange Act Release No. 47972 (June 4, 2003), 68 FR 35258 (June 12, 2003) (soliciting comment on whether to eliminate the use of NRSRO credit ratings, and, if so, what alternative benchmarks could be used to meet the Commission's regulatory objectives); References to Ratings of Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 58070 (July 1, 2008), 73 FR 40088 (July 11, 2008) (proposing amendments to remove references to credit ratings from Commission rules under the Securities Act of 1933 ("Securities Act"), Exchange Act, and Investment Company Act of 1940 ("Investment Company Act")); References to Ratings of Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 60789 (Oct. 5, 2009), 74 FR 52358 (Oct. 9, 2009) (adopting amendments to remove references to credit ratings in certain Commission rules); 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 on proposals to remove references to credit ratings in certain Commission rules); Security Ratings, Securities Act Release No. 9186 (Feb. 9, 2011), 76 FR 8961 (Feb. 16, 2011) (proposing amendments to remove references to credit ratings in certain Commission rules); 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) (proposing amendments to remove references to credit ratings in certain Commission rules); Security Ratings, Securities Act Release No. 9245 (July 27, 2011), 76 FR 46603 (Aug. 3, 2011) (adopting amendments to remove references to credit ratings in certain Commission rules).

14 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). The Commission also proposed amendments in 2011 to remove references to credit ratings in rules under the Securities Act and the Investment Company Act. See References to Credit Ratings in Certain Investment Company Act Rules and Forms, 76 FR 12896; Security Ratings, 76 FR 8961.

Regulation M applicable to distributions of securities, the Commission is currently reviewing comments and considering alternatives and intends to address this proposal separately.[15] In taking these actions, the Commission has carefully considered the eleven comment letters it received in response to the proposing release,[16] five of which discussed the proposed amendments to the broker-dealer financial responsibility rules,[17] and four of which discussed the proposed amendments to the confirmations of transactions rule.[18]

A number of other federal agencies have also taken action to implement section 939A of the Dodd-Frank Act, including regulations proposed or adopted by the Commodity Futures Trading Commission,[19] the Office of the Comptroller of the Currency,[20] the National Credit

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15 Regulation M is a set of anti-manipulation rules designed to preserve the integrity of the securities market by prohibiting activities that could artificially influence the market for an offered security. See 17 CFR 242.100-105. The rules include an exception for nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities that are rated by at least one NRSRO in one of its generic rating categories that signifies investment grade. See 17 CFR 242.101(c)(2); 17 CFR 242.102(d)(2).

16 Comment letter of Chris Barnard (June 6, 2011) ("Barnard Letter"); comment letter of Creative Investment Research, Inc. (July 4, 2011) ("Creative Investment Letter"); comment letter of Rothwell Consulting LLC (July 5, 2011) ("Rothwell Consulting Letter"); comment letter of Davis Polk & Wardwell LLP (July 5, 2011) ("Davis Polk Letter"); comment letter of Bond Dealers of America (July 5, 2011) ("Bond Dealers Letter"); comment letter of the Securities Industry and Financial Markets Association (July 5, 2011) ("SIFMA Letter"); comment letter of Better Markets, Inc. (July 5, 2011) ("Better Markets Letter"); comment letter of Sullivan & Cromwell LLP (July 5, 2011) ("Sullivan & Cromwell Letter"); comment letter of the Securitization Group, Securities Industry and Financial Markets Association (Sep. 23, 2011) ("SIFMA Securitization Letter"); comment letter of the CFA Institute (Dec. 20, 2011) ("CFA Institute Letter"); and comment letter of the Honorable Sean P. Duffy, U.S. House of Representatives (Oct. 4, 2013) ("Duffy Letter"). These comment letters are available at http://www.sec.gov/comments/s7-15-11/s71511.shtml. Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC (File No. S7-15-11).

17 See Barnard Letter; Better Markets Letter; Bond Dealers Letter; CFA Institute Letter; SIFMA Letter.

18 See Better Markets Letter; CFA Institute Letter; SIFMA Letter; Sullivan & Cromwell Letter. In addition, one letter discussed the proposed amendments to Regulation M and one letter discussed reference removal under section 939A generally. See Rothwell Consulting Letter (Regulation M); Duffy Letter (section 939A generally).

19 See Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions, 76 FR 78776 (Dec. 19, 2011) (final rule); Removing Any Reference to or Reliance on Credit Ratings in Commission Regulations; Proposing Alternatives to the Use of Credit Ratings, 76 FR 44262 (July 25, 2011) (final rule).

20 See Alternatives to the Use of External Credit Ratings in the Regulations of the OCC, 77 FR 35253 (June 13, 2012) (final rule).

Union Administration,[21] the Federal Housing Finance Agency,[22] the Department of Labor,[23] and jointly by the Office of the Comptroller of the Currency and the Federal Reserve Board.[24] The actions taken by these other regulators were considered in adopting today's amendments.

The following discussion summarizes the Commission's proposals with respect to the broker-dealer financial responsibility and confirmations of transaction rules, the comments received by the Commission in response to each of the proposals, and the amendments the Commission is adopting today.[25]

B. Amendments

1. The Broker-Dealer Financial Responsibility Rules

a. The Net Capital Rule

i. Proposal

In 1975, the Commission adopted the term nationally recognized statistical rating organization as part of amendments to the broker-dealer net capital rule ("Rule 15c3-1").[26] 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.[27] Rule

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21 See Alternatives to the Use of Credit Ratings, 77 FR 74103 (Dec. 13, 2012) (final rule).

22 See Removal of References to Credit Ratings in Certain Regulations Governing the Federal Home Loan Banks, 78 FR 30784 (May 23, 2013) (proposed rule).

23 See Proposed Amendments to Class Prohibited Transaction Exemptions to Remove Credit Ratings Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, 78 FR 37572 (June 21, 2013) (proposed rule).

24 See Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-Weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 FR 62018 (Oct. 11, 2013) (interim final rule with request for comment).

25 In a separate release, the Commission is adopting final amendments to remove references to credit ratings in Rule 5b-3 and Forms N-1A, N-2, and N-3 under the Investment Company Act.

26 See Adoption of Uniform Net Capital Rule and an Alternative Net Capital Requirement for Certain Brokers and Dealers, Exchange Act Release No. 11497 (June 26, 1975), 40 FR 29795 (July 16, 1975); 17 CFR 240.15c3-1.

27 See 17 CFR 240.15c3-1.

15c3-1 prescribes a net liquid assets test that is designed to require a broker-dealer to maintain sufficient liquid assets to meet all obligations to customers and counterparties and have adequate additional resources to wind-down its business in an orderly manner without the need for a formal proceeding if the firm fails financially.[28] Among other things, Rule 15c3-1 requires broker-dealers to maintain specified minimum levels of net liquid assets, or net capital.[29] In particular, it requires that a broker-dealer perform two calculations: (1) a computation of the minimum amount of net capital the broker-dealer must maintain;[30] and (2) a computation of the amount of net capital the broker-dealer is maintaining.[31] The minimum net capital requirement is the greater of a fixed-dollar amount specified in the rule or an amount determined by applying one of two financial ratios.[32]

In computing net capital, a broker-dealer must, among other things, make certain adjustments to net worth, including deducting illiquid assets, taking other net capital charges, and adding qualifying subordinated loans.[33] The amount remaining after these adjustments is defined as tentative net capital.[34] The final step in computing net capital is to take prescribed percentage deductions ("haircuts") from the mark-to-market value of proprietary positions (e.g., securities, money market instruments, and commodities) that are included in the broker-dealer's tentative net capital.[35] The haircuts are designed to account for the market risk inherent in these positions

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28 See Net Capital Rule, Exchange Act Release No. 38248 (Feb. 6, 1997), 62 FR 6474 (Feb. 12, 1997).

29 See 17 CFR 240.15c3-1.

30 See 17 CFR 240.15c3-1(a).

31 See 17 CFR 240.15c3-1(c)(2). The computation of net capital is based on the definition of net capital in paragraph (c)(2) of Rule 15c3-1. Id.

32 See 17 CFR 240.15c3-1(a).

33 See 17 CFR 240.15c3-1(c)(2)(i) through (xiii).

34 See 17 CFR 240.15c3-1(c)(15).

35 See 17 CFR 240.15c3-1(c)(2)(vi).

and create a buffer of liquidity to protect against other risks associated with the securities business.[36]

Rule 15c3-1 prescribes differing haircut amounts for a variety of classes of securities.[37] The rule also contains catchall provisions to account for securities that are not included in the specified classes of securities.[38] Generally, the catchall provisions impose higher deductions (15% or 40% of the mark-to-market value of the positions) than the haircuts applicable to the specifically identified classes of securities.[39] Further, if a security does not have a ready market, it is subject to a 100% deduction from net worth.[40]

Prior to today's amendments, commercial paper, nonconvertible debt, and preferred stock rated in higher rating categories by at least two NRSROs were included in the classes of securities that had lower haircuts than securities subject to the catchall provisions.[41] Specifically, to qualify for this treatment, among other things, commercial paper needed to be rated in one of the three

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36 See, e.g., Uniform Net Capital Rule, Exchange Act Release No. 13635 (June 16, 1977), 42 FR 31778 (June 23, 1977) ("[Haircuts] are intended to enable net capital computations to reflect the market risk inherent in the positioning of the particular types of securities enumerated in [the rule.]"); Net Capital Rule, Exchange Act Release No. 22532 (Oct. 15, 1985), 50 FR 42961 (Oct. 23, 1985) ("These percentage deductions, or 'haircuts', take into account elements of market and credit risk that the broker-dealer is exposed to when holding a particular position."); Net Capital Rule, Exchange Act Release No. 39455 (Dec. 17, 1997), 62 FR 67996 (Dec. 30, 1997) ("Reducing the value of securities owned by broker-dealers for net capital purposes provides a capital cushion against adverse market movements and other risks faced by the firms, including liquidity and operational risks.") (footnote omitted).

37 See 17 CFR 240.15c3-1(c)(2)(vi)(A) through (H).

38 See 17 CFR 240.15c3-1(c)(2)(vi)(J) through (K).

39 Compare 17 CFR 240.15c3-1(c)(2)(vi)(A) through (H), with 17 CFR 240.15c3-1(c)(2)(vi)(J) through (K).

40 See 17 CFR 240.15c3-1(c)(2)(vii). The term ready market is defined in Rule 15c3-1 as "a market in which there exists independent bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined for a particular security almost instantaneously and where payment will be received in settlement of a sale at such price within a relatively short time conforming to trade custom." 17 CFR 240.15c3-1(c)(11).

41 See 17 CFR 240.15c3-1(c)(2)(vi)(E), (F), and (H). Generally, the haircut requirements in Rule 15c3-1 prior to today's amendments were based on the practice of many NRSROs having at least eight categories of ratings for debt securities, with the top four ratings commonly referred to in the industry as investment grade.

highest rating categories by at least two NRSROs,[42] nonconvertible debt needed to be rated in one of the four highest rating categories by at least two NRSROs,[43] and preferred stock needed to be rated in one of the four highest rating categories by at least two NRSROs.[44] Broker-dealers were not required to take as large a haircut for commercial paper, nonconvertible debt, and preferred stock meeting these rating conditions because the securities were considered to be less volatile in price than securities that were rated in lower rating categories or were unrated.

The Commission proposed to remove references to credit ratings in the provisions of Rule 15c3-1 establishing lower haircuts for higher rated commercial paper, nonconvertible debt, and preferred stock and to substitute an alternative standard of creditworthiness as a condition for qualifying for the lower haircut treatment.[45] The proposed amendments retained the non-credit rating conditions for these classes of securities to apply lower haircuts. Under the proposal, a broker-dealer would have been permitted to apply the lower haircuts for commercial paper (i.e., between zero and ½ of 1%), nonconvertible debt (i.e., between 2% and 9%), and preferred stock (i.e., 10%) if the position had only a minimal amount of credit risk as determined by the broker-dealer pursuant to written policies and procedures the broker-dealer established, maintained, and

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42 See 17 CFR 240.15c3-1(c)(2)(vi)(E). The amount of the haircut ranged from 0% to ½ of 1% depending on the time to maturity of the commercial paper. Id. Additional conditions to qualify for this treatment were that the commercial paper had a maturity at date of issuance not exceeding nine months exclusive of days of grace, or any renewal thereof, the maturity of which was likewise limited, and a fixed rate of interest or been sold at a discount. Id.

43 See 17 CFR 240.15c3-1(c)(2)(vi)(F). The amount of the haircut ranged from 2% to 9% depending on the time to maturity of the nonconvertible debt security. Id. Additional conditions to qualify for this treatment were that the nonconvertible debt security had a fixed rate of interest, a fixed maturity, and did not trade flat and was not in default as to principal or interest. Id.

44 See 17 CFR 240.15c3-1(c)(2)(vi)(H). The amount of the haircut was 10%. Id. Additional conditions to qualify for this treatment were that the preferred stock ranked prior to all other classes of stock of the same issuer and was not in arrears as to dividends. Id.

45 See Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934, 76 FR at 26552-26554.

enforced to assess creditworthiness.[46] Consequently, to use these lower haircuts for commercial paper, nonconvertible debt, and preferred stock, a broker-dealer would have been required to establish, maintain, and enforce written policies and procedures designed to assess the credit risks applicable to the position and, based on this process, would have had to determine that the investment had only a minimal amount of credit risk.[47] A broker-dealer would have been required to take a larger deduction, normally the 15% "catchall" haircut, on its proprietary positions in commercial paper, nonconvertible debt, and preferred stock if the firm did not have procedures to assess the creditworthiness of the class of security or money market instrument or determined its position was not of minimal credit risk.[48] Moreover, if an issuance of commercial paper, nonconvertible debt, or preferred stock did not trade in a ready market, the broker-dealer would continue to apply a 100% haircut – meaning that the broker-dealer could not include the value of the security in its net capital.[49]

In the proposing release, the Commission identified the following factors a broker-dealer could consider, to the extent appropriate, when assessing credit risk for purposes of determining whether an issuance of commercial paper, nonconvertible debt, or preferred stock was of minimal credit risk: (1) credit spreads; (2) securities-related research; (3) internal or external credit risk assessments; (4) default statistics; (5) inclusion in an index; (6) priorities and enhancements; (7) price, yield and/or volume; and (8) asset class-specific factors.[50] The Commission stated that the list of factors was not intended to be exhaustive nor mutually

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46 Id. at 26552.

47 Id.

48 Id.

49 Id.

50 Id. at 26552-26553.

exclusive and that the range and type of specific factors considered would vary depending on the particular securities that were reviewed.[51]

In addition, each broker-dealer would have been required to preserve for a period of not less than three years (the first two years in an easily accessible place) the written policies and procedures that the broker-dealer established, maintained, and enforced for assessing credit risk for commercial paper, nonconvertible debt, and preferred stock.[52] Broker-dealers would have been subject to this requirement in the broker-dealer record retention rule (Rule 17a-4), which the Commission proposed to amend in conjunction with the rulemaking.[53]

ii. Comments

Five commenters responded to the Commission's request for comment on the amendments to Rule 15c3-1.[54] One additional commenter – writing about section 939A generally – supported the goals of section 939A to provide incentive for more information and diligence for investors and to increase competition in the credit rating agency industry but also cautioned that implementation of section 939A could be confusing to smaller banks and investors.[55] Two commenters raised concerns generally about replacing credit ratings with a more subjective standard of creditworthiness.[56] Three other commenters suggested modifications to the Commission's list of factors that a broker-dealer could consider when

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51 Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934, 76 FR at 26553.

52 Id. at 26553.

53 Id.; see also 17 CFR 240.17a-4.

54 See Barnard Letter; Better Markets Letter; Bond Dealers Letter; CFA Institute Letter; SIFMA Letter; see also Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934, 76 FR at 26554.

55 See Duffy Letter, at 1.

56 See Bond Dealers Letter, at 2-3; SIFMA Letter, at 11.

assessing creditworthiness under the proposed minimal amount of credit risk standard.[57] Commenters also generally supported the Commission's proposal that broker-dealers document and retain their policies and procedures for assessing a position's creditworthiness to determine whether it is of minimal credit risk.[58]

Among commenters raising concerns about the Commission replacing credit ratings with a more subjective approach for determining haircuts, one commenter stated that the proposal contains an inherent conflict of interest, is complicated, and would disproportionately burden smaller firms.[59] This commenter also stated that the Commission's proposal could result in inconsistent net capital treatment across broker-dealers absent a mandatory list of factors or an objective standard that a broker-dealer could apply when determining net capital haircuts – "[f]or example, one firm may determine a security qualifies for a 9% haircut, while another might determine the haircut for the same security is 15%."[60] This commenter also has concerns that a subjective approach would reduce liquidity, increase volatility, and could increase costs for issuers of securities.[61]

The second commenter expressed concern that Commission and self-regulatory organization ("SRO") examiners would "second guess" a broker-dealer's policies and procedures and analysis under the new standard and that examiners should, instead, focus on the reasonableness of the policies and procedures.[62] This commenter also requested that examiners

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57 See Barnard Letter, at 1-2; Better Markets Letter, at 6-7; CFA Institute Letter, at 4.

58 See Barnard Letter, at 2; Better Markets Letter, at 6-8.

59 Bond Dealers Letter, at 2. This commenter argued that the proposed amendments disadvantage smaller broker-dealers that lack the necessary internal resources to determine creditworthiness and, as a result, will be unable to apply reduced haircuts.

60 Id.

61 Id.

62 SIFMA Letter, at 19.

avoid duplicating the work of other regulators who have already considered the adequacy of a broker-dealer's policies and procedures for assessing the creditworthiness of securities positions.[63]

Regarding the Commission's proposed list of factors that broker-dealers could consider when assessing creditworthiness under the minimal amount of credit risk standard, one commenter recommended that the Commission require broker-dealers to consider certain mandatory factors and suggested they be codified in the final rule.[64] In contrast, another commenter did not believe that factors should be codified in the rule.[65] Another stated that a broker-dealer's assessment of a security's creditworthiness should be based on "hard" factors, such as credit spreads and default statistics, rather than "soft" factors, such as securities-related research.[66]

One commenter requested that "term to maturity" and "concentration of credit risk" be included as factors that a broker-dealer could consider in assessing whether a position is of minimal credit risk.[67] Another suggested that a broker-dealer's policies and procedures for assessing creditworthiness under the proposed standard be permitted to take into account the "size of the [broker-dealer's] position and the purpose for which the position [was] acquired or held by the broker-dealer."[68] This commenter also stated that a broker-dealer's obligation to monitor credit determinations should be based on factors such as the volatility of business

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63 Id. at 20-21.

64 Better Markets Letter, at 5-6.

65 SIFMA Letter, at 20.

66 Barnard Letter, at 2.

67 CFA Institute Letter, at 4.

68 SIFMA Letter, at 10-11.

conditions within the relevant industry and the frequency with which the securities trade.[69]

One commenter suggested that a broker-dealer be allowed to rely on a parent's or an affiliate's credit determination.[70] Another stated that, to promote regulatory and market transparency, a broker-dealer that develops internal credit ratings should be required to compare its ratings to an external benchmark, such as NRSRO ratings, market data, or other credit information sources.[71] Another stated, however, that a broker-dealer should be prohibited from considering internally or externally developed credit ratings as part of its credit risk assessment process and that permitting such use would conflict with section 939A of the Dodd-Frank Act.[72]

Commenters generally supported the Commission's proposal that broker-dealers document their policies and procedures for determining creditworthiness under the minimal amount of credit risk standard.[73] One commenter suggested that such documentation be maintained indefinitely.[74] Another stated that the Commission should require a broker-dealer to maintain a record for each assessment of creditworthiness under the standard.[75] Another stated that the Commission should only require the retention of records for determinations of credit risk when a broker-dealer is engaged in "sophisticated credit analysis."[76] This commenter stated that a broker-dealer should not be required to document its credit analysis with respect to a position if

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69 Id. at 21.

70 Id.

71 CFA Institute Letter, at 4.

72 Better Markets Letter, at 7.

73 One commenter stated that broker-dealers would otherwise make self-interested determinations at the expense of customers. Better Markets Letter, at 6-8. Another commenter stated that these policies and procedures should be preserved for three years and updated to reflect significant changes. Barnard Letter, at 2. This commenter further argued that broker-dealers that create and enforce procedures to determine creditworthiness be granted the lesser haircut. Id.

74 Barnard Letter, at 2.

75 Better Markets Letter, at 7-8.

76 SIFMA Letter, at 22.

the analysis was based on a small number of objective factors and could be easily reconstructed by the broker-dealer.[77]

iii. Final Rule

The Commission is amending Rule 15c3-1 to remove references to NRSRO credit ratings in the provisions establishing lower haircuts for commercial paper, nonconvertible debt, and preferred stock. The Commission is adopting amendments to these provisions with modifications from the proposal, discussed below, to address issues raised by commenters.

Under the final amendments and consistent with the proposal, when a broker-dealer applies haircuts for commercial paper, nonconvertible debt, and preferred stock that have a ready market for purposes of its net capital computation, it will have the option of: (1) using the firm's own written policies and procedures to determine whether the security has only a minimal amount credit risk and, if so, applying the appropriate lower haircut if it meets the other conditions prescribed in Rule 15c3-1; or (2) applying the greater deduction applicable to the position, such as the 15% haircut under the catchall provision in paragraph (c)(2)(vi)(J) of Rule 15c3-1.[78] Commercial paper, nonconvertible debt, and preferred stock without a ready market would continue to be subject to a 100% haircut.[79]

Unlike the objective approach of using NRSRO credit ratings, the minimal amount of credit risk standard is a subjective approach because it allows broker-dealers in the first instance to determine through their credit assessments whether a lower haircut is applicable to a given position. Further, whereas the rule prior to today's amendments required that commercial paper, nonconvertible debt, and preferred stock be given high credit ratings by an NRSRO before a

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77 Id.

78 See paragraphs (c)(2)(vi)(E), (c)(2)(vi)(F), (c)(2)(vi)(H), and (c)(2)(vi)(I) of Rule 15c3-1, as amended.

79 See 17 CFR 240.15c3-1(c)(2)(vii).

reduced haircut is permitted, the minimal amount of credit risk standard provides flexibility to broker-dealers by allowing them to rely on a variety of factors, both objective and subjective, in assessing the credit and liquidity risks associated with their proprietary commercial paper, nonconvertible debt, and preferred stock positions. However, the Commission does not intend for the new standard to result in a more liberal requirement that broadens the scope of the rule by allowing more positions to qualify for the lower haircuts.[80] The Commission notes that credit ratings and market data (such as credit spreads and yields) can serve as useful benchmarks for evaluating whether a broker-dealer's policies and procedures, as applied to the minimal amount of credit risk standard, are increasing the types of commercial paper, nonconvertible debt, and preferred stock positions to which it applies the lower haircuts as compared to the eliminated NRSRO credit rating standard.

The Commission is amending paragraph (c)(2)(vi)(E) of Rule 15c3-1 (relating to commercial paper haircuts), paragraphs (c)(2)(vi)(F)(1) and (c)(2)(vi)(F)(2) of Rule 15c3-1 (relating to nonconvertible debt haircuts), and paragraph (c)(2)(vi)(H) of Rule 15c3-1 (relating to preferred stock haircuts) by replacing references to NRSRO credit ratings with the alternative minimal amount of credit risk standard.[81] Consistent with the proposal, the final rule provides that a broker-dealer may apply the lower haircuts applicable to commercial paper (i.e., between 0% and ½ of 1%), nonconvertible debt (i.e., between 2% and 9%), and preferred stock (i.e.,

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80 As noted above, to qualify for the lower haircuts under the NRSRO credit rating standard being replaced today, commercial paper needed to be rated in one of the three highest rating categories by at least two NRSROs, nonconvertible debt needed to be rated in one of the four highest rating categories by at least two NRSROs, and preferred stock needed to be rated in one of the four highest rating categories by at least two NRSROs. For an example of one NRSRO's definitions of its four highest credit rating categories, see Standard & Poor's Ratings Definitions for long-term issuances available at http://img.en25.com/Web/StandardandPoors/Ratings_Definitions.pdf. Information about the credit rating categories of all the NRSROs can be obtained through the Forms NRSRO they file with the Commission and make publicly available. Links to these forms are available at http://www.sec.gov/about/offices/ocr.shtml.

81 See paragraphs (c)(2)(vi)(E), (c)(2)(vi)(F), and (c)(2)(vi)(H) of Rule 15c3-1, as amended.

10%) if the security has only a minimal amount of credit risk.[82]

The Commission has made several modifications to its proposed rule text. First, the Commission has re-structured the rule by adding new paragraph (c)(2)(vi)(I) to specify requirements for the policies and procedures a broker-dealer must establish, document, maintain, and enforce for purposes of assessing whether a position has only a minimal amount credit risk under paragraphs (c)(2)(vi)(E), (c)(2)(vi)(F)(1), (c)(2)(vi)(F)(2), and (c)(2)(vi)(H).[83] Under the proposal, each of the paragraphs (i.e., paragraphs (c)(2)(vi)(E), (c)(2)(vi)(F)(1), (c)(2)(vi)(F)(2), and (c)(2)(vi)(H)) separately provided that a broker-dealer must determine whether a position has only a minimal amount of credit risk pursuant to "written policies and procedures the broker-dealer establishes, maintains, and enforces to assess creditworthiness."[84] Consistent with the proposal, each paragraph still requires that the security or money market instrument have only a minimal amount of credit risk before the lower haircut may be applied; however the reference to policies and procedures in each paragraph has been removed. Instead, new paragraph (c)(2)(vi)(I) of Rule 15c3-1 requires the broker-dealer to establish, document, maintain, and enforce policies and procedures to assess and monitor the creditworthiness of each security or money market instrument that are reasonably designed for the purpose of determining whether the position has only a minimal amount of credit risk.[85] Securities or money market instruments assessed to have only a minimal amount of credit risk also must meet the other non-credit rating conditions prescribed in Rule 15c3-1 in order to apply the lower haircuts under paragraphs

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82 Id.

83 See paragraph (c)(2)(vi)(I) of Rule 15c3-1, as amended.

84 See Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934, 76 FR at 26576.

85 See paragraph (c)(2)(vi)(I) of Rule 15c3-1, as amended.

(c)(2)(vi)(E), (c)(2)(vi)(F)(1), (c)(2)(vi)(F)(2), or (c)(2)(vi)(H).[86]

Under the final rule, new paragraph (c)(2)(vi)(I) of Rule 15c3-1 provides that in order to apply a deduction under paragraphs (c)(2)(vi)(E), (c)(2)(vi)(F)(1), (c)(2)(vi)(F)(2), or (c)(2)(vi)(H), the broker-dealer must assess the creditworthiness of the security or money market instrument pursuant to policies and procedures for assessing and monitoring creditworthiness that the broker-dealer establishes, documents, maintains, and enforces.[87] The Commission added the word "monitoring" to clarify that, after the initial determination by a broker-dealer, a position must continue to have only a minimal amount of credit risk in order to remain qualified for the lower haircut and that monitoring must be done in accordance with the firm's policies and procedures. Under Rule 15c3-1, a broker-dealer must at "all times" have and maintain an amount of net capital that is at least equal to the minimum amount of net capital required by the rule.[88] Consequently, the broker-dealer must monitor its securities and money market instrument positions in order to ensure that it is applying the appropriate haircuts to those positions. For example, under the NRSRO credit rating standard being eliminated today, a broker-dealer needed to monitor whether the positions it held continued to have the required credit ratings to apply the lower haircuts because credit rating agencies may adjust (e.g., downgrade) their credit ratings. The same is true under the new minimal credit risk standard because the

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86 Paragraph (c)(2)(vi)(E) of Rule 15c3-1, as amended, retains the non-credit rating conditions that the commercial paper must have a maturity at date of issuance not exceeding nine months exclusive of days of grace, or any renewal thereof, the maturity of which is likewise limited, and a fixed rate of interest, or be sold at a discount. See 17 CFR 240.15c3-1(c)(2)(vi)(E). Paragraph (c)(2)(vi)(F) of Rule 15c3-1, as amended, retains the non-credit rating conditions that the nonconvertible debt security must have a fixed rate of interest, a fixed maturity, and not be traded flat or in default as to principal or interest. See 17 CFR 240.15c3-1(c)(2)(vi)(F). Paragraph (c)(2)(vi)(H) of Rule 15c3-1, as amended, retains the non-credit rating conditions that the preferred stock must rank prior to all other classes of stock of the same issuer and not be in arrears as to dividends. See 17 CFR 240.15c3-1(c)(2)(vi)(H). See also 17 CFR 240.15c3-1(c)(2)(vii) (establishing a 100% deduction for securities for which there is no ready market).

87 See paragraph (c)(2)(vi)(I) of Rule 15c3-1, as amended.

88 See 17 CFR 240.15c3-1(a).

creditworthiness of a security or money market instrument can change over time and, consequently, a position that has only a minimal amount of credit risk at one point in time may not retain that status.

In the proposing release, the Commission requested comment on how often a broker-dealer should be required to update its assessments.[89] The Commission received one comment in response to this request.[90] The commenter stated that the frequency of review "should be a function of a number of factors, including, e.g., the size and purpose of the broker-dealer's position in the fixed-income security, the volatility of business conditions within the relevant industry, the amount of fixed-income securities issued, and the frequency with which the securities trade."[91] The Commission generally agrees with the commenter that the frequency of review should depend on a variety factors such as those identified by the commenter. However, as discussed above, the requirement for a broker-dealer to maintain its required minimum amount of net capital is moment-to-moment. Consequently, a broker-dealer's policies and procedures for assessing whether an issuance of commercial paper, nonconvertible debt, or preferred stock has only a minimal amount of credit risk must include a process that is designed to ensure that its credit determinations are current, and address the frequency with which the broker-dealer reviews and reassesses its credit determinations. For example, a broker-dealer's policies and procedures could require more frequent reassessments in the case of securities or money market instruments that are close to the line between having only a minimal amount of credit risk and having a greater level of credit risk or that are subject to macroeconomic conditions or issuer specific events that could have an impact on credit risk. In addition, a higher

89 See Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934, 76 FR at 26554.

90 See SIFMA Letter.

91 Id. at 21.

haircut must be taken when a security or money market instrument no longer has only a minimal amount of credit risk. The Commission expects that a broker-dealer's process for monitoring its credit determinations will be customized to the size and activities of the firm to ensure that it maintains the required amount of net capital at "all times."[92]

The Commission also modified the proposed rule text relating to policies and procedures by including in new paragraph (c)(2)(vi)(I) of Rule 15c3-1 the qualifier that the policies and procedures must be "reasonably designed" for the purpose of assessing creditworthiness.[93] As noted above, one commenter raised a concern that Commission and SRO examiners would "second guess" broker-dealer credit assessments and stated that the regulatory focus on compliance with the rule should be on the "reasonableness" of a firm's policies and procedures for assessing creditworthiness.[94] The Commission agrees that the starting point for reviewing whether a firm is in compliance with the amendments should be to evaluate the reasonableness of the firm's policies and procedures in light of the firm's circumstances (e.g., the size of the broker-dealer and the types and sizes of the positions typically held by the broker-dealer). In this regard, the policies and procedures must specify with sufficient detail the steps the broker-dealer will take in performing a credit assessment so that Commission and SRO examiners can evaluate them.

However, the Commission also modified the final rule to add new text that provides that policies and procedures that are reasonably designed "should result in assessments of creditworthiness that typically are consistent with market data."[95] In particular, this standard for

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92 See 17 CFR 240.15c3-1(a).

93 See paragraph (c)(2)(vi)(I) of Rule 15c3-1, as amended.

94 SIFMA Letter, at 19.

95 See paragraph (c)(2)(vi)(I) of Rule 15c3-1, as amended.

evaluating the reasonableness of a broker-dealer's policies and procedures will require examiners to compare market data (e.g., external factors such as credit spreads or yields) with the broker-dealer's determinations that a security or money market instrument has only a minimal amount of credit risk. This provision is designed to address concerns raised by commenters that the proposed minimal amount of credit risk standard was too subjective.[96] Commenters raised concerns about requiring the use of a subjective standard because, among other things, it presents an inherent conflict of interest, is complicated, could reduce liquidity, and could result in uncertainty on the part of market participants.[97] Requiring a broker-dealer's policies and procedures to produce credit risk determinations that typically are consistent with market data should mitigate concerns about potential consequences of the subjectivity inherent in the final rule. Furthermore, as explained throughout this release, a broker-dealer can make its credit risk determination pursuant to policies and procedures that specify the use of a small number of objective factors and, if a broker-dealer avails itself of this option, it should help the broker-dealer create a less-complicated methodology that aligns with market data, therefore easing the concerns of commenters.

Notwithstanding the reasonableness of a broker-dealer's policies and procedures, examiners may still question a broker-dealer's credit risk determination, and are particularly likely to question a determination related to large concentrated positions or that is not consistent with market data. In addition, if a broker-dealer incorrectly determines pursuant to paragraph (c)(2)(vi)(I) of Rule 15c3-1 that a security has only a minimal amount of credit risk, the broker-dealer could be in violation of Rule 15c3-1 to the extent the appropriate larger haircut would put

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96 Bond Dealers Letter, at 2-3; SIFMA Letter, at 3.

97 Bond Dealers Letter, at 2; SIFMA Letter, at 3.

the broker-dealer below the required minimum amount of net capital.[98] Thus, a broker-dealer would need to be able to support each credit determination it makes in the context of a Commission or SRO examination. If the broker-dealer's determination that a position has only a minimal amount of credit risk is not consistent with market data, that result would not necessarily be dispositive that the position is not entitled to the lower haircut. However, the broker-dealer would have a high burden to demonstrate to examiners that the position has only a minimal amount of credit risk.

When assessing whether a security or money market instrument has only a minimal amount of credit risk for purposes of Rule 15c3-1, a broker-dealer could consider pursuant to the policies and procedures it establishes, documents, maintains, and enforces the following factors, to the extent appropriate:

- Credit spreads (i.e., whether it is possible to demonstrate that a position in commercial paper, nonconvertible debt, and preferred stock has only a minimal amount of credit risk based on the spread between the security's yield and the yield on Treasury or other securities, or based on the spreads of credit default swaps that reference the security or money market instrument);
- Securities-related research (i.e., whether providers of research about securities or money market instruments believe the issuer of the security or money market instrument will be able to meet its financial commitments, generally, or specifically, with respect to securities or money market instruments held by the broker-dealer);
- Internal or external credit risk assessments (i.e., whether credit assessments developed

[98] Calculating a haircut incorrectly also could cause the broker-dealer to file incorrect reports with the Commission under Rule 17a-5. See 17 CFR 240.17a-5 (requiring broker-dealers to periodically file financial reports that, among other things, contain computations of net capital).

internally by the broker-dealer or externally by a credit rating agency, irrespective of its status as an NRSRO, express a view as to the credit risk associated with a particular security or money market instrument of the issuer thereof);

- Default statistics (i.e., whether providers of credit information relating to securities or money market instruments express a view that specific securities or money market instruments (or their issuers) have a probability of default consistent with other securities or money market instruments that have only a minimal amount of credit risk);
- Inclusion in an index (i.e., whether a security, money market instrument, or the issuer of a security or money market instrument, is included as a component of a recognized index of instruments that have only a minimal amount of credit risk);
- Enhancements and priorities (i.e., the extent to which a security or money market instrument is covered by credit enhancements, such as overcollateralization and reserve accounts, or has priority under applicable bankruptcy or creditors' rights provisions);
- Price, yield and/or volume (i.e., whether the price and yield of a security or money market instrument or a credit default swap that references the security or money market instrument are consistent with other securities or money market instruments that the broker-dealer has determined have only a minimal amount of credit risk and whether the price resulted from active trading); and
- Asset class-specific factors (e.g., in the case of structured finance products, the quality of the underlying assets).

The Commission does not intend this list of factors to be exhaustive or mutually exclusive. For example, other factors may be appropriate for assessing creditworthiness and, in particular, whether a position has only a minimal amount of credit risk.

As noted above, several commenters identified additional factors that they believe would be appropriate for purposes of assessing whether a security or money market instrument has only a minimal amount of credit risk and one commenter suggested making certain factors mandatory.[99] Some of these factors, such as the term to maturity of the security or money market instrument, are already factored into Rule 15c3-1 and therefore do not need to be specifically added to the list.[100] The Commission does not believe other factors should be added because the list is not meant to be exhaustive and broker-dealers should tailor their policies and procedures for assessing credit risk to their particular circumstances and specify in their policies and procedures those factors they deem appropriate, which may include factors that are not on the list above.[101] In addition, the Commission recognizes that a broker-dealer's policies and procedures may specify the use of different factors, different sets of factors, or different combinations of factors depending on the characteristics of the security or money market instrument being assessed, the amount of time the broker-dealer intends to hold the position, and the size of the position, among other things. Further, the Commission does not expect that in order for a broker-dealer's policies and procedures to be "reasonably designed" that they must specify the use of every factor, or any particular factor, on the list. Certain factors, such as credit spreads, may not be applicable for bonds that are thinly traded. Thus, mandating that factor, or any other factor, would not necessarily help a broker-dealer make a creditworthiness determination. Instead, each broker-dealer should analyze its unique situation when designing its

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99 Better Markets Letter, at 6 (suggesting that the list "be more comprehensive" and include factors such as the nature of the issuer, the terms of the security, and the financial and regulatory context in which the issuer is operating); Id. at 3 ("the use of credit spreads and/or inclusion of an index should be the objective standard used to determine creditworthiness of these securities"); CFA Institute Letter, at 4 (suggesting the addition of "term to maturity" and "concentration of credit risk" as factors on the list).

100 See, e.g., 17 CFR 15c3-1(c)(2)(vi)(F)(1) (nonconvertible debt securities must have a "fixed maturity date," among other factors, in order to qualify for a reduced haircut).

101 One commenter agreed with the Commission. SIFMA Letter, at 20.

policies and procedures, including, for example, its size, the amount of proprietary trading by the broker-dealer in commercial paper, nonconvertible debt, and preferred stock, and the size and characteristics of the positions the firm typically holds, among other things.

Under the amendments, a broker-dealer must apply a higher deduction, such as the 15% "catchall" haircut, on a proprietary position in commercial paper, nonconvertible debt, and preferred stock if the firm determines the security has more than a minimal amount of credit risk or the firm opts not to have policies and procedures to assess the creditworthiness of the class of security or money market instrument.[102] Moreover, if the commercial paper, nonconvertible debt, or preferred stock held by the broker-dealer does not trade in a ready market, the broker-dealer must apply a 100% haircut irrespective of the firm's credit risk determination.[103]

Under today's amendments, and consistent with the proposed amendments, a broker-dealer must preserve for a period of not less than three years, the first two years in an easily accessible place, the policies and procedures that the broker-dealer establishes, documents, maintains, and enforces for assessing and monitoring the credit risk of commercial paper, nonconvertible debt, and preferred stock. This requirement is codified in new paragraph (b)(13) of Rule 17a-4.[104]

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102 See paragraph (c)(2)(vi)(J) of Rule 15c3-1, as amended; 17 CFR 240.15c3-1(c)(2)(vi)(J). If a broker-dealer chooses to apply the net capital deduction under paragraph (c)(2)(vi)(J) of Rule 15c3-1 instead of making an assessment of the creditworthiness of each security, the broker-dealer will not be required to have policies and procedures to assess a security's creditworthiness for purposes of applying the haircuts prescribed in paragraphs (c)(2)(vi)(E), (c)(2)(vi)(F)(1), (c)(2)(vi)(F)(2), or (c)(2)(vi)(H) of Rule 15c3-1.

103 See 17 CFR 240.15c3-1(c)(2)(vii). As noted above, the term ready market is defined in Rule 15c3-1 as "a market in which there exists independent bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined for a particular security almost instantaneously and where payment will be received in settlement of a sale at such price within a relatively short time conforming to trade custom." 17 CFR 240.15c3-1(c)(11).

104 See paragraph (b)(13) of Rule 17a-4, as amended.

The amendments do not require a broker-dealer to maintain a record of each of its credit risk determinations for purposes of Rule 15c3-1.[105] However, a broker-dealer would need to be able to support each of its credit risk determinations both for internal risk management purposes and in the context of a Commission or SRO examination. A broker-dealer should maintain documentation of its credit risk determinations for this purpose. Alternatively, a firm that maintains or can access the data, information, and inputs used to make a credit risk determination could be in a position to replicate the original credit risk determination using the same process, information, and inputs employed to make the original determination.[106] For example, if a broker-dealer uses market data to assess creditworthiness, it should be able to access information showing the data as of the date the credit risk determination was made.[107] A broker-dealer that uses a model with multiple inputs should be able to replicate the model output upon request or maintain a record of the model output as of the date of the original credit risk determination.

The Commission recognizes that requiring a broker-dealer to make and maintain a record of each credit risk determination, as suggested by one commenter,[108] may help facilitate examinations of broker-dealers, but the Commission believes at this time that requiring broker-dealers to maintain a record of every credit risk determination could be burdensome in light of the benefits expected to be obtained. For example, a broker-dealer may make multiple determinations while assessing and monitoring the creditworthiness of a particular security. If

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105 Paragraph (b)(5) of Rule 17a-4 provides, in pertinent part, that a broker-dealer shall preserve for a period of not less than three years (the first two years in an easily accessible place) all trial balances and computations of aggregate indebtedness and net capital (and working papers in connection therewith). See 17 CFR 240.17a-4(b)(5). Working papers relating to credit risk determinations made for the purposes of computing net capital under Rule 15c3-1 will need to be preserved under this provision of Rule 17a-4. Id.

106 See SIFMA Letter, at 22.

107 Although not required by today's amendments, a broker-dealer could choose to keep a record of the market data it used to make the creditworthiness determination.

108 See Better Markets Letter, at 7-8.

the broker-dealer reaches the same result time after time showing that the security in question has only a minimal amount of credit risk, the benefits of keeping every determination for three years, when the broker-dealer has the ability to replicate the relevant determination for an examiner, could create costs that provide little benefits, given the examiner will have access to the replicated credit risk determinations. Furthermore, if market data and other external factors (e.g., external credit assessments and analysis), strongly support the broker-dealer's assessment that a security has only a minimal amount of credit risk, retaining a record of the credit risk determination may not provide any incremental benefit to examiners. A broker-dealer that can replicate through application of its policies and procedures its original analysis to explain the basis of a credit risk determination should be in a position to demonstrate to examiners whether it is following its policies and procedures, and whether those policies and procedures are reasonably designed and effective in producing credit assessments that typically are consistent with market data.

The Commission is cognizant of the potential conflict of interest inherent in a requirement that relies to some extent on the subjective judgment of the broker-dealer to determine whether a lower haircut should apply to a commercial paper, nonconvertible debt, or preferred stock position, as noted by some commenters.[109] For example, a broker-dealer may want to hold securities with higher yields to earn more interest but at the same time apply lower haircuts to the positions to increase its net capital. This could bias the broker-dealer's credit assessment towards finding the security has only a minimal amount of credit risk. As an initial matter, if a broker-dealer incorrectly determines a position has only a minimal amount of credit risk and applies a lower haircut, it could lead to the firm failing to maintain the minimum amount

[109] Better Markets Letter, at 5-6; Bond Dealers Letter, at 2; CFA Institute Letter, at 4.

of required net capital in violation of the rule. As discussed above, the final rule provides that policies and procedures that are reasonably designed should result in assessments of creditworthiness that typically are consistent with market data.[110] This provides objective benchmarks (i.e., market data) to use to evaluate the broker-dealer's policies and procedures. If a broker-dealer has policies and procedures in place that are reasonably designed under the rule, and those policies and procedures are followed, the potential for bias to be a part of the assessment process should be mitigated. The Commission also expects that this potential conflict of interest will be mitigated by the Commission and SRO examination process, during which Commission and SRO examiners will review the reasonableness of broker-dealers' policies and procedures, the assessments that result from those policies and procedures, and the firms' adherence to the policies and procedures.[111]

The Commission also is aware of the likelihood that broker-dealers may reach different conclusions when assessing whether a particular position has only a minimal amount of credit risk,[112] or may reach conclusions that are contrary to market data. The Commission expects that Commission and SRO staff will examine for these types of differences and raise questions when a broker-dealer consistently determines that positions have only a minimal amount of credit risk notwithstanding the fact that external benchmarks (e.g., market data) in the factors listed above indicate otherwise. A determination that a position has only a minimal amount of credit risk that is contrary to some market data points and factors would not necessarily mean that the broker-dealer has failed to comply with the rule, but the broker-dealer would have a higher hurdle to

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110 See paragraph (c)(2)(vi)(I) of Rule 15c3-1, as amended.

111 As noted above, broker-dealers that do not keep detailed records of their credit risk determinations can replicate those determinations for Commission and SRO examiners to demonstrate that they followed their policies and procedures for assessing and monitoring creditworthiness.

112 Bond Dealers Letter, at 3; SIFMA Letter, at 20.

overcome to demonstrate that its credit risk determination is correct. The Commission also notes that if a broker-dealer determines that a security or money market instrument has only a minimal amount of credit risk when the position actually does not meet that standard, and applies a lower haircut, the broker-dealer's net capital may be less than its minimum net capital requirement in which case the broker-dealer would be in violation of the rule.[113]

The Commission understands, as noted by commenters, that the amount of resources broker-dealers can allocate toward making assessments of creditworthiness for purposes of Rule 15c3-1 will differ across broker-dealers and expects that this difference will be reflected in the policies and procedures for assessing creditworthiness established by the firms.[114] For example, a small broker-dealer may not have the resources to support a credit risk department comprised of analysts that perform internal credit assessments. In this case, the firm may establish a process for assessing creditworthiness that relies more on external factors, such as credit spreads, default statistics, and credit analysis. A broker-dealer with a large portfolio of debt securities may instead use an internal approach for assessing creditworthiness, which takes into consideration a multitude of factors, such as default probabilities, expected and unexpected losses, time effects, default correlations, and loss distributions, among other things. The Commission also anticipates that some broker-dealers, particularly those that hold few positions, may elect not to devote resources toward performing credit risk analysis and maintaining policies and procedures, and instead will apply a greater haircut to their proprietary positions in commercial paper, nonconvertible debt, and preferred stock, as permitted by the rule.

Finally, as discussed above, a broker-dealer (rather than its parent or an affiliate) must

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113 As noted above, applying an incorrect haircut also could cause the broker-dealer to file incorrect reports with the Commission under Rule 17a-5. See 17 CFR 240.17a-5 (requiring broker-dealers to periodically file financial reports that, among other things, contain computations of net capital).

114 See Bond Dealers Letter, at 3; SIFMA Letter, at 18.

establish, document, maintain, and enforce the policies and procedures for assessing whether a position has only a minimal amount of credit risk.[115] This does not mean that a broker-dealer cannot incorporate into its own policies and procedures the credit policies and procedures used by its parent or an affiliate. However, the broker-dealer must establish, document, maintain, and enforce its own policies and procedures and apply them itself in making creditworthiness determinations. It may not simply rely on determinations made by its parent or an affiliate.

b. Appendix A to Rule 15c3-1

i. Proposal

Appendix A to Rule 15c3-1 permits broker-dealers to employ a standardized theoretical option pricing model to determine a potential loss for a portfolio of listed options positions and related positions to compute a single haircut for the group of positions.[116] Under Appendix A, a broker-dealer groups the options and related positions in a portfolio and stresses the current market price for each position at various equidistant points along a range of positive and negative potential future market movements, using an approved theoretical option pricing model that satisfies certain conditions specified in the rule.[117] Positions that have more potential price volatility must be stressed across a wider range of positive and negative potential future market movements than positions with lower price volatility.[118] For example, a broker-dealer other than a non-clearing option specialist or market maker must employ a range of potential future market movements for major market foreign currencies of (+/-) 6%, whereas the range for all other

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115 See SIFMA Letter, at 21.

116 See 17 CFR 240.15c3-1a(b)(1). Broker-dealers also may elect a strategy-based methodology. See 17 CFR 240.15c3-1a(b)(2).

117 See 17 CFR 240.15c3-1a(b)(1). Presently, there is only one theoretical options pricing model that has been approved for this purpose.

118 See 17 CFR 240.15c3-1a(b)(1)(iii).

foreign currencies is (+/-) 20%.[119] Thus, major market foreign currency options receive more favorable treatment than options on all other currencies when using theoretical option pricing models to compute net capital deductions.[120]

Prior to today's amendments, the rule defined the term major market foreign currency to mean "the currency of a sovereign nation whose short term debt is rated in one of the two highest categories by at least two nationally recognized statistical rating organizations and for which there is a substantial inter-bank forward currency market."[121] Further, the rule provided that "the European Currency Unit (ECU) shall be deemed a major market foreign currency."[122]

With respect to the definition of major market foreign currency, the Commission proposed to remove the phrase "whose short-term debt is rated in one of the two highest categories by at least two nationally recognized statistical rating organizations."[123] The proposed change would modify the definition to include foreign currencies only "for which there is a substantial inter-bank forward currency market."[124] The Commission also proposed to eliminate the specific reference in the rule to the European Currency Unit ("ECU"), which was the only currency explicitly identified in the rule as a major market foreign currency for the purposes of Appendix A.[125] As the Commission stated in the proposing release, because of the establishment of the euro as the official currency of the euro-zone, a specific reference to the ECU was no

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119 See 17 CFR 240.15c3-1a(b)(1)(iii)(B) through (C). A broker-dealer that is a non-clearing option specialist or market maker must employ a range of potential future market movements for major market foreign currencies of (+/-) 4% (i.e., less than the (+/-) 6% required of other broker-dealers). 17 CFR 240.15c3-1a(b)(1)(iv)(A).

120 See 17 CFR 240.15c3-1a(b)(1)(iii)(B) through (C) and (b)(1)(iv)(A).

121 Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934, 76 FR at 26554-26555.

122 Id.

123 Id.

124 Id.

125 Id.

longer needed.[126] The Commission also stated that a specific reference to the euro was not necessary, as it is a foreign currency with a substantial inter-bank forward currency market.[127]

ii. Comments

The Commission received two comment letters in response to its request for comment.[128] One commenter supported the proposed definition of the term major market foreign currency, stating that "the proposed definition is sufficient to allow broker-dealers to determine what currencies are 'major market foreign currencies.'"[129] Both commenters stated that the Commission should create a list of major market foreign currencies and update it periodically to clarify the new definition in Appendix A.[130] One commenter suggested that if the Commission chooses not to create a list of major market foreign currencies, it should propose an alternative measure of creditworthiness and define the term as one where the currency is issued by a nation whose sovereign debt presents "minimal credit risk."[131]

iii. Final Rule

For the reasons described below, the Commission is adopting the amendments to Appendix A as proposed.[132] Specifically, the Commission is removing from the definition of major market foreign currency the phrase "whose short-term debt is rated in one of the two

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126 Id.

127 Id.

128 See Better Markets Letter; CFA Institute Letter; see also Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934, 76 FR at 26555.

129 See CFA Institute Letter, at 4 ("[T]he existence of a substantial inter-bank forward currency market indicates market interest and the existence of market oversight and thus provides a strong indication of market sentiment about the quality of currencies within that definition.").

130 Better Markets Letter, at 9; CFA Institute Letter, at 5.

131 See Better Markets Letter, at 9.

132 See paragraph (b)(1)(i)(C) of Rule 15c3-1a, as amended.

highest categories by at least two nationally recognized statistical rating organizations."[133] The change modifies the definition to include foreign currencies only "for which there is a substantial inter-bank forward currency market."[134] Also, the Commission is eliminating the specific reference in the rule to the ECU, which was identified, by rule, as the only major market foreign currency for the purposes of Appendix A.[135] As the Commission noted in the proposing release, specific reference to the ECU is no longer needed because the euro has been established as the official currency of the euro-zone.[136] Further, the specific reference to the euro is not necessary as it is a foreign currency with a substantial inter-bank forward currency market, consistent with the rule as amended.

In order to retain a degree of flexibility, the Commission is not codifying in the rule a list of currencies that meet the definition of major market foreign currency though some commenters requested such a list. However, broker-dealers may treat a foreign currency as a major market foreign currency for the purposes of Appendix A if the currency is a major foreign currency for purposes of applying a 6% (rather than 20%) haircut under Rule 15c3-1. Currently, under a staff interpretation, broker-dealers are subject to a 6% (rather than 20%) unhedged currency risk exposure haircut on foreign currency balances and positions in the euro, the British pound, the Swiss franc, the Canadian dollar, and the Japanese yen.[137] The Commission believes the staff

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133 Id.

134 Id.

135 Id.

136 Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934, 76 FR at 26555.

137 See FINRA Interpretations of Financial and Operational Rules, Rule 15c3-1(c)(2)(vi)/08, available at http://www.finra.org/web/groups/industry/@ip/@reg/@rules/documents/interpretationsfor/p037763.pdf, p. 406 (publishing the staff's interpretation). A 20% haircut applies to unhedged currency risk exposure on all other foreign currency balances and positions. Id. These interpretations are provided to FINRA from the Commission staff in the Division of Trading and Markets. Broker-dealers can also seek assurance as to whether another foreign currency meets the definition of major market foreign currency by, for example, requesting guidance from the staff.

interpretation identifies currencies that all meet the definition of major market foreign currency for the purposes of Appendix A as they all have a substantial inter-bank forward currency market. Consequently, broker-dealers may treat these currencies as major market foreign currencies under Appendix A. By treating these currencies as major market foreign currencies, the haircuts applicable to foreign currencies under Rule 15c3-1 are more closely aligned with the haircuts applicable to options on the same foreign currencies under Appendix A.[138] Given this interpretation identifying certain foreign currencies that meet the definition of major market foreign currency, the Commission believes it has addressed the concern raised by one commenter that, in the absence of a list, the Commission should define the term as one where the currency is issued by a nation whose sovereign debt presents minimal credit risk.[139]

c. Appendix E to Rule 15c3-1

i. Proposal

Certain broker-dealers ("ANC broker-dealers") are approved by the Commission to use internal value-at-risk ("VaR") models to determine market risk charges for proprietary securities and derivatives positions and to take a credit risk charge in lieu of a 100% charge for unsecured receivables related to OTC derivatives transactions.[140] Specifically, under Appendix E to Rule

138 Treating the option consistently with the instrument underlying the option is supported by Appendix A. For example, under Appendix A, the range of potential future market movements that must be employed for a portfolio of equity positions with a ready market is (+/-) 15%. See 17 CFR 240.15c3-1a(b)(1)(iii)(A). Under Rule 15c3-1, the haircut that must be applied to an equity security with a ready market is 15%. See 17 CFR 240.15c3-1(c)(2)(vi)(J).

139 See Better Markets Letter, at 9.

140 See 17 CFR 240.15c3-1(a)(7); 17 CFR 240.15c3-1e. As part of the application to use internal models, an entity seeking to become an ANC broker-dealer must identify the types of positions it intends to include in its model calculation. See 17 CFR 240.15c3-1e(a)(1)(iii). After approval, an ANC broker-dealer must obtain Commission approval to make a material change to the model, including a change to the types of positions included in the model. See 17 CFR 240.15c3-1e(a)(8). An ANC broker-dealer must maintain minimum tentative net capital of at least $1 billion and minimum net capital of at least $500 million. See 17 CFR 240.15c3-1(a)(7)(i). The Commission has proposed raising these requirements to $5 billion and $1 billion, respectively. See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers

15c3-1, ANC broker-dealers are permitted to add back to net worth uncollateralized receivables from counterparties arising from OTC derivatives transactions (i.e., they can add back the amount of the uncollateralized current exposure).[141] Instead of the 100% deduction that applies to most unsecured receivables under Rule 15c3-1, ANC broker-dealers are permitted to take a credit risk charge based on the uncollateralized credit exposure to the counterparty.[142] In most cases, the credit risk charge is significantly less than a 100% deduction, since it is a percentage of the amount of the receivable that otherwise would be deducted in full. ANC broker-dealers are permitted to use this approach because they are required to implement processes for analyzing credit risk to OTC derivative counterparties and to develop mathematical models for estimating credit exposures arising from OTC derivatives transactions.

Under Appendix E, the credit risk charge is the sum of three calculated amounts: (1) a counterparty exposure charge; (2) a concentration charge if the current exposure to a single counterparty exceeds certain thresholds; and (3) a portfolio concentration charge if aggregate current exposure to all counterparties exceeds certain thresholds.[143] The first component of the credit risk charge is the counterparty exposure charge.[144] The exposure charge for a given counterparty (other than a counterparty that is insolvent, in a bankruptcy proceeding, or in default of an obligation on its senior debt) is the credit equivalent amount of the ANC broker-

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and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Exchange Act Release No. 68071 (Oct. 18, 2012), 77 FR 70213 (Nov. 23, 2012).

141 See 17 CFR 240.15c3-1e(c).

142 See 17 CFR 240.15c3-1e(c); 17 CFR 240.15c3-1(a)(7). The Commission has proposed narrowing this treatment of OTC derivatives exposures so that it would apply only to uncollateralized receivables from commercial end users arising from security-based swaps (i.e., uncollateralized receivables from other types of counterparties would be subject to the 100% deduction from net worth). See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, 77 FR at 70240-70244.

143 17 CFR 240.15c3-1e(c).

144 17 CFR 240.15c3-1e(c)(1).

dealer's exposure to the counterparty multiplied by an applicable credit risk weight factor and then multiplied by 8%.[145] The credit equivalent amount is the sum of the ANC broker-dealer's: (1) maximum potential exposure ("MPE") to the counterparty multiplied by a back-testing determined factor; and (2) current exposure to the counterparty.[146] The MPE amount is a charge to address potential future exposure and is calculated using the ANC broker-dealer's VaR model as applied to the counterparty's positions after giving effect to a netting agreement with the counterparty, taking into account collateral received from the counterparty, and taking into account the current replacement value of the counterparty's positions.[147] The current exposure amount is the current replacement value of the counterparty's positions after giving effect to a netting agreement with the counterparty and taking into account collateral received from the counterparty.[148] The counterparty exposure charge is the sum of the MPE and current exposure amounts multiplied by an applicable credit risk weight factor and then multiplied by 8%.[149] Appendix E to Rule 15c3-1 prescribes three standardized credit risk weight factors (20%, 50%, and 150%) for transactions with counterparties and, as an alternative, permits an ANC broker-dealer with Commission approval to use internal methodologies to determine appropriate credit risk weights to apply to counterparties.[150] A higher percentage credit risk weight factor results in a larger counterparty exposure charge amount. Prior to today's amendments, ANC broker-dealers were permitted to use NRSRO credit ratings or internally derived credit ratings to determine the appropriate risk weight factor.

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145 See 17 CFR 240.15c3-1e(c)(1)(ii).

146 See 17 CFR 240.15c3-1e(c)(4)(i). The amount of the factor is based on back-testing exceptions.

147 See 17 CFR 240.15c3-1e(c)(4)(ii).

148 See 17 CFR 240.15c3-1e(c)(4)(iii).

149 See 17 CFR 240.15c3-1e(c)(1)(ii).

150 See 17 CFR 240.15c3-1e(c)(4)(vi).

The Commission proposed removing paragraphs (c)(4)(vi)(A) through (c)(4)(vi)(D) of Appendix E, which specify the appropriate risk weight factor of counterparties based on NRSRO credit ratings.[151] Consequently, under the proposal, an ANC broker-dealer would need to determine credit risk charges using internal credit ratings or to take a 100% capital charge with respect to the exposure to the counterparty.[152] By removing the option to use NRSRO credit ratings, a broker-dealer that applies to use the approach set forth in Appendix E would need to describe how it will determine the applicable counterparty credit risk charge based on internal credit ratings as part of its initial application to the Commission.[153]

ii. Comments

The Commission received two comments in response to its request for comment.[154] One commenter supported the proposed removal of NRSRO credit ratings as an option but raised two concerns.[155] The commenter stated first that an internal model may not take into account concentration of risk with a specific counterparty, and second that ANC firms will apply low risk weights to all but the most illiquid instruments.[156]

Another commenter suggested that the factors listed in the proposing release with respect to determining creditworthiness under Rule 15c3-1 should become part of Appendix E.[157] This

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151 See Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934, 76 FR at 26555-26556.

152 Id.

153 Id. at 26555.

154 Better Markets Letter; CFA Institute Letter; see also Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934, 76 FR at 26555-26556.

155 CFA Institute Letter, at 5-6.

156 Id.

157 Better Markets Letter, at 10.

commenter further argued that the factors each broker-dealer needed to use to make the determination should be explicitly stated in the rule.[158]

iii. Final Rule

The Commission is adopting the amendments to Appendix E to Rule 15c3-1 as proposed.[159] The amendments remove paragraphs (c)(4)(vi)(A) through (c)(4)(vi)(D) of Appendix E to Rule 15c3-1, which specify the appropriate risk weight factor based on NRSRO credit ratings.[160] By removing the provisions utilizing NRSRO credit ratings, the final rule requires an ANC broker-dealer to determine the appropriate risk weight factor using internal credit ratings or to take a 100% capital charge with respect to the exposure to the counterparty.[161]

All ANC broker-dealers calculate credit risk charges using internal credit ratings (rather than using NRSRO credit ratings approach) or take a 100% capital charge with respect to the exposure to the counterparty risk.[162] Consequently, removing the option to use NRSRO credit ratings will not have an immediate effect on these broker-dealers. A broker-dealer that applies to become an ANC broker-dealer will need to describe how it will determine internal credit ratings for the purpose of determining the applicable credit charges for counterparty risk in its application to the Commission.

In taking this action, the Commission has considered the views of commenters[163] and determined that whether a model adequately considers risks associated with a counterparty or a

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158 Id.

159 See paragraph (c)(4)(vi) of Rule 15c3-1e, as amended.

160 Id.

161 Id.

162 Currently, there are six ANC broker-dealers: Barclays Capital Inc.; Citigroup Global Markets, Inc.; Goldman Sachs & Co.; J.P. Morgan Chase Securities LLC; Merrill Lynch Pierce Fenner & Smith Incorporated; and Morgan Stanley & Co. Incorporated.

163 CFA Institute Letter, at 5; Better Markets Letter, at 10.

specific instrument is a concern that should be addressed during the initial review of the ANC broker-dealer's model, as well as during the monitoring and examination of the firm.[164] The amendments also do not incorporate the minimal amount of credit risk standard from Rule 15c3-1 into Appendix E, as suggested by one commenter.[165] This standard is replacing a binary NRSRO credit rating standard under which the application of a lower or higher haircut amount depends on whether the commercial paper is rated in the top three rating categories and the nonconvertible debt and preferred stock is rated in the top four rating categories. Consequently, a given instrument either meets the requirement to apply a lower haircut amount or is subject to the higher amount. The NRSRO credit rating standard in Appendix E to Rule 15c3-1 is not binary in that there are three different credit risk weights (20%, 50%, and 150%) that are determined by three different levels of credit rating: the two highest rating categories; the third and fourth highest rating categories; and below the fourth highest rating. Thus, the minimal amount of credit risk standard would not be a suitable replacement for the NRSRO credit ratings standard because the minimal amount of credit risk standard, as drafted for Rule 15c3-1, would apply only to the second gradation (the third and fourth highest rating categories).[166]

In addition, as stated throughout this release, the Commission has determined not to mandate that a broker-dealer use any specific factor in its credit analysis. Consequently, the Commission does not believe it would be appropriate to codify the list of factors in the rule as suggested by one commenter.

d. Appendix F to Rule 15c3-1 and Form X-17A-5, Part IIB

i. Proposal

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164 See, e.g., 17 CFR 15c3-1e(a)(1)(iv).

165 Better Markets Letter, at 10.

166 See 15 CFR 15c3-1e(c)(4)(vi)(B).

Similar to ANC broker-dealers, a type of limited purpose broker-dealer that deals solely in OTC derivatives (an "OTC derivatives dealer") is permitted, with Commission approval, to calculate net capital using internal models as the basis for taking market risk and credit risk charges in lieu of the standardized haircuts for classes of positions for which they have been approved to use VaR models.[167] Specifically, under Appendix F to Rule 15c3-1, OTC derivatives dealers are permitted to add back to net worth uncollateralized receivables from counterparties arising from OTC derivatives transactions (i.e., they can add back the amount of the uncollateralized current exposure). Instead of the 100% deduction that applies to most unsecured receivables under Rule 15c3-1, OTC derivatives dealers are permitted to take a credit risk charge based on counterparty factors and concentration charges.[168] In most cases, the counterparty factors and concentration charges are significantly less than a 100% deduction, since the charges are a percentage of the amount of the receivable that otherwise would be deducted in full. OTC derivatives dealers are permitted to use this approach because they are required to implement processes for analyzing credit risk to OTC derivative counterparties and to develop mathematical models for estimating credit exposures arising from OTC derivative transactions.

167 See 17 CFR 240.15c3-1(a)(5); 17 CFR 240.15c3-1f. As part of the application to use internal models, an entity seeking to become an OTC derivatives dealer must identify the types of positions it intends to include in its model calculation. See 17 CFR 240.15c3-1f(a)(1)(ii). After approval, an OTC derivatives dealer must obtain Commission approval to make a material change to the model, including a change to the types of positions included in the model. See 17 CFR 240.15c3-f(a)(3). OTC derivatives dealers are exempt from certain broker-dealer requirements, including membership in an SRO (17 CFR 240.15b9-2), broker-dealer margin rules (17 CFR 240.36a1-1), and application of the Securities Investor Protection Act of 1970 (17 CFR 240.36a1-2). OTC derivatives dealers are subject to special requirements, including limitations on the scope of their securities activities (17 CFR 240.15a-1), specified internal risk management control systems (17 CFR 240.15c3-4), recordkeeping obligations (17 CFR 240.17a-3(a)(10)), and reporting responsibilities (17 CFR 240.17a-12). They are also subject to alternative net capital treatment (17 CFR 240.15c3-1(a)(5)). See 17 CFR 240.15a-1, Preliminary Note. The minimum net capital requirements for an OTC derivatives dealer are tentative net capital of at least $100 million and net capital of at least $20 million. See 17 CFR 240.15c3-1(a)(5) and (c)(15).

168 See 17 CFR 240.15c3-1f(d); 17 CFR 240.15c3-1(a)(5).

Under Appendix F to Rule 15c3-1, OTC derivatives dealers are required to deduct from their net capital credit risk charges that take counterparty risk into consideration.[169] This charge has two parts and is computed on a counterparty-by-counterparty basis. First, for each counterparty with an investment or speculative grade rating, an OTC derivatives dealer must take a net capital charge equal to the net replacement value in the account of the counterparty ("net replacement value") multiplied by 8%, and further multiplied by a counterparty factor.[170] As part of this deduction, the OTC derivatives dealer must apply a counterparty risk weight factor of either 20%, 50%, or 100%.[171] Prior to today's amendments, the counterparty risk weight factor (i.e., 20%, 50%, or 100%) was determined using either NRSRO credit ratings or the firm's internal credit ratings.[172]

The second part of the credit risk charge consists of a concentration charge that applies when the net replacement value in the account of any one counterparty exceeds 25% of the OTC derivatives dealer's tentative net capital.[173] The concentration charge increases in relation to the OTC derivatives dealer's exposure to lower rated counterparties.[174] Prior to today's amendments, this concentration charge was also determined using either NRSRO credit ratings or the firm's internal credit ratings. Currently, OTC derivatives dealers do not use NRSRO credit ratings to determine their counterparty factors and concentration charges.

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169 See 17 CFR 240.15c3-1f(d).

170 See 17 CFR 240.15c3-1f(d)(2).

171 See 17 CFR 240.15c3-1f(d)(2)(i) through (iii).

172 See 17 CFR 240.15c3-1f(d)(2) and (4).

173 See 17 CFR 240.15c3-1f(d)(3).

174 For counterparties that are highly rated, the concentration charge equals 5% of the amount of the net replacement value in excess of 25% of the OTC derivatives dealer's tentative net capital. 17 CFR 240.15c3-1f(d)(3)(i). The concentration charge for counterparties with ratings among the lowest rating categories would equal 50% of the amount of the net replacement value in excess of 25% of the OTC derivatives dealer's tentative net capital. 17 CFR 240.15c3-1f(d)(3)(iii).

The Commission proposed to amend paragraphs (d)(2), (d)(3)(i), (d)(3)(ii), (d)(3)(iii), and (d)(4) of Appendix F to Rule 15c3-1, which permit the use of NRSRO ratings (as an alternative to internal credit ratings) to determine an OTC derivatives dealer's counterparty factors and concentration charges. Because the proposal would eliminate the option to use NRSRO credit ratings, a broker-dealer that applies to become an OTC derivatives dealer and operate under Appendix F will need, as part of its initial application, to request Commission approval to use internal credit ratings (as the option to use NRSRO credit ratings is being eliminated). The OTC derivatives dealer would need to describe how it will determine the applicable counterparty factors and concentration charges as part of its initial application to the Commission.

As part of its proposal, the Commission also proposed conforming amendments to the General Instructions to Form X-17A-5, Part IIB. This form constitutes the basic financial and operational report OTC derivatives dealers are required to file with the Commission. Under the heading "Computation of Net Capital and Required Net Capital," the Commission proposed making conforming changes to the section "Credit risk exposure." This section instructs an OTC derivatives dealer on how to compute the counterparty credit risk charges for purposes of the dealer's net capital computation. The proposed amendments to the instructions would eliminate references to NRSRO credit ratings for purposes of determining these charges.

ii. Comments

The Commission received two comments in response to its request for comment.[175] One commenter suggested that the Commission require OTC derivatives dealers to use counterparty factors similar to those proposed under Appendix E discussed above (e.g., 20%, 50% or 150%

175 CFA Institute Letter; Better Markets Letter; see also Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934, 76 FR at 26556.

risk weights based on internal credit ratings to determine capital deductions) and argued against requiring OTC derivatives dealers to reapply to the Commission to use internal credit ratings.[176] This commenter also expressed concern that an OTC derivatives dealer's internal model may not take into account concentration of risk with a specific counterparty.[177]

The second commenter suggested that the Commission "supply an appropriate alternative standard of creditworthiness that derivatives dealers must apply" such as "an explicit set of factors that will appropriately gauge the credit risk associated with counterparties in derivatives transactions."[178]

iii. Final Rule

The Commission is adopting the amendments to Appendix F to Rule 15c3-1 as proposed.[179] Specifically, the amendments remove the use of NRSRO credit ratings from paragraphs (d)(2), (d)(3)(i), (d)(3)(ii), (d)(3)(iii), and (d)(4) of Appendix F to Rule 15c3-1, which, prior to today's amendments, permitted the use of NRSRO ratings when determining counterparty credit risk and concentration charges.[180] Because the amendments remove the option to use NRSRO credit ratings, a broker-dealer that applies to become an OTC derivatives dealer will need, as part of its initial application, to request Commission approval to use internal credit ratings (as the option to use NRSRO credit ratings is being eliminated). The applicant will need to describe how it will use internal credit ratings to determine the applicable credit risk charges for counterparty risk in its application to the Commission. The current OTC derivatives

176 CFA Institute Letter, at 6.

177 Id.

178 Better Markets Letter, at 10, n.15.

179 See paragraph (d) of Rule 15c3-1f, as amended.

180 See paragraphs (d)(2), (d)(3)(i), (d)(3)(ii), (d)(3)(iii), and (d)(4) of Rule 15c3-1f, as amended.

dealers will not need to seek new approval from the Commission.[181]

The Commission also is adopting the conforming amendments to the General Instructions to Form X-17A-5, Part IIB as proposed.

Consistent with the discussion above relating to Appendix E to Rule 15c3-1, the Commission has determined that whether a model adequately considers concentration risk with a specific counterparty is a concern that is best addressed during the initial review of, or an amendment to, an OTC derivatives dealer's model as well as during the monitoring and examination of the OTC derivatives dealer.[182] Further, as stated above, the current OTC derivatives dealers do not use NRSRO ratings to compute the credit risk and concentration charges under Appendix F. Thus, the amendments will not impact these firms.

The Commission is not adopting an alternative standard in the rule, such as the minimal amount of credit risk standard. As discussed above, the minimal amount of credit risk standard is replacing a binary NRSRO credit rating standard under which the application of a lower or higher haircut amount depends on whether the commercial paper is rated in the top three rating categories and the nonconvertible debt and preferred stock is rated in the top four rating categories. Consequently, a given instrument either meets the requirement to apply a lower haircut amount or is subject to the higher amount. The NRSRO credit rating standard in Appendix F to Rule 15c3-1 is not binary in that there are three ranges of credit ratings to determine the applicable risk weight factors and concentration charges: the two highest rating categories; the third and fourth highest rating categories; and below the fourth highest rating category. Thus, the minimal amount of credit risk standard would not be a suitable replacement

181 Currently, four firms are operating pursuant to Appendix F to Rule 15c3-1. These firms are: Credit Suisse Capital LLC; Goldman Sachs Financial Markets, L.P.; Merrill Lynch Financial Markets, Inc.; and Natixis Derivatives Inc. Natixis Derivatives, Inc. filed a Form BDW on October 17, 2013.

182 See, e.g., 17 CFR 15c3-1f(a)(1)(ii); see also CFA Institute Letter, at 6.

for the credit risk charges required under Appendix F to Rule 15c3-1 because the minimal amount of credit risk standard, as drafted for Rule 15c3-1, would apply only to the second range (the third and fourth highest rating categories).[183]

In addition, as stated throughout this release, the Commission has determined not to mandate that a broker-dealer use any specific factor in its credit analysis; instead, each firm will need to tailor its procedures for determining credit risk to the broker-dealer's business model.[184]

e. Appendix G to Rule 15c3-1

Appendix G to Rule 15c3-1 provides that broker-dealers may use the ANC computation only if their ultimate holding companies agree to provide the Commission with additional information about the financial condition of the holding company and its affiliates.[185] Appendix G is intended to provide the Commission with certain information to assess the financial and operational health of the ultimate holding company and its potential impact on the risk exposure of the broker-dealer.[186] Paragraph (a) of Appendix G sets forth a methodology for computing allowable capital and allowances for market and credit risk at the consolidated holding company level. One aspect of calculating credit risk in Appendix G provided that those firms must use credit ratings in accordance with the applicable provisions of Appendix E. Since those provisions in Appendix E are being deleted, the Commission proposed deleting the corresponding references to those provisions in Appendix G.[187] Specifically, the Commission proposed to delete references in paragraph (a)(3)(i)(F) of Appendix G that correspond to the

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183 See 17 CFR 240.15c3-1f(d)(2)(ii); 17 CFR 240.15c3-1f(d)(3)(ii).

184 Better Markets Letter, at 10, n.15.

185 17 CFR 240.15c3-1g.

186 Id. Currently, each broker-dealer that uses the ANC computation has an ultimate holding company that has a principal regulator.

187 See Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934, 76 FR at 26556-26557.

provisions of Appendix E that the Commission is deleting as described above.[188]

The Commission received no comments addressing these changes.[189] The Commission is amending Appendix G to Rule 15c3-1 as proposed.[190] Accordingly, the Commission is adopting a conforming amendment to Appendix G that deletes references in paragraph (a)(3)(i)(F) of Appendix G that correspond to the provisions of Appendix E that the Commission is deleting as described above.[191]

f. Exhibit A to Rule 15c3-3

Rule 15c3-3 (the "Customer Protection Rule") under the Exchange Act is designed to protect customer funds and securities held by broker-dealers.[192] To meet this objective, Rule 15c3-3 requires a broker-dealer that maintains custody of customer securities and cash (a "carrying broker-dealer") to take two primary steps to safeguard these assets. The steps are designed to protect customers by segregating their securities and cash from the broker-dealer's proprietary business activities. If the broker-dealer fails financially, the securities and cash should be readily available to be returned to the customers. In addition, if the failed broker-dealer is liquidated in a formal proceeding under the Securities Investor Protection Act of 1970, the securities and cash should be isolated and readily identifiable as customer property and, consequently, available to be distributed to customers ahead of other creditors.[193]

The first step to safeguard customer assets under Rule 15c3-3 requires a carrying broker-dealer to maintain possession or control of all fully paid and excess margin securities of its

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188 Id.

189 Id. at 26557.

190 See paragraph (a)(3)(i)(F) of Rule 15c3-1g, as amended.

191 Id.

192 17 CFR 240.15c3-3.

193 See 15 U.S.C. 78aaa et seq.

customers.[194] Physical possession or control means the broker-dealer must hold these securities in one of several locations specified in Rule 15c3-3 and free of liens or any other interest that could be exercised by a third party to secure an obligation of the broker-dealer.[195] Permissible locations include a bank, as defined in section 3(a)(6) of the Exchange Act, and a clearing agency.[196] A broker-dealer must make a daily determination of the amount of fully paid and excess margin securities it holds for customers and compare it to the amount actually held in the permissible locations in order to comply with this aspect of the rule.[197]

The second step covers customer funds and requires that a carrying broker-dealer must maintain a reserve of cash or qualified securities in one or more accounts at a bank that is at least equal in value to the net cash owed to customers and the amount of cash obtained from the use of customer securities.[198] The account must be titled "Special Account for the Exclusive Benefit of Customers of the Broker-Dealer" ("customer reserve account").[199] The amount of cash and/or qualified securities that must be kept in the customer reserve account is computed pursuant to a formula set forth in Exhibit A to Rule 15c3-3.[200] Under the Exhibit A formula, the broker-dealer adds customer credit items (e.g., cash in customer securities accounts) and then subtracts from that amount customer debit items (e.g., margin loans).[201] If credit items exceed debit items, the net amount must be on deposit in the customer reserve account in the form of cash and/or

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194 17 CFR 240.15c3-3(b)(1).

195 17 CFR 240.15c3-3(c).

196 17 CFR 240.15c3-3(c).

197 17 CFR 240.15c3-3(d).

198 17 CFR 240.15c3-3(e).

199 17 CFR 240.15c3-3(e)(1).

200 17 CFR 240.15c3-3a.

201 17 CFR 240.15c3-3a.

qualified securities.[202] If the debits exceed credits, no deposit is necessary. Funds deposited in a customer reserve account cannot be withdrawn until the broker-dealer completes another computation that shows that the broker-dealer has on deposit more funds than the reserve formula requires.

Under Note G to Exhibit A, a carrying broker-dealer may include margin collateral for transactions in security futures products as a debit in its reserve formula computation if that margin collateral is required and on deposit at a clearing agency or derivatives clearing organization that meets at least one of four conditions: (1) the clearing agency or derivatives clearing organization maintains the highest investment-grade rating from an NRSRO; (2) the clearing agency or derivatives clearing organization maintains security deposits from clearing members in connection with regulated options or futures transactions and assessment power over member firms that equal a combined total of at least \$2 billion, at least \$500 million of which must be in the form of security deposits; (3) the clearing agency or derivatives clearing organization maintains at least \$3 billion in margin deposits; or (4) the clearing agency or derivatives clearing organization obtains an exemption from the Commission.

Margin collateral that is posted for customer positions in security futures products constitutes an unsecured receivable from the clearing agency or derivatives clearing organization. Therefore, requiring a clearing agency or a derivatives clearing organization to meet certain minimum creditworthiness criteria before margin collateral deposited with that entity may be included as a debit in a broker-dealer's customer reserve formula is consistent with the customer protection function of Rule 15c3-3 because the debit offsets any credits when computing the customer reserve deposit requirement. Accordingly, this requirement is intended

[202] 17 CFR 240.15c3-3(e).

to provide reasonable assurance that customer margin collateral deposited with a clearing agency or derivatives clearing organization related to security futures products will be available to be returned to the broker-dealer and, therefore, can serve as an appropriate offset to customer credits in the reserve formula.

The Commission proposed to remove the first criterion described above (i.e., the highest investment-grade rating from an NRSRO).[203] The criteria are disjunctive and, therefore, a clearing agency or derivatives clearing organization needs to satisfy only one criterion to permit a broker-dealer to treat posted customer margin collateral as a reserve formula debit. In the proposing release, the Commission stated that the proposed amendment would not lessen the protections for customer funds and securities.[204] While one potential criterion would be removed, currently, only the Options Clearing Corporation ("OCC") clears and accepts margin on security futures products. The OCC qualifies under two of the other criteria in Note G.[205] If at a later date another clearing entity accepts margin on security futures products, and it did not meet one of the remaining criteria, a broker-dealer may request an exemption for that clearing entity under Note G to Appendix A to Rule 15c3-3.[206] Thus, the proposed amendment does not disqualify any current clearing entities, nor require a broker-dealer to obtain new clearing memberships to comply with Rule 15c3-3.

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203 See Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934, 76 FR at 26557.

204 Id.

205 At the end of 2012, OCC maintained $78.8 billion in margin deposits, well in excess of the $3 billion threshold set forth in paragraph (b)(1)(iii) of Note G. The OCC also maintained $2.7 billion in clearing member deposits, well in excess of the $500 million threshold set forth in paragraph (b)(1)(ii) of Note G. See OCC, 2012 Annual Report (2012) (Notes 3 and 4 to the Financial Statements).

206 The Commission may, in its sole discretion, grant such an exemption subject to such conditions as are appropriate under the circumstances if the Commission determines that such conditional or unconditional exemption is necessary or appropriate in the public interest and is consistent with the protection of investors. See 17 CFR 240.15c3-3a(b)(1)(iv), Note G.

The Commission received no comments on the proposed amendment to Rule 15c3-3. The Commission is adopting the amendment to Note G to Exhibit A to Rule 15c3-3 as proposed by removing paragraph (b)(1)(i).

2. Rule 10b-10

a. Proposal

Rule 10b-10 under the Exchange Act, the Commission's customer confirmation rule, generally requires broker-dealers effecting transactions for customers in securities, other than U.S. savings bonds or municipal securities, to provide those customers with a written notification, at or before completion of the securities transaction, disclosing certain information about the terms of the transaction.[207] This required disclosure includes, among other things, the date, time, identity, and number of securities bought or sold; the capacity in which the broker-dealer acted (e.g., as agent or principal); yields on debt securities; and, under special circumstances, the amount of compensation the broker-dealer will receive from the customer and any other parties.[208] By requiring these disclosures, the rule serves a basic customer protection function by conveying information that: (1) allows customers to verify the terms of their transactions; (2) alerts customers to potential conflicts of interest; (3) acts as a safeguard against fraud; and (4) allows customers a means of evaluating the costs of their transactions and the quality of the broker-dealer's execution.

The Commission proposed to delete paragraph (a)(8) from Rule 10b-10.[209] Paragraph (a)(8), which the Commission adopted in 1994, requires a broker-dealer to inform the customer

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207 See 17 CFR 240.10b-10.

208 Id.

209 See Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934, 76 FR at 26563-26564 & n.80. Consistent with this proposed change, the Commission also proposed to re-designate paragraph (a)(9) of the rule, under which a broker-dealer that is not a member of the Securities Investor Protection Corporation generally must disclose that fact, as paragraph (a)(8). Id. at 26564 n.89, 26576.

in the confirmation if a debt security, other than a government security, is unrated by an NRSRO.[210] As explained when it was added to Rule 10b-10 in 1994, paragraph (a)(8) was intended to alert customers to the potential need to obtain more information about a security from a broker-dealer; it was not intended to suggest that an unrated security is inherently riskier than a rated security.[211]

The Commission had previously proposed, and re-proposed, the deletion of paragraph (a)(8) from Rule 10b-10.[212] These previous proposals, however, were prompted by concerns regarding the undue reliance on NRSRO ratings and confusion about the significance of those ratings. Because paragraph (a)(8) of Rule 10b-10 does not refer to NRSRO ratings as a means of determining creditworthiness, it arguably does not come strictly within section 939A. Nevertheless, to the extent that the provision may focus investor attention on ratings issued by NRSROs, as distinct from other items of information, the Commission believed deleting it would be consistent with the intent of the Dodd-Frank Act.

b. Comments

The Commission received four comments regarding the proposed removal of paragraph (a)(8) from Rule 10b-10. One commenter was supportive of the deletion, without providing any additional comment.[213] Another commenter recommended that in place of the deletion, the

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210 See 17 CFR 240.10b-10(a)(8); Confirmation of Transactions, Exchange Act Release No. 34962 (Nov. 10, 1994), 59 FR 59612, 59617 (Nov. 17, 1994), corrected, Securities Exchange Act Release No. 34962A (Nov. 18, 1994), 59 FR 60555 (Nov. 25, 1994).

211 Id. (stating, "In most cases, this disclosure should verify information that was disclosed to the investor prior to the transaction. If the customer was not previously informed of the security's unrated status, then confirmation disclosure may prompt a dialogue between the customer and the broker-dealer," and noting that the disclosure was "not intended to suggest that an unrated security is inherently riskier than a rated security.").

212 See References to Ratings of Nationally Recognized Statistical Rating Organizations, 74 FR 52374; References to Ratings of Nationally Recognized Statistical Rating Organizations, 73 FR 40088.

213 See SIFMA Letter, n.3 ("SIFMA endorses the Commission's proposed changes to Rules 15c3-3 and Rule 10b-10.").

proposed rules should require Rule 10b-10 confirmations to include information that would ensure that investors understand the potential need to learn more about the debt securities that they have acquired from their broker-dealers.[214] The commenter recommended requiring broker-dealers to inform investors that debt securities vary in terms of their creditworthiness; that investors should understand the credit quality of the specific debt securities acquired through their broker-dealer; and that credit quality can affect not only the value of the debt securities, but also their liquidity and price stability.[215] In contrast, a third commenter believed that the removal of paragraph (a)(8) serves no useful purpose, stating: "We do not see how requiring disclosure of the absence of a credit rating in any way encourages greater reliance on credit ratings."[216] The commenter further recommended that if paragraph (a)(8) were deleted, the Commission should not replace it with any further required disclosures.[217] A fourth commenter recommended that paragraph (a)(8) of Rule 10b-10 should be retained.[218] The commenter stated that, given that the types of securities that are unrated by NRSROs typically include small offerings, the required broker-dealer disclosures may no longer signal to investors any need to investigate the quality of the securities being purchased.[219] The commenter added that the required notification that certain securities are unrated serves to encourage investors to evaluate the securities in which they are investing without undermining the overall intent to eliminate reliance upon ratings bestowed by NRSROs.[220]

c. Final Rule

214 See Better Markets Letter.

215 Id.

216 See Sullivan & Cromwell Letter.

217 Id.

218 See CFA Institute Letter.

219 Id.

220 Id.

After careful consideration of the received comments, the Commission has decided to delete paragraph (a)(8) from Rule 10b-10, as proposed. The Commission acknowledges that, to some extent, the paragraph may have served the purpose for which it was added to the rule in 1994 by prompting investors to investigate or question a broker-dealer about the quality of certain securities. Based on the comments received in response to the proposing release, however, the Commission believes it is likely that the paragraph's disclosure requirement has to a greater extent added to investors' undue reliance on credit ratings, and that the deletion of the paragraph is consistent with the intent of section 939A of the Dodd-Frank Act to reduce reliance on NRSRO credit ratings. In addition, requiring broker-dealers to use customer confirmations as a means of providing investors with general information related to credit risk and debt securities as suggested by commenters would not further paragraph (a)(8)'s purpose of flagging unrated securities for more careful investor scrutiny. The paragraph was added to the rule to require disclosure of information suggesting that investors may want to obtain more information about certain unrated securities, not to "require that confirmations alert customers to the importance of understanding the credit quality of a debt security and the impact of credit quality on the value, resale, and price of such securities."[221] The purpose of Rule 10b-10 is not to educate investors about the characteristics of different kinds of securities in general, but rather, in the context of particular transactions, convey information allowing investors to verify the terms of their transactions, alert investors to potential conflicts of interest with their broker-dealers, deter and prevent deceptive and fraudulent acts and practices, and assist customers in evaluating the costs

221 See Better Markets Letter, at 4.

and quality of services proved by broker-dealers in connection with the execution of their securities transactions.[222]

The Commission further notes, as it did in the proposing release, that after the deletion of paragraph (a)(8), broker-dealers will not be prohibited from continuing to provide the information currently required by paragraph (a)(8) on a voluntary basis.[223] If broker-dealers believe that continuing to provide such information on confirmations would, for example, give investors an incentive to carry out additional research on their debt securities, the broker-dealers may continue to provide this disclosure at their discretion.[224] Also, in particular circumstances they may believe that a reasonable investor likely would consider a security's lack of a credit rating significant.

After consideration of the comments received, the Commission is removing paragraph (a)(8) and believes that it is unnecessary to replace the paragraph with any other disclosure requirement. Although the Commission recognizes the potential benefit of requiring broker-dealers to remind investors of the varying creditworthiness of debt securities, the Commission believes that such a requirement would be unnecessary given the other security-specific

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222 See Confirmation of Transactions, at 59 FR 59613; Securities Confirmations, Exchange Act Release No. 15219 (Oct. 4, 1978), 43 FR 47495, 47496 (Oct. 16, 1978).

223 See Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934, 76 FR at 26564. The Commission understands that, as a practical matter, broker-dealers will likely not reprogram their systems solely to remove the information even though the legal obligation to include it has been eliminated. Rather, it is anticipated that firms may choose to make the change at a later date as part of a larger reprogramming initiative.

224 Based on a limited review of customer confirmations, the Commission understands that some broker-dealers currently disclose NRSRO ratings for rated securities even though this information is not required by paragraph (a)(8).

disclosures currently required by Rule 10b-10.[225] Also, general information about credit risk and other risks associated with corporate bonds is widely available to investors.[226]

III. PAPERWORK REDUCTION ACT

Certain provisions of the amendments to the rules and form contain "collection of information requirements" within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[227] The Commission solicited comment on the estimated burden associated with the collection of information requirements in the proposed amendments. The Commission submitted the proposed collection of information requirements to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507 and 5 CFR 1320.11. The titles of the affected information collections are Rule 15c3-1 (OMB Control Number 3235-0200), Rule 15c3-3 (OMB Control Number 3235-0078), Rule 17a-4 (OMB Control Number 3235-0279), Rule 10b-10 (OMB Control Number 3235–0444), and the General Instructions to Form X-17A-5, Part IIB (OMB Control Number 3235-0498). An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information requirement unless it displays a currently valid OMB control number.

As discussed above, the Commission received eleven comment letters on the proposed amendments. Some of the comments in these letters relate indirectly to the PRA and are addressed below. The estimates contained in this section do not include any other possible costs or economic effects beyond the costs required for PRA purposes.[228]

A. Summary of Collection of Information

225 See information broker-dealers must disclose as specified in paragraphs (a)(1) through (a)(7) of Rule 10b-10, as amended.

226 See, e.g., SEC's Office of Investor Education and Advocacy's Investor Bulletin, What Are Corporate Bonds? (June 2013), available at http://www.sec.gov/investor/alerts/ib_corporatebonds.pdf.

227 44 U.S.C. 3501 et seq.

228 See discussion below in Section IV.D.

As discussed above, the Commission is adopting amendments to Rule 15c3-1, Appendices A, E, F, and G to Rule 15c3-1, Exhibit A to Rule 15c3-3, Rule 17a-4, the General Instructions to Form X-17A-5, Part IIB, and Rule 10b-10. These amendments are consistent with section 939A of the Dodd-Frank Act.

The amendments to Rule 15c3-1, and Rule 17a-4 establish a new standard of creditworthiness that will allow broker-dealers to establish their own policies and procedures to determine whether a security has only a minimal amount of credit risk. If a broker-dealer chooses to establish these policies and procedures, it would create a new "collection of information" burden for those broker-dealers, as explained below. The amendments to Appendices A, E, F, and G to Rule 15c3-1 and the General Instructions to Form X-17A-5, Part IIB remove provisions permitting reliance on NRSRO ratings to calculate haircuts and credit risk charges related to counterparties. In addition, the amendments to the Customer Protection Rule remove one method for verifying the status of a registered clearing agency or derivatives clearing organization under Note G to Exhibit A. Broker-dealers have to use a new method for verifying the status of a registered clearing agency or derivatives clearing organization may have to comply with a new "collection of information" within the meaning of the PRA.

The Commission does not believe that the amendment to Rule 10b-10, which eliminates a requirement that broker-dealers inform customers in transaction confirmations for debt securities (other than government securities) if a security is unrated by an NRSRO, would change the existing paperwork burden for Rule 10b-10.

B. Proposed Use of Information

The written policies and procedures required by the amendments to Rule 15c3-1, and the retention of these policies and procedures required by the amendment to Rule 17a-4, will assist

Commission and SRO examination staff in evaluating whether the broker-dealer has a reasonable basis for determining if a security has only a minimal amount of credit risk. It also will assist examination staff and the broker-dealer in evaluating whether the broker-dealer has followed those policies and procedures when acquiring positions in commercial paper, nonconvertible debt, and preferred stock. In addition, written policies and procedures will provide a broker-dealer's personnel with consistent guidance on how to determine if a security has a minimal amount of credit risk for the purposes of complying with Rule 15c3-1.

The amendment to Rule 10b-10 will eliminate a requirement for transaction confirmations for debt securities (other than government securities) to inform customers if a security is unrated by an NRSRO. This amendment will alter neither the general requirement that broker-dealers generate transaction confirmations and send those confirmations to customers, nor the potential use of information contained in confirmations by the Commission, SROs, and other securities regulatory authorities in the course of examinations, investigations and enforcement proceedings.

C. Respondents

The Commission estimates that the collections of information would apply to the number of respondents as indicated in the following table.[229]

Rules	# of Broker-Dealers
Amendments to Rule 15c3-1 (not including appendices) and Rule 17a-4	434
Amendments to Appendices A, E, F, and G to Rule 15c3-1	115
Amendments to Exhibit A to Rule 15c3-3	72
Amendments to the General Instructions to Form X-17A-5, Part IIB	4
Amendments to Rule 10b-10	502

229 See also section IV.B., infra.

D. Total Initial and Annual Reporting and Recordkeeping Burden

1. Rule 15c3-1 Appendices A, E, F, and G to Rule 15c3-1, Rule 17a-4, and the General Instructions to Form X-17A-5, Part IIB

The amendments to Rule 15c3-1 and Rule 17a-4 modify broker-dealers' existing practices to impose additional voluntary recordkeeping burdens. The amendments to Rule 15c3-1 replace NRSRO ratings-based criteria for evaluating creditworthiness with an option for a broker-dealer to apply a new standard based on the broker-dealer's own evaluation of creditworthiness. A broker-dealer that chooses not to make such an evaluation could instead take the higher haircuts as specified in Rule 15c3-1. A broker-dealer that chooses to evaluate the creditworthiness of securities will have to establish, document, maintain, and enforce policies and procedures that are reasonably designed to determine whether a security has a minimal amount of credit risk. Broker-dealers will be required to develop (if they have not already) criteria for assessing creditworthiness and apply those criteria to commercial paper, nonconvertible debt, and preferred stock included in their net capital calculations.

The Commission requested comment on the PRA burden associated with its proposed amendments to Rule 15c3-1 and Rule 17a-4. Two commenters discussed costs, although the comments did not explicitly address the PRA.[230] One commenter stated that "[a] significant number of large broker-dealers have sophisticated internal credit review functions" but those broker-dealers may not "have access to internally generated analyses of all or nearly all issuers and securities."[231] Both commenters were concerned that the costs imposed by the proposed

230 Bond Dealers Letter; SIFMA Letter.

231 SIFMA Letter, at 11, 18.

amendments could be considerable, particularly for small and medium-sized broker-dealers.[232] One commenter noted, however, that "the burden on small and medium-sized broker-dealers would be significantly reduced if the proposed amendment were to be interpreted . . . to permit policies and procedures that base the credit risk analysis solely on a small number of objectively determinable factors."[233] The amended rule allows a broker-dealer to establish policies and procedures customized to its size and business activities.[234] For example, a smaller broker-dealer may decide to establish procedures that use a small number of objective factors or that default to the higher haircuts with respect to certain types of securities or money market instruments in lieu of establishing policies and procedures to address them. Both of these options should minimize the compliance burden on the broker-dealer. Furthermore, the Commission believes that many of the firms that hold commercial paper, nonconvertible debt securities, and preferred stock (or combinations thereof) have established policies and procedures for assessing creditworthiness; broker-dealers that have not established such policies and procedures do not typically hold large portfolios of these types of positions.[235] In addition, the broker-dealer should be able to use its policies and procedures to replicate its credit determinations and is not required to create and maintain records of those determinations. Nonetheless, the Commission believes that those broker-dealers that already have policies and procedures in place for evaluating the overall risk and liquidity levels of proprietary securities for the purposes of Rule 15c3-1 may incur additional burdens as a result of the amendments.. In particular, the policies and procedures may need to be modified to address the particular requirements of the amendments.

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232 Bond Dealers Letter, at 2; SIFMA Letter, at 18.

233 SIFMA Letter, at 18.

234 See section II.B.1.a.iii., supra.

235 SIFMA Letter, at 18 ("A number of broker-dealers have access to credit analysis functions that could be applied to generate internal credit analysis of debt instruments.").

According to data collected by the Commission, of the approximately 4,462 broker-dealers registered with the Commission as of year-end 2012, approximately 434 broker-dealers maintained proprietary positions in debt securities and took haircuts on these securities pursuant to paragraphs (c)(2)(vi)(E), (c)(2)(vi)(F)(1), (c)(2)(vi)(F)(2) and (c)(2)(vi)(H) of Rule 15c3-1.[236] The Commission estimated in the proposing release that, on average, broker-dealers would spend 25 hours developing policies and procedures or revising their current policies and procedures for evaluating creditworthiness for purposes of the amendments to Rule 15c3-1.[237] The Commission received no comments on this estimate. The Commission believes that this estimate is still valid, resulting in an aggregate initial burden of 10,850 hours.[238] This estimate is based on the Commission's belief that many of these broker-dealers already have their own criteria in place for evaluating creditworthiness and, therefore, most broker-dealers will only be revising their current policies and procedures. If a broker-dealer does not have policies and procedures in place (e.g., a small broker-dealer holding only a few debt securities) but determines to establish

236 The number of 434 broker-dealers was obtained by reviewing broker-dealer Financial and Operational Combined Single (or "FOCUS") Reports for 2012 year-end and then calculating how many firms reported holding proprietary debt positions. For FOCUS Part II filers, the balances examined were "Bankers Acceptances" and "Corporate Debt." For FOCUS CSE filers, the balances examined were: "Money Market Instruments," "Private Label Mortgage Backed Securities," "Other Asset Backed Securities," and "Corporate Debt." For Part IIA filers, the balance examined was "Debt Securities." Broker-dealers that hold preferred stock also may hold positions in debt securities. However, because preferred stock is not a separate line item on the FOCUS Report, broker-dealers that hold only preferred stock and no other debt securities are not included in this estimate.

237 Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934, 76 FR at 26568.

238 434 broker-dealers x 25 hours = 10,850 hours. It should be noted that this hour burden is less than the hour burden in the proposing release. This decrease is a result of the number of broker-dealers that reported holding proprietary debt positions on the FOCUS Report. The number decreased from 480 at 2009 year end to 434 at 2012 year end.

them rather than taking the larger haircut, the Commission believes that such a firm will likely establish less complex policies and procedures using a small number of objective factors.[239]

The Commission also estimated in the proposing release that, on average, each broker-dealer will spend an additional 10 hours a year reviewing and adjusting its own standards for evaluating creditworthiness for purposes of the amendments to Rule 15c3-1.[240] The Commission received no comments on this estimate and believes it is still valid. As a result, the Commission estimates that a broker-dealer will spend approximately twenty-five hours initially and ten hours on an annual basis on its policies and procedures. Thus, the industry, as a whole, is estimated to spend approximately 10,850 hours initially and 4,340 hours[241] annually reviewing and adjusting its standards for evaluating creditworthiness for purposes of the amendments to Rule 15c3-1.[242]

The Commission received no comments on the estimated burdens associated with the record retention requirements arising from the proposed amendments to Rule 17a-4. The Commission continues to believe that the requirement to retain the policies and procedures for

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239 See SIFMA Letter, at 18 ("the burden on small and medium-sized broker-dealers would be significantly reduced if the proposed amendment were to be interpreted . . . to permit policies and procedures that base the credit risk analysis solely on a small number of objectively determinable factors. . .").

240 Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934, 76 FR at 26568. Although the Commission has added language to the rule to clarify that a broker-dealer's policies and procedures must be reasonably designed to monitor its creditworthiness determination, the duty to monitor was required under the proposed rule and was reflected in the corresponding burden estimate. See section II.B.1.a.iii, supra.

241 434 broker-dealers x 10 hours = 4,340 hours.

242 The Commission estimated in the proposing release that firms would use a controller to review these standards, both initially and on an annual basis. The Commission received no comments on this estimate. Thus, the Commission believes the per-firm costs of the controller to be approximately $10,475 initially and $4,190 on an annual basis, for an aggregate industry cost of $4,546,150 initially and $1,818,460 on an annual basis. For purposes of this analysis, the Commission is using salary data from the Securities Industry and Financial Markets Association ("SIFMA") Report on Management and Professional Earnings in the Securities Industry 2012, which provides base salary and bonus information for middle management and professional positions within the securities industry, as modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead. Hereinafter, references to data derived from the report as modified in the manner described above will be cited as SIFMA Report on Management and Professional Earnings in the Securities Industry 2012. The Commission believes that the reviews required by the proposed amendments would be performed by the controller at an average rate $419 per hour. $419 x 25 = $10,475 x 434 = $4,546,150; $419 x 10 = $4,190 x 434 = $1,818,460.

three years pursuant to Rule 17a-4 would result in de minimis incremental costs beyond those already incurred under Rule 17a-4. The three-year preservation requirement in Rule 17a-4 will only be applicable once a broker-dealer changes its policies and procedures as the operative policies and procedures must be documented and maintained under the amendments to Rule 15c3-1. In addition, all broker-dealers are currently required to comply with the three-year preservation period in Rule 17a-4 for other records and should have procedures in place to satisfy such preservation requirements.

The amendments to the appendices to Rule 15c3-1 include amendments to certain recordkeeping and disclosure requirements that are subject to the PRA. The amendment to Appendix A to Rule 15c3-1 removes the NRSRO reference from the definition of the term major market foreign currency. However, the Commission does not intend to change which currencies would meet the definition of major market foreign currency because they will still have to have a substantial inter-bank foreign currency market. In the proposing release the Commission stated that there would be a recordkeeping burden if a broker-dealer wanted to request that a currency be deemed to meet the definition of major market foreign currency, by submitting such a request to the Commission. After further review, and based on staff experience with paragraph (c)(2)(vi) of Rule 15c3-1, the Commission believes that broker-dealers will rarely formally request in writing that a currency be added to the list. Thus, the Commission does not believe there is a burden associated with this amendment.[243]

The amendments to Appendices E and F to Rule 15c3-1 and conforming amendments to Appendix G would remove the provisions permitting reliance on NRSRO ratings for the

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[243] In the proposing release, the Commission estimated that submitting a request that a new currency met the definition of "major market foreign currency" would take 10 hours for a total burden to the industry of 1,580 hours. See Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934, 76 FR at 26568.

purposes of determining counterparty risk. As a result of these deletions, an entity that wishes to use the approach set forth in these appendices to determine counterparty risks would need, as part of its initial application to use the alternative approach or in an amendment, to request Commission approval to determine credit charges based on internal credit ratings and make and keep current a record of the basis for the credit risk weight applied to each counterparty.

The Commission does not believe that the removal of the option permitting reliance on NRSRO ratings would affect the small number of entities that currently elect to compute their net capital deductions pursuant to the alternative methods set forth in Appendices E or F. Although the collections of information obligations imposed by the amendments are mandatory, applying for approval to use the alternative capital calculation is voluntary.[244] To date, a total of six entities are using the methods set forth in Appendix E, while four are using the methods set forth in Appendix F. All of the approved firms already use internal credit ratings to calculate market and credit risks under the alternative net capital calculation methods set forth in the appendices or are taking a 100% charge for counterparty risk. No firms are using NRSRO ratings to measure counterparty risk.[245] For each entity that already employs its own models to calculate market and credit risk and keeps current a record of the basis for the credit risk weight of each counterparty, the amendments would not alter the paperwork burden currently imposed by Appendices E and F. Firms that have Commission-approved models to calculate market and credit risk, but have chosen not to seek Commission approval to calculate counterparty risk during their initial applications, can file an amendment to their applications to calculate

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244 See, e.g., Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities, Exchange Act Release No. 34-49830 (June 8, 2004), 69 FR 34428 at 34456 (June 21, 2004).

245 In the proposing release, the Commission stated that all firms have models approved to calculate counterparty risk. Although the Commission received no comments on this estimate, upon further review the staff has determined that although no firm is using NRSRO ratings to calculate counterparty risk, not all firms have models approved to calculate counterparty risk (i.e., some firms take the 100% charge).

counterparty risk. Based on the staff's review of how firms approved to use Appendices E and F are calculating counterparty risk, the staff believes that of the firms that do not have models approved to calculate counterparty risk, none would use NRSRO ratings to calculate counterparty risk even if it remained an option. Instead, these firms would continue to take a 100% charge for counterparty risk or would amend their application if charges related to counterparty risk increased to the point that the 100% charge was no longer economically practical. Any PRA burdens from these amended applications are included in the PRA burden associated with Appendix E or Appendix F. Thus, the Commission does not believe there are any additional burdens associated with this rulemaking.

The staff estimates that three additional firms may apply for permission to use Appendix E and one additional firm may apply to use Appendix F. However, the Commission believes, and commenters did not contest, that there should be no additional paperwork burden on these firms based on the amendments. Any firm that applies to use Appendices E or F to Rule 15c3-1 must submit its internal models to the Commission for approval as part of that process. These models will calculate market risk and credit risk, including the counterparty charge, which is not a change from the previous approval process for a firm that is applying to use Appendix E or Appendix F. Thus, the Commission does not believe the amendments to Appendices E and F will alter the existing paperwork burden estimates for these collections.

The instructions to Form X-17A-5, Part IIB currently include a summary of the credit risk calculation in paragraph (d) of Rule 15c3-1f. Paragraph (d) of Rule 15c3-1f is amended to remove that part of the credit risk calculation that is summarized in Form X-17A-5, Part IIB. Accordingly, the Commission is adopting a conforming amendment to the form that would remove the summary of the credit risk calculation. The Commission received no comments on its estimate in the proposing release that there would be no change in the burden for the collection of information related to the instructions to Form X-17A-5, Part IIB in the proposing release. The summary in the instructions provides additional information for the benefit of the filer and is not related to the information reported on the forms. Accordingly, the Commission does not believe the amendment would result in a substantive revision to these collections of information.

2. Exhibit A to Rule 15c3-3

The amendment to Note G to Exhibit A to Rule 15c3-3 imposes additional recordkeeping burdens on certain broker-dealers that are mandatory. Note G allows a broker-dealer to include, as a debit in its customer reserve formula, the amount of customer margin related to customer positions in security futures products posted to a registered clearing or derivatives clearing organization that meets certain minimum standards that are indicia of long-term financial strength. Prior to this amendment, clearing organizations that maintained the highest investment grade rating from an NRSRO qualified under Note G.[246] The amendment removes this NRSRO criterion such that firms including the debit in their reserve formula calculations must rely on one of the remaining three non-NRSRO criterions, or seek an exemption from the Commission. Broker-dealers are expected to ensure that any clearing or derivatives clearing organization it posts margin to meets one of the criterions under Note G, which results in the creation and maintenance of records of those assessments. The Commission requested comment on all

246 A broker-dealer may also include customer margin related to customers' positions in security futures products posted to a registered clearing or derivatives clearing organization: (1) that maintains security deposits from clearing members in connection with regulated options or futures transactions and assessment power over member firms that equal a combined total of at least $2 billion, at least $500 million of which must be in the form of security deposits; (2) that maintains at least $3 billion in margin deposits; or (3) which does not meet any of the other criteria but which the Commission has agreed, upon a written request from the broker-dealer, that the broker-dealer may utilize. 17 CFR 240.15c3-3a, Note G, (b)(1)(ii)-(iv).

aspects of the burdens associated with Note G to Exhibit A to Rule 15c3-3 and received no comments. The Commission estimates that approximately 72 firms would be required to comply with the provisions of Note G as amended.[247] In the final release that added Note G to Exhibit A to Rule 15c3-3,[248] the Commission estimated that firms would each spend approximately 0.25 hours to verify that the clearing or derivatives clearing organizations they post customer margin to satisfy the conditions of Note G. In the proposing release for these rule amendments, the Commission again estimated that firms would spend approximately 0.25 hours to verify that a clearing or derivatives clearing organization satisfies the conditions of Note G. The Commission received no comments on this estimate and believes it is still valid. The Commission therefore estimates that broker-dealers that trade in single stock futures will spend a total of approximately 18 hours per year, initially and on an ongoing basis, to verify the status of a registered clearing or derivatives clearing organization imposed by this amendment.[249]

The Commission estimated in the proposing release that firms would spend one hour changing their methods of determining whether a clearing or derivatives clearing organization meets the remaining four requirements of Note G. The Commission received no comments on this estimate and believes it is still accurate. The result is an aggregate, one-time initial burden of 72 hours.[250]

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247 The number 72 comes from reviewing the members of the OCC listed in the member directory on the OCC's website, available at http://www.optionsclearing.com/membership/member-information/. Of the list of 228 members, the Commission looked only at those who trade in single stock futures. Of the list of members that trade in single stock futures, the Commission deleted any members who had the exact same firm name but different firm numbers. This methodology is consistent with the methodology used in the proposing release. Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934, 76 FR at 26570 n.115. The Commission received no comments on this estimate.

248 See Reserve Requirements for Margin Related to Security Futures Products, Exchange Act Release No. 34-50295 (Aug. 31, 2004), 69 FR 54182, 54188 (Sep. 7, 2004).

249 72 broker-dealers x .25 hours = 18 hours.

250 72 broker-dealers x 1 hour = 72 hours. The Commission notes that this hour burden is less than the hour burden in the proposing release. This decrease is a result of the number of OCC member firms that trade in

3. Rule 10b-10

In the proposing release, the Commission stated that the proposed amendment to Rule 10b-10 was not expected to result in any significant change to the cost of providing confirmations to customers in connection with those transactions covered by paragraph (a)(8) of the rule.[251] The Commission did not receive any comments that addressed the Rule 10b-10 amendment's potential effects on the burden associated with generating and sending confirmations. The Commission continues to believe that broker-dealers need not incur any new costs if they choose not to input information that a debt security is unrated into their existing confirmation systems. Accordingly, the Commission continues to believe that the Rule 10b-10 amendment will not result in any significant change to the recordkeeping or reporting burdens of generating and sending confirmations, and retains this conclusion as originally proposed.

IV. ECONOMIC ANALYSIS

A. Overview

The Commission is sensitive to the costs and benefits of its rules. When engaging in rulemaking that requires the Commission to consider or determine whether an action is necessary or appropriate in the public interest, section 3(f) of the Exchange Act requires that the Commission consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[252] In addition, section 23(a)(2) of the Exchange Act requires that the Commission consider the effects on competition of any rules the

single stock futures decreasing from 90 to 72. The Commission estimated in the proposing release that firms will use a senior operations manager to review these standards. The Commission received no comments on this estimate and believes that it is still accurate. The Commission therefore estimates that the one-time costs of a senior operations manager to be $341 per hour, resulting in an aggregate, one-time cost to the industry of $24,552. 72 broker-dealers x $341/hour x 1 hour = $24,552. SIFMA Report on Management and Professional Earnings in the Securities Industry 2012.

251 See Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934, 76 FR at 26575.

252 15 U.S.C. 78c(f).

Commission adopts under the Exchange Act, and prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.[253]

In the proposing release, the Commission solicited comment on the costs and benefits of the proposed amendments, including whether estimates of the costs and benefits were accurate and comprehensive.[254] The Commission further encouraged commenters to provide specific data and analysis in support of their views.[255] The Commission also requested comment on whether the proposed amendments would place a burden on competition, and promote efficiency, competition, and capital formation.[256]

The Commission received two comment letters addressing the Commission's estimates of the costs associated with the proposed amendments.[257] Generally, these commenters expressed concerns that the potential costs associated with the proposed rules could be considerable.[258] While commenters stated that the costs may be high, they did not provide quantified estimates of the costs—this reflects the fact that many of the costs and benefits of today's amendments are difficult to quantify with any degree of certainty, especially as practices at broker-dealers are expected to evolve and appropriately adapt to market developments. Moreover, this difficulty is aggravated by the fact that limited public data exists that is related to a broker-dealer's net capital

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253 15 U.S.C. 78w(a)(2).

254 An economic analysis was included in the proposing release. See Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934, 76 FR at 26571-26574.

255 See Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934, 76 FR at 26574.

256 Id.

257 See SIFMA Letter; Bond Dealers Letter.

258 See Bond Dealers Letter, at 2 ("the cost to comply may be prohibitively high for the smaller or middle-market broker-dealers"); SIFMA Letter, at 18 ("we believe the cost and complexity of developing a credit evaluation infrastructure covering many issuers and securities may be beyond the means of many broker-dealers").

calculation that could assist in quantifying certain costs. Consequently, the Commission has relied on qualitative assessments of the likely costs and benefits in its analysis. As discussed throughout this release, the Commission has modified the amendments being adopted today in a way that it believes will help to minimize costs to broker-dealers. A number of costs and benefits that are related to the rules being adopted today are discussed below.

As discussed above, the amendments to Rule 15c3-1, Appendices A, E, F, and G to Rule 15c3-1, Exhibit A to Rule 15c3-3, Rule 17a-4, the General Instructions to Form X-17A-5, Part IIB, and Rule 10b-10 implement section 939A of the Dodd-Frank Act by eliminating the reference to and requirement for the use of NRSRO ratings in these rules. The Commission recognizes that there are additional costs associated with adopting the amendments that are separate from the costs associated with the hour and cost burdens discussed in the PRA. The discussion below focuses on the Commission's reasons for adopting these amendments, the affected parties, the impact on efficiency, competition, and capital formation, and the costs and benefits of the amendments as compared to the baseline, described below, and to alternative courses of action.

B. Economic Baseline

The regulatory changes adopted today amend requirements that apply to broker-dealers registered with the Commission. However, security issuers, NRSROs, non-NRSRO credit rating agencies, and other providers of credit risk analysis as well as a broker-dealer's customers and counterparties could all be affected by the amendments. The discussion below characterizes the economic baseline against which the costs and benefits, as well as the impact on efficiency, competition, and capital formation, of today's amendments are measured. It includes the approximate numbers of broker-dealers that would be directly affected by today's amendments and a description of the relevant features of the economic and regulatory environment in which the various impacted parties operate. The economic baseline being used for this analysis is the economic and regulatory framework in existence just prior to the adoption of today's amendments.

The regulations that are affected by today's amendments include Rule 15c3-1, which provided prior to today's amendments, among other things, that a broker-dealer could apply a lesser capital charge (e.g., less than the 15% catchall charge) for commercial paper, nonconvertible debt, and preferred stock if the instrument is rated in the higher rating categories by two NRSROs; the Appendices to Rule 15c3-1, which rely on credit ratings for calculating haircuts or credit risk charges related to counterparties; Exhibit A to Rule 15c3-3, which uses NRSRO ratings to determine whether a broker-dealer can include customer margin for transactions in securities futures products as a debit in its reserve formula; and Rule 10b-10, which requires disclosing in customer confirmations of securities transactions if non-government debt securities have not been rated by an NRSRO. The rule amendments would help to reduce any perceived Commission endorsement of NRSROs and NRSRO ratings and reduce reliance on credit ratings. The relevant rule amendments are described in detail below.

The broker-dealers registered with the Commission vary significantly in terms of their size, business activities, and the complexity of their operations. For example, carrying broker-dealers hold customer securities and funds.[259] Clearing broker-dealers clear transactions as

[259] Rule 15c3-1 specifies that a broker-dealer shall be deemed to carry customer or broker-dealer accounts "if, in connection with its activities as a broker or dealer, it receives checks, drafts, or other evidences of indebtedness made payable to itself or persons other than the requisite registered broker or dealer carrying the account of a customer, escrow agent, issuer, underwriter, sponsor, or other distributor of securities" or "if it does not promptly forward or promptly deliver all of the securities of customers or of other brokers or dealers received by the firm in connection with its activities as a broker or dealer." 17 CFR 240.15c3-1(a)(2)(i); see also the description of Rule 15c3-1 in section II.B.1.a.i., supra. Further, Rule 15c3-3, defines the term securities carried for the account of a customer to mean "securities received by or on behalf of a broker or dealer for the account of any customer and securities carried long by a broker or dealer for the

members of securities exchanges, the Depository Trust & Clearing Corporation, and the OCC.[260] Many clearing broker-dealers are carrying broker-dealers, but some clearing broker-dealers clear only their own transactions and do not hold customer securities and cash.

A broker-dealer that claims an exemption from Rule 15c3-3 is generally referred to as "non-carrying broker-dealer." Non-carrying broker-dealers include "introducing brokers."[261] These non-carrying broker-dealers typically accept customer orders and introduce their customers to a carrying broker-dealer that will hold the customers' securities and cash along with the securities and cash of customers of other introducing broker-dealers and those of direct customers of the carrying broker-dealer. The carrying broker-dealer generally receives and executes orders of the introducing broker-dealer's customers.[262] Carrying broker-dealers generally also prepare trade confirmations, settle trades, and organize book entries of the securities.[263] Introducing broker-dealers also may use carrying broker-dealers to clear the firm's proprietary trades and carry the firm's securities. Another group of non-carrying broker-dealers

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account of any customer," as well as securities sold to, or bought for, a customer by a broker-dealer. 17 CFR 240.15c3-3(a)(2); see also the description of the Customer Protection Rule in section II.B.1.f., supra.

260 See Definitions of Terms and Exemptions Relating to the "Broker" Exceptions for Banks and Exemptions for Banks under Section 3(a)(5) of the Securities Exchange Act of 1934, Exchange Act Release No. 34-56501(Sep. 24, 2007), 72 FR 56514 (Oct. 3, 2007), at n.269.

261 See Net Capital Rule, Exchange Act Release No. 34-31511 (Nov. 24, 1992), 57 FR 56973 (Dec. 2, 1992) (describing the role of introducing broker-dealers).

262 Id.

263 See, e.g., FINRA Rule 4311 (Carrying Agreements). This FINRA rule governs the requirements applicable to FINRA members when entering into agreements for the carrying of any customer accounts in which securities transactions can be effected. Historically, the purpose of this rule has been to require that certain functions and responsibilities are clearly allocated to either the introducing or carrying firm, consistent with the requirements of the SRO's and Commission's financial responsibility rules and other rules and regulations, as applicable. See also Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of a Proposed Rule Change Adopting, as Modified by Amendment No. 1, Rules Governing Guarantees, Carrying Agreements, Security Counts and Supervision of General Ledger Accounts in the Consolidated FINRA Rulebook, Exchange Act Release 34-63999 (Mar. 7, 2011), 76 FR 12380 (Mar. 7, 2011).

effects transactions in securities such as mutual funds on a subscription-way basis.[264] Generally, customers purchase the securities by providing the funds directly to the issuer. Finally, some non-carrying broker-dealers act as finders by referring prospective purchasers of securities to issuers.[265]

The broker-dealer industry is the primary industry affected by the rule amendments, although the amendments impose different requirements on different types of broker-dealers. For example, only those broker-dealers that hold proprietary positions in commercial paper, nonconvertible debt, and preferred stock will be affected by the amendments to Rules 15c3-1 and 17a-4, only those broker-dealers that trade in foreign currency options will be affected by the amendments to Appendix A to Rule 15c3-1, and only those broker-dealers that clear and carry positions in security futures products for customers will be affected by the amendment to Exhibit A to Rule 15c3-3. The amendments to Appendices E and F to Rule 15c3-1 and the conforming amendments to Appendix G to Rule 15c3-1 and the General Instructions to Form X-17A-5, Part IIB will affect only ANC broker-dealers and OTC derivatives dealers. The amendment to Rule 10b-10 eliminates a disclosure requirement for broker-dealers that currently produce transaction confirmations for debt securities other than government securities.

To establish a baseline for competition among broker-dealers, the Commission looks at the status of the broker-dealer industry detailed below. In terms of size, the following tables illustrate the variance among broker-dealers with respect to total capital. The information in the tables is based on FOCUS Report data for calendar year 2012.

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264 See Books and Records Requirements for Brokers and Dealers Under the Securities Exchange Act of 1934, Exchange Act Release No. 34-44992 (Oct. 26, 2001), 66 FR 55818 (Nov. 2, 2001) ("[T]he Commission recognizes that for some types of transactions, such as purchases of mutual funds or variable annuities, the customer may simply fill out an application or a subscription agreement that the broker-dealer then forwards directly to the issuer.").

265 See American Bar Association, Report and Recommendations of the Task Force on Private Placement Broker-Dealers, 23-24 (2005); see also Net Capital Rule, 57 FR 56973.

Broker-Dealer Capital at Calendar Year-end 2012
($ millions)

Capital	Number of Firms	Sum of Total Capital
Less than $500,000	2,347	$345
Greater than or equal to $500,000 and less than $5 million	1,273	$2,207
Greater than or equal to $5 million and less than $50 million	569	$9,712
Greater than or equal to $50 million and less than $100 million	83	$5,632
Greater than or equal to $100 million and less than $500 million	121	$25,465
Greater than or equal to $500 million and less than $1 billion	27	$19,688
Greater than or equal to $1 billion and less than $5 billion	26	$56,034
Greater than or equal to $5 billion and less than $10 billion	7	$47,922
Greater than or equal to $10 billion	9	$185,022
Total	**4,462**	**$352,028**

According to FOCUS Report data, as of December 31, 2012, there were approximately 4,462 broker-dealers registered with the Commission. Nine broker-dealers account for more than half of all capital held by broker-dealers. Of the 4,462 registered broker-dealers, 434 firms reported holding proprietary debt positions on their FOCUS Reports.[266] The Commission has also estimated that there are 101 broker-dealers that trade foreign currency options and are, therefore, subject to Appendix A to Rule 15c3-1.[267] Furthermore, there are six ANC broker-dealers (i.e., firms that operate under Appendix E to Rule 15c3-1) and four OTC derivatives

266 See section III.C., supra.

267 To arrive at this number, the Commission reviewed the members of the OCC listed in the member directory on the OCC's website available at http://www.optionsclearing.com/membership/member-information/. Of the list of 228 members, the Commission looked only at those that trade in index options because members approved to trade index options are also approved to trade such foreign currency options. Of the list of members that trade in index options, the Commission deleted any members that had the exact same firm name but different firm numbers. The Commission received no comments on its estimate of the number of broker-dealers that would be affected by the amendment to Appendix A to Rule 15c3-1 in the proposing release. See also Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934, 76 FR at 26568.

dealers (i.e., firms that operate under Appendix F to Rule 15c3-1). In addition, the staff estimates that, for reasons unrelated to the rule amendments being adopted today, an additional three firms will apply to operate as ANC broker-dealers and one additional firm will apply to operate as an OTC derivatives dealer. The Commission also has estimated that there are 72 firms subject to Note G to Exhibit A to Rule 15c3-3.[268]

The Commission also believes other parties could be affected by today's amendments. Under the economic baseline, issuers of securities who obtain favorable ratings from two or more NRSROs enjoy the benefit of greater access to the capital markets because such securities are – holding other things constant – more attractive to broker-dealers who can take lower haircuts on such securities for the purposes of compliance with Rule 15c3-1. While the Commission does not intend the amendments to Rule 15c3-1 to alter the scope of securities and money market instruments that qualify for the lower haircuts, eliminating preferential regulatory treatment of NRSRO-rated securities could affect security issuers by altering the portfolio preferences of broker-dealers if, for example, broker-dealers establish policies and procedures for assessing creditworthiness that produce more conservative results than the NRSRO credit rating standard. These conservative results could cause broker-dealers to avoid holding positions that they would have held under the NRSRO credit rating standard. Alternatively, if the policies and procedures produce less conservative results, the amendments could alter the risk of broker-dealers' portfolios by causing them to hold positions that they would not have held when applying the NRSRO credit rating standard. Altering the risk of broker-dealers' portfolios could affect broker-dealers' customers, counterparties, and investors, all of whom are protected by Rule 15c3-1.

[268] See section III.C., supra.

Finally, today's amendments could have a significant effect on the credit ratings industry. Currently there are ten NRSROs with the three largest accounting for the majority of all credit ratings.[269] The favorable regulatory treatment of NRSRO-rated securities increases demand for securities that have been favorably rated by at least two NRSROs. Eliminating this favorable treatment may alter incentives for broker-dealers to hold NRSRO-rated securities and may increase a broker-dealer's use of alternative providers of credit risk analysis, which could increase competition in the credit ratings industry.

1. Overview of Rule 15c3-1, Appendices A, E, F, and G to Rule 15c3-1, Exhibit A to Rule 15c3-3, the General Instructions to Form X-17A-5, Part IIB, and Rule 10b-10 prior to today's amendments

a. Rule 15c3-1

As discussed above, Rule 15c3-1 prescribes minimum regulatory capital requirements for broker-dealers.[270] Rule 15c3-1 prescribes a "net liquid assets test" designed to require a broker-dealer to maintain at all times more than one dollar of highly liquid assets for each dollar of liabilities (e.g., money owed to customers and counterparties), excluding liabilities subordinated by contract to all other creditors. Under the economic baseline, Rule 15c3-1 prescribed a lower haircut to certain types of debt instruments held by a broker-dealer if the securities were rated in higher rating categories by at least two NRSROs, since those securities typically are less volatile in price than securities that are rated in the lower categories or are unrated. Specifically, to receive the benefit of a reduced haircut on commercial paper, the commercial paper had to be

269 See Commission, Annual Report on Nationally Recognized Statistical Rating Organizations (December 2012) (estimating that as of December 2011, the three largest NRSROs accounted for approximately 96% of all outstanding credit ratings); Commission, Report to Congress on Assigned Credit Ratings (December 2012) (estimating that as of December 2011, the three largest credit rating agencies accounted for approximately 91% of structured product ratings).

270 See 17 CFR 240.15c3-1; see also discussion in section II.B.1.a.i., supra.

rated in one of the three highest rating categories by at least two NRSROs;[271] to receive the benefit of a reduced haircut on a nonconvertible debt security and preferred stock, the security had to be rated in one of the four highest rating categories by at least two NRSROs.[272] If securities were not eligible for the reduced haircut, they were subject to a greater haircut (e.g., 15%), provided they had a ready market. The 15% haircut is derived from the catchall haircut amount that applies to a security not specifically identified in Rule 15c3-1 as having an asset-class specific haircut, provided the security is otherwise deemed to have a ready market, among other requirements. Securities without a ready market are subject to a 100% haircut.

b. Appendix A to Rule 15c3-1

Appendix A to Rule 15c3-1 permits broker-dealers to employ a standardized theoretical option pricing model to determine a potential loss for a portfolio of listed options positions and related positions to compute a single haircut for the group of positions.[273] Under Appendix A, a broker-dealer groups the options and related positions in a portfolio and stresses the current market price for each position at ten equidistant points along a range of positive and negative potential future market movements, using an approved theoretical option pricing model that satisfies certain conditions specified in the rule.[274] Positions that have more potential price volatility must be stressed across a wider range of positive and negative potential future market movements than positions with lower price volatility.[275] For example, a broker-dealer other than a non-clearing option specialist or market maker must employ a range of potential future market movements for major market foreign currencies of (+/-) 6%, whereas the range for all other foreign currencies is

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271 17 CFR 240.15c3-1(c)(2)(vi)(E).

272 17 CFR 240.15c3-1(c)(2)(vi)(F)(1), (c)(2)(vi)(F)(2) and (c)(2)(vi)(H).

273 See 17 CFR 240.15c3-1a(b)(1); see also discussion in section II.B.1.b.i., supra.

274 See 17 CFR 240.15c3-1a(b)(1).

275 See 17 CFR 240.15c3-1a(b)(1)(iii).

(+/-) 20%.[276] Thus, major market foreign currency options receive more favorable treatment than options on all other currencies when using theoretical option pricing models to compute net capital deductions.[277] Under the economic baseline, the rule defined the term major market foreign currency to mean "the currency of a sovereign nation whose short term debt is rated in one of the two highest categories by at least two nationally recognized statistical rating organizations and for which there is a substantial inter-bank forward currency market."

c. Appendix E to Rule 15c3-1

Under Appendix E to Rule 15c3-1, ANC broker-dealers are permitted to add back to net worth uncollateralized receivables from counterparties arising from OTC derivatives transactions (i.e., they can add back the amount of the uncollateralized current exposure).[278] Instead of the 100% deduction that applies to most unsecured receivables under Rule 15c3-1, ANC broker-dealers are permitted to take a credit risk charge based on the uncollateralized credit exposure to the counterparty.[279] The credit risk charge is derived, in part, by using an applicable credit risk weight factor.[280] Appendix E to Rule 15c3-1 prescribes three standardized credit risk weight factors (20%, 50%, and 150%) and, as an alternative, permits an ANC broker-dealer with Commission approval to use internal methodologies to determine appropriate credit risk weights to apply to counterparties.[281] Under the economic baseline, ANC broker-dealers were permitted to use NRSRO credit ratings or internally derived credit ratings to determine the appropriate credit risk weight factor.

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276 See 17 CFR 240.15c3-1a(b)(1)(iii)(B) through (C).

277 See 17 CFR 240.15c3-1a(b)(1)(iii)(B) through (C) and (b)(1)(iv)(A).

278 See 17 CFR 240.15c3-1e(c); see also discussion in section II.B.1.c.i., supra.

279 See 17 CFR 240.15c3-1e(c); 17 CFR 240.15c3-1(a)(7).

280 See 17 CFR 240.15c3-1e(c)(1)(ii).

281 See 17 CFR 240.15c3-1e(c)(4)(vi).

d. Appendix F to Rule 15c3-1 and Form X-17A-5, Part IIB

Under Appendix F to Rule 15c3-1, OTC derivatives dealers are required to deduct from their net capital credit risk charges that take counterparty risk into consideration.[282] As part of this deduction, the OTC derivatives dealer must apply a counterparty risk weight factor of either 20%, 50%, or 100%.[283] In addition, OTC derivatives dealers must take a concentration charge where the net replacement value in the account of any one counterparty exceeds 25% of the OTC derivatives dealer's tentative net capital.[284] Under the economic baseline, the counterparty risk weight factor (i.e., 20%, 50%, or 100%) was determined using either NRSRO credit ratings or the firm's internal credit ratings.[285] The concentration charge also was determined using either NRSRO credit ratings or the firm's internal credit ratings.

e. Appendix G to Rule 15c3-1

Appendix G to Rule 15c3-1 provides that broker-dealers may use the ANC computation only if their ultimate holding companies agree to provide the Commission with additional information about the financial condition of the holding company and its affiliates.[286] Paragraph (a) of Appendix G sets forth a methodology for computing allowable capital and allowances for market and credit risk at the consolidated holding company level. Under the economic baseline, one aspect of calculating credit risk in Appendix G provided that those firms must use credit ratings in accordance with the applicable provisions of Appendix E

f. Exhibit A to Rule 15c3-3

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282 See 17 CFR 240.15c3-1f(d); see also discussion in section II.B.1.d.i., supra.

283 See 17 CFR 240.15c3-1f(d)(2).

284 See 17 CFR 240.15c3-1f(d)(3).

285 See 17 CFR 240.15c3-1f(d)(2) and (4); see also discussion in section II.B.1.d.i., supra.

286 17 CFR 240.15c3-1g.

Rule 15c3-3 is designed to protect customer funds and securities held by broker-dealers.[287] In general, Rule 15c3-3 requires a broker-dealer to take two steps. First, a broker-dealer must maintain possession or control of all fully paid and excess margin securities of its customers. In this regard, a broker-dealer must make a daily determination in order to comply with this aspect of the rule. Second, the broker-dealer must make a periodic computation to determine how much money it is holding that is either customer money or money obtained from the use of customer securities ("credits"). From that figure, the broker-dealer subtracts the amount of money that it is owed by customers relating to customer transactions ("debits"). If the credits exceed the debits after this "reserve formula" computation, the broker-dealer must deposit the excess in a customer reserve account. If the debits exceed credits, no deposit is necessary. Funds deposited in a customer reserve account cannot be withdrawn until the broker-dealer completes another computation that shows that the firm has on deposit more funds than the reserve formula requires.

Exhibit A to Rule 15c3-3 prescribes the formula that a broker-dealer must use to determine its reserve requirement. Under the economic baseline, Note G to Exhibit A provided that a broker-dealer could include margin required for customer transactions in security futures products as a debit in its reserve formula computation if that margin is on deposit at a clearing agency or derivatives clearing organization that: (1) maintains the highest investment-grade rating from an NRSRO; (2) maintains security deposits from clearing members in connection with regulated options or futures transactions and assessment power over member firms that equal a combined total of at least $2 billion, at least $500 million of which must be in the form of

[287] See 17 CFR 240.15c3-3; see also discussion in section II.B.1.f., supra.

security deposits; (3) maintains at least $3 billion in margin deposits; or (4) obtains an exemption from the Commission.[288]

g. Rule 10b-10

Rule 10b-10, the Commission's customer confirmation rule, generally requires broker-dealers effecting transactions for customers in securities, other than U.S. savings bonds or municipal securities, to provide those customers with a written notification, at or before completion of the securities transaction, disclosing certain information about the terms of the transaction.[289] This required disclosure includes the date, time, identity, and number of securities bought or sold; the capacity in which the broker-dealer acted (e.g., as agent or principal); yields on debt securities; and, in some circumstances, the amount of compensation the broker-dealer will receive from the customer and any other parties. By requiring these disclosures, the rule serves a basic customer protection function by conveying information that: (1) allows customers to verify the terms of their transactions; (2) alerts customers to potential conflicts of interest; (3) acts as a safeguard against fraud; and (4) allows customers a means of evaluating the costs of their transactions and the quality of the broker-dealer's execution. Under the economic baseline, Rule 10b-10 required a broker-dealer to inform the customer in the confirmation if a debt security, other than a government security, is unrated by an NRSRO.

C. Effect on Efficiency, Competition, and Capital Formation

The amendments adopted today have the potential to affect competition, efficiency, and capital formation. This section discusses what the Commission believes to be potential effects

288 17 CFR 240.15c3-3a, Note G.

289 17 CFR 240.10b-10; see also discussion in section II.B.2.a., supra.

across three groups of market participants: (1) broker-dealers, (2) security issuers, and (3) issuers of credit ratings.[290]

1. Effects on the Broker-Dealer Industry

Under the economic baseline, all broker-dealers employ a uniform standard – an NRSRO credit rating – to determine whether a position in commercial paper, nonconvertible debt, or preferred stock is entitled to a lower haircut for purposes of Rule 15c3-1. Today's amendments eliminate this uniform standard and require that broker-dealers develop internal policies and procedures for determining whether these types of positions have only a minimal amount of credit risk and, therefore, are entitled to the lower haircut. As one commenter noted, "the cost and complexity of developing a credit evaluation infrastructure covering many issuers and securities may be beyond the means of many broker-dealers."[291] Also, as the FOCUS Report data for calendar year 2012 makes clear, the majority of broker-dealers are small (with capital less than \$500,000).[292] As noted by several commenters, any new regulatory requirement with significant fixed costs has the potential to disadvantage small and medium-sized broker-dealers.[293] Such disadvantages could result in increased concentration in the broker-dealer industry.

However, the Commission does not intend or expect broker-dealers to individually duplicate the function of credit rating agencies. To do so would require broker-dealers, particularly small and medium sized broker-dealers, to incur significant expense, potentially reducing competition in the broker-dealer industry and harming economic efficiency through

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290 Although this section IV.C. of the release focuses on these three groups of market participants whose businesses may be more directly impacted by the final rules, the impacts on other participants are discussed elsewhere in the release. See, e.g., section IV.D., infra.

291 SIFMA Letter, at 18.

292 See section IV.B., supra.

293 SIFMA Letter, at 11; Bond Dealers Letter, at 2.

duplication of effort.[294] Instead, the Commission expects that today's amendments will create opportunities for NRSROs, non-NRSRO credit rating agencies, and other providers of credit risk analysis to offer products and services that facilitate compliance with today's amendments. Although broker-dealers with large portfolios of debt securities and well-developed credit analysis capabilities may prefer to use an internal credit risk function for assessing creditworthiness, it will not be cost effective or practical for other broker-dealers to support an internal credit risk department comprised of analysts who perform internal credit assessments. These broker-dealers may instead establish a process for assessing creditworthiness that relies more on external factors, such as external credit assessments and market data, and that process will be evaluated for reasonableness in light of the firm's circumstances (e.g., the size of the broker-dealer and the types and sizes of the positions typically held by the broker-dealer). The Commission also anticipates that some broker-dealers, particularly those with minimal proprietary positions in commercial paper, nonconvertible debt, and preferred stock, will choose to devote no resources toward credit risk analysis and to maintenance of policies and procedures, and instead will apply a greater haircut to their proprietary positions as permitted by the rule.[295]

Based on these considerations, the Commission does not believe that the burden of complying with today's amendments will result in significant changes to the competitive structure of the broker-dealer industry in general, nor to the small subset of broker-dealers with positions in commercial paper, nonconvertible debt, and preferred stock that are directly affected by today's amendments.

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294 See generally SIFMA Letter, at 11.

295 Although this approach would decrease the firm's direct cost of complying with the rule amendments, it would increase the amount of capital the broker-dealer is required to maintain to comply with Rule 15c3-1, increasing the indirect compliance costs.

In addition to the aforementioned potential direct effects on efficiency and competition, today's amendments may affect economic efficiency indirectly by altering the net capital levels in the broker-dealer industry. A broker-dealer that elects to take a higher haircut rather than make a credit risk determination or one that overestimates the credit risk in its position will reserve more net capital than is required by Rule 15c3-1. This could affect the broker-dealer's ability to hold (or add to) its positions. Conversely, some broker-dealers may underestimate the credit risk of their positions. Indeed, broker-dealers have an incentive to underestimate credit risk in order to apply the lower capital charge. Such a determination could have a potential impact on the firm's ability, if it experiences financial difficulties, to be in a position to meet its obligations to customers, investors, and other counterparties and generate resources to wind-down its operations in an orderly manner without the need of a formal liquidation proceeding, with attendant costs. Increasing discretion in assessing creditworthiness for purposes of Rule 15c3-1 can facilitate such underestimation of credit risk. The Commission believes that this represents a significant risk in today's amendments. Broker-dealers whose internal evaluations typically are inconsistent with market data likely will need to spend more time addressing examiners' concerns regarding the reasonableness of their policies and procedures and the accuracy of their determinations that a security or money market instrument has only a minimal amount of credit risk; a broker-dealer's desire to avoid these costs may help mitigate the broker-dealers' incentives to underestimate credit risk.

2. Effects on Security Issuers

Today's amendments could impact capital formation by altering the set of securities that qualify for preferential treatment under Rule 15c3-1. Under the economic baseline, issuers of commercial paper, nonconvertible debt securities, and preferred stock who obtain favorable ratings from two or more NRSROs benefit from having lower haircuts apply to their issuances. Consequently, these issuers may have greater access to the capital markets, while issuers without such a rating may have more limited access. The regulatory preference for NRSRO-rated securities also benefits issuers who can afford to have their securities rated by NRSROs, and discourages broker-dealers from considering all the relevant credit risk factors when making portfolio decisions. By eliminating the regulatory preference for NRSRO-rated securities, today's amendments could alter the set of securities qualifying for lower net capital charges, which would affect broker-dealers' portfolio preferences. For example, the amendments could increase access to capital markets for smaller issuers whose commercial paper, nonconvertible debt securities, or preferred stock have only a minimal amount of credit risk, but for whom the costs of obtaining an NRSRO rating is potentially prohibitive. Such changes could increase competition among issuers for capital and improve the efficiency of the capital allocation process.

While it is the intent of the Commission that today's amendments not alter the quality of assets that qualify for the lower haircut, it is nonetheless a possibility that the policies and procedures that broker-dealers establish will change the risk and/or net capital levels of broker-dealers. Changes or perceived changes to the amount of net capital being held by a broker-dealer could have negative repercussions on confidence in broker-dealers' financial position among their customers, counterparties, and investors. These impacts on confidence could disrupt the orderly functioning of the markets – for example, by encouraging counterparties to reduce their exposures to broker-dealers in response to uncertainty about broker-dealers' financial positions – and thereby harm the capital formation process.

3. Effects on the Credit Ratings Industry

Finally, today's amendments could have an effect on competition in the credit rating agency industry with consequences on economic efficiency. Currently there are ten NRSROs with the three largest accounting for the majority of all credit ratings. As noted earlier, the favorable regulatory treatment of NRSRO-rated securities increases demand for securities that have been rated by at least two NRSROs. Eliminating this favorable treatment may increase broker-dealers' use of alternative providers of credit risk analysis, which could increase competition in the credit rating agency industry. Furthermore, to the extent that NRSRO ratings are biased, as some have argued, additional competition among credit rating providers could help expose any such biases and increase incentives for NRSROs to produce accurate ratings.

Reducing the emphasis on NRSRO ratings also could adversely affect the quality of NRSRO ratings. Currently, the importance attached to NRSRO ratings may impart franchise value to the NRSRO's ratings business. Eliminating references to NRSRO ratings in certain federal regulations could reduce these franchise values and mitigate NRSROs' incentives to produce credible and reliable ratings. Moreover, the Commission recognizes that the elimination of the required use of credit ratings in the specified Commission rules and forms may reduce the incentive for credit rating agencies to register as NRSROs with the Commission and thereby be subject to the Commission's oversight and the statutory and regulatory requirements applicable to NRSROs. To the extent that the quality and accuracy of NRSRO ratings is adversely affected, negative impacts on the capital allocation process and economic efficiency could result.

D. Costs and Benefits of the Rule Amendments

1. Rule 15c3-1 and Rule 17a-4

a. Benefits

The Commission requested comment on all aspects of the benefits associated with the amendments to Rule 15c3-1, the appendices to Rule 15c3-1, and Rule 17a-4, and received no comments. The Commission believes that one of the primary benefits of the amendments being adopted today is reducing potential undue reliance on NRSRO ratings that could be caused by references to NRSROs in Commission rules. Significantly, the Commission believes that eliminating references to NRSRO ratings in its rules would remove any appearance that the Commission has placed its imprimatur on such ratings. The Commission, however, also recognizes that credit ratings provide useful information to institutional and retail investors as part of the process of making an investment decision.

The Commission believes that the amendments to Rule 15c3-1 and its appendices, as well as the conforming amendment to Rule 17a-4, will encourage a more complete assessment of the credit risks associated with securities held by broker-dealers. As the NRSROs themselves have stressed, NRSRO ratings are a one-dimensional measure that summarizes the likelihood that an obligor or financial obligation will fail to repay investors in accordance with the terms on which they made their investment and investors' expected recoveries in the event of such a failure.[296] The simplicity of a one-dimensional measure is both its major advantage and its main limitation. For comparing securities with similar risk profiles, one-dimensional credit ratings are a useful summary measure. However, for securities with different risk profiles, such ratings can obscure important information about underlying differences in risk, such as time effects, default correlations, and the shape of loss distributions. The Commission expects that the amendments

[296] See, e.g., Fitch, Inside the Ratings: What Credit Ratings Mean, (Aug. 2007), at 1; Testimony of Michael Kanef, Group Managing Director, Moody's Investors Service, Before the United States Senate Committee on Banking, Housing, and Urban Affairs (Sep. 26, 2007), at 2; Testimony of Vickie A. Tillman, Executive Vice President, Standard & Poor's Credit Market Services, Before the United States Senate Committee on Banking, Housing, and Urban Affairs (Sep. 26, 2007), at 3.

adopted today will encourage broker-dealers to incorporate this additional information in their credit risk evaluation process.

Many broker-dealers already conduct their own risk evaluation. As one commenter noted "[a] significant number of large broker-dealers have sophisticated internal credit review functions."[297] However, for those broker-dealers that do not currently have their own means of evaluating risk for purposes of the amendments to Rule 15c3-1, the approach being adopted today will allow them to incorporate various observable factors and external information sources in their new risk evaluation processes, which will lead to a better understanding of the risks associated with those securities.

b. Costs

The Commission recognizes, as a result of today's amendments, that broker-dealers may incur additional costs associated with performing a more detailed and comprehensive analysis of the debt securities they own. The Commission received two comments on the costs associated with the proposed amendments to Rule 15c3-1.[298] As stated above, one commenter noted that "the cost and complexity of developing a credit evaluation infrastructure covering many issuers and securities may be beyond the means of many broker-dealers."[299] Another commenter worried that "the cost to comply may be prohibitively high for the smaller or middle-market broker-dealers."[300] As has been noted above, the Commission does not intend or expect broker-dealers to individually duplicate the function of credit rating agencies. Thus, the Commission believes that the costs of compliance with the amendments to Rule 15c3-1 and its appendices, as

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297 SIFMA Letter, at 11.

298 Bond Dealers Letter, at 2; SIFMA Letter, at 11, 18.

299 SIFMA Letter, at 18.

300 Bond Dealers Letter, at 2.

well as the conforming amendment to Rule 17a-4, would be minimal for the "significant number of large broker-dealers" that have a "sophisticated internal credit review function" for net capital purposes.[301] Of the approximately 434 broker-dealers that hold proprietary debt positions, the Commission recognizes that the level of sophistication varies widely. The broker-dealers with less sophisticated internal procedures for analyzing credit risk may incur costs to establish and develop procedures that would be used to assess financial instruments for the purposes of determining whether the lower haircuts could appropriately be applied. However, the Commission believes that because the determination of a minimal amount of credit risk will vary among firms, and because broker-dealers may create policies and procedures using a small number of objective factors and external assessments, firms will be able to keep costs lower than if they were mandated to create policies and procedures based on numerous specified factors.[302]

There will be minimal costs associated with the amendments for firms that use Appendix A to Rule 15c3-1. The amendment to the definition of major market foreign currency is not intended to change the foreign currencies that currently receive lower haircuts under the rule. Therefore, the Commission does not believe there will be any costs associated with the amendments.

Firms that use Appendices E and F to Rule 15c3-1 already undergo an approval process to use internal credit ratings to determine credit risk charges for each counterparty. Any new firms that apply to use either Appendix E or Appendix F will not incur any separate costs as a result of the amendments. Currently, firms that apply to use these appendices must have their

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301 SIFMA Letter, at 11.

302 See SIFMA Letter, at 18 ("we believe the burden on small and medium-sized broker-dealers would be significantly reduced if the proposed amendment were to be interpreted . . . to permit policies and procedures that base the credit risk analysis solely on a small number of objectively determinable factors . . .").

internal models approved by the Commission prior to using their selected appendix. Although the Commission will have to assess the firm's process for determining internal credit ratings, this step will not cause broker-dealers who are applying to use these appendices to incur any additional costs. Furthermore, because the firms currently using these appendices have traditionally used models to compute capital charges, as opposed to NRSRO ratings, these firms will not incur any additional costs by complying with the amendments.

2. Exhibit A to Rule 15c3-3

a. Benefits

The Commission requested comment on all aspects of the benefits associated with the amendment to Exhibit A to Rule 15c3-3 and received no comments. The amendment eliminates a criterion that qualified the debits at a clearing agency or derivatives clearing organization if it was assigned the highest credit rating given by any NRSRO. Broker-dealers instead will be required to look to two other criterions based on financial metrics.

b. Costs

The Commission requested comment on all aspects of the costs associated with Note G to Exhibit A to Rule 15c3-3 and received no comments. The total cost of compliance with Note G to Exhibit A to Rule 15c3-3 will be minimal as the removal of the NRSRO credit ratings criterion from Note G is neither intended nor expected to change current security futures margining practices by broker-dealers. As stated in the PRA section, the Commission anticipates that a broker-dealer will incur a one-time cost to verify that a clearing or derivatives clearing organization meets the requirements of Note G. If a broker-dealer is currently using one of the non-NRSRO criterions, it will not incur any one-time costs.

3. **Rule 10b-10**

a. **Benefits**

The Commission believes that the amendment to Rule 10b-10 will benefit investors. As explained previously, the existing requirement to inform customers if a debt security, other than a government security, is unrated by an NRSRO may have the unintended effect of suggesting that rated securities are inherently better or less risky than unrated debt securities. The Commission believes that the existence of a rating should not give an investor extra comfort regarding the risks associated with the rated security. The amendment, by removing paragraph (a)(8)'s requirement to disclose whether certain securities are rated by an NRSRO, should help avoid promoting excessive reliance on NRSRO ratings. It also should help encourage investors to view NRSRO ratings as only one of multiple types of information relevant to evaluating credit risk. This in turn should help investors make more informed decisions regarding investments in debt securities.

b. **Costs**

As stated in the proposing release, the Commission does not expect the amendment to result in any significant changes in the costs associated with Rule 10b-10. Broker-dealers will continue to generate transaction confirmations and send those confirmations to customers, and the amendment is not expected to change the cost of generating and sending confirmations. Moreover, the Commission believes that broker-dealers may not incur costs if they choose not to input information that a debt security is unrated into their existing confirmation systems.

As stated above, the Commission acknowledges that, in some instances, eliminating paragraph (a)(8) of Rule 10b-10 may remove some incentive to investigate the quality of unrated debt securities. The Commission believes, however, that any such potential cost would be balanced by the benefit of encouraging investors not to rely excessively on credit ratings for information about credit risk and to consider additional information.

E. Alternatives

1. Rule 15c3-1 and Rule 17a-4

In adopting the amendments to Rule 15c3-1, the Commission considered several alternative approaches, including suggestions by commenters. The main suggestion by commenters was to use an objective standard of creditworthiness instead of a subjective standard of creditworthiness.[303] Specifically, one commenter suggested the use of credit spreads and/or inclusion on an index as an objective standard.[304] Although the Commission considered these standards, it determined the alternatives would not be practical because not all bonds are included on an index and for bonds that are thinly traded the yield spreads could include liquidity premia that have little relation to the credit risk of the bond, reducing the usefulness of the yield spreads as a signal for credit risk. Furthermore, creating different standards of creditworthiness for different securities could increase costs for broker-dealers that hold multiple types of securities. The Commission does, however, believe that objective factors could play an important role in determining whether a security or money market instrument has a minimal amount of credit risk. To emphasize this point, the Commission added language to paragraph (c)(2)(vi)(I) that was not in the proposed rule text that states that policies and procedures that are reasonably designed "should result in assessments of creditworthiness that typically are consistent with market data." This language should encourage broker-dealers to review at least one external factor, such as credit spreads or pricing, when making its credit risk determination. In addition, assessments that are consistent with market data should take some of the subjectivity

303 See Bond Dealers Letter, at 3; SIFMA Letter, at 11.

304 Bond Dealers Letter, at 3.

away from each broker-dealer when making a credit risk determination. Rather than mandate a specific set of factors that broker-dealers must use when assessing credit risk, the Commission thought it was better to allow broker-dealers to determine what specific factors would work best for their specific circumstances.

The Commission understands that by not mandating an objective standard to determine the creditworthiness of a security or money market instrument there is a risk that a broker-dealer may incorrectly assess the credit risk. Using a subjective standard also could lead to inconsistent determinations of credit risk of the same security or money market instrument among broker-dealers. Inconsistent determinations of credit risk will lead to situations where broker-dealers that determine the security has only a minimal amount of credit risk will apply a lower haircut to the position than broker-dealers that determine that the security does not have a minimal amount of credit risk. The Commission expects, however, that the risk of this occurring will be mitigated by the Commission and SRO examination process, during which Commission and SRO examiners will assess the reasonableness of broker-dealers' policies and procedures for determining net capital haircuts under the minimal amount of credit risk standard and review the firms' adherence to the policies and procedures. A broker-dealer will need to be able to explain its credit risk analysis and ultimate determination to examiners as part of the examination process. If a broker-dealer has reasonable policies and procedures in place for determining credit risk, and those policies and procedures are followed, the potential for bias to be a part of the assessment process should be mitigated.

The Commission also considered mandating that broker-dealers use a certain number of factors or specific factors when making a credit risk determination. Ultimately, the Commission decided that allowing broker-dealers to establish policies and procedures that are tailored to the size and activities of the broker-dealer would keep costs down. Further, a given factor may be appropriate only for certain types of positions and could, if applied inappropriately, lead to inaccurate credit risk determinations. Allowing a broker-dealer the flexibility in selecting the factors it uses to assess the credit risk of its portfolio could lead to more accurate credit risk determinations.

In adopting the amendments to Appendices E and F of Rule 15c3-1, the Commission considered the alternative proposed by commenters that the minimal amount of credit risk standard be used. However, as explained earlier, the Commission does not believe such a standard would work in Appendices E and F because the minimal amount of credit risk standard in Rule 15c3-1 replaced a binary NRSRO credit rating standard under which the application of a lower or higher haircut amount depends on whether the commercial paper is rated in the top three rating categories and the nonconvertible debt and preferred stock is rated in the top four rating categories. Thus, the instrument either meets the requirement to apply the lower haircut or is subject to the higher haircut. The NRSRO credit ratings standard in Appendices E and F to Rule 15c3-1 is not binary because there are three gradations for credit risk weights. Thus, the minimal amount of credit risk standard would not be a suitable replacement.[305]

2. Exhibit A to Rule 15c3-3

In adopting the amendments to Exhibit A to Rule 15c3-3, the Commission did not consider any alternatives to the proposal and did not receive comments offering any alternatives to the proposal. The Commission could have established an alternative criterion but chose not to because the remaining three criteria in the rule are alternatives that permit broker-dealers to meet the objectives of the rule.

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[305] See sections II.B.1.c.iii. and II.B.1.d.iii., supra.

3. Rule 10b-10

In adopting the amendments to Rule 10b-10, the Commission considered not deleting paragraph (a)(8) as proposed. The Commission also considered requiring broker-dealers to disclose alternative information relating to the credit risk of certain debt securities. The Commission determined, however, that requiring the disclosure of alternative information regarding credit risk associated with debt securities similar to that required by paragraph (a)(8) would be inconsistent with the goal of reducing investors' reliance on credit ratings. Elevating an alternative measure of credit risk to the status now conferred upon NRSRO ratings by paragraph (a)(8) would merely substitute one standard upon which investors may have come to rely upon excessively for another. Prohibiting any reference to NRSRO credit ratings in confirmations, however, would seem to go too far by preventing broker-dealers from including information that they believe a reasonable investor would want to consider in particular circumstances. The Commission also determined that substituting another credit risk-related disclosure requirement for paragraph (a)(8) was unnecessary, given that credit risk information is likely to be disclosed before a transaction for reasons independent of paragraph (a)(8),[306] and given the other disclosures required by Rule 10b-10 in connection with transactions in certain asset-backed securities.[307]

V. FINAL REGULATORY FLEXIBILITY ANALYSIS

The Regulatory Flexibility Act of 1980 ("RFA")[308] requires the Commission, in promulgating rules, to consider the impact of those rules on small entities. An Initial Regulatory

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306 See Confirmation of Transactions, at 59 FR 59617 (explaining that the information required by paragraph (a)(8) should, in most cases, "verify information that was disclosed to the investor prior to the transaction.").

307 For example, in connection with transactions in certain asset-backed securities, paragraphs (a)(4) through (a)(7) of Rule 10b-10 require disclosure of information relating to prepayment risk and yield information.

308 5 U.S.C. 601 et seq.

Flexibility Act Analysis was prepared in accordance with the Regulatory Flexibility Act and included in the proposing release. The Commission certified in the proposing release, pursuant to section 605(b) of the RFA,[309] that the proposed rule would not, if adopted, have a significant impact on a substantial number of small entities. The Commission received no comments on this certification.

For purposes of Commission rulemaking in connection with the RFA, small entities include broker-dealers with total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a-5 under the Exchange Act,[310] or, if not required to file such statements, a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than $500,000 on the last day of the preceding fiscal year (or in the time that it has been in business, if shorter) and is not affiliated with any person (other than a natural person) that is not a small business or small organization.[311]

The amendments adopted today relating to the securities haircut provisions in Rule 15c3-1 and the conforming amendment to Rule 17a-4 will not have a significant economic impact on a small number of entities. Only seven of the 434 broker-dealers that hold proprietary debt positions are considered small for purposes of the RFA and, in the staff's experience, broker-dealers with less than $500,000 in total capital typically hold very few proprietary securities positions and, in particular, a small number of debt securities. Thus, there are few small entities that will be impacted by these amendments. In addition, the amendments allow broker-dealers that hold these debt positions, including those broker-dealers that are considered small for

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309 See 5 U.S.C. 605(b).

310 See 17 CFR 240.17a-5(d).

311 See 17 CFR 240.0-10(c).

purposes of the RFA, to establish policies and procedures that rely on only a few factors to keep costs low. Further, a small broker-dealer could choose to take the 15% catchall haircut instead of establishing policies and procedures if it determines such an approach is cost-effective. Accordingly, the amendments will not have a significant economic impact on a substantial number of small entities because even if the small entities have to change their current process, they can do so in such a way to minimize economic impact and still comply with the rule amendments.

The amendment to Appendix A to Rule 15c3-1 will not result in a significant impact on small entities. Although the definition of major market foreign currency will change, the Commission does not intend that the currencies that meet the definition of major market foreign currency will change because the currency will still have to have a substantial inter-bank forward currency market. Consequently, the amendments should not have a significant impact on broker-dealers, including small broker-dealers. Furthermore, the broker-dealers that operate under Appendix A to Rule 15c3-1 generally are market makers and trading firms that are not small entities as defined in Rule 0-10.

The amendments to the Appendices E and F to Rule 15c3-1 (which include conforming amendments to Appendix G to Rule 15c3-1 and the General Instructions to Form X-17A-5, Part IIB) will not apply to small entities. Appendices E and G apply to ANC broker-dealers and Appendix F and Form X-17A-5, Part IIB apply to OTC derivatives dealers. The ANC broker-dealers and the OTC derivatives dealers are not small entities as defined in Rule 0-10.

The amendments to Exhibit A to Rule 15c3-3 will not have a significant economic impact on a substantial number of small entities. As noted above, the OCC is the only clearing agency that meets the criteria to qualify for the debit for purposes of the reserve computation. The fact that the OCC meets the criteria to qualify for the debit is well understood among broker-dealers, including small broker-dealers.

The amendment to Rule 10b-10 will not have a significant economic impact on a substantial number of small entities. While a number of the broker-dealers that effect transactions in the debt securities currently subject to paragraph (a)(8) may be small entities, the Commission believes that it is uncommon for small broker-dealers to issue confirmations.[312] The Commission does not have a precise numerical estimate of the small broker-dealers that issue confirmations in connection with transactions in securities covered by paragraph (a)(8). The Commission believes, however, that the number is unlikely to be significant. In addition, the Commission continues to believe that the proposed amendment should not result in any significant change to the cost of providing confirmations to customers in connection with transactions in securities covered by paragraph (a)(8). Consequently, the Commission continues to believe that the removal of paragraph (a)(8) from Rule 10b-10 should not have a significant economic impact on a substantial number of small entities.

For the reasons described above, the Commission again certifies that the amendments to Rule 15c3-1, Appendices A, E, F, and G to Rule 15c3-1, Exhibit A to Rule 15c3-3, Rule 17a-4, the General Instructions to Form X-17A-5, Part IIB, and Rule 10b-10 will not have a significant economic impact on a substantial number of small entities.

VI. STATUTORY BASIS AND TEXT OF THE PROPOSED AMENDMENTS

Pursuant to the Exchange Act, 15 U.S.C. 78a et seq., and particularly, Sections 3(b), 15, 23(a), and 36 (15 U.S.C. 78c(b), 78o, 78w(a), and 78mm), thereof, and Sections 939 and 939A of the Dodd-Frank Act, the Commission is amending §§ 240.10b-10, 240.15c3-1, 240.15c3-1a,

312 The Commission understands that most small broker-dealers introduce their accounts to clearing firms that, in turn, would typically issue the confirmations.

240.15c3-1e, 240.15c3-1f, 240.15c3-1g, 240.15c3-3a, 240.17a-4, and Form X-17A-5 Part IIB General Instructions under the Exchange Act.

List of Subjects in 17 CFR Parts 240 and 249

Brokers, Fraud, Reporting and recordkeeping requirements, Securities.

Text of Amendment

In accordance with the foregoing, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

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

1. The authority citation for part 240 is amended by revising the general authority and adding sectional authorities for §§ 240.15c3-1a, 240.15c3-1e, 240.15c3-1f, 240.15c3-1g and § 240.15c3-3a in numerical order, and by revising the sectional authorities for §§ 240.10b-10, 240.15c3-1, and 240.17a-4 to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78c-3, 78c-5, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78n-1, 78o, 78o-4, 78o-10, 78p, 78q, 78q-1, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, 7201 et seq., and 8302; 7 U.S.C. 2(c)(2)(E); 12 U.S. C. 5221(e)(3); 18 U.S.C. 1350, unless otherwise noted.

* * * * *

Sections 240.15c3-1a, 240.15c3-1e, 240.15c3-1f, 240.15c3-1g are also issued under Pub. L. No. 111-203, §§ 939, 939A, 124. Stat. 1376 (2010) (15 U.S.C. 78c, 15 U.S.C. 78o–7 note).

* * * * *

Section 240.15c3-3a is also issued under Pub. L. No. 111-203, §§ 939, 939A, 124. Stat. 1376 (2010) (15 U.S.C. 78c, 15 U.S.C. 78o–7 note).

* * * * *

2. Section 240.10b-10 is amended by removing paragraph (a)(8) and redesignating paragraph (a)(9) as paragraph (a)(8).

3. Section 240.15c3-1 is amended by:

a. Revising paragraphs (c)(2)(vi)(E) introductory text, (c)(2)(vi)(F)(1) introductory text, (c)(2)(vi)(F)(2) introductory text, and (c)(2)(vi)(H); and

b. Adding paragraph (c)(2)(vi)(I).

The revisions and addition read as follows:

§ 240.15c3-1 Net capital requirements for brokers or dealers.

* * * * *

(c) * * *

(2) * * *

(vi) * * *

(E) Commercial paper, bankers' acceptances and certificates of deposit. In the case of any short term promissory note or evidence of indebtedness which has a fixed rate of interest or is sold at a discount, which has a maturity date at date of issuance not exceeding nine months exclusive of days of grace, or any renewal thereof, the maturity of which is likewise limited and has only a minimal amount of credit risk, or in the case of any negotiable certificates of deposit or bankers' acceptance or similar type of instrument issued or guaranteed by any bank as defined in section 3(a)(6) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(6)), the applicable percentage of the market value of the greater of the long or short position in each of the categories specified below are:

* * * * *

(F)(1) <u>Nonconvertible debt securities.</u> In the case of nonconvertible debt securities having a fixed interest rate and a fixed maturity date, which are not traded flat or in default as to principal or interest and which have only a minimal amount of credit risk, the applicable percentages of the market value of the greater of the long or short position in each of the categories specified below are:

* * * * *

(2) A broker or dealer may elect to exclude from the above categories long or short positions that are hedged with short or long positions in securities issued by the United States or any agency thereof or nonconvertible debt securities having a fixed interest rate and a fixed maturity date and which are not traded flat or in default as to principal or interest, and which have only a minimal amount of credit risk if such securities have maturity dates:

* * * * *

(H) In the case of cumulative, non-convertible preferred stock ranking prior to all other classes of stock of the same issuer, which has only a minimal amount of credit risk and which are not in arrears as to dividends, the deduction shall be 10% of the market value of the greater of the long or short position.

(I) In order to apply a deduction under paragraphs (c)(2)(vi)(E), (c)(2)(vi)(F)(1), (c)(2)(vi)(F)(2), or (c)(2)(vi)(H) of this section, the broker or dealer must assess the creditworthiness of the security or money market instrument pursuant to policies and procedures for assessing and monitoring creditworthiness that the broker or dealer establishes, documents, maintains, and enforces. The policies and procedures must be reasonably designed for the purpose of determining whether a security or money market instrument has only a minimal amount of credit risk. Policies and procedures that are reasonably designed for this purpose should result in assessments of creditworthiness that typically are consistent with market data. A broker-dealer that opts not to make an assessment of creditworthiness under this paragraph may not apply the deductions under paragraphs (c)(2)(vi)(E), (c)(2)(vi)(F)(1), (c)(2)(vi)(F)(2), or (c)(2)(vi)(H) of this section.

> Note to paragraph (c)(2)(vi)(I): For a discussion of the "minimal amount of credit risk" standard, see Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934, Exchange Act Release No. 34-71194 (Dec. 27, 2013), [Insert #] Federal Register [Insert #] ([Insert Date]).

* * * * *

4. Section 240.15c3-1a, paragraph (b)(1)(i)(C), is amended by removing the phrase "whose short term debt is rated in one of the two highest categories by at least two nationally recognized statistical rating organizations and" and by removing the last sentence.

5. Section 240.15c3-1e is amended by:

a. Revising the introductory text in paragraph (c)(4)(vi);

b. Removing paragraphs (c)(4)(vi)(A) through (c)(4)(iv)(D);

c. Redesignating paragraphs (c)(4)(vi)(E), (F), and (G) as paragraphs (c)(4)(vi)(A), (B), and (C), respectively; and

d. revising newly redesignated paragraph (c)(4)(vi)(A).

The revisions read as follows:

§ 240.15c3-1e Deductions for market and credit risk for certain brokers or dealers (Appendix E to 17 CFR 240.15c3-1).

* * * * *

(c) * * *

(4)* * *

(vi) Credit risk weights of counterparties. A broker or dealer that computes its deductions for credit risk pursuant to this Appendix E shall apply a credit risk weight for transactions with a counterparty of either 20%, 50%, or 150% based on an internal credit rating the broker or dealer determines for the counterparty.

(A) As part of its initial application or in an amendment, the broker or dealer may request Commission approval to apply a credit risk weight of either 20%, 50%, or 150% based on internal calculations of credit ratings, including internal estimates of the maturity adjustment. Based on the strength of the broker's or dealer's internal credit risk management system, the Commission may approve the application. The broker or dealer must make and keep current a record of the basis for the credit rating of each counterparty;

* * * * *

6. Section 240.15c3-1f is amended by:

a. Removing from paragraph (d)(2) introductory text the phrase "the counterparty factor. The counter party factors are:" and adding in its place "a counterparty factor of 20%, 50%, or 100% based on an internal credit rating the OTC derivatives dealer determines for the counterparty; and";

b. removing paragraphs (d)(2)(i) through (d)(2)(iii); and

c. revising paragraphs (d)(3)(i), (d)(3)(ii), (d)(3)(iii), and (d)(4).

The revisions read as follows:

§ 240.15c3-1f Optional market and credit risk requirements for OTC derivatives dealers (Appendix F to 17 CFR 240.15c3-1).

* * * * *

(d) * * *

(3) * * *

(i) For counterparties for which an OTC derivatives dealer assigns an internal rating for senior unsecured long-term debt or commercial paper that would apply a 20% counterparty factor under (d)(2) of this section, 5% of the amount of the net replacement value in excess of 25% of the OTC derivatives dealer's tentative net capital;

(ii) For counterparties for which an OTC derivatives dealer assigns an internal rating for senior unsecured long-term debt that would apply a 50% counterparty factor under (d)(2) of this section, 20% of the amount of the net replacement value in excess of 25% of the OTC derivatives dealer's tentative net capital;

(iii) For counterparties for which an OTC derivatives dealer assigns an internal rating for senior unsecured long-term debt that would apply a 100% counterparty factor under (d)(2) of this section, 50% of the amount of the net replacement value in excess of 25% of the OTC derivatives dealer's tentative net capital.

(4) Counterparties may be rated by the OTC derivatives dealer, or by an affiliated bank or affiliated broker-dealer of the OTC derivatives dealer, upon approval by the Commission on application by the OTC derivatives dealer. Based on the strength of the OTC derivatives dealer's internal credit risk management system, the Commission may approve the application. The OTC

derivatives dealer must make and keep current a record of the basis for the credit rating for each counterparty.

* * * * *

7. Section 240.15c3-1g(a)(3)(i)(F) is amended by removing the phrase "paragraphs (c)(4)(vi)(D) and (c)(4)(vi)(E)" and adding in its place "paragraphs (c)(4)(vi)(A) and (c)(4)(vi)(B)".

8. Section 240.15c3-3a is amended by removing paragraph (b)(1)(i) of Note G and redesignating paragraphs (b)(1)(ii), (iii), and (iv) of Note G as paragraphs (b)(1)(i), (ii), and (iii), respectively.

9. Section 240.17a-4 is amended by:

a. Removing from paragraph (b)(12) the phrase "§240.15c3-1e(c)(4)(vi)(D) and (E)" and adding in its place "§240.15c3-1e(c)(4)(vi) "; and

b. Adding paragraph (b)(13).

The addition reads as follows:

§240.17a-4 Records to be preserved by certain exchange members, brokers and dealers.

(a) * * *

(b) * * *

(13) The written policies and procedures the broker-dealer establishes, documents, maintains, and enforces to assess creditworthiness for the purpose of §240.15c3-1(c)(2)(vi)(E), (F)(1), (F)(2), and (H).

* * * * *

PART 249 – FORMS, SECURITIES EXCHANGE ACT OF 1934

10. The authority citation for Part 249 is amended by adding a sectional authority in numerical order to read as follows:

Authority: 15 U.S.C. 78a et seq. and 7201 et. seq.; 12 U.S.C. 5461 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

Section 249.617 is also issued under Pub. L. No. 111-203, §§939, 939A, 124. Stat. 1376 (2010) (15 U.S.C. 78c, 15 USC 78o–7 note).

* * * * *

11. Amend Form X-17A-5 Part IIB General Instructions (referenced in § 249.617) by:

a. Removing Schedule IV: Internal Credit Rating Conversion; and

b. Removing all but the first sentence in the section "Credit risk exposure" under the heading "Computation of Net Capital and Required Net Capital," and adding a second sentence that reads "The counter-party charge is computed using the credit risk weights assigned to the OTC derivatives dealer's internal calculations by the Commission under paragraph (d)(2) of Appendix F."

Note: The text of Form X-17A-5 Part IIB does not, and this amendment will not, appear in the Code of Federal Regulations.

* * * * *

By the Commission.

Lynn M. Powalski
Deputy Secretary

Dated: December 27, 2013

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 239, 270, and 274

Release Nos. 33-9506; IC-30847; File No. S7-7-11

RIN 3235-AL02

Removal of Certain References to Credit Ratings Under the Investment Company Act

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission ("Commission") is adopting amendments to a rule and three forms under the Investment Company Act of 1940 ("Investment Company Act") and the Securities Act of 1933 ("Securities Act") in order to implement a provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). Specifically, rule 5b-3 under the Investment Company Act contains a reference to credit ratings in determining when an investment company ("fund") may treat a repurchase agreement as an acquisition of securities collateralizing the repurchase agreement for certain purposes under the Investment Company Act. The amendments we are adopting today replace this reference to credit ratings with an alternative standard designed to retain a similar degree of credit quality to that in current rule 5b-3. The Commission is also adopting amendments to Forms N-1A, N-2, and N-3 under the Investment Company Act and Securities Act to eliminate the required use of NRSRO credit ratings when a fund chooses to depict its portfolio holdings by credit quality.

DATES: Effective Date: [insert date 30 days after date of publication in the Federal Register]; Compliance Date: [insert date 180 days after date of publication in the Federal Register].

FOR FURTHER INFORMATION CONTACT: Adam Bolter, Senior Counsel, Thoreau Bartmann, Branch Chief, or C. Hunter Jones, Assistant Director (202) 551-6792, Office of

Investment Company Rulemaking, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-8549.

SUPPLEMENTARY INFORMATION: The Commission is adopting amendments to rule 5b-3 [17 CFR 270.5b-3] under the Investment Company Act.[1] The Commission is also adopting amendments 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.[2]

Table of Contents

I. BACKGROUND

The first use of a reference to ratings or rating agencies in Commission rules was in 1975, when the Commission adopted the term "nationally recognized statistical rating organization" ("NRSRO") as part of amendments to the net capital rule for broker-dealers, rule 15c3-1 under the Securities Exchange Act of 1934 ("Exchange Act") (the "Net Capital Rule").[3] The

1 15 U.S.C. 80a. Unless otherwise noted, all references to statutory sections are to the Investment Company Act, and all references to rules under the Investment Company Act are to Title 17, Part 270 of the Code of Federal Regulations [17 CFR 270].

2 15 U.S.C. 77a.

3 *See* Adoption of Uniform Net Capital Rule and an Alternative Net Capital Requirement for Certain Brokers and Dealers, Exchange Act Release No. 11497 (June 26, 1975) [40 FR 29795

Commission eventually included references to credit ratings issued by NRSROs in other rules under the securities laws, including the Investment Company Act.[4] 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.[5] Even prior to the enactment of the Dodd-Frank Act,[6] concerns about the wide-spread use of NRSRO credit ratings in statutes and regulations prompted the Commission to explore whether to eliminate references to credit ratings in Commission rules because of the potential overreliance by investors and, investment advisers and other financial professionals on these ratings, and whether there are practical alternatives to NRSRO credit ratings that could be used as benchmarks in regulations.[7]

Section 939A of the Dodd-Frank Act requires each Federal agency, including the Commission, to "review any regulation issued by such agency that requires the use of an assessment of the credit-worthiness of a security or money market instrument and any references to or requirements in such regulations regarding credit ratings."[8] That section further provides

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(July 16, 1975)]; 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 a broker-dealer must apply to certain types of debt instruments. *See* 17 CFR 240.15c3-1. The regulatory purpose was to provide a method for determining net capital charges on different grades of debt securities under the Net Capital Rule. *See* 17 CFR 240.15c3-1.

4 *See, e.g.*, Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies, Investment Company Act Release No. 14983 (Mar. 12, 1986) [51 FR 9773 (Mar. 21, 1986)] (incorporating the concept of NRSROs into the definition of "eligible security" in rule 2a-7 (governing money market funds)).

5 *See, e.g.*, Report to Congress on Credit Ratings, Board of Governors of the Federal Reserve System (July 2011); References to Credit Ratings in FDIC Regulations, Federal Deposit Insurance Corporation (July 2011); and Basel Committee on Banking Supervision, Stocktaking on the use of credit ratings, Joint Forum (June 2009).

6 *See* Pub. L. No. 111-203, 124 Stat. 1376 (2010).

7 *See infra* section II.A (discussing other Commission actions to remove references to credit ratings from its rules). *See also infra* section II.B (discussing actions of other regulators to remove references to credit ratings from their rules).

8 Pub. L. No. 111-203 § 939A(a)(1)-(2). Section 939A of the Dodd-Frank Act applies to all federal

that each such agency shall "modify any such regulations identified by the review . . . to remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations."[9]

As a step toward implementing these mandates, in March 2011 the Commission proposed to replace references to ratings issued by NRSROs in two Commission rules and four Commission forms under the Investment Company Act, including rule 5b-3 and Forms N-1A, N-2, and N-3.[10] We received 26 comment letters on the proposed rule and form amendments.[11]

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agencies.

9 Pub. L. No. 111-203 § 939A(b).

10 *See* References to Credit Ratings in Certain Investment Company Act Rules and Forms, Investment Company Act Release No. 29592 (Mar. 3, 2011) [76 FR 12896 (Mar. 9, 2011)] ("2011 Proposing Release"). Specifically, we proposed to: (i) remove references to credit ratings in rules 2a-7 and 5b-3 under the Investment Company Act and replace them with alternative standards of creditworthiness; (ii) adopt new rule 6a-5 under the Investment Company Act that would establish a creditworthiness standard to replace the credit rating reference in section 6(a)(5) removed by the Dodd-Frank Act; (iii) eliminate required disclosures of credit ratings in Form N-MFP; and (iv) remove the requirement that credit ratings be used when portraying credit quality in shareholder reports from Forms N-1A, N-2, and N-3. The Commission adopted new rule 6a-5 on November 19, 2012 and noted in its 2013 proposing release for money market reform that the Commission would address references to credit ratings in rule 2a-7 and Form N-MFP in a separate rulemaking. *See* Purchase of Certain Debt Securities by Business and Industrial Development Companies Relying on an Investment Company Act Exemption, Investment Company Act Release No. 30268 (Nov. 19, 2012) [77 FR 70117 (Nov. 23, 2012)]; Money Market Fund Reform; Amendments to Form PF, Investment Company Act Release No. 30551 (June 5, 2013) [78 FR 36834 (June 19, 2013)]. Rule 3a-7 under the Investment Company Act also contains a reference to ratings. In August 2011, in a concept release soliciting comment on the treatment of asset-backed issuers under the Investment Company Act, we sought comment on the role, if any, that credit ratings should continue to play in the context of rule 3a-7. *See* Treatment of Asset-Backed Issuers under the Investment Company Act, Investment Company Act Release No. 29779 (Aug. 31, 2011) [76 FR 55308 (Sept. 7, 2011)] at section III.A.1.

11 Most of these commenters criticized removing credit ratings from rule 2a-7, but acknowledged that the Commission's proposal was in response to the mandate in the Dodd-Frank Act. The Commission plans to address these comments in a future rulemaking. *See supra* note 10. The comment letters on the 2011 Proposing Release (File No. S7-07-11) are available at http://www.sec.gov/comments/s7-07-11/s70711.shtml. In addition, to facilitate public input on the Dodd-Frank Act, we provided a series of e-mail links, organized by topic on our website at http://www.sec.gov/spotlight/regreformcomments.shtml. The public comments we received on

Several commenters addressed specific provisions of the proposal to amend rule 5b-3 and Forms N-1A, N-2, and N-3, which we discuss in more detail below.

We are adopting, largely as proposed, amendments to rule 5b-3 and Forms N-1A, N-2, and N-3 to implement section 939A of the Dodd-Frank Act and effectuate Congressional intent to reduce reliance on NRSRO credit ratings.[12] As discussed below, the amendments replace a reference to required NRSRO credit ratings in rule 5b-3 for certain securities held by funds as collateral for repurchase agreements with an alternative standard that is designed to retain a similar degree of credit quality. We are also amending Forms N-1A, N-2, and N-3 to eliminate the required use of NRSRO credit ratings by funds that choose to use credit quality categorizations in the required table, chart, or graph of portfolio holdings. Under the amendments, funds that choose to use credit quality to depict portfolio holdings must include a description of how the credit quality of the holding was determined. If a fund chooses to use credit ratings issued by a credit rating agency to depict the credit quality of portfolio holdings, the fund must include a description of how the credit ratings were identified and selected.

In a separate release, the Commission is adopting final amendments to remove references to credit ratings from rules on broker-dealer financial responsibility and confirmations of transactions. These amendments follow the Commission's April 2011 proposed rules in which we proposed to amend rules and one form under the Exchange Act applicable to broker-dealer financial responsibility, distributions of securities, and confirmations of transactions in order to

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section 939A of the Dodd-Frank Act are available on our website at http://www.sec.gov/comments/df-title-ix/credit-rating-agencies/credit-rating-agencies.shtml.

12 *See* Section 939A of the Dodd-Frank Act. Section 939A was intended, at least in part, to address potential over-reliance on NRSRO credit ratings resulting from perceived government-endorsement of NRSROs. *See* Report of the House of Representatives Financial Services Committee to Accompany H.R. 4173, H. Rep. No. 111-517 at 871 (2010).

remove references to credit ratings pursuant to section 939A of the Dodd-Frank Act.[13]

II. Prior Actions of the Commission and Other Regulators

As part of our implementation of section 939A, we have reviewed our prior actions and those of other regulators. As discussed below, both the Commission and other regulators have proposed and issued several final rules towards implementation of the mandate under section 939A of the Dodd-Frank Act. In some cases, the references to credit ratings were replaced with an alternative standard of credit quality designed to retain the same degree of credit quality and liquidity as reflected by the use of credit ratings.

A. Prior Commission Actions

The Commission has long been concerned with the use of credit ratings and has taken a variety of actions even before the enactment of the Dodd-Frank Act regarding the use of NRSRO credit ratings in its rules. For example, in 1994, the Commission published a concept release soliciting comment on, among other things, whether the Commission should eliminate references to NRSRO credit ratings from certain rules.[14] The Commission continued to consider the use of credit ratings in its rules, when in 2003, we sought comment on alternative benchmarks that

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13 *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)] (requesting public comment on proposed amendments to rule 15c3-1 (17 CFR 240.15c3-1), rule 15c3-3 (17 CFR 240.15c3-3), rule 17a-4 (17 CFR 240.17a-4), rules 101 and 102 of Regulation M (17 CFR 242.101 and 242.102), and rule 10b-10 (17 CFR 240.10b-10), and one form – the General Instructions to 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). For purposes of implementing section 939(e) of the Dodd-Frank Act, which eliminated provisions in sections 3(a)(41) and 3(a)(53)(A) of the Exchange Act that referenced NRSRO credit ratings, the Commission also requested comment in the proposing release on potential standards of creditworthiness to replace the credit rating references.

14 *See* Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34616 (Aug. 31, 1994) [59 FR 46314 (Sep. 7, 1994)]; *see also* Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934, Exchange Act Release No. 39457 (Dec. 17, 1997) [62 FR 68018 (Dec. 30, 1997)].

could be used to meet the Commission's regulatory objectives.[15] Finally, in 2008, the Commission proposed amendments to remove references to NRSRO credit ratings from certain of its rules under the Securities Act, Exchange Act, and Investment Company Act.[16] As previously noted, after the enactment of the Dodd-Frank Act, in 2011, the Commission proposed to remove credit ratings references from certain rules and forms under the Investment Company Act.[17] Also in 2011, the Commission separately proposed and adopted amendments removing references to credit ratings in rules and forms under the Securities Act and the Exchange Act related to offerings of securities or issuer disclosure.[18] Generally, in these prior actions, the

15 *See* Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws, Exchange Act Release No. 47972 (June 4, 2003) [68 FR 35258 (June 12, 2003)]; *see also* Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets: As Required by Section 702(b) of the Sarbanes-Oxley Act of 2002, Commission (Jan. 2003).

16 *See, e.g.,* References to Ratings of Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 58070 (July 1, 2008) [73 FR 40088 (July 11, 2008)]. In October 2009, the Commission adopted several of the 2008 proposed amendments and re-opened for comment the remaining amendments. *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).

17 *See* 2011 Proposing Release *supra* note 10. One aspect of that rule proposal has already been adopted. New rule 6a-5, adopted by the Commission, replaced a credit rating requirement (removed by Congress as part of the Dodd-Frank Act) applicable to debt securities that certain business and industrial development companies ("BIDCOs") relying on the Investment Company Act exemption in section 6(a)(5) may invest in. Under new rule 6a-5, a BIDCO that relies on the exemption in section 6(a)(5) may invest in certain debt securities, provided that the BIDCO board determines, at the time of purchase, that the debt security is (1) of no greater than moderate credit risk and (2) is sufficiently liquid. The standard for liquidity is whether the security can be sold at or near its carrying value within a reasonably short period of time. *See* Purchase of Certain Debt Securities by Business and Industrial Development Companies Relying on an Investment Company Act Exemption, Investment Company Act Release No. 30268 (Nov. 19, 2012) [77 FR 70117 (Nov. 23, 2012)].

18 *See* Security Ratings, Securities Act Release No. 9186 (Feb. 9, 2011) [76 FR 8946 (Feb. 16, 2011)]; *see also* Security Ratings, Securities Act Release No. 9245 (July 27, 2011) [76 FR 46603 (Aug. 3, 2011)] (adopting amendments to rule 134 (17 CFR 230.134), rule 138 (17 CFR 230.138), rule 139 (17 CFR 230.139), rule 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; rescinding Form F-9 (17 CFR 239.39); adopting amendments to the Securities Act and Exchange Act forms and rules that referred to Form F-9 to eliminate those references; and amending Schedule 14A (17 CFR 240.14a-101) under the Exchange Act).

Commission has proposed or adopted amendments to its rules that seek to retain a similar degree of credit quality to that in the rule being amended by replacing credit ratings references with a two-part standard that includes an assessment of the credit quality and the liquidity of the security, the details of which vary according to the requirements of the particular rule or form.

B. Actions of Other Regulators

A number of other federal agencies have also taken action to implement section 939A of the Dodd-Frank Act, including regulations proposed or adopted by the Commodity Futures Trading Commission ("CFTC"),[19] the Office of the Comptroller of the Currency ("OCC"),[20] the National Credit Union Administration ("NCUA"),[21] the Federal Housing Finance Agency ("FHFA"),[22] the Department of Labor ("DOL"),[23] and jointly by the OCC and Federal Reserve Board ("FRB").[24] The actions taken by these other regulators were considered in adopting today's amendments.

19 CFTC, Removing Any Reference to or Reliance on Credit Ratings in Commission Regulations; Proposing Alternatives to the Use of Credit Ratings, 76 FR 44262 (July 25, 2011).

20 OCC, Alternatives to the Use of External Credit Ratings in the Regulations of the OCC, 77 FR 35253 (June 13, 2012).

21 NCUA, Alternatives to the Use of Credit Ratings, 77 FR 74103 (Dec. 13, 2012).

22 FHFA, Removal of References to Credit Ratings in Certain Regulations Governing the Federal Home Loan Banks, 78 FR 30784 (May 23, 2013).

23 DOL, Proposed Amendments to Class Prohibited Transaction Exemptions to Remove Credit Ratings Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, 78 FR 37572 (June 21, 2013).

24 OCC & FRB, Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 FR 62018 (Oct. 11, 2013).

III. Discussion

A. Rule 5b-3

Rule 5b-3 allows funds to treat the acquisition of a repurchase agreement as an acquisition of securities collateralizing the repurchase agreement for certain diversification and broker-dealer counterparty limit purposes under the Investment Company Act[25] if the obligation of the seller to repurchase the securities from the fund is "collateralized fully."[26] In a typical investment company repurchase agreement, a fund enters into a contract with a broker, dealer, or bank (the "counterparty" to the transaction) to purchase securities. The counterparty agrees to repurchase the securities at a specified future date, or on demand, for a price that is sufficient to return to the fund its original purchase price, plus an additional amount representing a return to the fund on its investment. Economically, a repurchase agreement functions as a loan from the

[25] Section 5(b)(1) of the Investment Company Act limits the amount that a fund that holds itself out as being a diversified investment company may invest in the securities of any one issuer (other than the U.S. Government). This provision may limit the number and principal amounts of repurchase agreements that a diversified fund may enter into with any one counterparty. Section 12(d)(3) of the Investment Company Act generally prohibits a fund from acquiring an interest in a broker, dealer, or underwriter. Because a repurchase agreement may be considered to be the acquisition of an interest in the counterparty, section 12(d)(3) may limit a fund's ability to enter into repurchase agreements with many of the firms that act as repurchase agreement counterparties. Rule 12d3-1 provides an exemption from the prohibitions of section 12(d)(3) under certain conditions, which exemption a fund may be able to rely on in the event the repurchase agreement fails to meet the look-through requirements of rule 5b-3. *See* Rule 5b-3 Adopting Release, *infra* note 27, at section II.C. The ability of funds to rely on rule 5b-3 of the Investment Company Act may affect the degree to which a fund invests in repurchase agreements.

[26] Rule 5b-3(a). The term "collateralized fully" is defined in rule 5b-3(c)(1). In general, under rule 5b-3, a fund investing in a repurchase agreement looks to the value and liquidity of the securities collateralizing the repurchase agreement rather than the creditworthiness of the counterparty for satisfaction of the repurchase agreement. *See* Rule 5b-3 Adopting Release, *infra* note 27, at section II.A.3. *But see* rule 2a-7(c)(4)(ii)(A) (requiring money market fund boards to evaluate the counterparty's creditworthiness).

fund to the counterparty, in which the securities purchased by the fund serve as collateral for the loan.[27]

Under current requirements, a repurchase agreement is collateralized fully if, among other things, the collateral for the repurchase agreement consists entirely of (i) cash items, (ii) government securities,[28] (iii) securities that at the time the repurchase agreement is entered into are rated in the highest rating category by the "requisite NRSROs"[29] or (iv) unrated securities that are of a comparable quality to securities that are rated in the highest rating category by the requisite NRSROs, as determined by the fund's board of directors or its delegate.[30] When the Commission proposed rule 5b-3, we explained that the highest rating category requirement in the definition of fully collateralized was designed to help ensure that the market value of the collateral would remain stable and that the fund could liquidate the collateral quickly in the event of a default by the counterparty. The high quality requirement was also designed to limit a

27 *See* Treatment of Repurchase Agreements and Refunded Securities as an Acquisition of the Underlying Securities, Investment Company Act Release No. 25058 (July 5, 2001) [66 FR 36156 (July 11, 2001)] ("Rule 5b-3 Adopting Release"). Repurchase agreements provide funds with a convenient means to invest excess cash on a secured basis, generally for short periods of time.

28 Government Security means "any security issued or guaranteed as to principal or interest by the United States, or by a person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States; or any certificate of deposit for any of the foregoing." Section 2(a)(16) of the Investment Company Act. Government securities include, for example, U.S. Treasury notes and bonds, and securities issued by the Federal Home Loan Mortgage Company ("Freddie Mac"), Federal National Mortgage Association ("Fannie Mae"), and Government National Mortgage Association ("Ginnie Mae").

29 The term "requisite NRSROs" means any two NRSROs that have issued a rating with respect to a security or class of debt obligations of an issuer or, if only one NRSRO has issued a rating with respect to such security or class of debt obligations of an issuer at the time the investment company acquires the security, that NRSRO. Rule 5b-3(c)(6). This definition is deleted under the amended rule.

30 Rule 5b-3(c)(1)(iv). The term "unrated securities" means securities that have not received a rating from the requisite NRSROs. Rule 5b-3(c)(8). This definition is deleted under the amended rule.

fund's exposure to the ability of the counterparty to maintain sufficient collateral, and reflected the understanding that securities of lower quality may be subject to greater price fluctuation.[31]

Today we are amending rule 5b-3 to eliminate the requirement that collateral other than cash or government securities be rated in the highest category by the requisite NRSROs or be of comparable quality. In place of this requirement, the amended rule requires that collateral other than cash or government securities consist of securities that the fund's board of directors (or its delegate) determines at the time the repurchase agreement is entered into are: (i) issued by an issuer that has an exceptionally strong capacity to meet its financial obligations on the securities collateralizing the repurchase agreement; and (ii) sufficiently liquid that they can be sold at approximately their carrying value in the ordinary course of business within seven calendar days.[32]

The new credit quality standard we are adopting is designed to retain a degree of credit quality that is similar to the existing standard under rule 5b-3 and consistent with the two-part approach we have taken in establishing credit quality standards to replace credit rating references in other rules under the federal securities laws.[33] We note that our amendment to rule 5b-3 does not affect a money market fund that seeks special treatment of its repurchase agreement holdings under the diversification provisions of rule 2a-7 because in order to obtain such treatment, a money market fund is limited to investing in repurchase agreements collateralized by cash items or government securities (which remain unaffected by our amendments today).[34] We are

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31 *See* Treatment of Repurchase Agreements and Refunded Securities as an Acquisition of the Underlying Securities, Investment Company Act Release No. 24050 (Sept. 23, 1999) [64 FR 52476 (Sept. 29, 1999)] ("Rule 5b-3 Proposing Release") at n.43 and accompanying text.

32 Amended rule 5b-3(c)(1)(iv)(C).

33 *See supra* section II.A.

34 *See* rule 2a-7(a)(5).

adopting the liquidity component of the new standard as proposed, but we have revised the credit quality component from what was proposed to address certain commenters' concerns.

We proposed that collateral issuers be required to have the "highest capacity" to meet their financial obligations on the collateral securities.[35] Three of the five commenters who addressed the proposed amendments to rule 5b-3 argued that this standard is not consistent with the standard established by the ratings reference in the current rule because the proposed standard does not contemplate any variation in creditworthiness among issuers that meet the highest rating standard.[36] Commenters suggested that short-term collateral securities rated "A-1+" or "A-1" by Standard & Poor's both would satisfy the rating condition under the current rule, but that only those rated "A-1+" would likely have satisfied the credit standard under our proposal.[37] Accordingly, as these commenters recommended, the amended rule requires an issuer to have an "exceptionally strong" capacity to meet its financial obligations on the collateral securities.[38] We are adopting this standard, as revised from our proposal, because we believe that, like the current rule, it permits some variation in creditworthiness among issuers while being designed to retain a degree of risk limitation similar to the current rule.[39] In the case

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35 *See* proposed rule 5b-3(c)(1)(iv)(C)(1).

36 Federated Investors, Inc. Comment Letter (Apr. 25, 2011) ("Federated Comment Letter"); Investment Company Institute Comment Letter (Apr. 25, 2011) ("ICI Comment Letter"); T. Rowe Price Associates, Inc. Comment Letter (Apr. 25, 2011) ("T. Rowe Price Comment Letter"). *But see* 2011 Proposing Release (discussing the proposed "highest capacity" standard and noting that "[a]n issuer of collateral securities that the board (or its delegate) determined has an exceptionally strong capacity to repay its short or long-term debt obligations . . . would satisfy the proposed [highest capacity] standard").

37 *See* Standard & Poor's Ratings Definitions, *infra* note 39 at 5 (which may designate an "A-1" rating with a plus sign to designate the obligor's capacity to meet its financial obligations is extremely strong).

38 *See* ICI Comment Letter; Federated Comment Letter (supporting the ICI Comment Letter); and T. Rowe Price Comment Letter (generally agreeing with the ICI Comment Letter).

39 *See* Fitch Ratings, International Issuer and Credit Rating Scales,

of asset-backed securities that serve as collateral, an evaluation of the capacity of the issuer to meet its financial commitment on the security should include an assessment of the quality of the underlying assets and the structure of the asset-backed security.[40]

As discussed above, we are adopting the liquidity component of the new standard as proposed. The liquidity standard in the amended rule is similar to the standard used in rule 2a-7 governing money market funds, and is also used in other rules under the Investment Company Act.[41] No commenters addressed the proposed liquidity standard.

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http://www.fitchratings.com/web_content/ratings/fitch_ratings_definitions_and_scales.pdf (stating that a rating of AAA is used in cases of "exceptionally strong capacity for payment of financial commitments"); Moody's Investor Service Rating Symbols and Definitions, https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004 (stating that ratings of Aaa are of the "highest quality, subject to the lowest level of credit risk"); and Standard & Poor's Ratings Definitions, http://img.en25.com/Web/StandardandPoors/Ratings_Definitions.pdf (stating that for a rating of AAA, "[t]he obligor's capacity to meet its financial commitment on the obligation is extremely strong").

40 *See* Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 19959 (Dec. 17, 1993) [58 FR 68585 (Dec. 28, 1993)] at text accompanying nn.108-109 ("[t]he credit quality of a typical asset backed security depends both upon the structure of the security and the quality of the underlying assets."); Money Market Fund Reform, Investment Company Act Release No. 29132 (Feb. 23, 2010) [75 FR 10060 (Mar. 4, 2010)] at text accompanying n.131 (noting that the minimal credit risk analysis that a money market fund board (or its delegate) must conduct before investing in an asset-backed security should include, among other things, (i) an analysis of the underlying assets to ensure they are properly valued and provide sufficient asset coverage for the cash flow required to fund the asset-backed security under various market conditions and (ii) an analysis of the terms of any liquidity or other support provided by the sponsor of the asset-backed security). *See also* Alternatives to the Use of External Credit Ratings in the Regulations of the Office of the Comptroller of the Currency (June 4, 2012) [77 FR 35253 (June 13, 2012)] at text following n.2 (in adopting an issuer-based credit quality standard to replace credit ratings, the OCC indicates that, in the case of a structured finance transaction, principal and interest repayment is not necessarily solely reliant on the direct debt repaying capacity of the issuer or obligor).

41 *See* rule 2a-7(a)(19) (defining illiquid security to mean a security that cannot be sold or disposed of in the ordinary course of business within seven calendar days at approximately the value ascribed to it by the fund). *See also* rule 10f-3(a)(3) (requiring, among other things, that "eligible municipal securities" be sufficiently liquid that they can be sold at or near their carrying value within a reasonably short period of time).

We expect that securities that actively trade in a secondary market at the time of the acquisition of the repurchase agreement will satisfy the liquidity component of the standard. We also understand that most securities used to collateralize repurchase agreements generally actively trade in a secondary market.[42] Securities that do not actively trade in a secondary market would likely require a more in-depth evaluation by the board or its delegate to determine whether they meet the liquidity standard.

The final amendments do not, as one commenter suggested, include specific factors or tests that the board or its delegate must apply in performing its credit analysis.[43] This commenter acknowledged that a reliable and objective shorthand measure of credit risk that could be incorporated into Commission regulations is currently unavailable.[44] The Commission considered including specific factors for funds to consider in performing credit analysis under rule 5b-3. On balance, we believe that, in the context of rule 5b-3, the new credit quality standards provide sufficiently clear criteria under which a fund board or its delegate can make determinations regarding credit quality and liquidity for this particular purpose. Fund boards

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42 Repurchase agreements are often collateralized by securities that include, but are not limited to, agency collateralized mortgage-backed obligations ("CMOs"), agency debentures and strips, agency mortgage-backed securities, private label CMOs, corporate debt, equity securities, money market instruments and U.S. Treasury securities. *See, e.g.*, Tri-Party Repo Statistical Data (as of August 2013), http://www.newyorkfed.org/banking/tpr_infr_reform_data.html. The securities that often collateralize repurchase agreements trade frequently. For example, data from the Securities Industry and Financial Markets Association for January through August 2013 shows average daily trading volume, in billions of dollars, as follows: agency debentures and strips ($7.1); agency mortgage-backed securities ($242.9); corporate debt ($145.4); U.S. Treasury securities ($551.4) (available at http://www.sifma.org/research/statistics.aspx).

43 *See* Better Markets Comment Letter (Apr. 25, 2011) ("Better Markets Comment Letter"). This commenter suggested certain factors that they believed funds should be required to consider when evaluating the creditworthiness of an issuer or a debt security.

44 *Id.* We note that another commenter that recommended that we establish an objective standard for credit quality determinations did not provide any examples of such criteria. *See* New York City Bar Committee on Investment Management Regulation Comment Letter (Apr. 29, 2011) ("NY City Bar Comment Letter").

should also be familiar with applying similar credit quality standards used in other Commission rules.[45] Fund boards may also consult external resources and Commission staff guidance (if applicable) for additional guidance on making credit quality determinations in certain circumstances.[46]

The new credit quality standard is intended to achieve the same objectives that the credit rating requirement was designed to achieve, *i.e.*, to limit collateral securities to those that are likely to retain a sufficiently stable market value and that, under ordinary circumstances, the fund would be able to liquidate quickly, at or near their carrying value in the event of a counterparty default.[47] Amended rule 5b-3 would not, however, prohibit a fund board from establishing its own additional criteria for what the fund may accept as collateral for repurchase agreements under the amended rule.

Under the final rule, as was proposed, the fund's board will be required to make credit quality determinations for all collateral securities that are not cash items or government securities, rather than just for unrated securities. In addition, as in the current rule, the amended rule continues to permit the board to delegate these credit quality and liquidity determinations.[48] We do not agree with the concerns of one commenter that this determination will impose undue

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45 *See* adopting release, *supra* note 16 (the Commission adopted amendments to rule 10f-3, revising the definition of "eligible municipal security" by replacing references to credit ratings with a similar two-part credit quality standard). *See also* text accompanying note 49.

46 *See, e.g.*, Tri-Party Repo Infrastructure, Reform Task Force, http://www.newyorkfed.org/tripartyrepo/. *See cf.* Securities and Exchange Commission, Division of Investment Management, IM Guidance Update, *Counterparty Risk Management Practices with Respect to Tri-Party Repurchase Agreements* (July 2013) (providing guidance to funds on the legal and operational steps that funds should consider if a counterparty fails and defaults on its obligations under a tri-party repurchase agreement), available at http://www.sec.gov/divisions/investment/guidance/im-guidance-2013-03.pdf.

47 *See supra* note 31.

48 This is similar to rule 2a-7, which permits the board to delegate decisions regarding credit quality. *See* rule 2a-7(e).

burdens on the board because the determination is similar to what rule 5b-3 currently requires a fund board (or its delegate) to make with respect to unrated collateral securities.[49] In addition, the amended rule will continue to permit the board of directors to delegate credit quality and liquidity determinations that the board believes are within the delegate's expertise if the board retains sufficient oversight.[50]

Under the amended rule, when determining credit quality and liquidity, the board (or its delegate) may incorporate into its analysis ratings, reports, opinions and other assessments issued by third parties, including NRSROs. A board should evaluate the basis for using any third-party assessment, including an NRSRO rating, in determining whether collateral meets the new standard and would not rely on the use of an NRSRO rating as a standard by itself without evaluating the quality of each NRSRO's assessment. In this way, the board could determine which third-party providers are credible and reliable and provide assessments that would be most appropriate to incorporate in making determinations under the amended rule. Delegation of these functions, as well as the use of third-party providers, may help to limit the potential increase in burdens on the board. One commenter suggested that we not allow a fund board to

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49 *See* NY City Bar Comment Letter (asserting that fund boards would be assigned responsibility for making determinations that are not within their expertise and arguing that the ability to delegate the determination does not relieve them of ultimate responsibility). *See also infra* section V.b.2. *See* rule 5b-3(c)(1)(iv)(D) (requiring that unrated securities other than government securities be "of comparable quality" to securities rated in the highest category by requisite NRSROs).

50 *See* Amended rule 5b-3(c)(1)(iv)(C); *see also* 2011 Proposing Release, *supra* note 10, at n.51 ("As in the current rule, the proposed rule would permit the board to delegate this credit quality and liquidity determination."). We expect that a fund's written policies and procedures would include guidelines for the fund's delegate (typically, the investment adviser) in making required determinations under rule 5b-3 and oversight of the fund adviser's compliance in making such determinations. *See* rule 38a-1. These policies and procedures typically would identify the process to be followed by the board (or its delegate) in making these credit and liquidity evaluations, including, as appropriate, the types of data to be used or factors to be considered and the person(s) or position(s) responsible. They also typically would provide for regular reporting to the board, as appropriate, about these evaluations, to allow the board to provide effective oversight of the process.

consider credit ratings in determining if a repurchase agreement is fully collateralized, stating that this would conflict with section 939A of the Dodd-Frank Act.[51] We believe, however, that credit ratings can serve as a useful data point for evaluating credit quality, and as noted above, a fund's board (or its delegate) may not rely solely on the credit ratings of an NRSRO without performing additional due diligence.

A fund that enters into repurchase agreements and relies on rule 5b-3 must maintain written policies and procedures that are reasonably designed to comply with the conditions of the rule, including the credit quality and liquidity requirements we are adopting today, and funds may therefore have to amend their policies and procedures.[52] We also understand that credit quality standards for securities collateralizing repurchase agreements are typically negotiated in the agreements between funds and counterparties.[53] We understand that those standards currently include a rating (for rated collateral securities) and any additional criteria that a fund manager considers necessary to ensure that the credit quality of collateral securities meets the fund's requirements, or, for unrated securities, a comparable credit quality standard. The amended rule does not prohibit fund boards (or their delegates) from considering the credit quality standards in current repurchase agreements and policies and procedures adopted to

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51 *See* Better Markets Comment Letter.

52 Registered funds are required to adopt and implement written policies and procedures reasonably designed to prevent the fund's violation of federal securities laws. *See* rule 38a-1(a); *see also infra* sections IV.A and V.B.

53 Many repurchase market participants will only accept AAA-rated paper such as government bonds as collateral. *See* Moorad Choudhry, The Repo Handbook (2d ed. 2010) at 298. Counterparties to repurchase agreements generally assess counterparty credit risk exposure based on the "haircut"–For example, $100 of securities collateralizing a loan of $97 produces a 3% haircut. The haircut may be greater depending on the counterparties' assessment of the collateral provider's creditworthiness. *See* Repo and Securities Lending, Staff Report No. 529, Federal Reserve Bank of New York (Dec. 2011, Rev. Feb. 2013). Assessments of credit quality are not standardized but are participant specific and negotiated at the time of the transaction. *Id.*

comply with the current rule as part of their analysis, provided that fund boards (or their delegates) determine that the ratings specified in the repurchase agreements and policies and procedures meet the standards we are adopting today, and that the agencies providing the ratings used in the policies and procedures are credible and reliable for that use. A fund could also revise its repurchase agreements and policies and procedures to change or eliminate the consideration of specific credit ratings or to incorporate other third-party evaluations of credit quality.[54]

As discussed above, amended rule 5b-3 replaces the requirement that collateral for repurchase agreements consist of securities rated in the highest category by the requisite NRSROs (other than cash and government securities) with a requirement that the collateral other than cash and government securities consist of securities issued by an issuer that has an exceptionally strong capacity to meet its financial obligations and that are sufficiently liquid. Consistent with the protection of investors and as necessary and appropriate in the public interest, we are also amending rule 5b-3 to define an issuer to include an issuer of an unconditional guarantee of the security.[55] We proposed this amendment to preserve a fund's ability to use the same types of collateral securities as it currently uses to satisfy the conditions of rule 5b-3. We received no comments on this aspect of the proposal and are adopting it as proposed. Thus, under amended rule 5b-3, a collateral security with an unconditional guarantee, the issuer of which meets the new credit quality test, satisfies that element of the standard.

54 *See* 2011 Proposing Release, *supra* note 10, at n.58. An estimate of the potential costs is discussed *infra* at section IV.A.

55 Amended rule 5b-3(c)(4) (defining "issuer" to mean "the issuer of a collateral security or the issuer of an unconditional obligation of a person other than the issuer of the collateral security to undertake to pay, upon presentment by the holder of the obligation (if required), the principal amount of the underlying collateral security plus accrued interest when due or upon default.").

B. Forms N-1A, N-2, and N-3

We are also adopting amendments to Forms N-1A, N-2, and N-3 to remove the required use of credit ratings assigned by an NRSRO. Forms N-1A, N-2, and N-3, among other things, contain the requirements for shareholder reports of mutual funds, closed-end funds, and certain insurance company separate accounts that offer variable annuities.[56]

Currently, Forms N-1A, N-2, and N-3 require shareholder reports to include a table, chart, or graph depicting portfolio holdings by reasonably identifiable categories (*e.g.*, type of security, industry sector, geographic region, credit quality, or maturity).[57] The forms require the categories to be selected in a manner reasonably designed to depict clearly the types of investments made by the fund, given its investment objectives. If credit quality is used to present portfolio holdings, the forms currently require that credit quality be depicted using the credit ratings assigned by a single NRSRO. We are amending Forms N-1A, N-2, and N-3, as proposed, to no longer *require* the use of NRSRO credit ratings by funds that choose to use credit quality categorizations in the required table, chart, or graph of portfolio holdings. Accordingly, funds that choose to show credit quality categorizations in the required table, chart, or graph may use alternative categorizations that are not based on NRSRO credit ratings.

In a change from the 2011 Proposing Release, however, under the amended forms, funds that choose to continue to use credit ratings will no longer be restricted to using the credit ratings assigned by a single NRSRO. Accordingly, funds that choose to depict credit quality using credit ratings assigned by a credit rating agency may use different credit rating agencies for split-

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56 Open-end management investment companies, commonly known as mutual funds, use Form N-1A. Closed-end management investment companies use Form N-2. Separate accounts organized as management investment companies that offer variable annuity contracts use Form N-3.

57 Item 27(d)(2) of Form N-1A; Instruction 6(a) to Item 24 of Form N-2; Instruction 6(i) to Item 28(a) of Form N-3.

rated securities (*i.e.*, securities that have received different ratings from multiple credit rating agencies) and they may use ratings provided by credit rating agencies that are not NRSROs.[58] Funds will also be required to describe how the credit quality of the holdings was determined, and if credit ratings are used, a description of how they were identified and selected.[59]

Four of the five substantive comments we received on the proposed amendments to Forms N-1A, N-2, and N-3, supported eliminating the required use of NRSRO credit ratings to depict credit quality.[60] Two of these commenters noted that shareholders would benefit from information about the credit quality of a fund's portfolio securities, whether determined by an NRSRO or internally.[61]

Although most commenters supported eliminating the required use of credit ratings to depict credit quality, four commenters opposed the proposed requirement that a fund that chooses to use NRSRO credit ratings must use the credit ratings of a single NRSRO. Instead, these commenters recommended that when a security is split-rated, the fund be permitted to choose which NRSRO rating to use, provided the choice is made consistently pursuant to a

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58 We are replacing the term "ratings" with "credit ratings" and "nationally recognized statistical rating organization 'NRSRO'" with "credit rating agency" as defined under the Exchange Act. *See* sections 3(a)(60) [15 U.S.C. 78c(a)(60)] and 3(a)(61) [15 U.S.C. 78c(a)(61)] of the Exchange Act, which define "credit rating" and "credit rating agency", respectively.

59 *See* Amended Item 27(d)(2) of Form N-1A; Amended Instruction 6(a) to Item 24 of Form N-2; Amended Instruction 6(i) to Item 28(a) of Form N-3.

60 ICI Comment Letter; Vanguard Comment Letter; T. Rowe Price Comment Letter; Federated Comment Letter (supporting the ICI's comments). The fifth commenter argued that the Commission is not required to remove references to credit ratings from the forms pursuant to section 939A of the Dodd-Frank Act. *See* BlackRock Comment Letter. Regardless of whether the Commission is required to remove from the forms references to credit ratings, the Commission believes that the removal of such references is consistent with the purpose of section 939A of the Dodd-Frank Act.

61 ICI Comment Letter; Federated Comment Letter (supporting the ICI's comments).

disclosed policy.[62] These commenters argued that this approach would benefit funds and investors by allowing funds to disclose credit quality information in shareholder reports in a manner consistent with marketing materials and internal investment policies.[63]

We agree with commenters and have revised the final form amendments to provide this additional degree of flexibility. Accordingly, the amended forms permit funds to consider alternative approaches to presenting credit quality that accurately and effectively describe the credit quality of the fund's portfolio. For example, under the amended forms, a fund could have a policy of disclosing the median credit quality rating for split-rated securities instead of only using the ratings of a single credit rating agency (when more than two rating agencies rate the security).[64] In the 2011 Proposing Release, we proposed to maintain the general requirement that ratings be selected from a single NRSRO because we were concerned about the possibility that a fund may select the most favorable credit ratings among credit ratings assigned by multiple NRSROs. On balance, we are persuaded by commenters that the benefits of this additional flexibility outweigh the potential "cherry picking" concern. We believe that the risks associated with cherry picking ratings are mitigated by the disclosure requirements discussed below.[65] For example, if a fund discloses that, with respect to split-rated securities, it is the fund's policy to

62 ICI Comment Letter; Vanguard Comment Letter; T. Rowe Price Comment Letter; Federated Comment Letter (supporting the ICI's comments). Two commenters noted that the Financial Industry Regulatory Authority ("FINRA") permits funds to use different approaches to portray the credit quality of split-rated bonds in marketing materials (noting further that funds receive credit rating information through data feeds and that it would be more cost efficient for funds to rely on a single data feed to comply with one consistent SEC/FINRA requirement). *See* ICI Comment Letter; Vanguard Comment Letter.

63 *See* ICI Comment Letter; Federated Comment Letter (supporting the ICI's comments); Vanguard Comment Letter.

64 *See infra* note 70 and accompanying and following text (discussing the difference between using median and average credit ratings).

65 *See* Amended Item 27(d)(2) of Form N-1A; Amended Instruction 6(a) to Item 24 of Form N-2; Amended Instruction 6(i) to Item 28(a) of Form N-3.

select the highest credit rating provided by a credit rating agency, investors will be on notice that the fund has made a decision not to include potentially lower and more conservative measures of credit quality. In addition, we believe that in some circumstances selecting credit ratings from more than one credit rating agency may reflect a more comprehensive approach to credit quality analysis that results in information about credit quality that may be more accurate or complete. For example, a fund that reviews credit ratings from three rating agencies, discards the outliers (*i.e.*, the highest and lowest ratings), and selects the middle rating,[66] has evaluated credit quality from a broader set of market participants that may lead to a more complete evaluation of credit quality.

Under the amended forms, funds that choose to depict portfolio holdings according to credit quality must include a description of how the credit quality of the holdings was determined.[67] This description should include a discussion of the credit quality evaluation process, the rationale for its selection, and an overview of the factors considered, such as the terms of the security (*e.g.*, interest rate, and time to maturity), the obligor's capacity to repay the debt, and the quality of any collateral. If the fund uses credit ratings issued by a credit rating agency to depict credit quality, the fund should explain how the credit ratings were identified and selected, and include this description near, or as part of, the graphical representation.[68] This

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66 *See, e.g.*, Fact Sheet, BlackRock Bond Index Fund (portraying credit quality using the median credit rating from among S&P, Moody's, and Fitch, when all three agencies rate a security), available at https://www2.blackrock.com/webcore/litService/search/getDocument.seam?venue=PUB_IND&source=CONTENT&serviceName=publicServiceView&ContentID=1111147239&venue=FP_ML ; Fact Sheet, Vanguard High-Yield Tax-Exempt Fund Investor Shares (same), available at https://personal.vanguard.com/us/funds/snapshot?FundId=0044&FundIntExt=INT.

67 *See supra* note 65; *see also* ICI Comment Letter (recommending that funds be permitted to choose which NRSRO rating to use for split-rated securities, provided that the choice is made pursuant to a disclosed policy).

68 If a fund does not use credit ratings, its description of how the credit quality of the holdings was

description should include, if applicable, a discussion of: (i) the criteria considered or process used in selecting the credit ratings (*e.g.*, the fund might use the median credit rating from among three rating agencies[69]); (ii) how the fund evaluated those criteria (*i.e.*, the due diligence performed); (iii) how the fund reports credit ratings for any security that is not rated by the credit rating agency selected if the fund has a policy of using the ratings of a single rating agency (*e.g.*, has the fund selected a designated alternate rating agency); (iv) how the fund reports credit ratings for any security that is not rated by any credit rating agency (*i.e.*, the process for self-rating); or (v) other fund policies on selecting credit ratings for purposes of disclosure. We expect that this discussion, modified and expanded upon by funds as appropriate, will provide investors with insight into how the fund identified and selected the credit ratings used in depicting the fund's portfolio by credit quality.

We recognize that under the final form amendments, a fund has a variety of options when depicting its portfolio holdings using credit quality. For example, a fund might choose not to use credit ratings and could rely instead on internal credit assessments. If a fund does not use credit ratings, we note that it might be misleading for a fund to describe its portfolio holdings quality with similar descriptions as the ratings nomenclature used by rating agencies (*e.g.*, AAA, Aa), or to characterize the securities as "rated." If a fund chooses to depict its portfolio using credit

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determined would also need to be near, or as part of, the graphical representation. *See* Amended Item 27(d)(2) of Form N-1A; Amended Instruction 6(a) to Item 24 of Form N-2; Amended Instruction 6(i) to Item 28(a) of Form N-3.

69 For example, Morningstar prefers that bonds be classified using the Barclays Capital Family of Indices ratings rules (*i.e.*, use the middle rating of Moody's, S&P and Fitch after dropping the highest and lowest available ratings; if only two rating agencies rate a security then the lowest rating should be used; and if only one agency rates a security then that rating should be used). *See* Morningstar Fixed-Income Style Box Methodology (Apr. 30, 2012) at http://corporate.morningstar.com/us/documents/MethodologyDocuments/MethodologyPapers/FixedIncomeStyleBoxMeth.pdf.

ratings issued by a credit rating agency, a fund could choose to use the *median* credit rating from among multiple credit rating agencies (discarding the highest and lowest ratings) when a security is split-rated.[70] We note, however, that it might be misleading for a fund to disclose an *average* credit quality rating that is based on ratings from multiple credit rating agencies because credit rating agencies may use different criteria to evaluate the credit quality of an issuer. A fund might also choose other methods for evaluating credit quality of portfolio securities, such as a policy of selecting the highest or lowest credit rating for split-rated securities among the ratings issued by certain specified rating agencies.[71] As discussed above, a fund must include in its disclosure a description of how the credit quality of the holdings was determined, no matter the method used.

The amended forms are intended to provide funds with the flexibility to present credit ratings in a manner that more clearly explains the credit quality of the fund's portfolio and the method by which the fund determined that quality.

IV. Paperwork Reduction Act

Certain provisions of the amendments we are adopting contain "collections of information" within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[72] The titles for the existing collections of information we are amending are: (i) "Rule 30e-1 under the Investment Company Act of 1940, Reports to Stockholders of Management Companies";[73] and

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70 *Id.; see also supra* note 66.

71 *See, e.g.*, Fact Sheet, Fidelity Institutional Money Market Prime Money Market Portfolio – Institutional CL (categorizing portfolio credit quality for investment grade taxable and municipal bond funds and multi-asset class funds with a fixed income component using the highest credit rating among Moody's, S&P, or Fitch), available at https://fundresearch.fidelity.com/mutual-funds/composition/31607A208.

72 44 U.S.C. 3501-3520.

73 The amendments to Forms N-1A, N-2, and N-3 relate solely to the contents of fund shareholder reports. The PRA burden associated with fund shareholder reports is included in the burden associated with the collection of information for rule 30e-1 under the Investment Company Act

(ii) "Rule 38a-1 under the Investment Company Act of 1940, Compliance procedures and practices of registered investment companies." We adopted those rules pursuant to the Investment Company Act. There is currently no approved collection of information for rule 5b-3, and the amendments do not create any new collections under that rule. The amendments to rule 5b-3 do, however, affect the collection of information burden for rule 38a-1.

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. We published notice soliciting comments on the collection of information requirements in the 2011 Proposing Release and submitted the proposed collections of information to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11 under the control numbers 3235-0025 (rule 30e-1) and 3235-0586 (rule 38a-1). We received no comments on the PRA estimates contained in the 2011 Proposing Release.

A. Rule 38a-1

Rule 5b-3 under the Investment Company Act allows funds to treat the acquisition of a repurchase agreement as an acquisition of securities collateralizing the repurchase agreement for purposes of sections 5(b)(1) and 12(d)(3) of the Investment Company Act under certain conditions. Rule 5b-3, as amended, requires that the securities collateralizing a repurchase agreement consist of securities that the fund's board of directors, or its delegate, determines are issued (or have unconditional guarantees that are issued) by an issuer that has an exceptionally strong capacity to meet its financial obligations and are highly liquid.[74] To that end, the fund's board of directors, pursuant to rule 38a-1 under the Investment Company Act, must have

rather than Forms N-1A, N-2 and N-3.

[74] Amended rule 5b-3(c)(1)(iv)(C). *See supra* section III.A.

procedures that are reasonably designed to ensure that the fund is able to comply with the conditions of amended rule 5b-3, including the credit quality and liquidity requirements outlined in the amended rule.[75] As discussed above, these procedures should be designed to limit collateral securities to those that are likely to retain a stable market value and that, in ordinary circumstances, the fund would be able to liquidate quickly in the event of a default. This rule 38a-1 collection of information will be mandatory for funds that rely on rule 5b-3. Records of information made in connection with this requirement will be required to be maintained for inspection by Commission staff, but the collection will not otherwise be submitted to the Commission. To the extent that the Commission receives confidential information pursuant to this collection of information, such information would be kept confidential, subject to the provisions of applicable law.[76]

We do not anticipate that the amendments to rule 5b-3 will significantly change collection of information burdens under rule 38a-1 because we believe funds would likely rely significantly on their current policies and procedures to determine the credit quality of collateral securities and comply with amended rule 5b-3. As we indicated above, we understand that credit quality standards for securities collateralizing repurchase agreements typically are contained in the repurchase agreements between funds and counterparties.[77] We understand that those

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75 Under rule 38a-1, funds must have written policies and procedures reasonably designed to prevent violation of the federal securities laws. Rule 38a-1(a)(1). Funds thus would have policies and procedures for complying with rule 5b-3, which would include policies and procedures relating to credit quality determinations of unrated collateral securities, if appropriate.

76 *See, e.g.*, 5 U.S.C. 552. Exemption 4 of the Freedom of Information Act provides an exemption for "trade secrets and commercial or financial information obtained from a person and privileged or confidential." 5 U.S.C. 552(b)(4). Exemption 8 of the Freedom of Information Act provides an exemption for matters that are "contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions." 5 U.S.C. 552(b)(8).

77 *See supra* note 53 and accompanying text.

standards currently include a rating (for rated collateral securities) and any additional criteria a fund manager considers necessary to ensure that the credit quality of the collateral securities meets the fund's requirements, or, for unrated securities, a comparable credit quality standard. Counterparties provide collateral securities to conform to these standards and funds confirm that the securities are conforming. As we have noted above, funds can continue to consider evaluations of outside sources, including credit ratings that the board determines are credible and reliable in making their credit quality determinations under the amended rule. We expect that funds will likely continue to rely on their current policies and procedures (*i.e.*, using credit quality standards that include ratings currently set forth in their repurchase agreements with counterparties). Thus, we do not expect that the amendments to rule 5b-3 will significantly change the current collection of information burden estimates for rule 38a-1.[78] Nevertheless, funds may review their repurchase agreements and policies and procedures that address rule 5b-3 compliance and make technical changes to those documents in response to the amendments. Staff estimated in the proposal and continues to believe that it will take, on average, 1.5 hours of a senior business analyst's time to perform this review and make any technical changes for an individual fund portfolio, for an estimated one-time additional burden of 15,176 hours for all fund portfolios (other than money market fund portfolios).[79] Amortized over three years, the

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78 The current approved annual burden for rule 38a-1 under the PRA is 248,455 hours. As discussed below, as amended, the collection of information requirement will be 263,631 hours (248,455 + 15,176).

79 For purposes of this PRA analysis, we assume that all funds enter into repurchase agreements and rely on rule 5b-3. We have not included money market funds in our estimates, however, because they are subject to different requirements for the collateralization of repurchase agreements under rule 2a-7. *See* text accompanying note 34. The staff's estimate is based on staff examination of industry data as of August 31, 2013 and includes 10,117 fund portfolios. We therefore estimate that there will be 10,117 respondents to this collection of information. The amount is calculated as follows: 10,117 fund portfolios x 1.5 hours = 15,176 one-time additional burden hours for all fund portfolios. We estimate that the one-time additional annual burden is 1.5 hours per

staff estimates that the estimated annual aggregate burden will be 5,059 burden hours.[80]

We anticipate that the fund's board will review the fund manager's recommendation, but that the cost of this review will be incorporated in the fund's overall annual board costs and would not result in any particular additional cost. We received no comments on these estimates and therefore have not modified them.[81]

B. Rule 30e-1

The amendments to Forms N-1A, N-2, and N-3 eliminate the required use of NRSRO credit ratings by funds that choose to use credit quality categorizations in the table, chart, or graph of portfolio holdings provided in shareholder reports. The collection of information is mandatory for those funds that choose to use credit quality categorizations in these forms. If a fund chooses to depict portfolio holdings according to credit quality, the fund must include a description of how the credit quality of the holdings was determined. If credit ratings assigned by a credit rating agency are used, the fund must disclose how it identified and selected the credit ratings. Responses to the disclosure requirements will not be kept confidential.

Although funds would remain obligated to provide a table, chart, or graph of portfolio holdings by reasonably identifiable categories, the amendments require that certain funds must

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respondent.

The monetized burden hours are calculated as follows: 15,176 hours x \$245 per hour = \$3,718,120 one-time additional costs. The staff estimates that the internal cost for time spent by a senior business analyst is \$245 per hour. This estimate, as well as other internal time cost estimates made in this analysis, is derived from SIFMA's Management and Professional Earnings in the Securities Industry 2012, modified by Commission staff to account for an 1800-hour work week and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

80 The amount is calculated as follows: 15,176 burden hours / 3 = 5,059 burden hours. Amortized over three years, staff estimates that the annual aggregate burden cost will be: \$3,718,820 /3 = \$1,239,373.

81 The PRA costs have been modified slightly since the 2011 Proposing Release to reflect a more current estimate of the number of fund portfolios affected, as well as updated hourly wages based on the 2012 SIFMA table.

make new disclosures. Under our proposed amendment, we estimated that there would be no additional collection of information burden as a result of proposing to remove the required use of credit ratings from the forms.[82] Under our amended rule, however, funds that choose to use credit quality categorizations must disclose how the fund made the credit quality determinations, and if the fund uses credit ratings issued by a credit rating agency, the fund must disclose how it identified and selected the credit ratings.[83]

Accordingly, based on staff experience, the staff estimates that it will take, on average, 3 hours of an attorney's time to perform this review and make any technical changes to an individual fund's disclosures, for an estimated burden of 32,049 hours for all funds.[84] Amortized over three years, the staff estimates that the estimated annual aggregate burden will be 10,683 burden hours and that there will be approximately 10,683 respondents.[85]

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82 *See* 2011 Proposing Release, section IV.C.

83 The current approved annual burden for rule 30e-1 under the PRA is 903,000 hours. As discussed below, as amended, the collection of information requirement will be 935,049 hours (903,000 + 32,049).

84 The staff's estimate of the number of funds is based on staff examination of industry data as of August 31, 2013 and includes 10,683 funds that collectively file reports on Forms N-1A, N-2, and N-3 each year. We note that this estimate is conservative because it is likely that some fund complexes will achieve economies of scale when revising their disclosures, do not use credit quality when describing portfolio holdings, or whose current disclosures already satisfy the requirements of the amended rule and thus would not need to make any changes. The amount is calculated as follows: 10,683 funds x 3 hours = 32,049 one-time additional burden hours for all funds. We estimate that the one-time additional annual burden is 3 hours per respondent.

The monetized burden hours are calculated as follows: 32,049 hours x $379 per hour = $12,146,571 one-time additional costs. The staff estimates that the internal cost for time spent by an in-house attorney is $379 per hour. This estimate, as well as other internal time cost estimates made in this analysis, is derived from SIFMA's Management and Professional Earnings in the Securities Industry 2012, modified by Commission staff to account for an 1800-hour work week and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

85 The amount is calculated as follows: 32,049 burden hours / 3 = 10,683 burden hours. Amortized over three years, staff estimates that the annual aggregate burden cost will be: $12,146,571 / 3 = $4,048,857.

V. ECONOMIC ANALYSIS

A. Overview

As discussed above, we are adopting rule and form amendments to implement section 939A of the Dodd-Frank Act. The amendments to rule 5b-3 replace a NRSRO credit rating standard with alternative credit quality and liquidity criteria that are designed to achieve the same purposes as the NRSRO credit rating standard without imposing unnecessarily burdensome costs. The amendments to Forms N-1A, N-2, and N-3 remove the required use of credit ratings when portraying credit quality in shareholder reports, but require that those funds include a description of how the credit quality of the holdings were determined, and if credit ratings assigned by a credit rating agency are used, how the credit ratings were identified and selected. The regulatory changes adopted today will directly affect investment companies registered under the Investment Company Act and could affect the demand for rating agencies' services by eliminating the required use of NRSRO credit ratings in rule 5b-3 and Forms N-1A, N-2, and N-3. The amendments to rule 5b-3 may also affect other parties such as repurchase agreement counterparties (*e.g.*, broker-dealers and banks), investors, and issuers of collateral securities. Finally, we recognize that the elimination of the required use of NRSRO credit ratings in rule 5b-3 and Forms N-1A, N-2, and N-3 may reduce the incentive for credit rating agencies to register as NRSROs and thereby be subject to the Commission's oversight and statutory and regulatory requirements applicable to NRSROs. We received no comments on the cost-benefit analysis contained the 2011 Proposing Release.

At the outset, the Commission notes that, where possible, we have attempted to quantify the costs and benefits expected to result from adopting the amendments to rule 5b-3 and Forms N-1A, N-2, and N-3. However, wherever the discussion of costs or benefits is not quantified in this section it is because the Commission is unable to quantify the economic effects because it lacks the information necessary to provide a reasonable estimate. For example, as discussed below, the Commission does not have available to it comprehensive information on the exposure of funds to different repurchase agreement market segments, the nature and type of collateral used in repurchase agreements, or the extent to which funds rely on rule 5b-3. Because of this lack of data, including the extent to which funds may rely on rule 5b-3, we are unable to quantify the costs to comply with the amended rule and note that the costs could vary from our estimates. We discuss below the economic baseline, costs and benefits of our final rule and form amendments, alternatives considered, as well as the impact on efficiency, competition, and capital formation.

B. Rule 5b-3

Rule 5b-3, as amended, permits a fund to treat the acquisition of a repurchase agreement as an acquisition of securities collateralizing the repurchase agreement for purposes of sections 5(b)(1) and 12(d)(3) of the Investment Company Act if the collateral other than cash or government securities consists of securities that the fund's board of directors, or its delegate, determines at the time the repurchase agreement is entered into are: (i) issued by an issuer that has an exceptionally strong capacity to meet its financial obligations; and (ii) sufficiently liquid that they can be sold at approximately their carrying value in the ordinary course of business within seven calendar days.

1. Economic Baseline

The economic baseline against which we measure the economic effects of these amendments is the regulatory framework as it exists immediately before the adoption of today's amendments. Currently, rule 5b-3 allows funds to treat the acquisition of a repurchase agreement as an acquisition of securities collateralizing the repurchase agreement for certain diversification and broker-dealer counterparty limit purposes under the Investment Company Act if the obligation of the seller to repurchase the securities from the fund is "collateralized fully." In general, under rule 5b-3, a fund investing in a repurchase agreement looks to the value and liquidity of the securities collateralizing the repurchase agreement rather than the creditworthiness of the counterparty for satisfaction of the repurchase agreement. Under current requirements, a repurchase agreement is collateralized fully if, among other things, the collateral for the repurchase agreement consists entirely of (i) cash items, (ii) government securities, (iii) securities that at the time the repurchase agreement is entered into are rated in the highest rating category by the "Requisite NRSROs" or (iv) unrated securities that are of a comparable quality to securities that are rated in the highest rating category by the Requisite NRSROs, as determined by the fund's board of directors or its delegate.

As of the end of 2012, the total repurchase agreement market approximated $3 trillion.[86] The repurchase agreement market has two primary segments, bilateral and tri-party.[87] The bilateral segment comprises cash-driven transactions against specific collateral while the tri-party segment comprises cash-driven transactions against general collateral. We believe that investment companies' primary exposure to repurchase agreements is through the tri-party market, but the Commission does not have available to it comprehensive information on the exposure in either market segment. The collateral used in the approximately $2 trillion tri-party market is dominated by government securities: approximately 35% consists of Treasury

86 *See* Financial Stability Oversight Council, 2013 Annual Report at 65-66, available at http://www.treasury.gov/initiatives/fsoc/Documents/FSOC%202013%20Annual%20Report.pdf

87 *See id.* (noting a third repo market segment—the general collateral finance market—which primarily settles inter-dealer transactions on the tri-party repo platform).

securities and approximately 50% consists of agency mortgage-backed securities, agency debentures, and agency collateralized mortgage obligations.[88]

While we believe that many funds invest in tri-party repurchase agreements, comprehensive information about the extent to which funds invest in these agreements is not available to us. Nor are we able to estimate how often funds rely on rule 5b-3 when entering into repurchase agreements, or the extent to which fund repurchase agreements are collateralized with securities other than cash or government securities. However, we are able to estimate the extent of money market fund participation in the tri-party repurchase market using Form N-MFP data, which shows that money market funds held approximately $591 billion in tri-party repurchase agreements as of the end of 2012. While we understand almost all funds rely on rule 5b-3 on occasion (for example when approaching diversification limits or avoiding restrictions on investments in certain entities), we do not have the information necessary to determine how frequently those funds rely on rule 5b-3 in their daily transactions in repurchase agreements. Accordingly, we are largely unable to quantify the benefits and costs discussed below.

2. Economic Analysis

Amended rule 5b-3 is intended to establish a similar credit quality standard to the NRSRO credit rating standard we are replacing in order to achieve the same objectives that the NRSRO credit rating reference requirement was designed to achieve in the existing rule, *i.e.*, limit collateral securities to those that are likely to retain a stable market value and that, under ordinary circumstances, the fund would be able to liquidate quickly at or near its carrying value in the event of a counterparty default. Although amended rule 5b-3 seeks to maintain a similar degree of credit quality as the standard it replaces, the Dodd-Frank Act mandate is designed to

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88 *Id.*

reduce reliance on NRSRO credit ratings.[89]

Some fund boards or their delegates, after independent analysis, might make a determination of credit quality that comports with the analysis of the NRSRO credit ratings and, accordingly, make no substantive changes to the funds' investments in repurchase agreements. Other fund boards might turn to non-NRSRO sources ("third-party providers") to satisfy the new requirements, which may result in a different pool of assets from which the funds may select for collateralizing repurchase agreements. We believe that this flexibility of allowing for a broader range of credit quality models will increase competition for such models, whether from internal assessments made by the fund or from external assessments made by third-party providers such as credit rating agencies. As a result, credit assessments, and the repurchase agreement market in general, may become more efficient and may promote capital formation through a more accurate assessment of credit risk that may increase investment in repurchase agreements.

We recognize, as discussed above, that funds typically establish standards for the credit quality of collateral securities (that include credit ratings and additional credit quality criteria required by the fund) in repurchase agreements with counterparties.[90] Funds could change their policies and procedures to reflect changes made to the rule by the amendments, but the rule would not prohibit funds from considering the standards in current repurchase agreements and policies and procedures provided that the fund's board or its delegate made the determination that those standards satisfy the standards in amended rule 5b-3. As a result, amended rule 5b-3 may not significantly change the types of collateral securities held by funds relying on rule 5b-3.

89 *See supra* note 12.

90 *See supra* text preceding note 53.

Amended rule 5b-3 requires the fund's board or its delegate to make a determination about the collateral of each repurchase agreement. This will increase the regulatory burden on the fund's board,[91] but we believe that the burden is significantly reduced by the fund board's ability to incorporate ratings, reports, analyses, and other assessments issued by third parties, including NRSRO ratings that the fund's board concludes are credible and reliable for purposes of making the evaluation. Moreover, fund boards that find these increased regulatory burdens to be excessive can mitigate them by restricting the fund to repurchase agreement collateral that consists of cash and government securities.

If the fund's board decides to rely primarily on NRSRO ratings as part of the process of evaluating credit quality, the fund may incur some additional costs from today's amendments.[92] However, some fund boards may decide not to rely primarily on NRSRO ratings, perhaps because of a more cost efficient way of making the required determinations or because they believe NRSRO ratings are not helpful or sufficient in evaluating credit quality. Reducing the emphasis on NRSRO ratings could also adversely affect the quality of NRSRO ratings. Currently, the importance attached to NRSRO ratings may impart franchise value to the NRSRO's ratings business. By eliminating references to NRSRO ratings in Federal regulations, section 939A of the Dodd-Frank Act could reduce these franchise values and mitigate NRSROs' incentives to produce credible and reliable ratings. Moreover, the Commission recognizes that the elimination of the required use of credit ratings in Commission rules and forms may reduce the incentive for credit rating agencies to register as NRSROs with the Commission and thereby be subject to the Commission's oversight and the statutory and regulatory requirements

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91 *See* NY City Bar Comment Letter, *supra* note 44.

92 *See supra* text following note 53.

applicable to NRSROs. To the extent that the quality and accuracy of NRSRO ratings is adversely affected, negative impacts on the capital allocation process and economic efficiency would result.

The new methodologies that the fund's board employs may result in a pool of assets from which the fund may select for collateralizing repurchase agreements that is different from a pool based on NRSRO ratings. This may affect the fund relative to the baseline of NRSRO ratings by including or excluding as collateral assets that are different from the collateral permitted under the current rule. In turn, this could increase the credit risk in the pool of collateral assets or decrease the return earned by investing in repurchase agreements. Both of these effects may lead to a less efficient market for repurchase agreement collateral. Issuers' ability to raise capital may also be adversely affected to the extent that issuers of collateral securities lose the regulatory preference that currently exists because of the required use of NRSRO ratings within rule 5b-3. We do not, however, believe that the amended rule is likely to lead to the acceptance of riskier collateral in practice because the standard we are adopting is very similar to the standard articulated by the NRSROs for securities that have received the highest ratings. In addition, we anticipate that fund boards and advisers will retain the credit quality standards in their current repurchase agreements and their existing policies and procedures that address compliance with current rule 5b-3 and include ratings that they believe are credible and reliable.

Although we believe that boards of funds relying on rule 5b-3 have established policies and procedures for complying with the rule,[93] funds may incur costs to revise existing policies and procedures for investing in repurchase agreements to comply with amended rule 5b-3. We recognize that increased compliance costs are a necessary result of our amendments to rule 5b-3

93 *See* rule 38a-1(a).

and may disproportionately impact smaller funds to the extent these funds do not today have policies and procedures for assessing creditworthiness. As noted above, we are not able to quantify many of the costs (and benefits) discussed above. However, we estimate that each fund will incur, at a minimum, the collection of information costs discussed in the Paperwork Reduction Act section for a total average one-time cost of approximately $368 per fund.[94] Funds may also incur additional costs in complying with the amendments which we are unable to quantify, for the reasons discussed above.

3. Alternatives

In adopting today's amendments to rule 5b-3, the Commission considered, as noted by one commenter, including specific factors or tests that a fund board must apply in performing its credit analysis under the rule.[95] As noted above, the number and scope of factors that may be appropriate to making a credit quality determination with respect to a security may vary significantly depending on the particular security and through time. Accordingly, we are not adopting specific factors or tests that a fund board must apply in performing credit analysis, but may provide guidance in the future.[96]

We also considered different standards to replace credit ratings that would help ensure that funds can liquidate collateral quickly in the event of a default. These alternatives included, for example, omitting an explicit liquidity requirement because securities in the "highest rating category" generally are more liquid than lower quality securities. Other liquidity alternatives we considered included limiting collateral securities only to cash and government securities because

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94 *See supra* note 79 and accompanying text. Staff estimates that all funds will incur a one-time aggregate cost of approximately $3.7 million to make any necessary changes related to collections of information under the Paperwork Reduction Act. *Id.*

95 *See supra* note 43.

96 *See supra* notes 43-46 and accompanying text.

liquidity may decline between the time of acquisition and the time of default, or prohibiting a fund from relying on rule 5b-3 if, at any point after the time a fund enters into a repurchase agreement, the collateral could no longer be liquidated within seven calendar days. After considering the alternatives, we believe that amended rule 5b-3 strikes a better balance than the alternatives by imposing a liquidity requirement that is similar to the liquidity standard inherent to the credit quality rating required under the current rule, while not unduly restricting funds' flexibility to utilize a larger pool of assets for collateralizing repurchase agreements.

C. Forms N-1A, N-2, and N-3

Forms N-1A, N-2, and N-3, as amended, eliminate the required use of NRSRO credit ratings by funds that choose to use credit quality categorizations in the required table, chart, or graph of portfolio holdings. If a fund chooses to depict portfolio holdings according to credit quality, the fund must include a description of how the credit quality of the holdings was determined. If a fund uses credit ratings assigned by a credit rating agency to depict credit quality, the fund must disclose how it identified and selected the credit ratings.

1. Economic Baseline

As noted above, the economic baseline against which we measure the economic effects is the regulatory framework as it exists immediately before the adoption of today's amendments. Currently, Forms N-1A, N-2, and N-3 require shareholder reports to include a table, chart, or graph depicting portfolio holdings by reasonably identifiable categories (*e.g.*, type of security, industry sector, geographic region, credit quality, or maturity). The forms require the categories to be selected in a manner reasonably designed to depict clearly the types of investments made by the fund, given its investment objectives. If credit quality is used to present portfolio holdings, the forms currently require that credit quality be depicted using the credit ratings assigned by a single NRSRO.

We believe, based on staff experience, that the majority of funds choose to depict their portfolios using credit quality, and accordingly, report credit ratings from a single NRSRO. As discussed above, we conservatively estimate that 10,683 funds collectively file reports on Forms N-1A, N-2, and N-3 each year and will be affected by the amendments.[97]

2. Economic Analysis

The Dodd-Frank Act mandate is designed to reduce potential reliance on NRSRO credit ratings. Under the amendments, funds have greater flexibility to assess and depict credit quality, which may lead to better-informed investors who can, in turn, make better capital allocation decisions. Accordingly, better-informed investors may make more effective investment decisions based on their risk tolerance and may promote increased competition among funds. We note, however, that funds might choose to report credit quality in a more positive light than is possible under the prior requirement to use the credit ratings from a single NRSRO. However, as discussed above, the disclosure requirements we are adopting today should mitigate many of the potential adverse consequences. As a result, today's amendments may have a varied effect on investors' ability to make effective capital allocation choices.

Because we do not anticipate that these amendments will result in large changes in the portfolios held by funds or their investors, we do not believe the amendments would have more than a marginal effect on efficiency or capital formation. A potential benefit may arise by allowing funds to use different credit rating agencies for split-rated securities because that may promote competition between credit rating agencies to provide ratings that are more accurate if funds use the most accurate ratings for each part of their portfolios even if those ratings come

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97 *See supra* note 84.

from different credit rating agencies. This may foster innovation in the industry, and it may foster the growth of niche credit rating agencies. Although some funds may eliminate the specific use of credit ratings in their depiction of portfolio credit quality, we anticipate that many of those funds are likely to consider some outside analyses in evaluating the credit quality of portfolio securities.[98] A fund's consideration of external analyses by third-party sources determined to be credible and reliable may contribute to the accuracy of funds' determinations and thus help funds arrive at consistent and more accurate depictions of credit quality.

Under the amended forms, funds may continue to depict portfolio holdings as they do today: funds can continue to depict portfolio holdings without making reference to credit quality, and funds can continue to depict portfolio holdings using credit ratings from one NRSRO. Today's amendments impose no new costs on funds that depict portfolio holdings based on criteria other than credit quality, but they do impose small additional costs on funds that choose to portray portfolio holdings using credit ratings from one NRSRO because they must make new disclosures about how the ratings were identified and selected. We believe that the majority of costs related to today's amendments to Forms N-1A, N-2, and N-3 are the costs described above related to the collections of information under the Paperwork Reduction Act. Accordingly, we estimate that funds on average will incur costs of approximately $1,137 per fund in complying with the amendments.[99] In addition, funds may voluntarily incur additional costs if they choose to develop and apply new methodologies to depict credit quality. Funds that

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98 Funds may elect to use a combination of factors, including NRSRO credit ratings, in depicting credit quality; or funds may use or establish entirely new methods of depicting credit quality. *See* ICI Comment Letter; Federated Comment Letter (supporting the ICI Comment Letter).

99 *See supra* note 84 and accompanying text. Staff estimates that all funds will incur a one-time aggregate cost of approximately $12.1 million to make any necessary changes to the registration statement related to collections of information under the Paperwork Reduction Act. *Id.*

choose to do so will incur a cost not only to determine the credit quality of portfolio holdings but also a cost to include in the registration statement a description of how the credit quality of portfolio holdings was determined, and if credit ratings are used, how the ratings were identified and selected.

3. Alternatives

In adopting the amendments to the forms, the Commission considered replacing the required use of credit ratings with an option to depict a fund's portfolio by credit quality using the credit ratings of only a single credit rating agency. This approach, proposed in 2011, was intended to eliminate the possibility that a fund could choose to use NRSRO credit ratings and then select the most favorable ratings among the credit ratings assigned by multiple NRSROs. As discussed above, a number of commenters suggested that funds be permitted to use the credit ratings assigned by more than one NRSRO for split-rated securities, provided the choice is made consistently, pursuant to a disclosed policy. On balance, we believe that the benefits of this additional flexibility outweigh the potential costs associated with the possibility that funds cherry pick the highest credit rating available. We note that the risks associated with cherry picking ratings are mitigated by the fact that the forms, as amended, require that funds disclose how they identified and selected the credit ratings, which would include, for example, a fund policy that selects the highest credit rating available.

VI. Final Regulatory Flexibility Analysis

The Commission has prepared the following Final Regulatory Flexibility Analysis ("FRFA") in accordance with section 4(a) of the Regulatory Flexibility Act regarding the rule and form amendments we are adopting today to give effect to provisions of the Dodd-Frank

Act.[100] The FRFA relates to amendments to rule 5b-3 under the Investment Company Act and Forms N-1A, N-2, and N-3 under the Investment Company Act and Securities Act. We prepared an Initial Regulatory Flexibility Analysis ("IRFA") in conjunction with the 2011 Proposing Release in March 2011.[101]

A. Need for and Objectives of the Rule and Form Amendments

As described more fully in sections I and III of this Release, to implement section 939A of the Dodd-Frank Act, the Commission is adopting amendments to (i) rule 5b-3 to eliminate references to the credit rating and replace it with an alternative standard of creditworthiness that is intended to achieve the same objectives that the credit rating requirement was designed to achieve and (ii) Forms N-1A, N-2, and N-3 to eliminate the required use of NRSRO credit ratings by funds that choose to use credit quality categorizations in the required table, chart, or graph of portfolio holdings in their shareholder reports, and to permit funds that choose to depict credit quality using credit ratings assigned by a credit rating agency to use different credit rating agencies for split-rated securities.

B. Significant Issues Raised by Public Comment

In the 2011 Proposing Release, we requested comment on the IRFA. In particular, we sought comment on how many small entities would be subject to the proposed rule and form amendments and whether the effect of the proposed rule and form amendments on small entities subject to them would be economically significant. None of the comment letters we received addressed the IRFA. None of the comment letters made comments about the effect of the rule and form amendments on small investment companies.

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100 5 U.S.C. 604(a).

101 *See* 2011 Proposing Release, *supra* note 10, at section VIII.

C. Small Entities Subject to the Rule and Form Amendments

The amendments to rule 5b-3 and Forms N-1A, N-2, and N-3 under the Investment Company Act would affect funds, including entities that are considered to be a small business or small organization (collectively, "small entity") for purposes of the Regulatory Flexibility Act.

Investment Companies. Under Commission rules, for purposes of the Investment Company Act and the Regulatory Flexibility Act, an investment company is a small entity if it, together with other investment companies in the same group of related investment companies, has net assets of $50 million or less as of the end of its most recent fiscal year.[102] Based on a current review of filings submitted to the Commission, we estimate that 171 investment companies may be considered small entities and that all of these investment companies may potentially rely on rule 5b-3.[103] As discussed above, we recognize that increased compliance costs are a necessary result of the amendments to rule 5b-3 and may disproportionately impact smaller funds to the extent these funds do not have policies and procedures for assessing creditworthiness. Based on a current review of filings submitted to the Commission, we estimate that approximately 131 investment companies that meet the definition of small entity would be subject to the amendments to Forms N-1A, N-2, and N-3.

D. Projected Reporting, Recordkeeping, and Other Compliance Requirements

Rule 5b-3. The amendments to rule 5b-3 allow a fund to treat the acquisition of a repurchase agreement as an acquisition of securities collateralizing the repurchase agreement for purposes of sections 5(b)(1) and 12(d)(3) of the Investment Company Act if the collateral other

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[102] 17 CFR 270.0-10(a).

[103] The 183 investment companies that meet the definition of small entity include 12 business development companies, which are subject to sections 5 and 12 of the Investment Company Act. 15 U.S.C. 80a-58; 15 U.S.C. 80a-59.

than cash or government securities consists of securities that the fund's board of directors (or its delegate) determines at the time the repurchase agreement is entered into are: (i) issued by an issuer that has an exceptionally strong capacity to meet its financial obligations; and (ii) sufficiently liquid that they can be sold at approximately their carrying value in the ordinary course of business within seven calendar days. A fund that acquires repurchase agreements and intends the acquisition to be treated as an acquisition of the collateral securities must determine whether it must change its policies for evaluating collateral securities under the amended rule and must adopt and implement written policies and procedures reasonably designed to comply with the conditions of amended rule 5b-3, including these credit quality and liquidity requirements that we are adopting.[104] The costs associated with the amendments to rule 5b-3 are those discussed in section IV.A and V.B above.

Forms N-1A, N-2, and N-3. The amendments to Forms N-1A, N-2, and N-3 apply to open-end management investment companies, closed-end management investment companies, and separate accounts organized as management investment companies that offer variable annuity contracts, including those that are small entities. The amendments to Forms N-1A, N-2, and N-3 eliminate the required use of NRSRO credit ratings by funds that choose to use credit quality categorizations in the required table, chart, or graph of portfolio holdings in their shareholder reports. If a fund chooses to depict portfolio holdings according to credit quality, it must include a description of how the credit quality of the holdings was determined, and if credit ratings assigned by a credit rating agency are used to depict credit quality, the fund must disclose how it identified and selected the credit ratings. The amended forms also permit funds that choose to depict credit quality using credit ratings assigned by a credit rating agency to use

[104] 17 CFR 270.38a-1(a).

different credit rating agencies for split-rated securities. The costs associated with the amendments to the forms are those discussed in section IV.B and V.C above.

E. Agency Action to Minimize Effect on Small Entities

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish our stated objectives, while minimizing any significant adverse effect on small entities. In connection with the rule and form amendments, the Commission considered the following alternatives: (i) establishing different compliance standards or timetables that take into account the resources available to small entities; (ii) clarifying, consolidating, or simplifying compliance and reporting requirements under the rule for small entities; (iii) use of performance rather than design standards; and (iv) exempting small entities from all or part of the requirements.

We believe that special compliance or reporting requirements for small entities, or an exemption from coverage for small entities, is not appropriate or consistent with investor protection or the Dodd-Frank Act. We believe that, with respect to rule 5b-3, different credit quality standards, special compliance requirements or timetables for small entities, or an exemption from coverage for small entities, may create a risk that those entities could acquire repurchase agreements with collateral that is less likely to retain its market value or liquidity in the event of a counterparty default. Further consolidation or simplification of the rule and form amendments for funds that are small entities is inconsistent with the Commission's goals of fostering investor protection.

The form amendments apply to all investment companies that use Forms N-1A, N-2, and N-3 to register under the Investment Company Act and to offer their securities under the Securities Act. If the Commission had excluded small entities from the form amendments, small entities would have been required to use NRSRO credit ratings if they chose to depict credit quality, while other entities would not have been subject to that requirement. We believe that special compliance or reporting requirements, or an exemption, for small entities would not be appropriate because the amended requirement—eliminating the required use of credit ratings where a fund chooses to depict the fund's portfolio based on credit quality—is intended to eliminate potential reliance on NRSRO credit ratings resulting from the perception that the Commission endorses the ratings because of their required use in Commission forms.

We have endeavored through the form amendments to minimize regulatory burdens on investment companies, including small entities, while meeting our regulatory objectives. We have endeavored to clarify, consolidate, and simplify the requirements applicable to investment companies, including those that are small entities. Finally, the amendments will use performance rather than design standards for determining the credit quality of specific securities. For these reasons, we have not adopted alternatives to rule 5b-3 and Forms N-1A, N-2, and N-3.

STATUTORY AUTHORITY

The Commission is adopting amendments to rule 5b-3 under the authority set forth in sections 6(c) and 38(a) of the Investment Company Act [15 U.S.C. 80a-6(c), 80a-37(a)] and section 939A of the Dodd-Frank Act. The Commission is adopting amendments to Form N-1A, Form N-2, and Form N-3 under the authority set forth in sections 5, 6, 7, 10 and 19(a) of the Securities Act [15 U.S.C. 77e, 77f, 77g, 77j, and 77s(a)]; sections 8, 24(a), 30 and 38 of the Investment Company Act [15 U.S.C. 80a-8, 80a-24(a), 80a-29, and 80a-37]; and section 939A of the Dodd-Frank Act.

List of Subjects

17 CFR Part 239

Reporting and recordkeeping requirements, Securities.

17 CFR Parts 270 and 274

Investment companies, Reporting and recordkeeping requirements. Securities.

TEXT OF RULE AND RULE AND FORM AMENDMENTS

For reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

PART 239—FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

1. The authority citation for Part 239 is revised to read in part as follow:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77sss, 78c, 78l, 78m, 78n, 78o(d), 78o-7, 78o-7 note, 78u-5, 78w(a), 78ll, 78mm, 80a-2(a), 80a-3, 80a-8, 80a-9, 80a-10, 80a-13, 80a-24, 80a-26, 80a-29, 80a-30, 80a-37, and Pub. L. No. 111-203, § 939A, 124 Stat. 1376 (2010), unless otherwise noted.

* * * * *

PART 270--RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

2. The authority citation for Part 270 is revised to read in part as follows:

Authority: 15 U.S.C. 80a-1 *et seq.*, 80a-34(d), 80a-37, 80a-39, and Pub. L. No. 111-203, § 939A, 124 Stat. 1376 (2010), unless otherwise noted.

* * * * *

3. Section 270.5b-3 is amended by:

a. Adding "or" at the end of paragraph (c)(1)(iv)(B);

b. Revising paragraph (c)(1)(iv)(C);

c. Removing paragraph (c)(1)(iv)(D);

d. Removing paragraphs (c)(5), (c)(6), and (c)(8);

e. Redesignating paragraph (c)(4) as (c)(5);

f. Adding new paragraph (c)(4); and

g. Redesignating paragraph (c)(7) as paragraph (c)(6).

The revisions read as follows:

§ 270.5b-3 Acquisition of repurchase agreement or refunded security treated as acquisition of underlying securities.

* * * * *

(c) * * *

(1) * * *

(iv) * * *

(C) Securities that the investment company's board of directors, or its delegate, determines at the time the repurchase agreement is entered into:

(1) Each issuer of which has an exceptionally strong capacity to meet its financial obligations; and

NOTE to paragraph (c)(1)(iv)(C)(*1*): For a discussion of the phrase "exceptionally strong capacity to meet its financial obligations" see Investment Company Act Release No. 30847, (December 27, 2013).

(2) Are sufficiently liquid that they can be sold at approximately their carrying value in the ordinary course of business within seven calendar days; and

* * * * *

(4) *Issuer*, as used in paragraph (c)(1)(iv)(C)(*1*) of this section, means the issuer of a collateral security or the issuer of an unconditional obligation of a person other than the issuer of the collateral security to undertake to pay, upon presentment by the holder of the obligation (if required), the principal amount of the underlying collateral security plus accrued interest when due or upon default.

PART 239—FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

PART 274—FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940

4. The authority citation for Part 274 is revised to read in part as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78l, 78m, 78n, 78o(d), 80a-8, 80a-24, 80a-26, 80a-29, and Pub. L. No. 111-203, § 939A, 124 Stat. 1376 (2010), unless otherwise noted.

* * * * *

5. Form N-1A (referenced in §§ 239.15A and 274.11A) is amended by revising Item 27(d)(2) to read as follows:

Note: The text of Form N-1A does not, and these amendments will not, appear in the Code of Federal Regulations.

FORM N-1A

* * * * *

Item 27. Financial Statements

* * * * *

(d) Annual and Semi-Annual Reports. * * *

(2) Graphical Representation of Holdings. One or more tables, charts, or graphs depicting the portfolio holdings of the Fund by reasonably identifiable categories (*e.g.*, type of security, industry sector, geographic region, credit quality, or maturity) showing the percentage of net asset value or total investments attributable to each. The categories and the basis of presentation (*e.g.*, net asset value or total investments) should be selected, and the presentation should be formatted, in a manner reasonably designed to depict clearly the types of investments

made by the Fund, given its investment objectives. If the Fund depicts portfolio holdings according to credit quality, it should include a description of how the credit quality of the holdings were determined, and if credit ratings, as defined in section 3(a)(60) of the Securities Exchange Act [15 U.S.C. 78(c)(a)(60)], assigned by a credit rating agency, as defined in section 3(a)(61) of the Securities Exchange Act [15 U.S.C. 78(c)(a)(61)], are used, explain how they were identified and selected. This description should be included near, or as part of, the graphical representation.

* * * * *

6. Form N-2 (referenced in §§ 239.14 and 274.11a-1) is amended by revising Instruction 6.a. to Item 24 to read as follows:

Note: The text of Form N-2 does not, and these amendments will not, appear in the Code of Federal Regulations.

FORM N-2

* * * * *

Item 24. Financial Statements

* * * * *

Instructions:

* * * * *

6. * * *

a. one or more tables, charts, or graphs depicting the portfolio holdings of the Fund by reasonably identifiable categories (*e.g.*, type of security, industry sector, geographic region, credit quality, or maturity) showing the percentage of net asset value or total investments attributable to each. The categories and the basis of presentation (*e.g.*, net asset value or total investments) should be selected, and the presentation should be formatted, in a manner reasonably designed to depict clearly the types of investments made by the Fund, given its investment objectives. If the Fund depicts portfolio holdings according to credit quality, it should include a description of how the credit quality of the holdings were determined, and if credit ratings, as defined in section 3(a)(60) of the Securities Exchange Act [15 U.S.C. 78(c)(a)(60)], assigned by a credit rating agency, as defined in section 3(a)(61) of the Securities Exchange Act [15 U.S.C. 78(c)(a)(61)], are used, explain how they were identified and selected. This description should be included near, or as part of, the graphical representation.

*   *   *   *   *

7. Form N-3 (referenced in §§ 239.17a and 274.11b) is amended by revising Instruction 6.(i) to Item 28(a) to read as follows:

Note: The text of Form N-3 does not, and these amendments will not, appear in the Code of Federal Regulations.

FORM N-3

*   *   *   *   *

Item 28. Financial Statements

(a) *   *   *

Instructions:

*   *   *   *   *

6. *   *   *

(i) One or more tables, charts, or graphs depicting the portfolio holdings of the Fund by reasonably identifiable categories (*e.g.*, type of security, industry sector, geographic region, credit quality, or maturity) showing the percentage of net asset value or total investments attributable to each. The categories and the basis of presentation (*e.g.*, net asset value or total investments) should be selected, and the presentation should be formatted, in a manner reasonably designed to depict clearly the types of investments made by the Fund, given its investment objectives. If the Fund depicts portfolio holdings according to credit quality, it should include a description of how the credit quality of the holdings were determined, and if credit ratings, as defined in section 3(a)(60) of the Securities Exchange Act [15 U.S.C. 78(c)(a)(60)], assigned by a credit rating agency, as defined in section 3(a)(61) of the Securities Exchange Act [15 U.S.C. 78(c)(a)(61)], are used, explain how they were identified and selected. This description should be included near, or as part of, the graphical representation.

*　*　*　*　*

By the Commission

Lynn M. Powalski
Deputy Secretary

Dated: December 27, 2013

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9507 / December 30, 2013

SECURITIES EXCHANGE ACT OF 1934
Release No. 71204 / December 30, 2013

INVESTMENT ADVISERS ACT OF 1940
Release No. 3749 / December 30, 2013

INVESTMENT COMPANY ACT OF 1940
Release No. 30851 / December 30, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15255

In the Matter of JOHN THOMAS CAPITAL MANAGEMENT GROUP LLC d/b/a PATRIOT28 LLC, GEORGE R. JARKESY, JR., JOHN THOMAS FINANCIAL, INC., and ANASTASIOS "TOMMY" BELESIS	ORDER EXTENDING DEADLINE FOR FILING INITIAL DECISION

On October 31, 2013, respondents John Thomas Capital Management Group LLC d/b/a Patriot28 LLC and George R. Jarkesy, Jr. filed a petition with the Commission for interlocutory review of rulings made by an administrative law judge. We issued an interim stay on November 13, 2013 for the duration of our consideration of the petition. We denied the petition for interlocutory review on December 6, 2013.

The Order Instituting Proceedings was issued on March 22, 2013. It directs the law judge to issue an initial decision within 300 days of the date of service of the OIP. On our own motion, and pursuant to Rules 100(c), 161(a), and 360(a)(2), we extend the time period within which the law judge must issue the initial decision.[1] We find that it is appropriate and in interests of justice to extend the deadline because proceedings were stayed by our November 13 order.

[1] 17 C.F.R. §§ 201.100(c), 201.161(a), 360(a)(2); *Michael Sassano*, Exchange Act Release No. 56874, 2007 WL 4699012, at *4 (Nov. 30, 2007) (tolling the "300-day period for rendering an initial decision in this proceeding . . . for the period of the Commission's consideration" of a petition for interlocutory review).

Accordingly, IT IS ORDERED that the deadline for filing the initial decision in this proceeding is extended to April 17, 2014.

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. 71205 / December 30, 2013

ACCOUNTING AND AUDITING ENFORCEMENT ACT
Release No. 3524 / December 30, 2013

Admin. Proc. File No. 3-15168

In the Matter of JOHN J. AESOPH, CPA, and DARREN M. BENNETT, CPA	ORDER GRANTING EXTENSION

Chief Administrative Law Judge Brenda P. Murray has moved, pursuant to Commission Rule of Practice 360(a)(3),[1] for a six-month extension to issue the initial decision in this proceeding. For the reasons set forth below, we grant her motion.

On January 9, 2013, we issued an Order Instituting Administrative Proceedings ("OIP") against John J. Aesoph, CPA and Darren M. Bennett, CPA, auditors at KPMG, LLP.[2] The OIP alleges that Aesoph and Bennett repeatedly engaged in improper professional conduct, as defined in Section 4C of the Securities Exchange Act of 1934 and Rule 102(e)(1)(ii) of the Commission Rules of Practice,[3] during their year-end 2008 audit of TierOne Corporation, a holding company for TierOne Bank (collectively, "TierOne"), by failing to subject TierOne's loan loss estimates to appropriate scrutiny.

The OIP directs the presiding law judge to issue an initial decision within 300 days of the date of service of the OIP. On November 26, 2013, Chief Judge Murray filed a motion stating that the initial decision is due on January 1, 2014, and requesting an extension pursuant to Commission Rule of Practice 360(a)(3).

We adopted Rules of Practice 360(a)(2) and 360(a)(3) to enhance the timely and efficient adjudication and disposition of Commission administrative proceedings by setting deadlines for

1 17 C.F.R. § 201.360(a)(3).

2 *John J. Aesoph, CPA*, Exchange Act Release No. 68605, 2013 WL 98717 (Jan. 9, 2013).

3 15 U.S.C. § 78d-3 and 17 C.F.R. § 201.102(e)(1)(ii).

issuance of an initial decision.[4] The rules further provide for deadline extensions under certain circumstances, if supported by a motion from the Chief Administrative Law Judge and we determine that "additional time is necessary or appropriate in the public interest."[5]

In her motion, Chief Judge Murray states that it will not be possible for the presiding law judge to issue an initial decision by the due date. She notes that the hearing in this proceeding, which took place between October 7 and 11, 2013, and October 28 and 31, 2013, had been "postponed for over three months" because (i) the parties and the judge agreed to a delay because Bennett's long-time counsel was recovering "from a sudden medical condition;" and (ii) "uncertainty of a government shutdown in early October 2013." She also notes that the "nine-day hearing produced a record of over 2,300 pages of transcript and over 150 exhibits," and the post-hearing reply briefs are not due until December 19, 2013. Moreover, the presiding law judge is responsible for initial decisions in two proceedings with hearings that concluded in May and September 2013, one of which produced an extensive record. Under the circumstances, it is appropriate in the public interest to grant the Chief Administrative Law Judge's request and to extend the deadline for issuance of a decision in this matter.

Accordingly, IT IS ORDERED that the deadline for filing the initial decision in this proceeding is extended to July 1, 2014.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

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4 *See Adopting Release*, Exchange Act Release No. 48018, 2003 WL 21354791, at *2 (June 11, 2003).

5 17 C.F.R. § 201.360(a)(3).

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 71207 / December 30, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15664

In the Matter of **Peter B. Madoff, Esq.,** **Respondent.**	**ORDER OF FORTHWITH SUSPENSION PURSUANT TO RULE 102(e)(2) OF THE COMMISSION'S RULES OF PRACTICE**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate to issue an order of forthwith suspension of Peter B. Madoff pursuant to Rule 102(e)(2) of the Commission's Rules of Practice [17 C.F.R. § 200.102(e)(2)].[1]

II.

The Commission finds that:

1. Peter B. Madoff, 64, is an attorney admitted to the practice of law in the state of New York. Madoff served as the Chief Compliance Officer and Senior Managing Director at Bernard L. Madoff Investment Securities LLC (BMIS) from 1969 to December 2008. Madoff purported to create false policies and procedures for BMIS' investment advisory operations and its compliance program, but in fact no such policies and procedures ever existed. Additionally, Madoff created false and misleading compliance documents, filed false reports with the SEC that misstated the nature and scope of BMIS' investment advisory business, and made false statements to investors about BMIS' compliance program.

2. On June 29, 2012, Madoff pleaded guilty in the United States District Court for the Southern District of New York to the following felonies: (1) conspiracy to

[1] Rule 102(e)(2) provides in pertinent part that "[a]ny attorney who has been suspended or disbarred by a court of the United States or any State... or 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."

(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. *See United States v. Peter Madoff*, 10 Cr. 228 (S.D.N.Y.) (LTS).

3. On December 20, 2012, the United States District Court for the Southern District of New York imposed a ten-year prison sentence against Madoff and ordered him to forfeit approximately $143 million in personal assets.

III.

In view of the foregoing, the Commission finds that Madoff has been convicted of felonies within the meaning of Rule 102(e)(2) of the Commission's Rules of Practice.

Accordingly, it is HEREBY ORDERED that Peter B. Madoff, Esq. is forthwith suspended from appearing or practicing before the Commission pursuant to Rule 102(e)(2) of the Commission's Rules of Practice.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

SECURITIES AND EXCHANGE COMMISSION
Release No. 34-71219

December 31, 2013

Order Granting Temporary Exemption of Morningstar Credit Ratings, LLC from the Conflict of Interest Prohibition in Rule 17g-5(c)(1) of the Securities Exchange Act of 1934

I. Introduction

Rule 17g-5(c)(1) of the Securities Exchange Act of 1934 ("Exchange Act") prohibits a nationally recognized statistical rating organization ("NRSRO") from issuing or maintaining a credit rating solicited by a person that, in the most recently ended fiscal year, provided the NRSRO with net revenue equaling or exceeding 10% of the total net revenue of the NRSRO for the fiscal year. In adopting this rule, the Commission stated that such a person would be in a position to exercise substantial influence on the NRSRO, which in turn would make it difficult for the NRSRO to remain impartial.[1]

II. Application and Exemption Request of Morningstar Credit Ratings, LLC

Morningstar Credit Ratings, LLC ("Morningstar"), formerly known as Realpoint, LLC ("Realpoint"), is a credit rating agency registered with the Commission as an NRSRO under Section 15E of the Exchange Act for the class of asset-backed securities ratings, described in clause (iv) of Section 3(a)(62)(A) of the Exchange Act. On June 23, 2008, the Commission granted Realpoint a temporary exemption from Rule 17g-5(c)(1) in connection with its initial registration as an NRSRO ("Realpoint Exemptive Order"). Morningstar has traditionally operated mainly under the "subscriber-paid" business model, in which the NRSRO derives its revenue from restricting access to its ratings to paid subscribers. After Morningstar acquired Realpoint in the spring of 2010, Morningstar began to expand the scope of its business and initiated an issuer-paid ratings service for initial ratings on commercial mortgage-backed

[1] Release No. 34-55857 (June 5, 2007), 72 FR 33564, 33598 (June 18, 2007).

securities ("CMBS"). In connection with this expansion, the Commission granted Morningstar an exemption from Rule 17g-5(c)(1) on March 5, 2012,[2] ("Morningstar Exemptive Order" and, together with the Realpoint Exemptive Order, the "Previous Exemptive Orders") which covered the 2011 and 2012 fiscal years, and was effective until January 1, 2013.

Morningstar states that the exemption will enable it to continue to diversify its revenue into other markets and products. Morningstar further states that a high concentration of issuers/arrangers in the CMBS market coupled with the comparatively higher fees paid for an initial rating than those of a single subscriber increases the chances that when a smaller NRSRO, such as Morningstar, enters into the initial ratings business it will potentially violate Rule 17g-5(c)(1). Accordingly, Morningstar has requested that the Commission grant it an extension of the temporary exemption from Rule 17g-5(c)(1) until January 1, 2015.

III. Discussion

The Commission, when adopting Rule 17g-5(c)(1), noted that it intended to monitor how the prohibition operates in practice, particularly with respect to asset-backed securities, and whether exemptions may be appropriate.[3] The Commission noted in the Previous Exemptive Orders that an exemption would further the primary purpose of the Credit Rating Agency Reform Act of 2006 ("Rating Agency Act") to "improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency and competition in the credit rating industry."[4] The Commission cited these same factors in granting exemptions to LACE Financial Corp[5] and Kroll Bond Rating Agency, Inc.[6]

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2 Release No. 34-66514 (March 5, 2012), 77 FR 14580-14581 (March 12, 2012).

3 Release No. 34-55857 (June 5, 2007), 72 FR 33564, 33598 (June 18, 2007).

4 See Report of the Senate Committee on Banking, Housing, and Urban Affairs to Accompany S. 3850, Credit Rating Agency Reform Act of 2006, S. Report No. 109-326, 109th Cong., 2d Sess. (Sept. 6, 2006).

5 Securities Exchange Act Release No. 34-57301 (Feb. 11, 2008), 73 FR 8720 (Feb. 14, 2008).

6 Securities Exchange Act Release No. 65339 (Sep. 14, 2011), 76 FR 58319 (Sep. 20, 2011).

Morningstar has informed Commission staff that in the current fiscal year, Morningstar may receive more than 10% of its total net revenue from one or more clients that paid it to rate asset-backed securities. In the request that is subject to this order, Morningstar stated that it expects to have more diverse revenue sources over time and that a temporary exemption from Rule 17g-5(c)(1) would enable it to grow its NRSRO business further so that eventually it will not need an exemption.

The Commission believes that a temporary, limited, and conditional exemption allowing Morningstar to continue to diversify its business beyond CMBS ratings is consistent with the Commission's goal, as established by the Rating Agency Act, of improving ratings quality by fostering accountability, transparency, and competition in the credit rating industry, and is necessary and appropriate in the public interest and consistent with the protection of investors. In order to maintain this exemption, Morningstar will be required to comply with the following conditions: (1) Morningstar shall review, update, maintain, and comply with policies, procedures, and internal controls specifically designed to address the conflict of interest created by exceeding the 10% threshold, including that Morningstar's Designated Compliance Officer ("DCO") shall review a sample of rating files from fiscal years 2013, 2014 and 2015 for ratings solicited by the applicable client or clients that provided Morningstar with 10% or more of its total net revenue, shall take other steps acceptable to the examination staff to verify that ratings of any such clients were not influenced by commercial concerns and that Morningstar adhered to its policies, procedures, and internal controls concerning the conflict created by exceeding the 10% threshold, and shall report quarterly about these efforts to Morningstar's President and Nominating and Corporate Governance Committee; (2) Morningstar's President shall file with the Commission, on a quarterly basis, a certification that ratings on deals for any client or clients that provided Morningstar with 10% or more of its total net revenue sufficiently adhered to policies, procedures, and internal controls to address the conflict of interest created by exceeding the 10% threshold and that the DCO took appropriate efforts to confirm this adherence; (3) Morningstar shall appropriately address, as applicable, the Commission staff's 2013 and 2014 annual Section 15E(p) examination findings and recommendations; (4) net revenue from a single client may not exceed 20% of Morningstar's total net revenue for either the fiscal year ending December 31, 2013 or the fiscal year ending December 31, 2014; and (5) Morningstar shall publicly disclose in Exhibit 6 to Form NRSRO, as applicable, that the firm received 10% or more of its total net revenue in fiscal year 2013 or 2014 from a client or clients.

Section 15E(p) of the Exchange Act, as added by Section 932(a)(8) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, requires Commission staff to conduct an examination of each NRSRO at least annually. As an integrated part of the applicable annual examinations, OCR staff will examine Morningstar's satisfaction of the conditions to this order set forth in Section IV below. If the conditions are not being fulfilled to the staff's satisfaction, the staff will consider whether to recommend that the Commission take additional action, administrative or otherwise.

The Commission therefore finds that a temporary, limited, and conditional exemption allowing Morningstar to continue to diversify its business beyond CMBS ratings is consistent with the Commission's goal, as established by the Rating Agency Act, of improving ratings quality by fostering accountability, transparency, and competition in the credit rating industry and is necessary and appropriate in the public interest and consistent with the protection of investors, subject to Morningstar's satisfaction of the conditions set forth below.

IV. Conclusion

Accordingly, pursuant to Section 36 of the Exchange Act,

IT IS HEREBY ORDERED that Morningstar Credit Ratings, LLC, formerly known as Realpoint, LLC, is exempt from the conflict of interest prohibition in Exchange Act Rule 17g-5(c)(1) until January 1, 2015, with respect to any revenue derived from issuer-paid ratings, provided that: (1) Morningstar shall review, update, maintain, and comply with policies, procedures, and internal controls specifically designed to address the conflict of interest created by exceeding the 10% threshold, including that Morningstar's Designated Compliance Officer shall review a sample of rating files from fiscal years 2013, 2014 and 2015 for ratings solicited by the applicable client or clients that provided Morningstar with 10% or more of its total net revenue, shall take other steps acceptable to the examination staff to verify that ratings of any such clients were not influenced by commercial concerns and that Morningstar adhered to its policies, procedures, and internal controls concerning the conflict created by exceeding the 10% threshold, and shall report quarterly about these efforts to Morningstar's President and Nominating and Corporate Governance Committee; (2) Morningstar's President shall file with the Commission, on a quarterly basis, a certification that ratings on deals for any client or clients that provided Morningstar with 10% or more of its total net revenue sufficiently adhered to policies, procedures, and internal controls to address the conflict created by exceeding the 10% threshold and that the Designated Compliance Officer took appropriate efforts to confirm this adherence; (3) Morningstar shall appropriately address, as applicable, the Commission staff's 2013 and 2014 annual Section 15E(p) examination findings and recommendations; (4) net revenue from a single client shall not exceed 20% of Morningstar's total net revenue for either the fiscal year ending December 31, 2013 or the fiscal year ending December 31, 2014; and (5)

Morningstar shall publicly disclose in Exhibit 6 to Form NRSRO, if applicable, that it received 10% or more of its total net revenue in fiscal year 2013 or 2014 from one or more issuers/arrangers.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary

SECURITIES AND EXCHANGE COMMISSION
Release No. 34-71220

December 31, 2013

Order Granting Temporary Exemption of Kroll Bond Rating Agency, Inc. from the Conflict of Interest Prohibition in Rule 17g-5(c)(1) of the Securities Exchange Act of 1934

I. Introduction

Rule 17g-5(c)(1) of the Securities Exchange Act of 1934 ("Exchange Act") prohibits a nationally recognized statistical rating organization ("NRSRO") from issuing or maintaining a credit rating solicited by a person that, in the most recently ended fiscal year, provided the NRSRO with net revenue equaling or exceeding 10% of the total net revenue of the NRSRO for the fiscal year. In adopting this rule, the Commission stated that such a person would be in a position to exercise substantial influence on the NRSRO, which in turn would make it difficult for the NRSRO to remain impartial.[1]

II. Application and Exemption Request of Kroll Bond Rating Agency, Inc.

Kroll Bond Rating Agency, Inc. ("Kroll"), formerly known as LACE Financial Corp. ("LACE"), is a credit rating agency registered with the Commission as an NRSRO under Section 15E of the Exchange Act for the classes of credit ratings described in clauses (i) through (v) of Section 3(a)(62)(A) of the Exchange Act. The Commission has previously granted Kroll a temporary exemption from Rule 17g-5(c)(1), until January 1, 2013, in connection with its entering the market for rating structured finance products ("Kroll Order").[2] The Commission had also previously granted a temporary exemption from Rule 17g-5(c)(1) to LACE in

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1 Exchange Act Release No. 34-55857 (June 5, 2007), 72 FR 33564, 33598 (June 18, 2007).
2 Exchange Act Release No. 34-65339 (Sept. 14, 2011), 76 FR 58319, 58321 (Sept. 20, 2011).

connection with its initial registration as an NRSRO[3] ("LACE Order," and collectively with the Kroll Order, "Previous Exemptive Orders").

Kroll has informed the Commission that it intends to further expand its existing NRSRO business into other sectors of the capital markets. In connection with this planned expansion, Kroll has requested an extension of its temporary and limited exemption from Rule 17g-5(c)(1) on the grounds that the restrictions imposed by Rule 17g-5(c)(1) would pose a substantial constraint on the firm's ability to grow its business further and thereby foster competition in the credit rating industry. Specifically, Kroll states that the number of commercial mortgage-backed securities ("CMBS") issuers in the market is limited, and that business development in other areas has been affected by market conditions and barriers to entry. Accordingly, Kroll has requested that the Commission grant it an extension of its exemption from Rule 17g-5(c)(1) until January 1, 2015.

III. Discussion

The Commission, when adopting Rule 17g-5(c)(1), noted that it intended to monitor how the prohibition operates in practice, particularly with respect to asset-backed securities, and whether exemptions may be appropriate.[4] The Commission noted several factors in granting the Previous Exemptive Orders, including that the exemptions would further the primary purpose of the Credit Rating Agency Reform Act of 2006 ("Rating Agency Act") to "improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating industry."[5] Citing the same factors, the Commission has issued similar orders granting temporary exemptions from the requirements of

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3 Exchange Act Release No. 34-57301 (Feb. 11, 2008), 73 FR 8720 (Feb. 14, 2008).

4 Exchange Act Release No. 34-55857 (June 5, 2007), 72 FR 33564, 33598 (June 18, 2007).

5 Report of the Senate Committee on Banking, Housing, and Urban Affairs to Accompany S. 3850, Credit Rating Agency Reform Act of 2006, S. Report No. 109-326, 109th Cong., 2d Sess. (Sept. 6, 2006).

Rule 17g-5(c)(1) to Realpoint LLC, in connection with its registration as an NRSRO,[6] and to Morningstar Credit Ratings, LLC, the successor to Realpoint LLC.[7]

Kroll has informed Commission staff that in the current fiscal year, Kroll may receive more than 10% of its total net revenue from one or more clients that paid it to rate asset-backed securities. In the request that is subject to this Order, Kroll states that it expects to have more diverse revenue sources over time and that a temporary exemption from Rule 17g-5(c)(1) would enable it to further grow its NRSRO business so that eventually it will not need an exemption.

The Commission believes that a temporary, limited, and conditional exemption allowing Kroll to continue to diversify its business beyond CMBS ratings is consistent with the Commission's goal, as established by the Rating Agency Act, of improving ratings quality by fostering accountability, transparency, and competition in the credit rating industry and is necessary and appropriate in the public interest and is consistent with the protection of investors. In order to maintain this exemption, Kroll will be required to comply with the following conditions: (1) Kroll shall review, update, maintain, and comply with policies, procedures, and internal controls specifically designed to address the conflict of interest created by exceeding the 10% threshold, including that Kroll's Designated Compliance Officer ("DCO") shall review a sample of rating files from fiscal years 2013, 2014, and 2015 for ratings solicited by the applicable client or clients that provided Kroll with 10% or more of its total net revenue, shall take other steps acceptable to the examination staff to verify that ratings of any such clients were not influenced by commercial concerns and that Kroll adhered to its policies, procedures, and internal controls concerning the conflict created by exceeding the 10% threshold, and shall report quarterly about these efforts to Kroll's CEO and board of directors; (2) Kroll's CEO shall file

6 Exchange Act Release No. 34-58001 (June 23, 2008), 73 FR 36362 (June 26, 2008).

7 Exchange Act Release No. 34-66514 (March 5, 2012), 77 FR 14580 (Mar. 12, 2012).

with the Commission, on a quarterly basis, a certification that ratings on deals for any client or clients that provided Kroll with 10% or more of its total net revenue sufficiently adhered to policies, procedures, and internal controls to address the conflict of interest created by exceeding the 10% threshold and that the DCO took appropriate efforts to confirm this adherence; (3) Kroll shall appropriately address, as applicable, the Commission staff's 2013 and 2014 annual Section 15E(p) examination findings and recommendations; (4) net revenue from a single client may not exceed 25% of Kroll's total net revenue for either the fiscal year ending December 31, 2013 or the fiscal year ending December 31, 2014; and (5) Kroll shall publicly disclose in Exhibit 6 to Form NRSRO, as applicable, that the firm received 10% or more of its total net revenue in fiscal year 2013 or 2014 from a client or clients.

Section 15E(p) of the Exchange Act, as added by Section 932(a)(8) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, requires Commission staff to conduct an examination of each NRSRO at least annually. As an integrated part of the applicable annual examinations, Commission staff will examine Kroll's satisfaction of the conditions to this Order set forth in Section IV below. If the conditions are not being fulfilled to the staff's satisfaction, the staff will consider whether to recommend that the Commission take additional action, administrative or otherwise.

The Commission therefore finds that a temporary, limited, and conditional exemption allowing Kroll to continue to diversify its business beyond CMBS ratings is consistent with the Commission's goal, as established by the Rating Agency Act, of improving ratings quality by fostering accountability, transparency, and competition in the credit rating industry, subject to the conditions set forth below, and is necessary and appropriate in the public interest and is consistent with the protection of investors.

IV. Conclusion

Accordingly, pursuant to Section 36 of the Exchange Act,

IT IS HEREBY ORDERED that Kroll Bond Rating Agency, Inc., formerly known as LACE Financial Corp., is exempt from the conflict of interest prohibition in Exchange Act Rule 17g-5(c)(1) until January 1, 2015, with respect to any revenue derived from issuer-paid ratings, provided that: (1) Kroll shall review, update, maintain, and comply with policies, procedures, and internal controls specifically designed to address the conflict of interest created by exceeding the 10% threshold, including that Kroll's Designated Compliance Officer shall review a sample of rating files from fiscal years 2013, 2014, and 2015 for ratings solicited by the applicable client or clients that provided Kroll with 10% or more of its total net revenue, shall take other steps acceptable to the examination staff to verify that ratings of any such clients were not influenced by commercial concerns and that Kroll adhered to its policies, procedures, and internal controls concerning the conflict created by exceeding the 10% threshold, and shall report quarterly about these efforts to Kroll's CEO and board of directors; (2) Kroll's CEO shall file with the Commission, on a quarterly basis, a certification that ratings on deals for any client or clients that provided Kroll with 10% or more of its total net revenue sufficiently adhered to policies, procedures, and internal controls to address the conflict of interest created by exceeding the 10% threshold and that the Designated Compliance Officer took appropriate efforts to confirm this adherence; (3) Kroll shall appropriately address, as applicable, the Commission staff's 2013 and 2014 annual Section 15E(p) examination findings and recommendations; (4) net revenue from a single client shall not exceed 25% of Kroll's total net revenue for either the fiscal year ending December 31, 2013 or the fiscal year ending December 31, 2014; and (5) Kroll shall publicly disclose in Exhibit 6 to Form NRSRO, as applicable, that the firm received 10% or more of its total net revenue in fiscal year 2013 or 2014 from a client or clients.

By the Commission.

Elizabeth M. Murphy

Elizabeth M. Murphy
Secretary