SECURITIES AND EXCHANGE COMMISSION

This file is maintained pursuant to the Freedom of Information Act (5 U.S.C. 552). It contains a copy of each decision, order, rule or similar action of the Commission, for December 2006, with respect to which the final votes of individual Members of the Commission are required to be made available for public inspection pursuant to the provisions of that Act.

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

CHRISTOPHER COX, CHAIRMAN

CYNTHIA A. GLASSMAN, COMMISSIONER

PAUL S. ATKINS, COMMISSIONER

ROEL C. CAMPOS, COMMISSIONER

ANNETTE NAZARETH, COMMISSIONER

2 Documents

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
December 1, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12492

In the Matter of **Exprofuels, Inc.,** **Oilex, Inc.,** **Windsor Acquisition Corp., and** **Zeros USA, Inc.,** **Respondents.**	**ORDER INSTITUTING 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").

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Exprofuels, Inc. (CIK No. 1034651) is a void Delaware corporation located in San Antonio, Texas with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Exprofuels is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended May 31, 1998, which reported net losses of $684,389.

2. Oilex, Inc. (CIK No. 1020333) is a revoked Nevada corporation located in Houston, Texas with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Oilex is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 1997, which reported a net loss of $1.3 million for the prior three quarters. As of November 29, 2006, the company's common stock (symbol "OLEX") was traded on the over-the-counter markets.

Document 1 of 2

3. Windsor Acquisition Corp. (CIK No. 1096115) is a void Delaware corporation located in Richardson, Texas with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Windsor is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-SB registration statement on October 1, 1999, which reported $500 in assets and no revenue.

4. Zeros USA, Inc. (CIK No. 1042907) is a Texas corporation located in Houston, Texas with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Zeros is delinquent in its periodic filings with the Commission, having not filed a periodic report since it filed a Form 10-QSB for the period ended June 30, 1998.

B. DELINQUENT PERIODIC FILINGS

5. As discussed in more detail above, all of the respondents are delinquent in their periodic filings with the Commission (*see* Chart of Delinquent Filings, attached hereto as Appendix 1), 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 (Forms 10-K or 10-KSB), and Rule 13a-13 requires issuers to file quarterly reports (Forms 10-Q or 10-QSB).

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

III.

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

A. Whether the allegations contained in Section II 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 of the Respondents identified in Section II registered pursuant to Section 12 of the Exchange Act.

IV.

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

IT IS HEREBY FURTHER ORDERED that 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 a Respondent fails to file the directed Answer, or fails to appear at a hearing after being duly notified, the Respondent may be deemed in default and the proceedings may be determined against 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 or Express Mail, or by other means permitted by the Commission's Rules of Practice.

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

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

By the Commission.

Nancy M. Morris
Secretary

Attachment

By: Jill M. Peterson
Assistant Secretary

Appendix 1

Chart of Delinquent Filings
Exprofuels, Inc., et al.

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Exprofuels, Inc.					
	10-KSB	08/31/98	11/30/98	Not filed	96
	10-QSB	11/30/98	01/14/99	Not filed	94
	10-QSB	02/28/99	04/14/99	Not filed	91
	10-QSB	05/31/99	07/15/99	Not filed	88
	10-KSB	08/31/99	11/29/99	Not filed	84
	10-QSB	11/30/99	01/14/00	Not filed	82
	10-QSB	02/29/00	04/14/00	Not filed	79
	10-QSB	05/31/00	07/17/00	Not filed	76
	10-KSB	08/31/00	11/29/00	Not filed	72
	10-QSB	11/30/00	01/16/01	Not filed	70
	10-QSB	02/28/01	04/16/01	Not filed	67
	10-QSB	05/31/01	07/16/01	Not filed	64
	10-KSB	08/31/01	11/29/01	Not filed	60
	10-QSB	11/30/01	01/14/02	Not filed	58
	10-QSB	02/28/02	04/15/02	Not filed	55
	10-QSB	05/31/02	07/15/02	Not filed	52
	10-KSB	08/31/02	11/29/02	Not filed	48
	10-QSB	11/30/02	01/14/03	Not filed	46
	10-QSB	02/28/03	04/14/03	Not filed	43
	10-QSB	05/31/03	07/15/03	Not filed	40
	10-KSB	08/31/03	12/01/03	Not filed	35
	10-QSB	11/30/03	01/14/04	Not filed	34
	10-QSB	02/28/04	04/13/04	Not filed	31
	10-QSB	05/31/04	07/15/04	Not filed	28
	10-KSB	08/31/04	11/29/04	Not filed	24
	10-QSB	11/30/04	01/14/05	Not filed	22
	10-QSB	02/28/05	04/14/05	Not filed	19
	10-QSB	05/31/05	07/15/05	Not filed	16
	10-KSB	08/31/05	11/29/05	Not filed	12
	10-QSB	11/30/05	01/16/06	Not filed	10
	10-QSB	02/28/06	04/14/06	Not filed	7

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Exprofuels, Inc.					
	10-QSB	05/31/06	07/17/06	Not filed	4
	10-KSB	08/31/06	11/29/06	Not filed	0
Total Filings Delinquent	33				
Oilex, Inc.					
	10-KSB	12/31/97	03/31/98	Not filed	104
	10-QSB	03/31/98	05/15/98	Not filed	102
	10-QSB	06/30/98	08/14/98	Not filed	99
	10-QSB	09/30/98	11/16/98	Not filed	96
	10-KSB	12/31/98	03/31/99	Not filed	92
	10-QSB	03/31/99	05/17/99	Not filed	90
	10-QSB	06/30/99	08/16/99	Not filed	87
	10-QSB	09/30/99	11/15/99	Not filed	84
	10-KSB	12/31/99	03/30/00	Not filed	80
	10-QSB	03/31/00	05/15/00	Not filed	78
	10-QSB	06/30/00	08/14/00	Not filed	75
	10-QSB	09/30/00	11/14/00	Not filed	72
	10-KSB	12/31/00	04/02/01	Not filed	67
	10-QSB	03/31/01	05/15/01	Not filed	66
	10-QSB	06/30/01	08/14/01	Not filed	63
	10-QSB	09/30/01	11/14/01	Not filed	60
	10-KSB	12/31/01	04/01/02	Not filed	55
	10-QSB	03/31/02	05/15/02	Not filed	54
	10-QSB	06/30/02	08/14/02	Not filed	51
	10-QSB	09/30/02	11/14/02	Not filed	48
	10-KSB	12/31/02	03/31/03	Not filed	44
	10-QSB	03/31/03	05/15/03	Not filed	42
	10-QSB	06/30/03	08/14/03	Not filed	39
	10-QSB	09/30/03	11/14/03	Not filed	36
	10-KSB	12/31/03	03/30/04	Not filed	32
	10-QSB	03/31/04	05/17/04	Not filed	30
	10-QSB	06/30/04	08/16/04	Not filed	27
	10-QSB	09/30/04	11/15/04	Not filed	24
	10-KSB	12/31/04	03/31/05	Not filed	20
	10-QSB	03/31/05	05/16/05	Not filed	18
	10-QSB	06/30/05	08/15/05	Not filed	15

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Oilex, Inc.					
	10-QSB	09/30/05	11/14/05	Not filed	12
	10-KSB	12/31/05	03/31/06	Not filed	8
	10-QSB	03/31/06	05/15/06	Not filed	6
	10-QSB	06/30/06	08/14/06	Not filed	3
	10-QSB	09/30/06	11/14/06	Not filed	0
Total Filings Delinquent	36				
Windsor Acquisition Corp.					
	10-QSB	09/30/99	11/15/99	Not filed	84
	10-KSB	12/31/99	03/30/00	Not filed	80
	10-QSB	03/31/00	05/15/00	Not filed	78
	10-QSB	06/30/00	08/14/00	Not filed	75
	10-QSB	09/30/00	11/14/00	Not filed	72
	10-KSB	12/31/00	04/02/01	Not filed	67
	10-QSB	03/31/01	05/15/01	Not filed	66
	10-QSB	06/30/01	08/14/01	Not filed	63
	10-QSB	09/30/01	11/14/01	Not filed	60
	10-KSB	12/31/01	04/01/02	Not filed	55
	10-QSB	03/31/02	05/15/02	Not filed	54
	10-QSB	06/30/02	08/14/02	Not filed	51
	10-QSB	09/30/02	11/14/02	Not filed	48
	10-KSB	12/31/02	03/31/03	Not filed	44
	10-QSB	03/31/03	05/15/03	Not filed	42
	10-QSB	06/30/03	08/14/03	Not filed	39
	10-QSB	09/30/03	11/14/03	Not filed	36
	10-KSB	12/31/03	03/30/04	Not filed	32
	10-QSB	03/31/04	05/17/04	Not filed	30
	10-QSB	06/30/04	08/16/04	Not filed	27
	10-QSB	09/30/04	11/15/04	Not filed	24
	10-KSB	12/31/04	03/31/05	Not filed	20
	10-QSB	03/31/05	05/16/05	Not filed	18
	10-QSB	06/30/05	08/15/05	Not filed	15
	10-QSB	09/30/05	11/14/05	Not filed	12
	10-KSB	12/31/05	03/31/06	Not filed	8

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Windsor Acquisition Corp.					
	10-QSB	03/31/06	05/15/06	Not filed	6
	10-QSB	06/30/06	08/14/06	Not filed	3
	10-QSB	09/30/06	11/14/06	Not filed	0
Total Filings Delinquent	29				
Zeros USA, Inc.					
	10-QSB	06/30/02	08/14/02	Not filed	51
	10-QSB	09/30/02	11/14/02	Not filed	48
	10-QSB	12/31/02	02/14/03	Not filed	45
	10-KSB	03/31/03	06/30/03	Not filed	41
	10-QSB	06/30/03	08/14/03	Not filed	39
	10-QSB	09/30/03	11/14/03	Not filed	36
	10-QSB	12/31/03	02/17/04	Not filed	33
	10-KSB	03/31/04	06/29/04	Not filed	29
	10-QSB	06/30/04	08/16/04	Not filed	27
	10-QSB	09/30/04	11/15/04	Not filed	24
	10-QSB	12/31/04	02/14/05	Not filed	21
	10-KSB	03/31/05	06/29/05	Not filed	17
	10-QSB	06/30/05	08/15/05	Not filed	15
	10-QSB	09/30/05	11/14/05	Not filed	12
	10-QSB	12/31/05	02/14/06	Not filed	9
	10-QSB	03/31/06	05/15/06	Not filed	6
	10-QSB	06/30/06	08/14/06	Not filed	3
	10-QSB	09/30/06	11/14/06	Not filed	0
Total Filings Delinquent	15				

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
December 13, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12504

In the Matter of **Energy Vision International, Inc. (f/k/a DeMarco Energy Systems of America, Inc.)** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

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

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENT

Energy Vision International, Inc. (f/k/a DeMarco Energy Systems of America, Inc.) ("EGVI") (CIK No. 1093993) is a Utah corporation located in Oxford, Mississippi with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). The company 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, 2003, which reported a net loss of $365,948 for the prior three months. For fiscal year 2003, EGVI's auditors expressed uncertainty as to whether the company could continue as a going concern in light of its recurring losses and working capital deficiency. As of August 21, 2006, the company's common stock was quoted on the Pink Sheets, had thirteen market makers, and was eligible for the piggyback exemption of Exchange Act Rule 15c2-11(f)(3). EGVI's common stock had an average daily trading volume of 174,785 shares during the six months ended December 5, 2006.

Document 2 of 2

B. DELINQUENT PERIODIC FILINGS

1. The Respondent is delinquent in its periodic filings with the Commission (*see* Chart of Delinquent Filings, attached hereto as Appendix 1), was quoted on the Pink Sheets as of August 21, 2006, had an average daily trading volume of 174,785 shares during the six months ended December 5, 2006, and has repeatedly failed to meet its obligations to file timely periodic reports.

2. The Respondent failed to cure its delinquency after being sent a delinquency letter by the Division of Corporation Finance requesting compliance with its periodic filing obligations.

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

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

III.

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

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

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months or to revoke the registration of each class of securities of the Respondent identified in Section II pursuant to Section 12(j) of the Exchange Act.

IV.

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

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

If the Respondent fails to file the directed Answer, or fails to appear at a hearing after being duly notified, the Respondent may be deemed in default and the proceedings may be

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

This Order shall be served forthwith upon the Respondent personally, by certified or express mail, or by any other means permitted by the Commission's Rules of Practice.

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

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

By the Commission.

Nancy M. Morris
Secretary

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

Attachment

Appendix 1

Chart of Delinquent Filings
In the Matter of Energy Vision International, Inc.

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Energy Vision International, Inc.					
	10-QSB	12/31/03	2/17/04	Not filed	34
	10-QSB	03/31/04	5/17/04	Not filed	31
	10-KSB	06/30/04	9/28/04	Not filed	27
	10-QSB	09/30/04	11/15/04	Not filed	25
	10-QSB	12/31/04	2/14/05	Not filed	22
	10-QSB	03/31/05	5/16/05	Not filed	19
	10-KSB	06/30/05	9/28/05	Not filed	15
	10-QSB	09/30/05	11/15/05	Not filed	13
	10-QSB	12/31/05	2/14/06	Not filed	10
	10-QSB	03/31/06	5/15/06	Not filed	7
	10-KSB	06/30/06	9/28/06	Not filed	3
	10-QSB	09/30/06	11/14/06	Not filed	1
Total Filings Delinquent	12				

SECURITIES AND EXCHANGE COMMISSION

This file is maintained pursuant to the Freedom of Information Act (5 U.S.C. 552). It contains a copy of each decision, order, rule or similar action of the Commission, for December 2006, with respect to which the final votes of individual Members of the Commission are required to be made available for public inspection pursuant to the provisions of that Act.

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

CHRISTOPHER COX, CHAIRMAN

PAUL S. ATKINS, COMMISSIONER

ROEL C. CAMPOS, COMMISSIONER

ANNETTE NAZARETH, COMMISSIONER

KATHLEEN L. CASEY, COMMISSIONER

58 Documents

Administrative Proceeding
File No. 3-12250

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION
October 16, 2006

In the Matter of GLOBAL CROWN CAPITAL, LLC, J&C GLOBAL SECURITIES INVESTMENTS, LLC, RANI T. JARKAS, and ANTOINE K. CHAYA, Respondents	ORDER STAYING PROCEEDINGS

On March 30, 2006, we instituted administrative proceedings against Global Crown Capital, LLC, J&C Global Securities Investments, LLC, Rani T. Jarkas, and Antoine K. Chaya (collectively, "Respondents"). On October 10, 2006, the Division of Enforcement requested that these proceedings be dismissed and that, pending consideration of the Division's request, they be stayed. The Division states that the motion "is made in light of the potential impact of the recent decision by the District of Columbia Circuit in Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006), on the validity of claims against these Respondents under Sections 206(1) and 206(2) of the [Investment] Advisers Act [of 1940]." 1/

The Division supports its request for a stay by noting that the law judge has scheduled the hearing in this case to begin on October 24, 2006, and has required the parties to file all prehearing submissions by October 17, 2006. According to the Division, "[a]n immediate stay is in the interest of justice and is necessary to preserve the resources of the parties while allowing the Commission adequate time to consider its ruling on the motion to dismiss." The Division further states that the Respondents have no objection to the Division's motion.

1/ The Division notes that the court, in Goldstein, "vacat[ed] and remand[ed] to the Commission the rule adopted in Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (Dec. 10, 2004), requiring that certain hedge fund advisers register under the Advisers Act."

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We have determined that, under the circumstances, it is appropriate to grant the Division's request for a stay. In granting this stay, we express no view with respect to the merits of the Division's motion to dismiss.

Accordingly, IT IS ORDERED that the request of the Division of Enforcement for a stay of the proceedings in this matter, pending Commission consideration of the Division of Enforcement's Agreed Motion to Dismiss be, and it hereby is, granted. 2/

By the Commission.

Nancy M. Morris
Secretary

By: Jill M. Peterson
Assistant Secretary

2/ In the event that the motion to dismiss is denied and the law judge determines that the issuance of this stay has prevented her from issuing an initial decision within the period specified by Rule 360(a)(2), Rule 360(a)(3) provides procedures for requesting an extension of the period for issuance of the decision. 17 C.F.R. § 201.360(a)(3).

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

November 17, 2006

IN THE MATTER OF DIGITAL GAS, INC. File No. 500-1	ORDER OF SUSPENSION OF TRADING

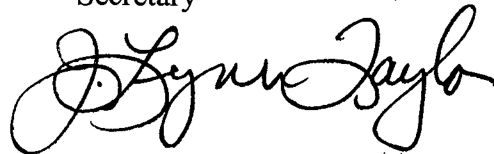
It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Digital Gas, Inc. ("Digital"), because of questions raised regarding the accuracy and adequacy of publicly disseminated information concerning, among other things, Digital's announced agreement with Techno Rubber, Inc. and Digital's assets.

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

Therefore, it is ORDERED, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the above-listed company is suspended for the period from 9:30 a.m. EST, November 17, 2006, through 11:59 p.m. EST, on December 4, 2006.

By the Commission.

Nancy M. Morris
Secretary



By: J. Lynn Taylor
Assistant Secretary

Document 2 of 58

Chairman Cox and Commissioners Campos and Nazareth Not Participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 54862 / December 1, 2006

INVESTMENT COMPANY ACT OF 1940
Release No. 27588 / December 1, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12496

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

I.

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

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") that 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, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Order"), as set forth below.

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III.

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

A. **RESPONDENT**

1. **Kevin W. Quinn**, age 40, resides in Needham, Massachusetts. From May 2002 until his employment was terminated in October 2004, he was associated with Jefferies & Co., Inc. ("Jefferies" or the "firm") as an account executive and held the position of senior vice president, equity and sales.

B. **OTHER RELEVANT PARTIES**

2. **Jefferies & Co., Inc.** is the principal operating subsidiary of Jefferies Group, Inc., a Delaware corporation with its principal place of business in Los Angeles, California. Jefferies is registered with the Commission as a broker-dealer (File No. 8-15074) pursuant to Section 15(b) of the Exchange Act and provides securities brokerage services primarily to institutional customers.

3. **Scott Jones** ("Jones"), age 50, resides in Chicago, Illinois. Since November 1980, he has been employed by Jefferies in various capacities. In 1998, he became director of equity trading. He was Quinn's immediate supervisor for most of Quinn's employment at Jefferies.

C. **FACTS**

Summary

4. This proceeding concerns Kevin Quinn's provision of extensive travel, entertainment and gifts to certain employees of an investment adviser (the "Fund Adviser") to a family of mutual funds ("the Funds"). The employees included several equities securities traders, whose job was to direct securities transactions for the Funds to securities brokerage firms for execution, and the head of the Fund Adviser's global equity trading desk ("Head of Equity Trading"), who supervised the securities traders and decided which securities brokerage firms would be approved to handle equity transactions for the Funds.[2]

5. Jefferies hired Quinn and his team of registered representatives in May 2002 to significantly increase the firm's brokerage business with the Funds. The firm anticipated that

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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 Several of the traders are no longer employed by the Fund Adviser, and the Head of Equity Trading has been reassigned to another position with an entity related to the Fund Adviser.

Quinn's connections with the Fund Adviser would generate as much as $50 million in commission revenues per year for Jefferies. Quinn received $4 million per year in salary. Quinn's team also received an annual travel and entertainment ("T&E") budget of $1.5 million, including pre-paid use of private planes for business travel and entertainment.

6. From May 2002 until October 2004, Quinn sought to obtain brokerage business from the Funds. In connection with this effort, Quinn provided travel, entertainment and gifts to a small group of the Fund Adviser's most successful traders. A skilled amateur golfer with connections at many exclusive golf courses, Quinn took the traders on expensive golf trips, flew them on private planes, lodged them at fancy hotels, and gave them golf merchandise and other presents. He also made private planes available for the traders to take on personal trips without his attendance. He gave tickets to the Fund Adviser's traders for major sporting events (such as Wimbledon and the U.S. Open), Broadway shows, and concerts, again without his attendance. He even helped pay for one trader's elaborate bachelor party in Miami. Quinn also included the Head of Equity Trading on some of the golf excursions and made a private plane available for his personal use. He also used his T&E budget for personal use of private plane travel, hotels, meals, car service, and tickets to major sporting events. Although this latter category of expenditures was unrelated to entertainment of the Fund Adviser's traders, Quinn improperly sought and obtained reimbursement from Jefferies for these expenses.

7. Section 17(e)(1) of the Investment Company Act makes it unlawful for an affiliated person of a registered investment company, or an affiliate of an affiliate, when acting as an agent, to accept compensation from any source (other than a salary or wages from the registered investment company) for the purchase or sale of any property to or for the registered investment company. The traders were affiliated persons of the Fund Adviser, which is an affiliated person of registered investment companies (the Funds), because the Fund Adviser advises those Funds. The Fund Adviser's employees' receipt of travel, entertainment and gifts from Quinn constituted compensation within the prohibition of Section 17(e)(1) of the Investment Company Act.

8. Sections 17(a)(1) of the Exchange Act and Rule 17a-3 thereunder require every registered broker-dealer to make and keep accurate books and records including ledgers reflecting, among other things, all expenses.

9. As a result of his conduct, Quinn aided and abetted and caused the Fund Adviser employees' violations of Section 17(e)(1) of the Investment Company Act. Quinn also aided and abetted and caused Jefferies' violations of 17(a)(1) of the Exchange Act and Rule 17a-3 thereunder by seeking and obtaining reimbursement for improper expenses.

Quinn's Employment Agreement with Jefferies

10. Prior to 2002, while he was employed at another registered broker-dealer, Quinn developed his business relationship with several of the Fund Adviser securities traders and

assembled a team of registered representatives to handle securities transactions for the Funds. Quinn left that firm in March 2002 when it closed its domestic equity division.

11. In May 2002, Jefferies hired Quinn and his team in order to increase its brokerage business with the Fund Adviser. The firm's president and chief operating officer (and also a member of its board of directors), conducted the initial interview with Quinn. Jefferies had received $4.3 million in equity commissions from the Fund Adviser in 2001, and the firm's president concluded that Quinn's relationship with the Fund Adviser could generate as much as $50 million in additional commission revenues per year for Jefferies.

12. On May 8, 2002, Jefferies and Quinn entered into an employment contract whereby Quinn would start working at the firm's Boston, Massachusetts office on September 3, 2002. The employment contract – which the firm's then-president approved – provided that Quinn would receive a guaranteed salary of $1.3 million for the remainder of 2002 and a guaranteed salary of $4 million per year in 2003 and 2004.[3] The contract also provided that Quinn and his team would receive a bonus if the adjusted gross commissions from the Fund Adviser exceeded certain target levels.[4] In addition, the contract provided Quinn and his team with a $500,000 T&E expense account for the remainder of 2002 and with a $1.5 million annual T&E expense account in 2003 and 2004. Quinn was allowed to start using the T&E expense account during the summer of 2002, even though he did not become a registered representative in Jefferies' Boston office until after September 3, 2002.

Jefferies' Written Policy Concerning Gifts

13. Jefferies maintained a *Statement of Policy on Standards of Employee Conduct* ("*Statement of Policy*") which prohibited the giving of gifts of substantial value to, or inappropriate entertainment of, persons doing business with the firm. All employees were required to sign the *Statement of Policy* as an acknowledgment of its receipt. The *Statement of Policy* prohibited any Jefferies employee from giving goods or services to a customer worth more than $100 per year without prior approval from the employee's manager. NASD Rule 3060 prohibits a broker from providing a customer with gifts and gratuities worth more than $100 per year.[5]

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[3] On April 21, 2003, the employment contract was amended to provide Quinn with a guaranteed salary of $4.75 million in 2004.

[4] While Quinn and his team were employed at Jefferies, their adjusted gross commissions from the Fund Adviser were too low to trigger their entitlement to any bonus.

[5] Although Jones, Quinn's immediate supervisor reviewed nearly all of Quinn's requests for reimbursement of T&E expenses, he routinely approved vouchers that indicated, on their face, that Quinn had given some of the Fund Adviser's employees items worth more than $100, in violation of the firm's policy, or that Quinn had not accompanied the Fund Adviser's employees on a private plane flight or to a particular event, in which case the expenses were gifts and could not properly be reimbursed under the firm's *Statement of Policy*.

Quinn's Lavish Entertainment of Some of the Fund Adviser's Employees

14. Quinn used his $1.5 million annual T&E budget to entertain a small group of the Fund Adviser's traders from whom he received substantial brokerage business, as well as the Head of Equity Trading.[6]

15. Quinn's most extravagant entertainment of Fund Adviser employees involved taking them on golf excursions and other vacations.[7] Examples include:

a. In November 2002, Quinn took the Head of Equity Trading and Traders A and B on a so-called "Fall Classic" golf excursion to Las Vegas, Nevada, and Cabo San Lucas, Mexico. The trip lasted four days. Quinn provided private plane flights and lodging in villas at expensive hotels (including the Bellagio in Las Vegas) and arranged for a band to play. He also gave each Fund Adviser employee golf merchandise and DVD players as golf prizes. The total cost for Jefferies was more than $215,000.

b. In December 2002, Quinn took Trader B for a golf weekend in South Carolina and Florida. Quinn provided private plane flights, lodging, limousine service, and golf prizes. The total cost for Jefferies was more than $35,000.

c. In January 2003, Quinn took the Head of Equity Trading and Trader A for a golf weekend in Georgia. Quinn provided private plane flights and lodging. The total cost for Jefferies was nearly $45,000.

d. In February 2003, Quinn took Trader C and his family on a vacation in Palm Beach, Florida. Quinn provided private plane flights, use of the facilities at the Breakers Hotel, limousine service, and a rental car. The total cost for Jefferies was more than $80,000.

e. In March 2003, Quinn joined with representatives of other brokerage firms to pay for Trader A's bachelor party in Miami. Quinn provided private plane flights and limousine service for the Head of Equity Trading, Trader A, several employees of other securities brokerage firms, and assorted guests to attend the party. The total cost for Jefferies was more than $75,000.

f. In December 2003, Quinn took Traders A and B on another "Fall Classic" golf excursion, this time to Las Vegas, Nevada, and Scottsdale, Arizona. The trip lasted four days. Quinn provided private plane flights, lodging at expensive hotels (including the MGM

[6] The five traders who received the bulk of Quinn's travel, gifts, and entertainment are referred to as Traders A, B, C, D and E. Two other traders who took trips on private planes provided by Quinn are referred to as Traders F and G.

[7] On some occasions, some of the Fund Adviser's employees attempted to pay Quinn sums for the travel, lodging and other expenses involved in these excursions, but the amount of their payments almost never equaled the actual cost of the expenses.

Grand in Las Vegas), and limousine service. He also gave each Fund Adviser employee golf merchandise and other items as golf prizes. The total cost for Jefferies was nearly $160,000.

g. In January 2004, Quinn took Trader A to the Super Bowl in Houston and while there, entertained Trader B. Quinn provided private plane flights, lodging at the Lancaster-King Hotel, tickets to the Playboy pre-game party, and a rental car. The total cost for Jefferies was over $150,000.

h. In February 2004, Quinn took Trader C and his family on a vacation in Palm Beach, Florida. Quinn provided private plane flights, lodging at the Breakers Hotel, and a rental car. The total cost for Jefferies was more than $62,500.

16. The private plane flights, fancy hotels, limousines and rental cars, and golf equipment, DVD players and other "prizes" provided by Quinn constituted compensation to the Fund Adviser's employees within the scope of the prohibition in Section 17(e)(1) of the Investment Company Act.

17. On many occasions, Quinn simply paid for some of the Fund Adviser's employees to take a private plane for their personal use without his attendance.[8] Examples include:

a. In November 2002, Trader F and his family took a vacation in Orlando, Florida. The cost for Jefferies was nearly $25,000.

b. In January 2003, Trader C and his wife flew from Naples, Florida to Boston. The cost for Jefferies was more than $20,000.

c. In February 2003, the Head of Equity Trading flew from Monterey, California, to Boston. The cost for Jefferies was nearly $45,000.

d. In September 2003, Trader A and his wife flew from Boston to Nantucket. A few days later, they flew from Nantucket to Los Angeles and then returned from Los Angeles. The total cost for Jefferies was nearly $75,000.

e. In November 2003, Trader G and his wife flew to and from St. Thomas, U.S.V.I. The cost for Jefferies was more than $46,000.

f. In December 2003, the Head of Equity Trading flew to Florida for the weekend. The cost for Jefferies was more than $45,000.

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[8] Quinn remarked in an email to one of the Fund Adviser's traders in November 2002, "I view private plane travel as one of the great perks of this biz and am more than willing to do it for a few guys when I can ... just as long as they keep it low."

g. In late December 2003, Trader A and his wife flew to Florida for the weekend. The cost for Jefferies was more than $31,000.

h. In March 2004, Trader B and his wife and Trader D and his girlfriend flew to the Bahamas and Turks & Caicos for vacation. The cost for Jefferies was more than $47,000.

18. The use of a private plane at Jefferies' expense constituted compensation to the Fund Adviser's employees within the scope of the prohibition in Section 17(e)(1) of the Investment Company Act.

19. Quinn also provided Fund Adviser employees with tickets to sporting events and concerts along with expensive wine.

a. Some of these events were extremely expensive. For example, Quinn gave Trader E tickets to attend the Wimbledon and U.S. Open tennis tournaments. The total cost to Jefferies of the Wimbledon tickets in 2002, 2003 and 2004 was nearly $90,000, the total cost of U.S. Open tickets in 2002 and 2003 was more than $17,000, and when Trader E attended Wimbledon in 2004, Jefferies also paid $12,000 for his hotel in London. Quinn did not attend any of these events.

b. Quinn provided Fund Adviser employees, including traders and a senior Fund Adviser officer, with numerous tickets to the theater (such as "The Lion King," "Hairspray," "Beauty and the Beast," "The Producers" and "Moving Out"), concerts (such as Bruce Springsteen, Justin Timberlake, Prince and Santana), the circus, and professional baseball, basketball, football and hockey games.[9] Quinn rarely attended these events with the Fund Adviser's employees.

c. Quinn provided the Fund Adviser's traders with extremely expensive bottles of wine as Christmas gifts. For example, Quinn gave Trader E over $13,000 worth of wine over two Christmases, and he provided over $4,000 worth of wine as a Christmas gift to Trader B.

20. The receipt of tickets and wine at Jefferies' expense constituted compensation to the Fund Adviser's employees within the scope of the prohibition in Section 17(e)(1) of the Investment Company Act.

Jefferies Increased Its Business with
<u>the Fund Adviser After Quinn's Arrival</u>

[9] In December 2002, Quinn told Trader E that certain tickets were "not easy by the way." Trader E responded, "I know. That's why I asked Kevin 'the Man' Quinn for a big favor."

21. Jefferies' status among the securities brokerage firms used by the Funds improved substantially after Quinn joined the firm. Jefferies for the first time began to commit capital in certain of its trades for the Fund Adviser. In addition, on a regular basis, Quinn provided the Fund Adviser's employees with the travel, entertainment and gifts described above.[10]

22. The Fund Adviser's traders were only permitted to send securities transactions to broker-dealers that had been approved by the Head of Equity Trading. The Fund Adviser grouped the approved firms into three categories: (1) "core brokers" handling the large majority of transactions; (2) "watch list brokers" handling a smaller, but still significant, amount of transactions; and (3) other "specialized brokers." Before Quinn began working there in September 2002, Jefferies was in the third category as a "specialized third-market" firm. As of January 2003 – after Quinn's first four months of the firm – the Fund Adviser had moved Jefferies to the second category as a "watch list" firm. As of April 2003 – after another three months of Quinn's efforts – the Fund Adviser had re-classified Jefferies once again, placing the firm in the first category of "core brokers."

23. Consistent with its change of status to a "core broker," the brokerage business that Jefferies received from the Fund Adviser increased substantially after Quinn began working there in September 2002. Before Quinn's arrival, in the second quarter of 2002, Jefferies handled 25.1 million shares of listed securities and 14 million shares of "over-the-counter" ("OTC") securities for the Fund Adviser. With this volume, Jefferies ranked 34th for listed securities and 25th for OTC securities among the brokerage firms used by the Fund Adviser. Jefferies' volume rose quickly after Quinn's arrival. In the fourth quarter of 2002, Quinn's first full quarter of employment, Jefferies' ranking had risen to 17th for listed securities and 18th for OTC securities. By the third quarter of 2004, Quinn's final full quarter of employment, Jefferies handled 277.7 million shares of listed securities and 193.6 million shares of OTC securities. Its volume ranking with the Fund Adviser was 13th in listed securities and 12th in OTC securities.

24. Just as the volume of Jefferies' brokerage business from the Funds increased, so did the brokerage commissions that the Funds paid to Jefferies. In the first six months of 2002, just prior to Quinn's arrival, Jefferies received $1.7 million in brokerage commissions, ranking it 43rd among the firms used by the Fund Adviser. By contrast, in the first nine months of 2004, Jefferies received $24.5 million in brokerage commissions from Funds, improving its ranking to 13th among the firms used by the Fund Adviser.

25. Most of the brokerage business that Jefferies received from the Fund Adviser came from four traders (Traders A, B, C and D) who went on most of Quinn's golf and other excursions and from a fifth trader (Trader E), who received expensive wine and the most expensive tickets to sporting events (such as Wimbledon and the U.S. Open). During the period of Quinn's employment at Jefferies (September 2002 to October 2004), these five traders sent trades generating approximately $39.4 million in commissions for Jefferies:

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10 Quinn once described himself to one of the Fund Adviser's traders as "a whore for biz." He told another trader, "I will do anything for an order (w/ my clothes on)."

Trader A	$18.4 million
Trader B	6.5 million
Trader C	2.6 million
Trader D	3.2 million
Trader E	8.7 million

In addition, Traders F and G, both of whom took vacations on private planes supplied by Quinn, sent trades generating an additional $2.9 million.

26. Although these traders routinely directed brokerage business to Jefferies, they sometimes sent a higher than average volume of business to Jefferies just before or just after Quinn provided them with travel and entertainment.

Quinn Sought and Obtained Reimbursement for Improper Expenses

27. Quinn submitted T&E vouchers to Jefferies reflecting hundreds of thousands of dollars of expenses that were for his own personal benefit by improperly characterizing them as business expenses.[11] This included private jet travel, along with personal trips with friends and family to such places as Aspen, Colorado; Sea Island, Georgia; and the Masters golf tournament in Augusta, Georgia. Quinn also sought and obtained reimbursement for a private jet flight taken by his supervisor Jones to Florida by improperly submitting a voucher that indicated that the Fund Adviser's Head of Equity Trading was the passenger on the flight.

28. Quinn's submission of improper T&E vouchers and the resulting reimbursement rendered Jefferies' ledgers of its expense accounts and compensation records related to its associated persons inaccurate in violation of Section 17(a)(1) of the Exchange Act and Rule 17a-3 thereunder.

D. VIOLATIONS

1. As a result of the conduct described above, Quinn willfully aided and abetted and caused violations of Section 17(e)(1) of the Investment Company Act by providing "compensation," namely extensive travel, entertainment, and gifts, to the Fund Adviser's Head of Equity Trading and certain of the Fund Adviser's traders, who willfully violated Section 17(e)(1) by accepting such compensation "for the purchase or sale of any property to or for such registered company," namely the direction of the Fund's brokerage business to Jefferies.

2. As a result of the conduct described above, Quinn willfully aided and abetted and caused Jefferies' violations of Section 17(a)(1) of the Exchange Act and Rule 17a-3 thereunder by submitting and receiving reimbursement for improper T&E vouchers from Jefferies, which failed to make and keep accurate books and records.

[11] After his termination, Quinn reimbursed Jefferies for an agreed-upon amount.

IV.

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

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

A. Respondent Quinn cease and desist from committing or causing any violations and any future violations of Section 17(e)(1) of the Investment Company Act and Section 17(a)(1) of the Exchange Act and Rule 17a-3 thereunder.

B. Respondent Quinn be, and hereby is barred from association with any broker or dealer, and is prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter.

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

D. Respondent Quinn shall, within 10 days of the entry of this Order, pay disgorgement of $1 and a civil money penalty of $468,000 to the Securities and Exchange Commission. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to David P. Bergers, District Administrator, Division of Enforcement, Securities and Exchange Commission, 33 Arch Street, 23rd Floor, Boston, MA 02110-1410.

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

agrees that he shall not, after offset or reduction in any Related Investor Action based on Respondent's payment of disgorgement in this action, argue that he is entitled to, nor shall he further benefit by offset or reduction of any part of Respondent's payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Respondent agrees that he shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the United States Treasury or to a Fair Fund, as the Commission directs. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against Respondent by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

V.

Upon further order by the Commission, the Division of Enforcement shall submit a proposed plan for the administration and distribution of the Fair Fund in this matter.

By the Commission.

Nancy M. Morris
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
December 1, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12493

In the Matter of Detour Media Group, Inc., DrivingAmerica.Com, Inc., Legends Enterprises, Inc., OXIR Investments, Inc., Spinplanet.Com, Inc. (n/k/a EntertainMax Worldwide, Inc.), and Tessa Complete Health Care, 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").

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Detour Media Group, Inc. ("Detour Media") (CIK No. 935730) is a dissolved Colorado corporation located in Los Angeles, California with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Detour Media is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 2002.

2. DrivingAmerica.Com, Inc. ("DrivingAmerica") (CIK No. 1063701) is a dissolved Colorado corporation located in Irvine, California with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g).

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DrivingAmerica is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 1999, which reported a net loss of $681,769 for the prior nine months.

3. Legends Enterprises, Inc. ("Legends Enterprises") (CIK No. 1125223) is a dissolved Oregon corporation located in Concord, Massachusetts with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Legends Enterprises is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2002, which reported a net loss of $71,393 for the prior nine months.

4. OXIR Investments, Inc. ("OXIR Investments") (CIK No. 1088431) is a suspended California corporation located in Las Vegas, Nevada with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). OXIR Investments is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 2001, which reported a net loss of $1,178,185 for the prior nine months.

5. Spinplanet.Com, Inc. ("Spinplanet") (n/k/a EntertainMax Worldwide, Inc.) (CIK No. 1046893) is a Colorado corporation located in Baltimore, Maryland with a class of equity securities registered pursuant to Exchange Act Section 12(g). Spinplanet is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended June 30, 2000, which reported a net loss of $2,540 for the prior six months.

6. Tessa Complete Health Care, Inc. ("Tessa") (CIK No. 859919) is a Georgia corporation located in Tigard, Oregon with a class of equity securities registered pursuant to Exchange Act Section 12(g). Tessa 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 $2,718,846 for the prior nine months.

B. DELINQUENT PERIODIC FILINGS

7. All of the Respondents, or their predecessors, are or were affiliated with another delinquent issuer, are delinquent in their periodic filings with the Commission (*see* Chart of Delinquent Filings, attached hereto as Appendix 1), 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 at their most recent address shown in their most recent filing with the Commission, or did not receive the letters because of their failure to keep an updated address on file with the Commission as required by Commission rules.

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 (Forms 10-K or 10-KSB), and Rule 13a-13 requires issuers to file quarterly reports (Forms 10-Q or 10-QSB).

9. As a result of their failure to file required periodic filings, 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 of this Order are true, and to afford the Respondents an opportunity to establish any defenses to such allegations; and

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months or to revoke the registrations of each class of securities registered pursuant to Exchange Act Section 12 of the Respondents identified in Section II.

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 each 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 a Respondent fails to file the directed Answer, or fails to appear at a hearing after being duly notified, the Respondent may be deemed in default and the proceedings may be determined against 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 each Respondent personally, by certified or registered mail, or by any other means permitted by the Commission's Rules of Practice.

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

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

By the Commission.

Nancy M. Morris
Secretary

Attachment

By: Jill M. Peterson
Assistant Secretary

Appendix 1

Chart of Delinquent Filings

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Detour Media Group, Inc.					
	10-QSB	06/30/02	08/14/02	Not filed	51
	10-QSB	09/30/02	11/14/02	Not filed	48
	10-KSB	12/31/02	03/31/03	Not filed	44
	10-QSB	03/31/03	05/15/03	Not filed	42
	10-QSB	06/30/03	08/14/03	Not filed	39
	10-QSB	09/30/03	11/14/03	Not filed	36
	10-KSB	12/31/03	03/30/04	Not filed	32
	10-QSB	03/31/04	05/17/04	Not filed	30
	10-QSB	06/30/04	08/16/04	Not filed	27
	10-QSB	09/30/04	11/15/04	Not filed	24
	10-KSB	12/31/04	03/31/05	Not filed	20
	10-QSB	03/31/05	05/16/05	Not filed	18
	10-QSB	06/30/05	08/15/05	Not filed	15
	10-QSB	09/30/05	11/14/05	Not filed	12
	10-KSB	12/31/05	03/31/06	Not filed	8
	10-QSB	03/31/06	05/15/06	Not filed	6
	10-QSB	06/30/06	08/14/06	Not filed	3
	10-QSB	09/30/06	11/14/06	Not filed	0
Total Filings Delinquent	18				
DrivingAmerica.Com, Inc.					
	10-KSB	12/31/99	03/30/00	Not filed	80
	10-QSB	03/31/00	05/15/00	Not filed	78
	10-QSB	06/30/00	08/14/00	Not filed	75
	10-QSB	09/30/00	11/14/00	Not filed	72
	10-KSB	12/31/00	04/02/01	Not filed	67
	10-QSB	03/31/01	05/15/01	Not filed	66
	10-QSB	06/30/01	08/14/01	Not filed	63
	10-QSB	09/30/01	11/14/01	Not filed	60
	10-KSB	12/31/01	04/01/02	Not filed	55
	10-QSB	03/31/02	05/15/02	Not filed	54
	10-QSB	06/30/02	08/14/02	Not filed	51
	10-QSB	09/30/02	11/14/02	Not filed	48
	10-KSB	12/31/02	03/31/03	Not filed	44

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
DrivingAmerica.Com, Inc.					
	10-QSB	03/31/03	05/15/03	Not filed	42
	10-QSB	06/30/03	08/14/03	Not filed	39
	10-QSB	09/30/03	11/14/03	Not filed	36
	10-KSB	12/31/03	03/30/04	Not filed	32
	10-QSB	03/31/04	05/17/04	Not filed	30
	10-QSB	06/30/04	08/16/04	Not filed	27
	10-QSB	09/30/04	11/15/04	Not filed	24
	10-KSB	12/31/04	03/31/05	Not filed	20
	10-QSB	03/31/05	05/16/05	Not filed	18
	10-QSB	06/30/05	08/15/05	Not filed	15
	10-QSB	09/30/05	11/14/05	Not filed	12
	10-KSB	12/31/05	03/31/06	Not filed	8
	10-QSB	03/31/06	05/15/06	Not filed	6
	10-QSB	06/30/06	08/14/06	Not filed	3
	10-QSB	09/30/06	11/14/06	Not filed	0
Total Filings Delinquent	27				
Legends Enterprises, Inc.					
	10-KSB	12/31/02	03/31/03	Not filed	44
	10-QSB	03/31/03	05/15/03	Not filed	42
	10-QSB	06/30/03	08/14/03	Not filed	39
	10-QSB	09/30/03	11/14/03	Not filed	36
	10-KSB	12/31/03	03/30/04	Not filed	32
	10-QSB	03/31/04	05/17/04	Not filed	30
	10-QSB	06/30/04	08/16/04	Not filed	27
	10-QSB	09/30/04	11/15/04	Not filed	24
	10-KSB	12/31/04	03/31/05	Not filed	20
	10-QSB	03/31/05	05/16/05	Not filed	18
	10-QSB	06/30/05	08/15/05	Not filed	15
	10-QSB	09/30/05	11/14/05	Not filed	12
	10-KSB	12/31/05	03/31/06	Not filed	8
	10-QSB	03/31/06	05/15/06	Not filed	6
	10-QSB	06/30/06	08/14/06	Not filed	3
	10-QSB	09/30/06	11/14/06	Not filed	0
Total Filings Delinquent	15				

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
OXIR Investments, Inc.					
	10-KSB	06/30/01	09/28/01	Not filed	62
	10-QSB	09/30/01	11/14/01	Not filed	60
	10-QSB	12/31/01	02/14/02	Not filed	57
	10-QSB	03/31/02	05/15/02	Not filed	54
	10-KSB	06/30/02	09/30/02	Not filed	50
	10-QSB	09/30/02	11/14/02	Not filed	48
	10-QSB	12/31/02	02/14/03	Not filed	45
	10-QSB	03/31/03	05/15/03	Not filed	42
	10-KSB	06/30/03	09/29/03	Not filed	38
	10-QSB	09/30/03	11/14/03	Not filed	36
	10-QSB	12/31/03	02/16/04	Not filed	33
	10-QSB	03/31/04	05/17/04	Not filed	30
	10-KSB	06/30/04	09/28/04	Not filed	26
	10-QSB	09/30/04	11/15/04	Not filed	24
	10-QSB	12/31/04	02/14/05	Not filed	21
	10-QSB	03/31/05	05/16/05	Not filed	18
	10-KSB	06/30/05	09/28/05	Not filed	14
	10-QSB	09/30/05	11/14/05	Not filed	12
	10-QSB	12/31/05	02/14/06	Not filed	9
	10-QSB	03/31/06	05/15/06	Not filed	6
	10-KSB	06/30/06	09/28/06	Not filed	2
	10-QSB	09/30/06	11/14/06	Not filed	0
Total Filings Delinquent	21				
Spinplanet.Com, Inc.					
	10-QSB	09/30/00	11/14/00	Not filed	72
	10-KSB	12/31/00	04/02/01	Not filed	67
	10-QSB	03/31/01	05/15/01	Not filed	66
	10-QSB	06/30/01	08/14/01	Not filed	63
	10-QSB	09/30/01	11/14/01	Not filed	60
	10-KSB	12/31/01	04/01/02	Not filed	55
	10-QSB	03/31/02	05/15/02	Not filed	54
	10-QSB	06/30/02	08/14/02	Not filed	51
	10-QSB	09/30/02	11/14/02	Not filed	48
	10-KSB	12/31/02	03/31/03	Not filed	44
	10-QSB	03/31/03	05/15/03	Not filed	42
	10-QSB	06/30/03	08/14/03	Not filed	39
	10-QSB	09/30/03	11/14/03	Not filed	36

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Spinplanet.Com, Inc. (n/k/a Entertainmax Worldwide, Inc.)					
	10-KSB	12/31/03	03/30/04	Not filed	32
	10-QSB	03/31/04	05/17/04	Not filed	30
	10-QSB	06/30/04	08/16/04	Not filed	27
	10-QSB	09/30/04	11/15/04	Not filed	24
	10-KSB	12/31/04	03/31/05	Not filed	20
	10-QSB	03/31/05	05/16/05	Not filed	18
	10-QSB	06/30/05	08/15/05	Not filed	15
	10-QSB	09/30/05	11/14/05	Not filed	12
	10-KSB	12/31/05	03/31/06	Not filed	8
	10-QSB	03/31/06	05/15/06	Not filed	6
	10-QSB	06/30/06	08/14/06	Not filed	3
	10-QSB	09/30/06	11/14/06	Not filed	0
Total Filings Delinquent	25				
Tessa Complete Health Care, Inc.					
	10-KSB	12/31/02	03/31/03	Not filed	44
	10-QSB	03/31/03	05/15/03	Not filed	42
	10-QSB	06/30/03	08/14/03	Not filed	39
	10-QSB	09/30/03	11/14/03	Not filed	36
	10-KSB	12/31/03	03/30/04	Not filed	32
	10-QSB	03/31/04	05/17/04	Not filed	30
	10-QSB	06/30/04	08/16/04	Not filed	27
	10-QSB	09/30/04	11/15/04	Not filed	24
	10-KSB	12/31/04	03/31/05	Not filed	20
	10-QSB	03/31/05	05/16/05	Not filed	18
	10-QSB	06/30/05	08/15/05	Not filed	15
	10-QSB	09/30/05	11/14/05	Not filed	12
	10-KSB	12/31/05	03/31/06	Not filed	8
	10-QSB	03/31/06	05/15/06	Not filed	6
	10-QSB	06/30/06	08/14/06	Not filed	3
	10-QSB	09/30/06	11/14/06	Not filed	0
Total Filings Delinquent	16				

Chairman Cox and Commissioners Campos and Nazareth Not Participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

CORRECTED COPY

SECURITIES EXCHANGE ACT OF 1934
Release No. 54861 / December 1, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12495

In the Matter of JEFFERIES & CO., INC. and SCOTT JONES, Respondents.	ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTIONS 15(b) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Jefferies & Co., Inc. ("Jefferies" or the "firm") and that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Exchange Act against Scott Jones ("Jones") (collectively, "Respondents").

II.

In anticipation of the institution of these proceedings, Respondents Jefferies and Jones have submitted Offers of Settlement (the "Offers") that 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 Jefferies and Jones consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Order"), as set forth below.

III.

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

A. RESPONDENTS

1. **Jefferies** is registered with the Commission as a broker-dealer (File No. 8-15074) pursuant to Section 15(b) of the Exchange Act and provides securities brokerage services primarily to institutional customers.

2. **Scott Jones**, age 50, resides in Chicago, Illinois. Since November 1980, he has been employed by Jefferies in various capacities. He is a member of Jefferies' board of directors. In 1998, he became director of equities. He was Quinn's immediate supervisor for most of Quinn's employment at Jefferies.

B. OTHER RELEVANT PARTY

3. **Kevin Quinn**, age 40, resides in Needham, Massachusetts. From May 2002 until his employment was terminated on October 11, 2004, he was associated with Jefferies as an account executive and held the position of senior vice president, equity and sales.

C. FACTS

Summary

4. This proceeding concerns Quinn's provision of approximately $2 million in extensive travel, entertainment and gifts to certain employees of an investment adviser (the "Fund Adviser") to a family of mutual funds (the "Funds"). The employees included several securities traders, whose responsibilities included directing securities transactions for the Funds to brokerage firms for execution, and the head of the Fund Adviser's global equity trading desk ("Head of Equity Trading"), who supervised the securities traders and decided which securities

[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.

brokerage firms would be approved to handle equity transactions for the Funds.[2]

5. Jefferies hired Quinn in May 2002 in an effort to increase the firm's brokerage business with the Funds. The firm anticipated that Quinn's business relationship with the Fund Adviser would generate as much as $50 million in commission revenues per year for Jefferies. To land Quinn as an expected rainmaker, the firm offered him an unprecedented compensation package whereby Jefferies would pay Quinn $4 million per year in salary and would provide him and his team of brokers with an annual travel and entertainment ("T&E") budget of $1.5 million, including pre-paying vendors of Quinn's choice for his blocks of flight hours on private planes for business travel and entertainment.

6. From May 2002 until his employment was terminated in October 2004, Quinn sought to obtain additional brokerage business from the Funds. A skilled amateur golfer with connections at many exclusive golf courses, Quinn took a small group of traders on expensive golf trips, flying them on private planes, lodging them at fine hotels, and at times, providing them with golf merchandise and other presents. He also made private planes available for the traders to take on personal trips without his attendance. He gave tickets to the Fund Adviser's traders for major sporting events (such as Wimbledon and the U.S. Open), Broadway shows, and concerts, again without his attendance. He even helped pay for one trader's elaborate bachelor party in Miami. Quinn also included the Head of Equity Trading on some of the golf excursions and made a private plane available for his personal use. He also used significant amounts of his T&E budget for personal use of extensive private plane travel, expensive hotels, meals, car service, and tickets to major sporting events for himself, his family, and several friends who were not affiliated with the Fund Adviser. Although this latter category of expenditures was unrelated to Quinn's entertainment of the Fund Adviser's traders, he improperly sought and obtained reimbursement from Jefferies for these expenses.

7. Section 17(e)(1) of the Investment Company Act of 1940 ("Investment Company Act") makes it unlawful for an affiliated person of a registered investment company, or an affiliate of an affiliate, when acting as an agent, to accept compensation from any source (other than a salary or wages from the registered investment company) for the purchase or sale of any property to or for the registered investment company. The traders were affiliated persons of the Fund Adviser, which is an affiliated person of registered investment companies (the Funds), because the Fund Adviser advises those funds. The Fund Adviser's employees' receipt of travel, entertainment and gifts from Quinn constituted compensation within the scope of the prohibition of Section 17(e)(1) of the Investment Company Act.

[2] Several of the traders are no longer employed by the Fund Adviser, and the Head of Equity Trading has been reassigned to another position with an entity related to the Fund Adviser.

8. Section 17(a)(1) of the Exchange Act and Rule 17a-3 thereunder require every registered broker-dealer to make and keep current accurate books and records, including ledgers reflecting, among other things, all expenses.

9. Section 15(b)(4) of the Exchange Act authorizes the Commission to censure a broker or dealer for failing reasonably to supervise, with a view to preventing violations of the federal securities law, another person who commits such a violation, if that person is subject to the broker or dealer's supervision.

10. Section 15(b)(6) of the Exchange Act, incorporating by reference Section 15(b)(4)(E) of the Exchange Act, authorizes the Commission to sanction a person associated with, or at the time of the alleged misconduct was associated with, a broker or dealer for failing reasonably to supervise, with a view to preventing violations of the federal securities law, another person who commits such a violation, if that person is subject to the person's supervision.

11. After providing Quinn and his team with an annual T&E budget of $1.5 million to spend on the Fund Adviser's employees, Jefferies failed reasonably to implement its existing policies and procedures and failed to develop new procedures to determine whether Quinn provided them with compensation in violation of Section 17(e)(1) of the Investment Company Act. Quinn was not required to obtain prior approval for his T&E expenditures or to account for his use of pre-paid private plane hours, which enabled Quinn to make private planes available to some of the Fund Adviser's employees for their personal use without firm oversight. Although Jones, Quinn's immediate supervisor, did review Quinn's requests for reimbursement of T&E expenses, he routinely approved vouchers that indicated, on their face, that Quinn had given some of the Fund Adviser's employees items worth more than $100, in violation of the firm's policy, or that Quinn had not accompanied the Fund Adviser's employees on a private plane flight or to a particular event, in which case the expenses were gifts and could not properly be reimbursed under the firm's policy. Further, Jefferies books and records of expenses were inaccurate as a result of Quinn's submission and Jefferies' approval of T&E vouchers in which Quinn characterized his personal use of T&E funds as reimbursable business expenses.

12. Jefferies failed reasonably to supervise, within the meaning of Section 15(b)(4)(E) of the Exchange Act, Quinn, with a view to preventing Quinn's aiding and abetting of the Fund Adviser's employees' violations of Section 17(e)(1) of the Investment Company Act. Jefferies also violated Section 17(a)(1) of the Exchange Act and Rule 17a-3 thereunder by failing to make and keep current books and records that accurately reflected expenses. In addition, Jones failed reasonably to supervise, within the meaning of Section 15(b)(6) of the Exchange Act, incorporating by reference Section 15(b)(4) of the Exchange Act, Quinn, with a view to preventing Quinn's aiding and abetting violations of Section 17(e)(1) of the Investment Company Act.

Quinn's Employment Agreement with Jefferies

13. Prior to joining Jefferies, while he was employed at two other registered broker-dealers, Quinn developed business relationships with several of the Fund Adviser's securities traders and assembled a team of registered representatives to handle securities transactions for the Funds. Quinn left the second of these firms in March 2002 when it closed its U.S. equity division.

14. In May 2002, Jefferies agreed to hire Quinn and his team in order to increase its brokerage business with the Fund Adviser. The firm's then-president and chief operating officer (and also a member of its board of directors), conducted the initial interview with Quinn. Jefferies had received $4.3 million in equity commissions from the Fund Adviser in 2001, and the firm's President concluded that Quinn's relationship with the Fund Adviser's employees could generate as much as $50 million in additional commission revenues per year for Jefferies.

15. On May 8, 2002, Jefferies and Quinn entered into an employment contract whereby Quinn would start working at the firm's Boston office on September 3, 2002. The employment contract – which the firm's then-president approved – provided that Quinn would receive a guaranteed salary of $1.3 million for the remainder of 2002 and a guaranteed salary of $4 million per year in 2003 and 2004.[3] The contract also provided that Quinn and his team would receive a bonus if the adjusted gross commissions from the Fund Adviser exceeded certain target levels.[4] In addition, the contract provided Quinn and his team with a $500,000 T&E expense account for the remainder of 2002 and with a $1.5 million annual T&E expense account in 2003 and 2004. Quinn was allowed to start using the T&E expense account during the summer of 2002, even though he did not become a registered representative in Jefferies' Boston office until after September 3, 2002.

16. Both the amount of Quinn's guaranteed salary and the T&E budget was unprecedented for the firm in several respects. First, Quinn received a guaranteed salary of $4 million (later $4.75 million), whereas other brokers at Jefferies were paid on a commission basis. Second, Jefferies funded the Quinn team's $1.5 million T&E budget, whereas other brokers at Jefferies had to pay their T&E expenses out of their own commissions. Third, Jefferies agreed to

[3] On April 21, 2003, the employment contract was amended to provide Quinn with a guaranteed salary of $4.75 million in 2004.

[4] While Quinn and his team were employed at Jefferies, their adjusted gross commissions from the Fund Adviser were too low to trigger their entitlement to any bonus.

pre-pay for Quinn's use of private planes for business travel, whereas other brokers at Jefferies were required to obtain prior approval for use of private planes chartered by Jefferies.

Jefferies' Written Policies Concerning
Travel, Entertainment and Gifts

17. At all relevant times, Jefferies maintained a *Statement of Policy on Standards of Employee Conduct* ("*Statement of Policy*"), which prohibited the giving of gifts of substantial value to, or inappropriate entertainment of, persons doing business with the firm. The *Statement of Policy* was distributed annually, and all employees were required to review the policy and sign an acknowledgment of its receipt. The *Statement of Policy* prohibited any Jefferies employee from giving goods or services to a customer worth more than $100 per year without prior approval from the employee's manager. NASD Rule 3060 prohibits a broker from providing a customer with gifts and gratuities worth more than $100 per year.

18. At all relevant times, Jefferies maintained a *Travel and Entertainment Policy* ("*T&E Policy*") which provided that requests for reimbursement of T&E expenses should identify the customers who attended the event, the business purpose of the event, and the business topics discussed during the event, and should include original itemized receipts for all expense items. In addition, a Jefferies employee was not entitled to reimbursement for event-related expenses unless the employee attended the event with the customer. The *T&E Policy* required Jefferies employees to be "responsible and prudent" in spending the firm's money, "as if [the money] were your own." The *T&E Policy* also required managers approving expense reports to identify "expenditures considered excessive or inappropriate" immediately to the employee submitting those receipts.

Quinn's Lavish Entertainment of Fund Adviser Employees

19. Quinn used his $1.5 million annual T&E budget to entertain the small group of the Fund Adviser's traders from whom he received substantial brokerage business, as well as the Head of Equity Trading.[5]

20. Quinn's most extravagant entertainment of the Fund Adviser's employees involved taking them on golf excursions and other vacations.[6] Examples include:

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[5] The five traders who received the bulk of Quinn's largesse are referred to as Traders A, B, C, D and E. Two other traders who took trips on private planes provided by Quinn are referred to as Traders F and G.

[6] The Fund Adviser employees sometimes tried to reimburse Quinn for travel, lodging and other expenses involved in these excursions, but the amount of their reimbursement almost never equaled the actual cost of the expenses.

a. In November 2002, Quinn took the Head of Equity Trading and Traders A and B on a so-called "Fall Classic" golf excursion to Las Vegas, Nevada, and Cabo San Lucas, Mexico. The trip lasted four days. Quinn provided private plane flights and lodging at expensive hotels (including the Bellagio in Las Vegas). He also gave each Fund Adviser employee golf merchandise and DVD players as golf prizes. The total cost for Jefferies was more than $215,000.

b. In December 2002, Quinn took Trader B for a golf weekend in South Carolina and Florida. Quinn provided private plane flights, lodging, limousine service, and golf prizes. The total cost for Jefferies was more than $35,000.

c. In January 2003, Quinn took the Head of Equity Trading and Trader A for a golf weekend in Georgia. Quinn provided private plane flights and lodging. The total cost for Jefferies was nearly $45,000.

d. In February 2003, Quinn took Trader C and his family on a vacation in Palm Beach, Florida. Quinn provided private plane flights, use of the facilities at the Breakers Hotel, limousine service, and a rental car. The total cost for Jefferies was more than $80,000.

e. In March 2003, Quinn joined with representatives of other brokerage firms to pay for Trader A's bachelor party in Miami. Quinn provided private plane flights and limousine service for the Head of Equity Trading, Trader A, several employees of other securities brokerage firms, and assorted guests to attend the party. The total cost for Jefferies was more than $75,000.

f. In December 2003, Quinn took Traders A and B on another "Fall Classic" golf excursion, this time to Las Vegas, Nevada, and Scottsdale, Arizona. The trip lasted four days. Quinn provided private plane flights, lodging at expensive hotels (including the MGM Grand in Las Vegas), and limousine service. He also gave each Fund Adviser employee golf merchandise and other items as golf prizes. The total cost for Jefferies was nearly $160,000.

g. In January 2004, Quinn took Trader A to the Super Bowl in Houston and while there, entertained Trader B. Quinn provided private plane flights, lodging at the Lancaster-King Hotel, tickets to the Playboy pre-game party, and a rental car. The total cost for Jefferies was over $150,000.

h. In February 2004, Quinn took Trader C and his family on a vacation in Palm Beach, Florida. Quinn provided private plane flights, lodging at the Breakers Hotel, and a rental car. The total cost for Jefferies was more than $62,500.

21. The private plane flights, fancy hotels, limousines and rental cars, and golf equipment, DVD players and other "prizes" provided by Quinn constituted compensation to the

Fund Adviser's employees within the scope of the prohibition in Section 17(e)(1) of the Investment Company Act.

22. On many occasions, Quinn simply paid for some of the Fund Adviser's employees to take a private plane for their personal use.[7] Examples include:

a. In November 2002, Trader F and his family traveled from Boston to and from Orlando, Florida. The cost for Jefferies was nearly $25,000.

b. In January 2003, Trader C and his wife flew from Naples, Florida to Boston. The cost for Jefferies was more than $20,000.

c. In February 2003, the Head of Equity Trading flew from Monterey, California, to Boston. The cost for Jefferies was nearly $45,000.

d. In September 2003, Trader A and his wife flew from Boston to Nantucket. A few days later, they flew from Nantucket to Los Angeles and then returned from Los Angeles. The total cost for Jefferies was nearly $75,000.

e. In November 2003, Trader G and his wife flew to and from St. Thomas, U.S.V.I. The cost for Jefferies was more than $46,000.

f. In December 2003, the Head of Equity Trading flew to Florida for the weekend. The cost for Jefferies was more than $45,000.

g. In late December 2003, Trader A and his wife flew to Florida for the weekend. The cost for Jefferies was more than $31,000.

h. In March 2004, Trader B and his wife and Trader D and his girlfriend flew to the Bahamas and Turks & Caicos for vacation. The cost for Jefferies was more than $47,000.

23. The use of a private plane at Jefferies' expense constituted compensation to the Fund Adviser's employees within the scope of the prohibition in Section 17(e)(1) of the Investment Company Act.

[7] Quinn remarked in an email to a Fund Adviser trader in November 2002, "I view private plane travel as one of the great perks of this biz and am more than willing to do it for a few guys when I can ... just as long as they keep it low."

24. Quinn also provided some of the Fund Adviser's employees with tickets to sporting events and concerts along with expensive wine. For example:

a. Quinn gave Trader E tickets to attend the Wimbledon and U.S. Open tennis tournaments. The total cost to Jefferies of the Wimbledon tickets in 2002, 2003 and 2004 was nearly $90,000, the total cost of U.S. Open tickets in 2002 and 2003 was more than $17,000, and when Trader E attended Wimbledon in 2004, Jefferies also paid $12,000 for his hotel in London. Quinn did not attend any of these events.

b. Quinn provided some of the Fund Adviser's employees, including traders and a senior Fund Adviser officer, with numerous tickets to the theater (such as "The Lion King," "Hairspray," "Beauty and the Beast," "The Producers" and "Moving Out"), concerts (such as Bruce Springsteen, Justin Timberlake, Prince and Santana), the circus, and professional baseball, basketball, football and hockey games.[8] Quinn rarely attended these events with the Fund Adviser's employees.

c. Quinn provided the Fund Adviser's traders with extremely expensive bottles of wine as Christmas gifts. For example, Quinn gave Trader E over $13,000 worth of wine over two Christmases, and he provided over $4,000 worth of wine as a Christmas gift to Trader B.

25. The receipt of tickets at Jefferies' expense constituted compensation to the Fund Adviser employees in violation of Section 17(e)(1) of the Investment Company Act.

Jefferies' Increased Business
with the Fund Adviser after Quinn's Hiring

26. Jefferies' status among the securities brokerage firms used by the Funds improved substantially after Quinn joined the firm. Jefferies for the first time began to commit capital in certain of its trades for the Fund Adviser. In addition, on a regular basis, Quinn provided the Fund Adviser's employees with the travel, entertainment and gifts described above.[9]

27. The Fund Adviser's traders were only permitted to send securities transactions to broker-dealers that had been approved by the Head of Equity Trading. The Fund Adviser grouped the approved firms into three categories: (1) "core brokers" handling the large majority of transactions; (2) "watch list brokers" handling a smaller, but still significant, amount of transactions; and (3) other "specialized brokers." Before Quinn began working there in

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8 In December 2002, Quinn told Trader E that certain tickets were "not easy by the way." Trader E responded, "I know. That's why I asked Kevin 'the Man' Quinn for a big favor."

9 Quinn once described himself to a Fund Adviser trader as "a whore for biz." He told another trader, "I will do anything for an order (w/ my clothes on)."

September 2002, Jefferies was in the third category as a "specialized third-market" firm. As of January 2003 – after Quinn's first four months of the firm – the Fund Adviser had moved Jefferies to the second category as a "watch list" firm. As of April 2003 – after another three months of Quinn's efforts – the Fund Adviser had re-classified Jefferies once again, placing the firm in the first category of "core brokers."

28. Consistent with its change of status to a "core broker," the brokerage business that Jefferies received from the Funds increased substantially after Quinn began working there in September 2002. Before Quinn's arrival, in the second quarter of 2002, Jefferies handled 25.1 million shares of listed securities and 14 million shares of "over-the-counter" ("OTC") securities for the Funds. With this volume, Jefferies ranked 34th for listed securities and 25th for OTC securities among the brokerage firms used by the Funds. Jefferies' volume rose quickly after Quinn's arrival. In the fourth quarter of 2002, Quinn's first full quarter of employment, Jefferies' ranking had risen to 17th for listed securities and 18th for OTC securities. By the third quarter of 2004, Quinn's final full quarter of employment, Jefferies handled 277.7 million shares of listed securities and 193.6 million shares of OTC securities. Its volume ranking with the Funds was 13th in listed securities and 12th in OTC securities.

29. Just as the volume of Jefferies' brokerage business from the Funds increased, so did the brokerage commissions that the Funds paid to Jefferies. In the first six months of 2002, just prior to Quinn's arrival, Jefferies received $1.7 million in brokerage commissions, ranking it 43rd among the firms used by the Fund Adviser. By contrast, in the first nine months of 2004, Jefferies received $24.5 million in brokerage commissions from the Funds, improving its ranking to 13th among the firms used by the Fund Adviser. During the period of Quinn's employment, Jefferies received over $60 million in commissions from the Funds.

30. Most of the brokerage business that Jefferies received from the Fund Adviser came from four traders (Traders A, B, C and D) who went on most of Quinn's golf and other excursions and from a fifth trader (Trader E), who received expensive wine and the most expensive tickets to sporting events (such as Wimbledon and the U.S. Open). During the period of Quinn's employment at Jefferies (September 2002 to October 2004), these five traders sent trades generating approximately $39.4 million in commissions for Jefferies:

Trader A	$18.4 million
Trader B	6.5 million
Trader C	2.6 million
Trader D	3.2 million
Trader E	8.7 million

In addition, Traders F and G, both of whom took vacations on private planes supplied by Quinn, sent trades generating an additional $2.9 million.

31. Although these traders (especially Traders A-E) routinely directed brokerage business to Jefferies after Quinn's arrival, they sometimes sent higher than average volume of business to Jefferies just before or just after Quinn provided them with travel and entertainment.

Jefferies' Failure to Supervise Quinn

32. As noted above, the $1.5 million annual T&E expense account that Quinn received from Jefferies was unprecedented for the firm. Quinn had only one significant customer, the Fund Adviser, and he obtained most of his brokerage business from only a small group of the Fund Adviser's traders. Giving Quinn and his team $1.5 million to spend each year on so few of the Fund Adviser's employees created a substantial risk that Quinn would use the money for travel, entertainment and gifts that would constitute compensation to the Fund Adviser employees in violation of Section 17(e)(1) of the Investment Company Act. Jefferies approved and reimbursed Quinn's expenditures to the Fund Adviser's employees and failed reasonably to implement its existing policies and procedures and failed to develop new procedures to determine whether Quinn provided the Fund Adviser's employees with compensation in violation of Section 17(e)(1) of the Investment Company Act.

33. Quinn was not required to obtain prior approval for his T&E expenditures. Jefferies also did not require Quinn to account for his use of pre-paid private plane hours.

34. If Jefferies had reasonably implemented its existing policies and procedures or adopted new procedures to oversee Quinn's use of the T&E expense account, it is likely that Jefferies could have prevented and detected Quinn's securities law violations.

Jones' Failure to Supervise Quinn

35. To be reimbursed for those expenditures after-the-fact, Quinn had to submit vouchers. Consistent with the *T&E Policy*, the vouchers were supposed to identify the customers who attended the event, the business purpose of the event, and the business topics discussed during the event. The vouchers were also supposed to include original itemized receipts for all expense items.

36. Jones, who was Quinn's immediate supervisor, reviewed and approved most of Quinn's expense vouchers.[10] After Jones approved a voucher, he sent it to the Equity Accounting office in New York, which then sent the voucher to the Accounting Department in Los Angeles for payment. Before issuing a reimbursement check, the Accounting Department was supposed to review the voucher to ensure that it had been approved by a supervisor and that it contained proper supporting documentation.

[10] On certain occasions, especially at the beginning of Quinn's employment at Jefferies, the regional manager in Jefferies' Boston office, rather than Jones, reviewed and approved Quinn's vouchers.

37. From June 2002 until October 2004, Quinn obtained reimbursement for 75 vouchers totaling $2.8 million. Jones and, on a few occasions, the Boston regional manager, approved the vouchers even though many of them were deficient in several respects, and reflected red flags that Quinn was not complying with firm procedures and could be facilitating the Fund Adviser's employees' violations of Section 17(e)(1) of the Investment Company Act.

38. Many of Quinn's vouchers indicated on their face that he had provided the Fund Adviser's employees with items worth more than $100. Examples include:

a. Quinn was reimbursed for substantial expenses associated with the so-called "Fall Classic" in November 2002, when he took the Head of Equity Trading and Traders A and B to Las Vegas and Mexico for golf and other activities. Jones approved the reimbursement of $5,199 for golf merchandise and $3,360 for four DVD players even though the vouchers (#172262 and 172461) indicated that the items were for the "annual golf outing with Fund Adviser traders."

b. Quinn was reimbursed $1,391 for merchandise that he claimed to have given to seven of the Fund Adviser's employees (including the Head of Equity Trading and Traders A, B, C and D) in April 2003. Jones approved the reimbursement even though the voucher (#183963) identified the items as "Seminole Golf Outing golf prizes."

c. Quinn was reimbursed for substantial expenses associated with the so-called "Fall Classic" in December 2003, when he took Traders A and B to Las Vegas and Arizona for golf and other activities. Jones approved the reimbursement of $10,332 for golf merchandise even though the voucher (#196189) identified the items as "golf supplies and prizes."

d. Quinn was reimbursed $10,333 for wine that he claimed to have given to fifteen Fund Adviser traders in December 2003. (In fact, the wine consisted of cases that Quinn gave to Traders B and E.) Jones approved the reimbursement even though the voucher (#198286) identified the wine as "[the Fund Adviser] Xmas gifts."

39. If Jones had conducted a reasonable examination of these vouchers, he would have seen that Quinn had given the Fund Adviser's employees items worth more than $100, in violation of the firm's *Statement of Policy*.

40. Many of Quinn's vouchers contained no indication that any Jefferies personnel had accompanied the Fund Adviser's employees to certain events (which, in fact, they had not). Examples include:

a. Quinn was reimbursed $24,493 for a private plane to Florida that he provided to Trader F and his family in November 2002. Jones approved the reimbursement even though the voucher (#173754) did not indicate that Quinn had been on the flight.

b. Quinn was reimbursed $3,610 for tickets to "Hairspray" that he gave to Trader E in December 2002. Jones approved the reimbursement even though the voucher (#175227) indicated that the tickets were for one of the Fund Adviser's senior officials and did not indicate that any Jefferies personnel had attended the event.

c. Quinn was reimbursed $23,600 for private plane flights to and from Las Vegas that he claimed to have provided to Trader C in March 2003. Jones approved the reimbursement even though the voucher (#180455) did not indicate that Quinn had been on the flight and the attached documentation indicated that Trader C had been the only passenger.

d. Quinn was reimbursed $31,216 for tickets to the Wimbledon tennis tournament that he gave to Trader E in July 2003. Jones approved the reimbursement even though the voucher (#186167) did not indicate that Jefferies personnel had attended the event.

41. If Jones had conducted a reasonable examination of these vouchers, he would have found no indication that any Jefferies personnel had accompanied the Fund Adviser's employees to the various events, and thus Quinn was not entitled to reimbursement under the firm's *T&E Policy*. He would also have seen that the unaccompanied private plane trips and tickets were gifts to a customer worth more than $100, in violation of the *Statement of Policy*.

42. Some of Quinn's vouchers were inconsistent with the attached documentation. Examples include:

a. Quinn was reimbursed $2,948.97 for a private plane to Nantucket that he provided to Trader A and his wife in September 2003. Jones approved the reimbursement. The voucher (#195455) indicated that Quinn and his wife were on the plane along with two Fund Adviser traders and their wives, but the attached air charter invoice indicated that there were only three passengers.

b. Quinn was reimbursed $46,237 for a private plane to Tortola in the Caribbean that he provided to Trader G and his wife in November 2003. Jones approved the reimbursement. The voucher (#195317) indicated that Quinn was on the plane, but the only person mentioned on the attached air flight detail was Trader G.

c. Quinn was reimbursed $38,208 for tickets to the Wimbledon tennis tournament that he gave to Trader E in July 2004 and was also reimbursed $12,809 for the trader's lodging at a London hotel. Jones approved the reimbursement. The vouchers (#210466 and 210486) listed business discussed as "tech stock volatility," but the attached invoice did not indicate that any Jefferies personnel had attended the event.

43. If Jones had obtained the charter company invoices and conducted a reasonable examination of these vouchers, they would have found that these were additional instances when no one from Jefferies accompanied the Fund Adviser employee on the trip and thus that Quinn was not entitled to reimbursement under the firm's *T&E Policy*. The unaccompanied flights were gifts to a customer worth more than $100, in violation of the firm's *Statement of Policy*, and also constituted compensation to the Fund Adviser employees in violation of Section 17(e)(1) of the Investment Company Act.

44. Jones also never required Quinn to account for his use of pre-paid private plane hours. A reasonable review of the charter company invoices would have revealed many additional occasions when no one from Jefferies accompanied a Fund Adviser employee on a private plane trip. Examples include:

a. A flight from California to Boston in February 2003 (worth nearly $45,000) by the Head of Equity Trading.

b. Round-trip flights between Boston and Florida in December 2003 (worth more than $45,000) by the Head of Equity Trading and three guests.

c. A flight to Puerto Rico in February 2004 (worth more than $23,000) by Trader A and his wife.

d. Round-trip flights between Boston and the Bahamas in March 2004 (worth more than $47,000) by Trader B and his wife and Trader D and his girlfriend.

45. If Jones had conducted a reasonable examination of the charter company invoices, he would have found that these were still more instances when no one from Jefferies accompanied the Fund Adviser employee on a private plane trip and thus that Quinn was not entitled to reimbursement under the firm's *T&E Policy*. Once again, the unaccompanied flights were gifts to a customer worth more than $100, in violation of the firm's *Statement of Policy*.

46. Jones was a senior Jefferies executive with considerable experience in the brokerage business and Quinn's supervisor. Nevertheless, he failed to reasonably monitor Quinn's use of his $1.5 million annual T&E expense account to entertain Fund Adviser employees. Indeed, as set forth above, Jones failed to reasonably respond to red flags related to Quinn's use of the T&E expense account. First, Jones approved a number of vouchers that reflected gifts to a customer worth more than $100, in violation of Jefferies' *Statement of Policy*, as well as expenses that were not eligible for reimbursement under the firm's *T&E Policy*.

47. In particular, Jones failed reasonably to respond to red flags that were reflected on the vouchers themselves, nearly all of Quinn's T&E expenditures were for the benefit of the same handful of Fund Adviser employees – especially the Head of Equity Trading and Traders

A, B, C, D and E. This concentration of Quinn's expenditures on such a small number of people only increased the chance that the expenditures would result in gifts worth more than $100 and in compensation to the Fund Adviser employees in violation of Section 17(e)(1) of the Investment Company Act.

48. If Jones had reasonably responded to red flags, it is likely that they could have prevented and detected Quinn's securities law violations.

Quinn Sought and Obtained Reimbursement for Improper Expenses

49. Quinn also submitted T&E vouchers to Jefferies reflecting hundreds of thousands of dollars of expenses that were for his own personal benefit by improperly characterizing them as business expenses.[11] This included private jet travel, along with personal trips with friends and family to such places as Aspen, Colorado; Sea Island, Georgia; and the Masters golf tournament in Augusta, Georgia. Quinn also sought and obtained reimbursement for a private jet flight taken by his supervisor Jones to Florida by improperly submitting a voucher that indicated that the Fund Adviser's Head of Equity Trading was the passenger on the flight.

50. Quinn's submission of improper T&E vouchers and the resulting reimbursement rendered Jefferies' ledgers of its expense accounts inaccurate in violation of Section 17(a)(1) of the Exchange Act and Rule 17a-3 thereunder.

Jefferies' Actions After the Beginning of the Investigation

51. After an NASD examination in August 2004 raised questions about Quinn's conduct, Jefferies commenced an internal investigation by outside counsel. Upon completion, Jefferies provided the report of the internal investigation to the Commission staff. In October 2004, Jefferies terminated Quinn for cause. Jefferies also fined Quinn's supervisor, Jones, $250,000, suspended him for 30 days without pay, and ordered him to participate in supervisory and compliance training.

52. In determining to accept Jefferies' Offer, the Commission considered its cooperation with the Commission staff.

D. VIOLATIONS

1. As a result of the conduct described above, Jefferies failed reasonably to supervise Quinn, with a view to preventing and detecting his aiding and abetting violations of Section 17(e)(1) of the Investment Company Act, within the meaning of Section 15(b)(4)(E) of the Exchange Act.

[11] After his termination, Quinn reimbursed Jefferies for an agreed-upon amount of these expenses.

2. As a result of the conduct described above, Jefferies willfully violated Section 17(a)(1) of the Exchange Act and Rule 17a-3 thereunder by failing to make and keep current accurate books and records of its expenses and compensation records related to its associated persons by means of the submission and approval of T&E vouchers that characterized Quinn's prohibited use of his T&E budget as business expenses of the company.

3. As a result of the conduct described above, Jones failed reasonably to supervise Quinn, with a view to preventing and detecting his aiding and abetting violations of Section 17(e)(1) of the Investment Company Act, within the meaning of Section 15(b)(6) of the Exchange Act, incorporating by reference Section 15(b)(4)(E) of the Exchange Act.

IV.

UNDERTAKINGS

1. **Independent Compliance Consultant**. Jefferies shall retain, within 30 days of the date of this Order, the services of an Independent Compliance Consultant not unacceptable to the staff of the Commission. The Independent Compliance Consultant's compensation and expenses shall be borne exclusively by Jefferies and Jefferies shall require the Independent Compliance Consultant to conduct a comprehensive review of Jefferies' supervisory, compliance, and other policies and procedures designed to detect and prevent breaches of the firm's policies and the federal securities laws with respect to the provision of gifts, travel, and entertainment by Jefferies and its employees. This review shall include, but shall not be limited to, a review of Jefferies' travel and entertainment of, and gifts to, customers and prospective customers; the provision of training for employees regarding travel and entertainment of, and provision of gifts to, customers; and supervisory review and approval of travel and entertainment expenses submitted by Jefferies' employees. Jefferies shall cooperate fully with the Independent Compliance Consultant and shall provide the Independent Compliance Consultant with access to its files, books, records, and personnel as reasonably requested for the review.

a. Jefferies shall require that, at the conclusion of the review, which in no event shall be more than 120 days after the date of entry of this Order, the Independent Compliance Consultant shall submit a Report to Jefferies and to the staff of the Commission. Jefferies shall require the Independent Compliance Consultant to address in the Report the issues described in paragraph 1 of these undertakings, and to include a description of the review performed, the conclusions reached, the Independent Compliance Consultant's recommendations for changes in or improvements to Jefferies' policies and procedures, and a procedure for implementing the recommended changes in or improvements to Jefferies' policies and procedures.

b. Jefferies shall adopt all recommendations contained in the Report of the Independent Compliance Consultant; provided, however, that within 150 days

from the date of the entry of this Order, Jefferies shall in writing advise the Independent Compliance Consultant and the staff of the Commission of any recommendations that it considers to be unnecessary or inappropriate. With respect to any recommendation that Jefferies considers unnecessary or inappropriate, Jefferies need not adopt that recommendation at that time but shall propose in writing an alternative policy, procedure, or system designed to achieve the same objective or purpose.

c. As to any recommendation with respect to Jefferies' policies and procedures on which Jefferies and the Independent Compliance Consultant do not agree, such parties shall attempt in good faith to reach an agreement within 180 days of the date of the entry of this Order. In the event Jefferies and the Independent Compliance Consultant are unable to agree on an alternative proposal acceptable to the staff of the Commission, Jefferies will abide by the determinations of the Independent Compliance Consultant.

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

e. Jefferies shall require the Independent Compliance 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 Compliance Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with Jefferies, 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 Compliance 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 Compliance Consultant in performance of his/her duties under this Order shall not, without prior written consent of the Commission's Boston District Office, enter into any employment, consultant, attorney-client, auditing or other professional relationship with Jefferies, 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.

f. Certification. No later than twelve months after the date of entry of this Order, the chief executive officer of Jefferies shall certify to the Commission in writing that Jefferies has fully adopted and complied in all material respects with the undertakings set forth in this section IV and with the recommendations of the Independent Compliance Consultant or, in the event of material non-adoption or non-compliance, shall describe such material non-adoption and non-compliance.

g. Recordkeeping. Jefferies shall preserve for a period not less than six years from the end of the fiscal year last used, the first two years in an easily accessible place, any record of Jefferies' compliance with the undertakings set forth in this section IV.

h. Deadlines. For good cause shown, the Commission's staff may extend any of the procedural dates set forth above.

i. Other Obligations and Requirements. Nothing in this Order shall relieve Jefferies of any other applicable legal obligation or requirement, including any rule adopted by the Commission subsequent to this Order.

2. **Compliance Affidavit**. Jones shall provide to the Commission, within ten (10) days after the end of the three-month suspension period described below in Section V, an affidavit that he has complied fully with this sanction. Such affidavit shall be submitted under cover letter that identifies Scott Jones as a Respondent and the file number of these proceedings, and hand-delivered or mailed to David P. Bergers, District Administrator, Boston District Office, 33 Arch Street, 23rd Floor, Boston, MA 02110-1424.

V.

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

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

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

B. be, and hereby is, censured.

C. shall, within 10 days of the entry of this Order, pay disgorgement of $4,214,945.65 and prejudgment interest of $580,316.26 to the Securities and Exchange Commission. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order;

(B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Jefferies as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to David P. Bergers, District Administrator, Boston District Office, 33 Arch Street, 23rd Floor, Boston, MA 02110-1424.

D. shall comply with its undertakings as enumerated in Section IV above.

Accordingly, pursuant to Section 15(b) of the Securities Exchange Act of 1934, it is hereby ORDERED that Respondent Jones:

A. be, and hereby is, suspended from acting in a supervisory capacity for any broker or dealer for a period of three (3) months, effective beginning the second Monday following the issuance of this Order.

B. shall, within 10 days of the entry of this Order, pay a civil money penalty of $50,000 to the Securities and Exchange Commission. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to David P. Bergers, District Administrator, Division of Enforcement, Securities and Exchange Commission, 33 Arch Street, 23rd Floor, Boston, MA 02110-1410.

C. shall comply with his undertaking as enumerated in Section IV above.

VI.

Upon further order by the Commission, the Division of Enforcement shall submit a proposed plan for the administration and distribution of the Fair Fund in this matter.

By the Commission.

Nancy M. Morris
Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 200

[Release No. 34-54867]

Delegation of Authority to Chief Administrative Law Judge

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission ("Commission") is amending its rules to delegate authority to the Chief Administrative Law Judge to issue orders to discontinue administrative proceedings as to a particular respondent who has died or cannot be found, or because of a mistake in the identity of a respondent named in the order for proceedings. The delegation is intended to conserve Commission resources, as well as expedite disposition of administrative proceedings.

EFFECTIVE DATE: [Insert date—30 days after publication in Federal Register].

FOR FURTHER INFORMATION CONTACT: Geoffrey D. Kruczek, Office of Administrative Law Judges, (202) 551-6030, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-2557.

SUPPLEMENTARY INFORMATION:

The Commission today is amending its rules governing the delegation of authority to the Chief Administrative Law Judge. The Commission's Office of the General Counsel has delegated authority to grant motions of staff counsel to discontinue administrative proceedings as to a particular respondent who has died or cannot be found, or because of a mistake in the identity of a respondent named in the order for proceedings.[1] The Commission has determined

[1] 17 CFR 200.30-14(g)(1)(vi).

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to extend this delegation to the Chief Administrative Law Judge.[2] The Commission believes that this delegation will conserve Commission and staff resources, as well as expedite the disposition of staff motions prompted by these circumstances. Nevertheless, the staff may submit motions to the Commission for consideration, as it deems appropriate. The amendment also deletes reference to the Public Utility Holding Company Act of 1935, which has been repealed.

Administrative Law Matters

The Commission finds, in accordance with section 553(b)(A) of the Administrative Procedure Act, 5 U.S.C. 553(b)(A), that this amendment relates solely to agency organization, procedure or practice. Accordingly, notice and opportunity for public comment are unnecessary. Because notice and comment are not required for this final rule, a regulatory flexibility analysis is not required under the Regulatory Flexibility Act.[3] Because the rule relates to "agency organization, procedure or practice that does not substantially affect the rights or obligations of non-agency parties," it is not subject to the Small Business Regulatory Enforcement Fairness Act.[4]

Section 23(a)(2) of the Securities Exchange Act of 1934 requires the Commission, in adopting rules under such Act, to consider the anticompetitive effects of any rules it adopts. The Commission does not believe this rule will have any impact on competition because it imposes no new burden on respondents in administrative proceedings, and is intended to expedite disposition of those proceedings. The rule does not contain any collection of information requirements as defined by the Paperwork Reduction Act of 1995, as amended.[5] The rule will not impose any costs on the public.

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[2] 17 CFR 200.30-10.
[3] See 5 U.S.C. 603.
[4] See 5 U.S.C. 804(3)(C).
[5] See 44 U.S.C. 3501 et seq.

Statutory Basis and Text of Amendment

This amendment to the Commission's delegations is being adopted pursuant to statutory authority granted to the Commission, including section 3 of the Sarbanes-Oxley Act of 2002, 15 U.S.C. 7202; section 19 of the Securities Act of 1933, 15 U.S.C. 77s; sections 4A, 19, and 23 of the Securities Exchange Act of 1934, 15 U.S.C. 78d-1, 78s, 78w; section 319 of the Trust Indenture Act of 1939, 15 U.S.C. 77sss; sections 38 and 40 of the Investment Company Act of 1940, 15 U.S.C. 80a-37 and 80a-39; and section 211 of the Investment Advisers Act of 1940, 15 U.S.C. 80b-11.

List of Subjects in 17 CFR Part 200

Authority delegations (Government agencies).

Text of Adopted Rule

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

Part 200—ORGANIZATION; CONDUCT AND ETHICS; AND INFORMATION AND REQUESTS

1. The authority citation for part 200, subpart A, continues to read as follows:

Authority: 15 U.S.C. 77s, 77o, 77sss, 78d, 78d-1, 78d-2, 78w, 78ll(d), 78mm, 80a-37, 80b-11, and 7202, unless otherwise noted.

* * * * *

2. Section 200.30-10 is amended by:

a. Removing "the Public Utility Holding Company Act of 1935, 15 U.S.C. 79a et seq.," in the introductory text to paragraph (a);

b. Removing the period at the end of paragraph (a)(7) and in its place adding a semicolon; and

c. Adding paragraph (a)(8).

The addition reads as follows:

§ 200.30-10 Delegation of authority to Chief Administrative Law Judge.

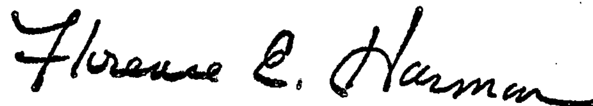
* * * * *

(a) * * *

(8) To grant motions of staff counsel to discontinue administrative proceedings as to a particular respondent who has died or cannot be found, or because of a mistake in the identity of a respondent named in the order for proceedings.

* * * * *

By the Commission.



Florence E. Harmon
Deputy Secretary

Date: December 4, 2006

Commissioner Casey
Not Participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 8758 / December 4, 2006

SECURITIES EXCHANGE ACT OF 1934
Release No. 54868 / December 4, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12497

In the Matter of

Health Enhancement Products, Inc.

Respondent.

ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933 AND SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934

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 Health Enhancement Products, Inc. ("HEPI" 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

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herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings, Making Findings, and Imposing a Cease-and-Desist Order Pursuant to Section 8A of the Securities Act of 1933 and Section 21C of the Securities Exchange Act of 1934 against Health Enhancement Products, Inc. as set forth below.

III.

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

Summary

1. HEPI, a start-up nutraceutical company, issued a number of materially misleading press releases, and made materially false statements (and omissions) in its public filings, as part of a fraudulent scheme to inflate HEPI's stock price. Specifically, Howard Baer, a recidivist securities law violator, orchestrated a scheme to inflate artificially the price of HEPI's common stock. First, Howard Baer obtained control over a majority of the stock of HEPI, and became CEO of the company. To increase the value of the stock, Howard Baer then directed HEPI to issue press releases about the company's primary product, ProAlgaZyme, a purported natural dietary supplement, as well as the company's business prospects. These public statements contained material misstatements or failed to disclose material information. While HEPI was issuing these misleading press releases, the stock price increased. After the stock price increased, Howard Baer sold HEPI stock through brokerage accounts he controlled at a significant profit.

Respondent

2. HEPI is a Nevada corporation with its principal place of business in Tempe, Arizona. HEPI's common stock is registered with the Commission pursuant to Section 12(g) of the Exchange Act. HEPI has described itself as a "fast growing nutraceutical company" that is "directed specifically at the development and marketing of supplementary health-enhancing products using only pure, all-natural and herbal extracts." According to HEPI's periodic filings with the Commission, HEPI generated revenue of approximately $288 during the fiscal year ended December 31, 2003, approximately $49,000 during the fiscal year ended December 31, 2004, and approximately $96,000 in 2005. These revenues were purportedly derived primarily from sales of ProAlgaZyme. HEPI incurred net losses of approximately $568,000 in 2003, $3.8 million in 2004, and $5.9 million in 2005. HEPI currently has six full-time and three part-time employees. HEPI's common stock is quoted on the OTC Bulletin Board.

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

Other Relevant Individual

3. Howard Baer, age 63, resides in Scottsdale, Arizona. Since 2003 and continuing to the present, Howard Baer is HEPI's Chairman and sole director, as well as the company's CEO, Secretary, and Treasurer. Howard Baer is also President of Carriage House Capital LLC ("Carriage House"), which purportedly advises start-up businesses. Howard Baer is a recidivist. In 1994, a United States District Court entered a final judgment on consent permanently enjoining Howard Baer from future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. See SEC v. Baer, Civil Action No. 93-5159 (JFK) (S.D.N.Y.) (In the Matter of Howard Baer, NY-6102). The Commission's complaint alleged that Howard Baer engaged in a free-riding scheme in which he placed trades through numerous broker-dealers to purchase stock in a public company without the intent or ability to pay for the purchases.

Background

4. In 2003, Howard Baer acquired Health Enhancement Corporation ("HEC"), a privately held company that claimed to have the material necessary to manufacture ProAlgaZyme. In approximately October and November 2003, Howard Baer negotiated an acquisition of HEC by Western Glory Hole, Inc. ("WGH"), a public shell company, and changed the name of WGH to HEPI. Following the acquisition, and as of December 31, 2003, there were over 10,000,000 shares of HEPI's common stock issued and outstanding. Howard Baer directly owned 6,402,450 shares, or approximately 62.55% percent of the outstanding shares. Following the acquisition, Howard Baer became the CEO, chairman of the board and sole director of HEPI.

HEPI Issued Misleading Public Statements to Investors

5. Beginning in late October 2003, Howard Baer directed HEPI (or its predecessor entity) to disseminate press releases about HEPI's primary product, ProAlgaZyme, as well as the company's business prospects. The public statements contained material misstatements or failed to disclose material information. In addition, Howard Baer executed trades in HEPI stock to increase and/or stabilize the price of HEPI stock.

6. For instance, beginning on October 30, 2003, HEPI (or its predecessor entity) issued a series of press releases that claimed HEPI was conducting "clinical trials" on ProAlgaZyme and that ProAlgaZyme had the potential to help fight a wide variety of diseases, including various types of cancer, AIDS, diabetes, heart disease and Chronic Fatigue Syndrome. For example, the October 30 press release, which announced the acquisition agreement between WGH and HEPI and the name change to HEPI, stated:

> Recent clinical trials performed by the company have indicated that ProAlgaZyme may increase and activate the white blood cells in individuals whose white cells are low or inactive, in effect enhancing the immune system. Heath Enhancements is currently doing internal clinical trials on several illnesses and diseases with

ProAlgaZyme, including various types of cancer, HIV/AIDS, diabetes and Chronic Fatigue Syndrome.

Similarly, in its Form 8-K, filed with the Commission on December 9, 2003, HEPI disclosed the acquisition agreement between WGH and HEC and the company's name change to HEPI, and further stated: "[r]ecent clinical trials performed by [HEPI] have indicated that [ProAlgaZyme] may increase and activate white blood cells in individuals whose white cells are low or inactive, in effect enhancing the immune system." HEPI made similar claims in its Form 10-KSB for the fiscal year ended December 31, 2003. In fact, as of October 30, 2003 and December 9, 2003, HEPI (or its predecessor entity) had not completed any clinical trials as the term is generally understood in the scientific community on the effects of ProAlgaZyme on the body. Rather, HEPI's Director of Medical Research had simply given ProAlgaZyme to his patients and gathered anecdotal evidence of its efficacy. The Director of Medical Research did not follow any accepted protocol during the period he gave ProAlgaZyme to his patients. HEPI did not disclose the informal nature of its purported clinical trials. Additionally, there were no studies that demonstrated that ProAlgaZyme may increase and activate white blood cells in individuals.

7. On January 20, 2004, HEPI issued a press release announcing "that an independent study conducted by the Biochemistry Department at [ASU] concluded that the Company's flagship product, ProAlgaZyme, possesses fibrinolytic properties, required in the breakdown of pathological fibrin gel, thus decreasing the risk of a stroke or heart attack." The January 20 press release further stated that the ASU study found that ProAlgaZyme "will neutralize the toxic or free radical-acting soluble fibrins that are released into the body." The press release then quoted Howard Baer as stating that the ASU "study provides conclusive evidence of the efficacy of ProAlgaZyme." The ASU study, however, did not determine what health benefits, if any, ProAlgaZyme possesses. According to the two scientists at ASU who performed the trials on ProAlgaZyme, the ASU test was not designed to determine whether ProAlgaZyme had any specific health benefits. Rather, the test was designed to determine whether ProAlgaZyme contained *in vitro*, or in the laboratory, "fibrinolytic" activity, which is the ability to break down fibrin clots and fibrinogen. While this type of activity is found in cancer retarding drugs, the mere presence of fibrinolytic activity *in vitro*, does not mean the drug has any specific health benefits *in vivo*, or in the body. Thus, the ASU test did not show that ProAlgaZyme "decreases the risk of a stroke or a heart attack" or "will neutralize the toxic or free radical-acting soluble fibrins that are released into the body" or, indeed, that ProAlgaZyme has any affect whatsoever on the body. Consequently, the ASU tests did not "provide[] conclusive evidence of the efficacy of ProAlgaZyme." Indeed, one ASU scientist stated that the statements pertaining to ProAlgaZyme in the press release are "inaccurate" and "simply not true."

8. HEPI also issued a baseless press release about its financial prospects. In January 2004, HEPI purchased the trademarks, licensing and sales rights for Zodiac Vitamins and Zodiac Herbal Teas Products. On January 13, 2004, HEPI issued a press release forecasting results for fiscal year 2004, announcing that HEPI "[e]xpects revenues for the year of $16 m[illion] or greater" based on anticipated sales of Zodiac Herbal Vitamins, a multivitamin designed for horoscope readers. The press release also quoted Howard Baer: "[Zodiac Herbal Vitamins] is a very attractive acquisition for us which we expect to be profitable in the first year, based on

conservative estimates." HEPI formulated its $16 million revenue projection simply by looking at the number of existing worldwide horoscope readers, and then assumed that a small percentage of those individuals would buy Zodiac Herbal Vitamins. HEPI had no history of sales upon which it could base its projection. Additionally, HEPI failed to conduct any other appropriate market research. Consequently, HEPI had no reasonable basis to project that its expected revenues would be at least $16 million for its new product.

9. Further, in its Form 10-QSB for the quarter ended March 31, 2005, HEPI misleadingly stated that testing conducted on ProAlgaZyme by a third party hired by HEPI to determine ProAlgaZyme's effects on diabetes, had ceased its testing due to a lack of test subjects: "The study being conducted by [the independent research company] was terminated because [the independent research company] was not able to recruit the specified number of participants (60)." In fact, the study was halted because the scientists at the independent research company were not obtaining positive results from their tests on ProAlgaZyme, and they felt that further testing would be fruitless. The scientist conducting the study informed Howard Baer of this reason for terminating the testing. Neither this Form 10-QSB, nor any other public filing made by HEPI, states that the independent research company halted the testing because the research company was not receiving positive results.

10. After HEPI began disseminating press releases, its stock price and the trading volume in the stock increased. From November 11, 2003 through February 2, 2004, HEPI's stock price increased from $1.62 (adjusted after split) to $7.54 per share, and then began generally to decline. For instance, as of January 31, 2005, HEPI stock price closed at $0.40 per share.

Howard Baer Profited From His Sales of HEPI Stock

11. After the price of HEPI's stock had started to climb, Howard Baer began to sell HEPI stock through brokerage accounts he controlled. Specifically, from November 26, 2003 through August 15, 2005, Howard Baer sold a total of 394,564 HEPI shares at prices ranging from $0.40 to $7.12 per share, for total proceeds of at least $1,349,592.81.

Violations of the Antifraud and Reporting Provisions of the Securities Laws

12. As a result of the conduct described above, HEPI 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. For example, HEPI knowingly or recklessly made material misrepresentations and omissions in its October 30, 2003, January 13, 2004 and January 20, 2004 press releases.

13. As a further result of the conduct described above, HEPI violated Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11, and 13a-13 thereunder, which require issuers with securities registered pursuant to Section 12 of the Exchange Act to file with the Commission accurate annual reports on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K. Rule 12b-20 requires that "in addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as

may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading." For example, HEPI made material misrepresentations and omissions in its Form 8-K, filed with the Commission on December 9, 2003, its Form 10-KSB for the fiscal year ended December 31, 2003, and in its Form 10-QSB for the quarter ended March 31, 2005.

IV.

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

Accordingly, it is hereby ORDERED that:

Respondent HEPI cease and desist from committing or causing any violations and any future violations of Sections 10(b) and 13(a) of the Exchange Act, and Rules 10b-5, 12b-20, 13a-1, 13a-11, and 13a-13 thereunder.

By the Commission.

Nancy M. Morris
Secretary

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

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34-54863; File No. S7-19-06]

RIN 3235-AJ41

Proposed Amendments to Municipal Securities Disclosure

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

ACTION: Proposed rule.

SUMMARY: The Commission is publishing for comment proposed amendments to a rule under the Securities Exchange Act of 1934 ("Exchange Act") relating to municipal securities disclosure which would delete references to the Municipal Securities Rulemaking Board ("MSRB") as a recipient of material event notices filed by or on behalf of issuers of municipal securities or other obligated persons.

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

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

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File No. S7-19-06 on the subject line; or
- Use the Federal eRulemaking Portal (http://www.regulations.gov). Follow the instructions for submitting comments.

Document 8 of 58

Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File No. S7-19-06. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (http://www.sec.gov/rules/proposed.shtml). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549. All comments received will be posted without change; 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: Martha Mahan Haines, Chief, Office of Municipal Securities, at (202) 551-5681; Mary N. Simpkins, Senior Special Counsel, at (202) 551-5683; or David Liu, Special Counsel, at (202) 551-5645, Division of Market Regulation, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-6628.

SUPPLEMENTARY INFORMATION: The Commission is requesting public comment on proposed amendments to Rule 15c2-12 [17 CFR 240.15c2-12] under the Exchange Act.

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I. Background

A. 1994 Amendments to Rule 15c2-12

On November 10, 1994, the Commission adopted amendments ("1994 Amendments") to Rule 15c2-12 ("Rule") under the Exchange Act[1] to provide, among other things, enhanced ongoing disclosure to the market for municipal securities.[2] Pursuant to subsection (b)(5)(i) of the Rule,[3] the Commission requires brokers, dealers, and municipal securities dealers ("Participating Underwriters"), prior to underwriting a primary offering of municipal securities of $1,000,000 or more, to reasonably determine that the issuer or obligated person for whom financial or operating data is presented in the final official statement ("Issuer"), has undertaken, in a written agreement or contract for the benefit of bondholders, to provide certain continuing disclosure information. Among other things, the Issuer must undertake to send to each nationally recognized municipal securities information repository ("NRMSIR") or the MSRB, and to the appropriate state information depository ("SID"), if any, certain material event notices designated in subsection (b)(5)(i)(C) of the Rule.[4] In addition, subsection (b)(5)(i)(D) of the Rule requires a Participating

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1 17 CFR 240.15c2-12.

2 Securities Exchange Act Release No. 34961 (November 10, 1994), 59 FR 59590 (November 17, 1994) ("1994 Adopting Release").

3 17 CFR 240.15c2-12(b)(5)(i).

4 17 CFR 240.15c2-12(b)(5)(i)(C). Subsection (b)(5)(i)(C) lists the following events which, if material, require notice: (1) principal and interest payment delinquencies; (2) non-payment related defaults; (3) unscheduled draws on debt service reserves reflecting financial difficulties; (4) unscheduled draws on credit enhancements reflecting

Underwriter to reasonably determine that the Issuer has agreed to notify those same repositories if it fails to provide annual financial information by the agreed-upon date.[5]

The Commission included the MSRB in its plan for dissemination of material event notices set forth in the Rule because, at the time of the 1994 Amendments, the MSRB already had a voluntary disclosure system in place for receiving and disseminating certain types of material event notices.[6] As the Commission noted in the 1994 Adopting Release, "permitting issuers and obligated persons to file such notices either with each NRMSIR or with the MSRB (as well as the appropriate SID) will facilitate prompt and wide disclosure."[7] In adopting the 1994 Amendments, the Commission also stated that inclusion of the MSRB as a filing option reflected the preference expressed by some commenters to file the required notices in one central place, rather than having to file with multiple NRMSIRs.[8] Under the Rule, the use of the MSRB filing alternative is optional, as the material event notice obligation can be satisfied by sending notice to each of the NRMSIRs rather than to the MSRB.

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financial difficulties; (5) substitution of credit or liquidity providers, or their failure to perform; (6) adverse tax opinions or events affecting the tax-exempt status of the security; (7) modifications to rights of security holders; (8) bond calls; (9) defeasances; (10) release, substitution, or sale of property securing repayment of the securities; and (11) rating changes.

In addition, in Rule 15c2-12(d)(2), the small issuer exemption is conditioned on an issuer or obligated person undertaking a limited disclosure obligation, including sending certain material event notices to each NRMSIR or the MSRB, as well as the appropriate SID. 17 CFR 240.15c2-12(d)(2).

5 17 CFR 240.15c2-12(b)(5)(i)(D).

6 See Securities Exchange Act Release No. 30556 (April 6, 1992), 57 FR 12534 (April 10, 1992) ("CDI System Approval Order"). See also Securities Exchange Act Release No. 33742 (March 9, 1994), 59 FR 12759 (March 17, 1994) ("1994 Proposing Release") at 12764, note 25.

7 See 1994 Adopting Release at 59605.

8 See 1994 Adopting Release at 59605.

B. CDI System and CDINet

The MSRB's original system for receiving material event notices, the Continuing Disclosure Information ("CDI") System, was approved by the Commission in April 1992 and commenced operation in January 1993.[9] On March 24, 1997, the MSRB implemented certain improvements to its dissemination process and replaced its earlier CDI System with CDINet. CDINet was approved by the Commission in December 1996[10] and, among other things, is designed to accept and disseminate material event notices submitted as a result of the Rule. Once a document has been accepted and processed by CDINet, it is broadcast to subscribers[11] and made available in the MSRB's public access facility.[12]

II. MSRB Petition

In a recent letter to the Commission,[13] the MSRB petitioned the Commission to remove the MSRB as a recipient of material event notices under the Rule.[14] According to the MSRB petition, CDINet was designed to permit Issuers to satisfy their material event undertakings through a single submission to the MSRB, rather than through separate filings to each of the NRMSIRs. However, the MSRB states that relatively few Issuers have opted to use CDINet and, in recent years, usage of CDINet has diminished. According to the MSRB, in 1997, CDINet

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9 CDI System Approval Order.

10 Securities Exchange Act Release No. 38066 (December 19, 1996), 61 FR 68322 (December 27, 1996) ("CDINet Approval Order").

11 The MSRB has represented to the Commission that CDINet has only two subscribers. See infra notes 18 and 19.

12 The MSRB has represented to the Commission that, as of September 2005, no one has requested CDINet information at the MSRB's public access facility for at least the last five years.

13 Letter from Diane G. Klinke, General Counsel, MSRB, to Jonathan G. Katz, Secretary, Commission, dated September 8, 2005 ("MSRB Petition").

14 17 CFR 240.15c2-12.

received over 10,000 material event notices. Since that time, submissions to the MSRB have dropped considerably, ranging from 1,000 to 2,500 annually.[15]

A review conducted by the MSRB of the material event notices received by CDINet in the first half of 2004 showed that, of the 1,104 notices received in that time period, 504 were bond calls, 213 were defeasances, and 145 were rating changes.[16] The MSRB also recently reviewed a sample of 100 material event notices received by CDINet in June 2005.[17] The MSRB believes that most of the material event notices received by CDINet also are provided to, or otherwise obtained by, the NRMSIRs.[18] In its petition, the MSRB also expressed concern that the notices filed exclusively with the MSRB may not be reaching the broader market as intended

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15 MSRB Petition at 2.

16 The remaining notices included the following categories: Failure to File Annual Report (70 notices); Information not specifically required under SEC Rule 15c2-12 (70); Bond Calls and Defeasances (56); Annual Report and CAFR Related Information (13); Various multiple categories indicated (10); Release, Substitution, or Sale of Property Securing Repayment of Securities (5); Principal and Interest Payment Delinquencies (4); Substitution of Credit or Liquidity Providers, or Their Failure to Perform (4); Non-Payment Related Defaults (3); Adverse Tax Opinions or Events Affecting the Tax-Exempt Status of the Security (3); Unscheduled Draws on Debt Service Reserves Reflecting Financial Difficulties (2); Unscheduled Draws Credit Enhancements Reflecting Financial Difficulties (1); and Modifications to the Rights of Security Holders (1). See Attachment to MSRB Petition.

17 MSRB Petition at 2-3.

18 Definitive information on 90 of the June 2005 notices was found by the MSRB in a review of information available from NRMSIRs that do not subscribe to CDINet. CDINet only has two NRMSIR subscribers: Kenny S&P and Thomson Financial Services. MSRB Petition at 2, note 7. The MSRB presumed that the remaining ten notices were not provided directly to all the NRMSIRs. These notices included six notices regarding failure to provide an annual financial statement, two bond calls, one rating change and one relating to "other information." The MSRB believes that there is some evidence, however, that at least one NRMSIR may have received some of the notices of failure to provide an annual financial statement but subsequently superseded such information with the annual financial statements themselves once these were received. MSRB Petition at 3, note 8.

by the Rule because not all NRMSIRs subscribe to CDINet and the information may not otherwise be widely distributed.[19]

In addition, the MSRB believes that the need for CDINet has also been lessened because an alternative document delivery system has become available to Issuers and dissemination agents who prefer to send their filings to a single location for delivery to all of the NRMSIRs and any appropriate SID.[20] In its petition to the Commission, the MSRB stated that it believes that the number of documents submitted to CDINet will further decrease and that the continued operation of CDINet would provide minimal continuing benefit to the marketplace.[21] Finally, because of the age of the CDINet system, the MSRB states that upgrades at an estimated cost of $500,000 to $1 million would be necessary to keep the system operational.[22]

III. Discussion

The Commission proposes to amend Rule 15c2-12[23] to delete references to the MSRB as an alternative recipient of material event notices filed by Issuers. Under the proposal, Issuers and their dissemination agents instead would undertake to send material event notices to each NRMSIR and the appropriate SID, if any. The Commission believes that, given the limited usage of the MSRB's CDINet system and the MSRB's petition for rulemaking, the proposed elimination of the option of filing material event notices with the MSRB is warranted. The relatively small number of filings made with CDINet indicates that there is little demand for the MSRB filing option. The Commission believes that requiring Issuers to send their material event

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19 MSRB Petition at 3.

20 The Commission understands that there may be other entities that have developed or are developing services related to Rule 15c2-12.

21 MSRB Petition at 3.

22 MSRB Petition at 3.

23 17 CFR 240.15c2-12.

notices only to each of the NRMSIRs and any appropriate SIDs would simplify the Rule and compliance by Issuers with their undertakings, because Issuers would be required to file material event notices at the same locations that annual financial information is required to be filed pursuant to undertakings in accordance with subsection (b)(5)(i)(A) of the Rule.[24] In addition, the Commission believes that eliminating the MSRB filing option would better assure that material event notices are widely disseminated to the market, since it appears that CDINet data may not be broadly distributed.[25] Requiring that each NRMSIR and the appropriate SID, if any, receives all material event notices should help assure the completeness and consistency of information available from those repositories.

Finally, the Commission notes the MSRB's statement that the upgrading of CDINet required to maintain the system would cost approximately $500,000 to $1 million.[26] In light of the current alternative options under Rule 15c2-12 for Issuers to file with NRMSIRs and SIDs and the lack of demand for the MSRB filing alternative—both by Issuers and information users—the Commission believes that the MSRB's proposal to cease CDINet's operations is reasonable. The Commission notes that the MSRB has committed to forward material event notices to the NRMSIRs and applicable SIDs for a period of one year from the date CDINet ceases operations.[27] The MSRB has also agreed to alert senders of such notices of the fact that CDINet is ceasing operations, and ask that such senders comply with their undertakings by sending future material event notices to the NRMSIRs and applicable SIDs.

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[24] 17 CFR 240.15c2-12(b)(5)(i)(A).

[25] As the MSRB's recent review showed, a portion of the notices received by the MSRB may not have been fully disseminated to the wider market, since there are only two subscribers to the MSRB's CDINet. See supra notes 18 and 19.

[26] MSRB Petition at 3.

[27] MSRB Petition at 4; Letter from Diane G. Klinke, General Counsel, MSRB, to Martha Mahan Haines, Chief, Office of Municipal Securities, Commission, dated April 20, 2006.

IV. Request for Comment

The Commission seeks comment on the proposed amendments to the Rule. Specifically, comment is requested on whether, in light of the alternative filing options available to Issuers and dissemination agents, there is still a need for the MSRB to be a recipient of material event notices. The Commission also requests comment on whether there exist any applicable continuing disclosure agreements which require issuers or other obligated persons to file material event notices solely with the MSRB that might require modification were the Commission to amend the Rule as proposed. It is the staff's understanding that such agreements often contain a requirement to file notices with both the (1) NRMSIRs and applicable SIDs and (2) MSRB. The Commission seeks comment on whether any such agreements require filings solely with the MSRB.

In addition, the Commission seeks comment on whether the proposed amendment would in fact simplify compliance with undertakings in accordance with the Rule, and better assure widespread dissemination of material event notices.

V. Paperwork Reduction Act

The proposed amendment to the Rule, contains no new "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[28] The title of the current information collection as required and under the Rule is Municipal Securities Disclosure (17 CFR 240.15c2-12) (OMB Control No. 3235-0372).

VI. Costs and Benefits of Proposed Amendments to Rule 15c2-12

The Rule currently requires Participating Underwriters to reasonably determine that Issuers have undertaken to submit material event notices to (1) each NRMSIR or the MSRB and

[28] 44 U.S.C. 3501 et. seq.

(2) the appropriate SID, if any. The proposed amendments would remove the MSRB as an option for the filing of such notices, thereby requiring submission, pursuant to the undertakings, to each NRMSIR and the appropriate SID, if any.

A. Benefits

The Commission preliminarily believes that the proposed amendments to the Rule should improve the disclosure of material event information to the municipal securities marketplace. Because the MSRB's CDINet system currently only has two subscribers, it is not clear that all material event notices submitted to the MSRB are fully distributed to the marketplace. Requiring that each NRMSIR and the appropriate SID, if any, receives all material event notices should help assure the completeness and consistency of information available from those repositories. The Commission also preliminary believes that the elimination of the MSRB as a filing option would simplify compliance by Issuers with their undertakings in accordance with the Rule. If the proposed amendments are adopted, Issuers would be required to file, pursuant to their undertakings, material event notices at the same locations–each NRMSIR and the appropriate SID, if any– that annual financial information is required to be filed. Finally, the Commission preliminarily concludes that the proposed amendments could save the MSRB substantial funds, represented by the MSRB to be approximately $500,000 to $1 million,[29] by not requiring it to perform certain upgrades to its CDINet system which would otherwise be required in order for the system to be maintained. As the costs of the MSRB are paid primarily from fees paid by brokers, dealers and municipal securities dealers, those parties and their customers would benefit from this savings.

29 MSRB Petition at 3.

B. Costs

The Commission preliminarily believes that the proposed amendments to the Rule should only minimally increase compliance costs for a few Issuers and may decrease overall compliance costs. Because some Issuers may currently be sending their material event notices only to the MSRB, the proposed amendments would require them to send such notices to each of the (currently four) NRMSIRs. However, the Commission believes that the cost of sending such notices to three additional locales would be minimal because such notices are generally short in length and would only encompass the additional costs of copying several pages, as well as the minor additional mailing costs. In addition, the MSRB has indicated that there is an alternative free document delivery system available to Issuers and dissemination agents who prefer to send their filings to a single location for delivery to all of the NRMSIRS and appropriate SIDs.[30] We request comment on whether this would result in any increased costs to issuers. Finally, the Commission preliminarily believes that those Issuers that currently send to their material event notices to each NRMSIR as well as the MSRB would reduce their costs because the proposed amendments would require those Issuers to send their material event notices to one fewer location.

To assist the Commission in evaluating the costs and benefits that may result from the proposed amendments to the Rule, the Commission requests comments on the potential costs and benefits identified in the release, as well as any other costs or benefits that may result from the proposed amendments to the Rule. In addition, the commenters should provide analysis and data to support their views on the costs and benefits.

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30 The Commission understands that there may be other entities that have developed or are developing services related to Rule 15c2-12.

VII. Consideration of Burden and Promotion of Efficiency, Competition, and Capital Formation

Section 3(f) of the Exchange Act[31] requires the Commission, whenever it engages in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action would promote efficiency, competition, and capital formation. In addition, Section 23(a)(2) of the Exchange Act[32] requires the Commission, when making rules under the Exchange Act, to consider the impact of such rules on competition. Section 23(a)(2) also prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

The Commission preliminarily believes that the proposed amendments to the Rule would not impose any burdens on efficiency, capital formation, and competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. The proposed amendments are expected to simplify the material event notice delivery requirements for Issuers, in accordance with their undertakings, by eliminating the MSRB as an alternative. In doing so, the Commission preliminarily believes that municipal securities disclosure would be enhanced, as all Issuers would be required to send all NRMSIRs (and appropriate SIDs) such notices. Under the current disclosure system, Issuers may choose to send such notices to the MSRB. However, there is some evidence[33] that some of the notices sent to the MSRB are not fully disseminated to the entire marketplace. By requiring delivery of such notices to all NRMSIRs and appropriate SIDs, if any, the Commission preliminarily believes that the completeness and consistency of

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31 15 U.S.C. 78c(f).

32 15 U.S.C. 78w(a)(2).

33 MSRB Petition at 3.

information from these repositories would be improved, thereby promoting efficiency and having no adverse impacts on competition or capital formation. In fact, competition to establish alternative delivery systems in the private sector may be enhanced by the elimination of the MSRB as a single filing location.

The Commission requests comment on all aspects of this analysis and, in particular, on whether the proposed amendments to the Rule would place a burden on competition, as well as the effect of the proposed amendments on efficiency, competition, and capital formation.

VIII. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"[34] we must advise the Office of Management and Budget as to whether the proposed regulation constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in: (1) an annual effect on the economy of $100 million or more (either in the form of an increase or a decrease); (2) a major increase in costs or prices for consumers or individual industries; or (3) significant adverse effect on competition, investment or innovation. The Commission preliminarily believes that this proposed amendment is not a major rule.

If a rule is "major," its effectiveness will generally be delayed for 60 days pending Congressional review. We request comment on the potential impact of the proposed rule on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

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

IX. Regulatory Flexibility Act Certification

Pursuant to Section 605(b) of the Regulatory Flexibility Act ("RFA"), the Commission hereby certifies that the proposed amendments to the Rule, would not, if adopted, have a significant economic impact on a substantial number of small entities. Under the RFA, the term "small entity" shall have the same meaning as the RFA defined terms "small business," "small organization," and "small governmental jurisdiction." According to Section 601(3) of the RFA, "the term "small business" has the same meaning as the term "small business concern" under Section 3 of the Small Business Act (15 U.S.C. 632), unless an agency, after consultation with the Small Business Administration and after opportunity for public comment, establishes one or more definitions of such term which are appropriate to the activities of the agency and publishes such definition(s) in the Federal Register." If the agency has not defined the term for a particular purpose, the Small Business Act states that "a small business concern...shall be deemed to be one which is independently owned and operated and which is not dominant in its field of operation." The Section 601(4) of the RFA defines a "small organization" to include "any not-for-profit enterprise which is independently owned and operated and is not dominant in its field." A "small governmental jurisdiction" is defined by Section 601(5) of the RFA to include "governments of cities, counties, towns, townships, villages, school districts, or special districts, with a population of less than fifty thousand."

It is likely that a substantial number of the Issuers required to submit material event notices are small governmental jurisdictions included in the RFA's definition of small entities. However, in this regard, the proposed amendments to the Rule would either not require any additional work for such small entities if they do not currently send material event notices to the MSRB, or would simply require them to send such notices to each of the (currently four)

NRMSIRs. However, the Commission believes that the cost of sending such notices to three additional locales would be minimal because such notices are generally short in length and would only encompass the additional costs of copying several pages, as well as the minor additional mailing costs. Finally, the Commission preliminarily believes that those Issuers that currently send their material event notices to each NRMSIR as well as the MSRB would reduce their costs because, under the proposed amendments, the MSRB would no longer be available as a location to send such notices. Thus, while the proposed amendments may impact a small entity, such impact would likely not be significant.

For the above reasons, the Commission certifies that the proposed amendments to the Rule would not have a significant economic impact on a substantial number of small entities. The Commission requests comments regarding this certification. The Commission requests that commenters describe the nature of any impact on small businesses and provide empirical data to support the extent of the impact.

X. Statutory Authority

Pursuant to the Exchange Act, and particularly Sections 3(b), 15(c), 15B and 23(a)(1) the Commission is proposing the amendments to § 240.15c2-12 of Title 17 of the Code of Federal Regulations in the manner set forth below.

TEXT OF PROPOSED RULE

List of Subjects in 17 CFR Part 240

Brokers, Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, Title 17, Chapter II, of the Code of Federal Regulations is proposed to be amended as follows.

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

1. The general authority citation for part 240 is revised to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

2. Section 240.15c2-12 is amended by revising the introductory text of paragraph (b)(5)(i)(C) and paragraphs (b)(5)(i)(D) and (d)(2)(ii)(B) to read as follows:

240.15c2-12 Municipal securities disclosure.

* * * * *

(b) * * *

(5) * * *

(i) * * *

(C) In a timely manner, to each nationally recognized municipal securities information repository and to the appropriate state information depository, if any, notice of any of the following events with respect to the securities being offered in the Offering, if material:

* * * * *

(D) In a timely manner, to each nationally recognized municipal securities information repository and to the appropriate state information depository, if any, notice of a failure of any person specified in paragraph (b)(5)(i)(A) of this section to provide required annual financial information on or before the date specified in the written agreement or contract.

* * * * *

(d) * * *

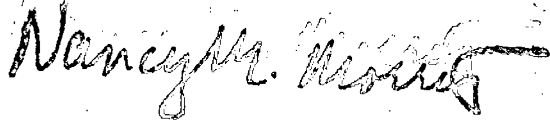
(2) * * *

(ii) * * *

(B) In a timely manner, to each nationally recognized municipal securities information repository and to the appropriate state information depository, if any, notice of events specified in paragraph (b)(5)(i)(C) of this section with respect to the securities that are the subject of the Offering, if material; and

* * * * *

By the Commission.



Nancy M. Morris
Secretary

Dated: December 4, 2006

UNITED STATES OF AMERICA
BEFORE THE
SECURITIES AND EXCHANGE COMMISSION

Securities Act of 1933
Release No. 8757/ December 4, 2006

Securities Exchange Act of 1934
Release No. 54865/ December 4, 2006

ORDER APPROVING PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD BUDGET AND ANNUAL ACCOUNTING SUPPORT FEE FOR CALENDAR YEAR 2007

The Sarbanes-Oxley Act of 2002 (the "Act") established the Public Company Accounting Oversight Board ("PCAOB") to oversee the audits of public companies and related matters, to protect investors, and to further the public interest in the preparation of informative, accurate and independent audit reports. The PCAOB is to accomplish these goals through registration of public accounting firms and standard setting, inspection, and disciplinary programs. Section 109 of the Act provides that the PCAOB shall establish a reasonable annual accounting support fee, as may be necessary or appropriate to establish and maintain the PCAOB. Section 109(h) amends Section 13(b)(2) of the Securities Exchange Act of 1934 to require issuers to pay the allocable share of a reasonable annual accounting support fee or fees, determined in accordance with Section 109 of the Act. Under Section 109(f), the aggregate annual accounting support fee shall not exceed the PCAOB's aggregate "recoverable budget expenses," which may include operating, capital and accrued items. Section 109(b) of the Act directs the PCAOB to establish a budget for each fiscal year in accordance with the PCAOB's internal procedures, subject to approval by the Securities and Exchange Commission (the "Commission").

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On July 18, 2006, the Commission amended its Rules of Practice related to its Informal and Other Procedures to add a rule that facilitates the Commission's review and approval of PCAOB budgets and accounting support fees.[1] The new budget rule provides, among other things, a timetable for the preparation and submission of the PCAOB budget and for Commission actions related to each budget, a description of the information that should be included in each budget submission, limits on the PCAOB's ability to incur expenses and obligations except as provided in the approved budget, procedures relating to supplemental budget requests, requirements for the PCAOB to furnish on a quarterly basis certain budget-related information, and a list of definitions that apply to the rule and to general discussions of PCAOB budget matters.

Although the new budget rule will not take effect until the budget process for fiscal year 2008, the PCAOB staff and the Commission staff used their best efforts to substantially comply with the timetable and other requirements in the new rule for the PCAOB budget submission for 2007. Accordingly, in March 2006 the PCAOB provided the Commission with a narrative description of its program issues and outlook for the 2007 budget year, and in April the Commission staff provided to the PCAOB staff economic assumptions and budgetary guidance for the 2007 budget year. The PCAOB subsequently delivered a preliminary budget and budget justification to the Commission. The staff from the Commission's Offices of the Chief Accountant, Executive Director and Information Technology dedicated a substantial amount of time to the review and analysis of the PCAOB's programs, projects and budget estimates, reviewed the PCAOB's estimates of 2006 actual spending, and attended several meetings with

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1 17 CFR 202.11. See Release No. 33-8724 (July 18, 2006) [71 FR 41998 (July 24, 2006)].

management and staff of the PCAOB to develop an understanding of the PCAOB's budget and operations. During the course of the Commission's review, the Commission staff relied upon representations and supporting documentation from the PCAOB. Also, substantially as provided in the new rule, there was a "pass back" from the Commission to the PCAOB. The PCAOB approved its 2007 budget on November 30, 2006 and submitted that budget for Commission approval.

After considering the above, the Commission did not identify any proposed disbursements in the 2007 budget adopted by the PCAOB that are not properly recoverable through the annual accounting support fee, and the Commission believes that the aggregate proposed 2007 annual accounting support fee does not exceed the PCAOB's aggregate recoverable budget expenses for 2007.

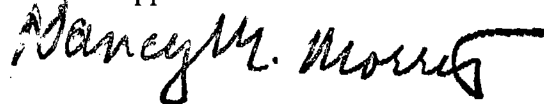
As part of its review of the 2007 PCAOB budget, the Commission notes that the PCAOB has reaffirmed its commitments, among other things, to build upon its 2007 goals and objectives to develop a comprehensive multi-year strategic plan that is integrated with the PCAOB budget process; to have the auditors of its 2007 annual financial statements opine on the PCAOB's internal control over financial reporting; to devote staff resources to train both PCAOB staff and the public on revisions to the standard for auditing internal control over financial reporting; and to comply with the new Commission rule related to the PCAOB budget approval process in connection with its budget for 2008. The Commission also recognizes that the PCAOB, upon the arrival of Chairman Olson in mid 2006, appropriately has undertaken reviews in a number areas, including its compensation, recruiting and information technology programs. Because of the potential significance of those reviews, during 2007 the PCAOB should supplement

the quarterly reports made available to the Commission under the new budget rule with periodic reports on the progress and results of those reviews and with monthly reports showing variances of actual or estimated expenditures from budgeted amounts, to the extent such progress reports and monthly reports are prepared for internal purposes.

Based on the foregoing, the Commission has determined that the PCAOB's 2007 budget and annual accounting support fee are consistent with Section 109 of the Act. Accordingly,

IT IS ORDERED, pursuant to Section 109 of the Act, that the PCAOB budget and annual accounting support fee for calendar year 2007 are approved.

By the Commission.



Nancy M. Morris
Secretary

Commissioner Atkins Not Participating

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 232, 239, 240, 249, 249b, 269, and 274

[Release No. 34-54864; File No. S7-14-06]

RIN 3235-AJ68

ELECTRONIC FILING OF TRANSFER AGENT FORMS

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission ("Commission") is adopting amendments to the rules and forms under Section 17A of the Securities Exchange Act of 1934 ("Act") to require that the forms filed with respect to transfer agent registration, annual reporting, and withdrawal from registration be filed with the Commission electronically. The forms will be filed on the Commission's EDGAR database in XML format and will be accessible to Commission staff and the public for search and retrieval. The amendments will improve the Commission's ability to utilize the information reported on the forms in performing its oversight function of transfer agent operations and to publicly disseminate the information on the forms.

EFFECTIVE DATE: [Insert date 30 days from publication in the Federal Register].

FOR FURTHER INFORMATION CONTACT: Jerry Carpenter, Assistant Director, or Catherine Moore, Special Counsel, Office of Clearance and Settlement, Division of Market Regulation, Securities and Exchange Commission, 100 F Street, NE, Washington, DC, 20549-6628 or at (202) 551-5710. For assistance with technical questions about EDGAR, call the EDGAR Filer Support Office at (202) 551-8900.

SUPPLEMENTARY INFORMATION:

I. INTRODUCTION

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On September 11, 2006, the Commission published a proposed rulemaking in the Federal Register to require transfer agents to file Form TA-1, Form TA-2, and Form TA-W ("transfer agent forms")[1] electronically through the Commission's Electronic Data Gathering, Analysis, and Retrieval ("EDGAR")[2] system.[3] The Commission has developed a new application in EDGAR ("EDGARLite") that enables filers to prepare an electronic version of transfer agent forms using a commercial software package, Microsoft InfoPath 2003 ("MS InfoPath")™, and to submit the forms to EDGAR over an Internet connection.[4] Transfer agents will not be required to use the EDGARLite application to prepare the forms, although it is likely that most will choose to do so.

An electronic filing system for transfer agent forms will streamline the filing process, improve the Commission's ability to register and monitor transfer agents, and facilitate the retrieval and public dissemination of the data collected on the forms. The purpose of the amendments is to change the manner in which the forms are submitted to the Commission; the substance of the information reported will not change. We are adopting the amendments to the rules and forms to implement the new filing system and to require that Forms TA-1, TA-2, and TA-W be filed electronically. To comply with an electronic filing requirement, transfer agents will need to have a computer that meets the system requirements in the EDGAR Filer Manual and Internet access and a

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[1] 17 CFR 249b.100, 249b.101, and 249b.102, respectively.

[2] EDGAR is the Commission's computer system for the receipt, acceptance, review, and dissemination of documents submitted in electronic format. The term electronic format means the computerized format of a document prepared in accordance with the EDGAR Filer Manual. 17 CFR 232.11.

[3] Securities Exchange Act Release No. 54356 (August 24, 2006), 71 FR 53494 [File No. S7-14-06].

[4] The application will produce an Extensible Markup Language ("XML") version of the filing with all data elements identified through XML tags. A "tag" is an identifier that highlights specific information to EDGAR that is in the format required by the EDGAR Filer Manual. 17 CFR 232.11.

web browser to download the forms from an EDGAR Web site and transmit the completed forms. Transfer agents will also have to apply for and obtain access to EDGAR prior to filing the forms electronically in EDGAR.

We received six comments from five commenters.[5] One commenter strongly supported the proposal. Three of the commenters objected to the proposal on the grounds that an electronic filing requirement would be more burdensome than the current requirement that the forms be filed in paper format. Two commenters suggested we make minor changes or clarifications to Form TA-2. For the reasons discussed below, we are adopting the amendments substantially as proposed.

II. BACKGROUND

A. Transfer Agent Forms

Section 17A(c)(1) of the Act requires an entity that performs the function of a transfer agent with respect to a security registered under Section 12 of the Act to register with that entity's appropriate regulatory agency ("ARA").[6] Depending on the type of entity that is registered as a transfer agent, the ARA is either the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, or the Commission.[7] There are

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[5] Kevin Kopaunik, Fidelity Transfer Company, dated August 31, 2006; Loren K. Hanson, Director, Investor Relations, Otter Tail Corporation, dated August 31, 2006; Loren K. Hanson, Assistant Secretary, Otter Tail Corporation, dated October 4, 2006; Angie Orr, Senior Legal Assistant, American Century Services, LLC, dated October 19, 2006; Diane M. Butler, Director of Transfer Agency & International Operations, Investment Company Institute, dated October 26, 2006; and Christeena G. Naser, Senior Counsel for Regulatory and Trust Affairs, American Banker Association, dated November 2, 2006.

[6] 15 U.S.C. 78q-1(c)(1).

[7] 15 U.S.C. 78c(a)(34)(B). When used with respect to a clearing agency or transfer agent, the term "appropriate regulatory agency" means: (i) the Comptroller of the Currency, in the case of a national bank or a bank operating under the Code of Law for the District of Columbia, or a subsidiary of any such bank; (ii) the Board of Governors of the Federal Reserve System, in the case of a State member bank of the Federal Reserve System, a subsidiary thereof, a bank holding company, or a subsidiary of a bank holding company

currently 785 registered transfer agents, of which 519 are registered with the Commission and 266 are registered with the other ARAs.

There are three transfer agent forms filed with the Commission: (1) Form TA-1, Uniform Form for Registration as a Transfer Agent and for Amendment to Registration Pursuant to Section 17A of the Securities Exchange Act of 1934; (2) Form TA-2, Form for Reporting Activities of Transfer Agents Registered Pursuant to Section 17A of the Securities Exchange Act of 1934; and (3) Form TA-W, Notice of Withdrawal from Registration as a Transfer Agent. Only transfer agents that are registered with the Commission file Form TA-1 and Form TA-W with the Commission. All transfer agents, however, whether they are registered with the Commission or another ARA, file Form TA-2 with the Commission. The Commission uses the information on the transfer agent forms to review and approve an entity's application for registration as a transfer agent, maintain current information about transfer agents, and monitor the operations performed by and the services provided by transfer agents. The information filed on the Form TA-1, Form TA-2, and Form TA-W is publicly available.

Over 1,000 transfer agent forms are filed with the Commission each year. The Commission receives new or amended transfer agent registrations on Form TA-1 and withdrawals from registration on Form TA-W; however, most of the transfer agent forms received by the Commission are the annual reports filed by transfer agents on Form TA-2, which are required to be filed with the

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which is a bank other than a bank specified in clause (i) or (ii) of this subparagraph; (iii) the Federal Deposit Insurance Corporation, in the case of a bank insured by the Federal Deposit Insurance Corporation (other than a member of the Federal Reserve System), or a subsidiary thereof; and (iv) the Commission in the case of all other clearing agencies and transfer agents.

Commission during the three month period between January 1 and March 31.[8] Although all registered transfer agents are required to file a Form TA-2, the Commission receives fewer Forms TA-2 than there are registered transfer agents. This may be because some registered transfer agents have dissolved without filing a Form TA-W, the paper Form TA-2 was lost or misdirected, or some transfer agents are not meeting the Form TA-2 filing requirement.

To facilitate public dissemination of the information, the Commission staff enters basic information from the forms into EDGAR, including the name and address of the transfer agent, the transfer agent's registration number, and the date the form was filed with the Commission. This data is then disseminated on the EDGAR section of Commission's Web site.[9] In order to view all of the information on a form, however, members of the public must request a hard copy of the form from the Commission's public reference room or obtain the information from a third party information service company for a fee.

B. Electronic Filing of Transfer Agent Forms

The electronic filing system for transfer agent forms will be beneficial for transfer agents, investors, and the Commission. Under the new electronic filing requirement, each answer provided by the transfer agent will be formatted as an XML data tag. XML is a widely used text format that allows for the flexible use and exchange of data. The Commission designed the filing system to use XML data tags so that all of the information filed by transfer agents could be used by Commission staff and the public for searches, retrievals, and data analysis. To facilitate the filing of the information as XML data tags, the

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[8] 17 CFR 240.17Ac2-2. For the years 2003 through 2005, the Commission received an average of 1,069 transfer agent forms each year, including 41 Forms TA-1, 247 amended Forms TA-1, 709 Forms TA-2, 31 amended Forms TA-2, and 39 Forms TA-W.

[9] http://www.sec.gov/edgar.shtml.

Commission developed EDGARLite to provide filers with an easy to use, form-driven tool that can gather information and convert it to XML. EDGARLite uses form templates created by the Commission with a commercial "off the shelf" software package, MS InfoPath.™ Transfer agents would need to have MS InfoPath™ installed on their computers in order to use EDGARLite.

As an alternative to purchasing the software, transfer agents could prepare the forms outside of EDGARLite by creating an XML tagged version of the filing as an ASCII document using technical specifications that would be available on the Commission's Web site.[10] This is a permissible means of filing because the amendments require only that the information reported on the forms be submitted in the electronic format set forth in the EDGAR Filer Manual and do not require that transfer agents use EDGARLite. Preparing XML data tags in ASCII text language would require some technical expertise on the part of the filer, however, and the Commission expects that most transfer agents would choose to purchase the software and prepare the forms using EDGARLite.[11] As another alternative, transfer agents could hire a third party to prepare and submit the electronic forms for them; however, this filing method would likely cost the transfer agent more than purchasing the MS InfoPath™ software.

Regulation S-T sets forth the rules governing electronic filing in EDGAR. The EDGAR Filer Manual, which is promulgated by the Commission under Rule 301 of Regulation S-T,[12] provides the instructions and technical requirements for submitting filings to EDGAR. In

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[10] An ASCII document is an electronic text document that has contents limited to American Standard Code for Information Interchange ("ASCII") characters. 17 CFR 232.11.

[11] Third party software developers may also use the technical specifications to create a software product to compete with or enhance the EDGARLite application.

[12] 17 CFR 232.301.

preparation for electronic filing, transfer agents should review Regulation S-T and the relevant portions of the EDGAR Filer Manual, Volume I (General Information).[13] In particular, transfer agents should review Section 2.5 of Volume I, which provides the EDGAR hardware and software requirements, Section 3 of Volume I, which provides instructions on becoming an EDGAR filer, and Section 6 of Volume I, which provides instructions for filing on EDGAR.

The Commission has drafted a new section of Volume II (EDGAR Filing) of the EDGAR Filer Manual which provides detailed instructions for preparing forms using EDGARLite. The updates to Volume II have not yet been adopted; however, the Commission, has posted a draft on its Web site[14] so that filers and other third parties may review and comment on the draft section. Any EDGAR Filer Manual draft is subject to Commission approval and may be revised prior to approval or not approved at all.[15] The new section will be adopted and effective prior to the January 1, 2007 effective date of these amendments.

The Commission is amending Regulation S-T, Rules 17Ac2-1, 17Ac2-2, and 17Ac3-1, and Form TA-1, Form TA-2, and Form TA-W to mandate that all transfer agent forms filed with the Commission be filed in electronic format.[16] However, transfer agents that believe filing in

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[13] Transfer agents may download the latest version of the Filer Manual from the Commission's Web site www.sec.gov under the section "Information for EDGAR Filers."

[14] http://www.sec.gov/info/edgar/edmanuals95_d.htm

[15] Any draft of the EDGAR Filer Manual that is posted before Commission approval of potential regulatory changes is provided as a service to the filing community to assist filers, agents, and software developers prepare for potential changes Commission staff anticipates. The Commission retains the right to change any part of the manual before the new system release is made final and the posting of the draft manual does not indicate Commission approval of any pending proposed changes relating to the potential changes reflected in the draft manual.

[16] A paper copy version of the forms and instructions will be available from the Commission Publications Office and on the Commission's Web site for information purposes and for use

electronic format is unduly burdensome will be able to apply for a continuing hardship exemption from the electronic filing requirement pursuant to Rule 202 of Regulation S-T.[17] Rule 202 provides that an electronic filer may apply in writing for a continuing hardship exemption if the filing cannot be submitted to the Commission in electronic format without undue burden or expense. The Commission determines whether to grant or to deny the application based on whether the exemption is appropriate and is consistent with the public interest and the protection of investors.

For the first year of electronic filing only, transfer agents that are registered with the Commission will be required to file an amended Form TA-1 before they file a Form TA-2.[18] By so requiring, the Commission will be able to establish a complete and current record of registration information for transfer agents registered with the Commission in a single, centralized, and searchable database. Form TA-1 collects important information regarding transfer agents, such as name, address, organizational structure, and control persons. The requirement to file an amended Form TA-1 when the electronic filing system first becomes effective will make the data previously reported on the paper form readily available electronically for Commission use and public dissemination. Additionally, the requirement is designed to ensure that transfer agents have a complete electronic version of the form to use as a template for future amendments. It will provide an opportunity for transfer agents to make sure that their Form TA-1 is current and that all amendments to correct inaccurate, misleading, or incomplete information are made. Because transfer agents are required to maintain a copy of Form TA-1 and any amendments to Form TA-1

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by transfer agents that were granted a hardship exemption from electronic filing under Rule 202 of Regulation S-T.

[17] 17 CFR 232.202.

[18] Transfer agents registered with an ARA other than the Commission do not file Form TA-1 or Form TA-W with the Commission and accordingly would not be subject to this requirement.

with their records,[19] they should have all the information necessary to complete and electronically file an amended Form TA-1.

The amendments will be effective [Insert date 30 days from publication in the Federal Register]. Accordingly, registered transfer agents should be prepared to file their Forms TA-2 for the 2006 reporting period, which are due be filed by March 31, 2007, and an amended Form TA-1 for those transfer agents registered with the Commission, electronically on EDGAR.

III. AMENDMENTS

The amendments make the following changes to Rules 17Ac2-1, 17Ac2-2, and 17Ac3-1, Regulation S-T, and to Form TA-1, Form TA-2, and Form TA-W and the instructions to the forms as well as to Form ID.

A. Changes to Rules 17Ac2-1, 17Ac2-2, and 17Ac3-1 to Require Electronic Filing

The amendments add a paragraph to each of Rules 17Ac2-1, 17Ac2-2, and 17Ac3-1 to require electronic filing of Form TA-1, Form TA-2, and Form TA-W, respectively, on the Commission's EDGAR system. The amendments require transfer agents to file their forms according to the instructions on the forms and in the EDGAR Filer Manual. Although the amendments to Rules 17Ac2-1, 17Ac2-2, and 17Ac3-1 mandate electronic filing, transfer agents will still be able to apply for a hardship exemption under Rule 202 of Regulation S-T which would allow them to continue to file the forms in paper format. The Commission will review each application on a case by case basis and in its discretion may grant an exemption if the transfer agent is able to show that electronic filing is unduly burdensome and that granting the exemption would benefit the public interest and protection of investors. Because transfer agents cannot rely on receiving a hardship

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[19] Instruction I.D. to Form TA-1.

exemption, we recommend that all transfer agents review the system requirements and EDGAR Filer Manual and be prepared to submit the forms on EDGAR.

The Commission received six comment letters on the proposal from five commenters.[20] One commenter strongly supports the proposal[21] and three of the commenters oppose the proposal on the grounds that it requires computer software and systems as well as experience with EDGAR that the transfer agent or its staff may not have.[22] The fifth commenter requested changes that relate only to Form TA-2 which is discussed in Section III.D. of this release.[23] The commenters who object to the proposal stated that the expense of meeting the new requirement competitively disadvantages small transfer agents and that these transfer agents should not have to bear the expense of a proposal which they believe serves primarily to benefit the Commission. One commenter stated that the public does not have any need to access the information reported on the transfer agent forms because transfer agents are not public companies and do not solicit investments and that a person interested in

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[20] Kevin Kopaunik, Fidelity Transfer Company, dated August 31, 2006; Loren K. Hanson, Director, Investor Relations, Otter Tail Corporation, dated August 31, 2006; Loren K. Hanson, Assistant Secretary, Otter Tail Corporation, dated October 4, 2006; Angie Orr, Senior Legal Assistant, American Century Services, LLC, dated October 19, 2006; Diane M. Butler, Director of Transfer Agency & International Operations, Investment Company Institute, dated October 26, 2006; and Christeena G. Naser, Senior Counsel for Regulatory and Trust Affairs, American Banker Association, dated November 2, 2006.

[21] Diane M. Butler, Director of Transfer Agency & International Operations, Investment Company Institute, dated October 26, 2006.

[22] Kevin Kopaunik, Fidelity Transfer Company, dated August 31, 2006; Loren K. Hanson, Director, Investor Relations, Otter Tail Corporation, dated August 31, 2006; Loren K. Hanson, Assistant Secretary, Otter Tail Corporation, dated October 4, 2006; and Christeena G. Naser, Senior Counsel for Regulatory and Trust Affairs, American Banker Association, dated November 2, 2006.

[23] Christeena G. Naser, Senior Counsel for Regulatory and Trust Affairs, American Banker Association, dated November 2, 2006.

obtaining such information may acquire it directly from the transfer agent.[24] This filer also suggested that electronic filing be optional and not mandatory. Two of the commenters also stated that although they find electronic filing on EDGAR to be burdensome, a PDF attachment or an internet based form that does not require special software would be feasible.[25] One commenter also expressed concerns about necessary software upgrades and any associated costs.[26]

The Commission is very sensitive to the cost concerns of small transfer agents. The EDGARLite program was designed to keep the costs to filers low and, while electronic filing may require EDGAR skills and computer systems that all transfer agents do not currently have, we believe any costs transfer agents may be required to incur are reasonable. The amendments to mandate electronic filing are necessary to ensure that the information reported by transfer agents is complete, accurate, and stored in a single, centralized database and that the information is publicly available in an easily searchable format. To achieve this goal, electronic submissions must be formatted as XML data tags and submitted on EDGAR. Forms submitted as PDF attachments are not usable for analytical tools such as data aggregation, statistical analysis, and report generation. The Commission designed EDGARLite to utilize commercial software because it was the most cost-efficient way to allow information reported on a relatively small number of forms to be filed on EDGAR as tagged data in XML format. It would not be economically feasible for the Commission to develop an EDGAR application for transfer agent forms without using commercial software or for the Commission to develop more than one electronic filing

[24] Kevin Kopaunik, Fidelity Transfer Company, dated August 31, 2006.

[25] Loren K. Hanson, Assistant Secretary, Otter Tail Corporation, dated October 4, 2006 and Christeena G. Naser, Senior Counsel for Regulatory and Trust Affairs, American Banker Association, dated November 2, 2006.

[26] Christeena G. Naser, Senior Counsel for Regulatory and Trust Affairs, American Banker Association, dated November 2, 2006.

system for transfer agent forms. The Commission considered the costs of the commercial software very carefully and chose software that we believed would best meet our needs for the EDGARLite functionality, including ease of use and data validation, and that we believed would be affordable for all filers. There may occasionally be upgrades to the software; however, transfer agents would only have to purchase upgraded software if the Commission makes changes to the EDGARLite application that use the features of the upgraded version of the software. Transfer agents who have not filed on EDGAR before will have to train staff to file the transfer agent forms on EDGAR; however, the EDGAR Filer Manual provides detailed instructions for each step of the filing process. Transfer agents will also have the option of applying for a continuing hardship exemption under Rule 202 of Regulation S-T to file in paper format if they believe the electronic filing requirement would cause them undue burden or expense.

For these reasons, we believe that any additional costs the electronic filing requirement may impose on transfer agents are necessary and reasonable in order to improve and modernize the Commission's filing program for transfer agent forms. Furthermore, we believe that the proposal benefits the investing public and transfer agents and not just to the Commission. Transfer agents act as the agents of issuers of securities and oversee such functions as stock transfers and dividend payments. With respect to the comment that the public does not need access to the information on the forms, we note that the Commission frequently receives requests for transfer agent data from issuers, who may be interested in hiring a transfer agent, and from investors, who may be seeking to contact the transfer agent or who want assurance that the transfer agent is registered and is current in all its filings with the Commission. Additionally, electronic filing will substantially improve the Commission's ability to monitor and regulate transfer agent activities. This benefit to the Commission will benefit the investing public as a whole because it will help to ensure that transfer

agents are registered and are operating in conformance with the requirements under Section 17A of the Act.

For these reasons, we are adopting the amendments to Rules 17Ac2-1, 17Ac2-2, and 17Ac3-1 to require electronic filing substantially as proposed.

B. Amendments to Regulation S-T

The Commission proposed to amend Regulation S-T to mandate the submission of the transfer agent forms in electronic format and to exclude the transfer agent forms from the applicability of Rule 104, and Rule 201. The Commission did not receive any comments on the proposed amendments to Regulation S-T and we are adopting them as proposed.

1. Rule 101(a), Mandated Electronic Submissions

Rule 101(a) of Regulation S-T lists the filings that must be submitted to the Commission in electronic format.[27] The Commission is amending Rule 101(a) to mandate that Form TA-1, Form TA-2, and Form TA-W be submitted to the Commission in electronic format.

2. Rule 104, Unofficial PDF Copies Included in an Electronic Submission

Rule 104 of Regulation S-T provides that an electronic submission may include one unofficial portable document format ("PDF") copy of each electronic document contained within a submission, tagged in the format required by the EDGAR Filer Manual.[28] The purpose of this rule is to allow filers to provide a copy of their submission in a format that creates a structured, easy to read document for public dissemination.

The electronic transfer agent forms are easy to read in the format in which they are submitted, and it will be unnecessary to have a PDF version of the forms submitted. Additionally,

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[27] 17 CFR 232.101(a).

[28] 17 CFR 232.104(a).

we do not believe transfer agents will find any need to submit an unofficial copy of their filings in PDF format. Therefore, the Commission is amending Rule 104(a) to prohibit filers from including an unofficial PDF copy of Form TA-1, Form TA-2, or Form TA-3 in an electronic submission.

3. Rule 201, Temporary Hardship Exemption

Rule 201 of Regulation S-T provides procedures for a temporary exemption from mandated electronic filing when, due to unanticipated technical difficulties, an electronic filer cannot submit its filing in electronic format by the filing date.[29] The filer may submit the filing in paper format no later than one business day after the filing was to be made with the Commission, and the filer must submit an electronic format copy of the form within six business days of filing the paper format document. Form TA-1 and Form TA-W do not have specified filing dates, and Form TA-2 may be filed any time between January 1 and March 31.[30] As a result, the Commission does not believe that there would be many cases where transfer agents would need the temporary hardship exemption.

If it is necessary that a transfer agent form be filed with the Commission on a date certain, there are two means by which the Commission typically would adjust the effective or filing date of a transfer agent form. First, the Commission has the authority under Section 17A(c) of the Act to accelerate, delay, or postpone the effective date of Form TA-1 and Form TA-W.[31] Second, Rule 13(b) of Regulation S-T provides that the Commission may adjust the filing date of an electronic filing, which would include Form TA-1, Form TA-2, or Form TA-W, if the filer in good faith attempts to file with the Commission in a timely manner but the filing is delayed due to technical

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[29] 17 CFR 232.201.

[30] 17 CFR 240.17Ac2-2(a).

[31] 15 U.S.C. 78q-1(c)(2), (c)(4)(A) and (B), and 17 CFR 240.17Ac2-1(a) and 240.17Ac3-1(b).

difficulties beyond the filer's control.[32] Accordingly, the Commission is amending Rule 201(a) to exclude the transfer agent forms from the applicability of Rule 201.

C. Miscellaneous Amendments

The Commission proposed miscellaneous amendments to Rules 17Ac2-1, 17A2-2, and 17Ac3-1 to remove outdated information. We did not receive any comments on the proposed amendments and are adopting them as proposed.

1. Revision to Rule 17Ac2-1

The amendments will integrate the SEC Supplement to Form TA-1 into the body of the form as Questions 8 through 10. As a result, there will no longer be a separate SEC Supplement. Consequently, the Commission is deleting the reference in Rule 17Ac2-1 to the SEC Supplement.

2. Deletion of Paragraph (c) in Rule 17Ac2-2

Paragraph (c) was added to Rule 17Ac2-2 as an amendment in June 2000.[33] The amendment changed the end of the annual reporting period for transfer agents from June 30 to December 31 of the calendar year. Paragraph (c) was added to Rule 17Ac2-2 to provide that transfer agents would not be required to file the annual report for the period ending June 30, 2000. Because this provision is no longer necessary, the Commission is removing it from the rule.

3. Reference to 17A(c)(3)(C) in Rule 17Ac3-1

Rule 17Ac3-1 implements the section of the Act that permits a transfer agent to withdraw from registration. The rule currently cites that section as 17A(c)(3)(C) of the Act; however, when

[32] 17 CFR 232.13(b). The filer must request an adjustment of the filing date, and the Commission or its staff, pursuant to delegated authority, may grant the request if it appears that such adjustment is appropriate and consistent with the public interest and the protection of investors.

[33] Securities Exchange Act Release No. 42892 (June 2, 2000), 65 FR 36602 (June 9, 2000).

the Act was amended in 1987, section 17A(c)(3)(C) was redesignated as 17A(c)(4).[34] The Commission is amending Rule 17Ac3-1 to reflect the change.

D. Amendments to Form TA-1, Form TA-2, and Form TA-W

The Commission proposed a number of amendments to the forms and instructions to reflect the requirement that they be submitted to EDGAR in electronic format and to amend outdated requests for information. We received two comment letters requesting that we make a minor changes or clarifications to Form TA-2.[35] Both commenters requested a change to Questions 8(c) and 9(a) in Form TA-2 to allow a "Not Applicable" response. Questions 8(c) and 9(a) currently allow only a "Yes" or "No" response and the commenter stated that there are some cases where a "Not Applicable" response is appropriate. After reviewing Questions 8(c) and 9(a), we have determined that the change is appropriate and will have it made to the form.[36] One commenter also asked two interpretative questions with respect to Questions 4(a) and 10(a) of Form TA-2.[37] That commenter asked if Question 4(a), which requests the number of items received for transfer during the reported period, should include transfers of ownership (e.g., a transfer from an individual to a trust) involving open-end fund shares. After reviewing the comment we have determined that such transfers of ownership should be disclosed in Question 4(a). The commenter also asked if Question 10(a), which requests the number of open-end investment company transactions processed, should

[34] Pub.L. 100-181 (S 1452), § 322(3), 101 Stat 1249, December 4, 1987.

[35] Diane M. Butler, Director of Transfer Agency & International Operations, Investment Company Institute, dated October 26, 2006; and Christeena G. Naser, Senior Counsel for Regulatory and Trust Affairs, American Banker Association, dated November 2, 2006.

[36] The changes to Questions 8(c) and 9(a) of Form TA-2 will be made in the EDGAR Release scheduled for February 2007.

[37] Diane M. Butler, Director of Transfer Agency & International Operations, Investment Company Institute, dated October 26, 2006

include ownership changes (e.g., individual to trust). After reviewing the comment we have determined that such ownership changes should be disclosed in Question 10(a) as transactions processed.

We are adopting the amendments to the forms and instructions substantially as proposed. Listed below is a summary of the amendments.

1. Amendments to All Forms and Instructions

The Commission is making the following amendments to Forms TA-1, TA-2, and TA-W:

i. Amend the instructions to require the forms to be filed electronically in EDGAR.

ii. Replace current instructions regarding how and where to file the forms with instructions for filing through EDGAR.

iii. Amend Question 1 to require information about the filer that is required for EDGAR filing.[38]

iv. Amend the forms to allow the transfer agent to include a cover letter or other correspondence as an attachment to the form.

v. Amend the forms and instructions to provide that the forms must be executed with an electronic signature pursuant to Rule 302, Signatures, of Regulation S-T.[39]

The amendments to the forms and instructions will also include nonsubstantive format changes that are related to electronic filing using the EDGARLite templates. Such

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[38] See EDGAR Filer Manual, Volume I (General Information).

[39] 17 CFR 232.302. Rule 302 provides that a signature to any electronic submission must be provided in typed rather than manual format. Each signatory is required to manually sign a signature page or other document authenticating, acknowledging, or otherwise adopting his or her signature that appears in typed form within the electronic filing before or at the time the electronic filing is made. Such document must be retained by the filer for a period of five years and must be furnished to the Commission or its staff upon request.

format changes include drop down data blocks that allow the filer to insert additional information to a question (instead of using attached sheets, schedules, or supplements), data fields that are designated as required fields, radio buttons that limit the filer to specific answers to a question, and hidden data fields for questions that are not applicable to the filer.[40] Filers that submit the information reported on the forms without using EDGARLite will not be affected by these amendments.

2. Amendments to Form TA-1 and Instructions

i. The instructions are amended to require a registered transfer agent to file an amended Form TA-1 in electronic format before it can file a Form TA-2 or Form TA-W in electronic format.

ii. A feature is added to allow the transfer agent to designate a filing as an amended filing. The instructions are amended to reflect this feature.

iii. Question 2, "Filing Status," is deleted because the question is moved to the top section of the form.

iv. Question 6, "Service Companies Engaged by the Filer," is amended to request the file number of the service company. The purpose of this amendment is to enable the Commission or other interested parties to confirm the identity of the service company engaged by the filer.

v. Question 7, "Filer Engaged as a Service Company by a Named Transfer Agent," is amended to request the file number of the named transfer agent. The purpose

[40] Filers can view the blank form in its entirety by checking the box at the top of the form that expands the form to show all fields. Filers can also print the blank form using this mechanism.

of this amendment is to enable the Commission or other interested parties to confirm the identity of the named transfer agent.

vi. Form TA-1 Supplement, "Control Person Information" for Corporations (Schedule A), Partnerships (Schedule B), and Other Entities (Schedule C), is integrated into the form as Questions 8 through 10.

vii. Form TA-1 Supplement, "Control Person Information," is amended to delete Schedule D because Schedule D is a blank sheet that provides additional space for responses and is not necessary in the electronic form.

viii. Form TA-1 Supplement, "Control Person Information" for Corporations (Schedule A), Partnerships (Schedule B), and Other Entities (Schedule C) currently requests the social security number of control persons. We are amending this question to delete the request for the social security number because of privacy concerns in light of the fact that the forms will be available for public dissemination through EDGAR.

ix. Form TA-1 Supplement, "Control Person Information" for Corporations (Schedule A), Partnerships (Schedule B), and Other Entities (Schedule C), is amended to delete the ADD, AMEND, and DELETE Columns. Transfer agents will instead provide the beginning date of the relationship with the control person and the ending date of the relationship.

x. Instruction II, Special Instructions for Filing and Amending Form TA-1, currently provides that the Financial Industry Number Standard ("FINS") number assigned by The Depository Trust Company ("DTC") may be obtained free of charge by submitting a request to DTC's New York city mailing address. We are amending

this instruction to reflect that the FINS number is now provided through DTC's Web site www.dtc.org for a nominal fee.

xi. Instruction II.A.4, the instruction regarding marking items as deleted is removed because the DELETE Column in the TA-1 Supplement has been removed.

xii. Instruction II.B, Amending Registration, is revised to provide instructions on filing an amended Form TA-1 in EDGAR. All required items on the electronic form, not just those fields being amended, must be completed.

xiii. Instruction III, SEC Supplement, Amending the Supplement, is deleted because the supplement has been integrated with the rest of the form.

3. Amendments to Form TA-2 and Instructions

i. Question 4, "Number of Items Received for Transfer During the Reporting Period," is amended to add a paragraph (b) to request the number of individual securityholder accounts for which the transfer agent maintained master securityholder accounts. The purpose of this amendment is to provide information as to whether Questions 6-10 are required to be answered under Instruction II.B of Form TA-2. A corresponding change is being made to Instruction II.B.

ii. The response "Not Applicable" will be added to Questions 8(c) and 9(a) because, in response to requests from commenters, the Commission has determined that for some transfer agents a "Yes" or "No" response is not appropriate.

iii. A feature is added to allow the transfer agent to designate a filing as an amended filing. The instructions are amended to reflect this feature. All required items on the electronic form, not just those answers that are being amended, must be completed.

4. Amendments to Form TA-W and Instructions

i. Question 7. The reference to "out of proof conditions" is deleted because the Commission no longer uses the term.

ii. Questions 9 and 10. The reference to Schedule B on Form TA-1 is deleted because Form TA-1 was previously amended and Schedule B no longer requires the referenced information.[41] Accordingly, the phrase "each issue shown on Schedule B of registrants Form TA-1, as amended," is deleted and replaced with the phrase "each issue for which registrant acted as transfer agent."

iii. Instruction 1. The reference to "Section 17A(c)(3)(C)" is revised to "Section 17A(c)(4)(B)."

5. Amendment to Form ID

The Commission proposed to amend Form ID, Uniform Application for Access Codes to File on EDGAR, to add "transfer agent" to the check-the-box list of applicant types (the form currently has boxes for "filer," "filing agent," "trainer," or "individual").[42] The purpose of this change is to allow the Commission to identify a new filer as a transfer agent for purposes of utilizing the special instructions in EDGARLite for the TA forms (for example, a TA-2 will be blocked if the transfer agent hasn't previously filed an electronic Form TA-1 or amended Form TA-1).[43]

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[41] Securities Exchange Act Release No. 23084 (March 27, 1986), 51 FR 12124 (April 9, 1986).

[42] 17 CFR 239.63, 249.446, 269.7, and 274.402.

[43] Transfer agents that have previously filed a transfer agent form with the Commission are currently in the system. Only those transfer agents that are filing a transfer agent form with the Commission for the first time would be required to complete and file a Form ID.

The Commission did not receive any comments to the proposed amendments to Form ID and is adopting them as proposed.

IV. PAPERWORK REDUCTION ACT

Certain provisions of the amendments to the rules and forms contain "collection of information requirements" within the meaning of the Paperwork Reduction Act of 1995.[44] We published a notice requesting comment on the collection of information requirements in the proposing release and submitted these requirements to the Office of Management and Budget ("OMB") for review.[45] These requests are pending before the OMB. When we receive OMB clearance, we will publish notice in the Federal Register. We did not receive any comments on the Paperwork Reduction Act analysis contained in the proposing release.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. The amendments would require Form TA-1, Form TA-2, and Form TA-W, which are currently filed with the Commission in paper form, to be filed electronically on EDGAR. The Commission collects this information pursuant to its authority under Section 17A of the Act and uses the information collected on the forms in determining whether to allow a transfer agent to register or to withdraw from registration and also uses the information in monitoring the annual activities of transfer agents. The information filed on the Form TA-1, Form TA-2, and Form TA-W is publicly available and is used by the public to locate, research, and confirm the registration of transfer agents.

The respondents to the collection of information are the registered transfer agents that file Form TA-1, Form TA-2, and Form TA-W with the Commission. Only transfer agents for whom the

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[44] 44 U.S.C. 3501 et seq.

[45] Publication and submission were in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.1.

Commission is the ARA file Form TA-1 and Form TA-W with the Commission; however, all registered transfer agents, whether they are registered with the Commission or another ARA, must file the annual Form TA-2 with the Commission. Compliance with the proposed amendments would be mandatory. The information required by the proposed amendments would not be kept confidential by the Commission. The Commission's regulations that implement Section 17A of the Act are at 17 CFR 200.80 et seq.

The amendments modify an existing collection of information by changing the format of a required filing from paper to electronic format and modify the text of the forms and the instructions to the forms to conform to the electronic filing requirement.

The Commission does not estimate that the hour burdens for Form TA-1, Form TA-2, and Form TA-W will change as a result of the proposed amendments because completing an electronic form template and submitting it electronically on EDGAR should not take longer than completing a paper form and mailing the original and two copies to the Commission. The Commission believes, however, that the estimated hour burdens of Form TA-1 and for Form TA-2 should be increased for the first year to reflect the initial burden associated with filing electronically on EDGAR and the initial burden associated with the proposed requirement for each transfer agent registered with the Commission to refile the information on its Form TA-1 electronically as an amended Form TA-1. We estimate that the one time burden associated with electronic filing of transfer agent forms is two hours. This increased burden would be incurred with respect to the first transfer agent form the transfer agent files with the Commission electronically. For transfer agents registered with the Commission, this would be Form TA-1, because the proposal would require transfer agents registered with the Commission to file an electronic amended Form TA-1 before they could file any other transfer agent forms electronically. For all other transfer agents, this would be Form TA-2 because that is the only form those transfer agents file with the Commission.

There are 519 transfer agents registered with the Commission. Accordingly, the increase in collection of information burden associated with filing electronically for Form TA-1 would be 1038 hours. There are 266 transfer agents registered with an ARA other than the Commission. Accordingly, the collection of information burden associated with filing electronically for Form TA-2 is 532 hours.

Additionally, we believe that the estimated hour burden for Form TA-1 will increase for the first year of electronic filing because the amendments require that transfer agents registered with the Commission refile the information on Form TA-1 electronically in EDGAR as an amended Form TA-1. The requirement to file an amended Form TA-1 would apply to the 519 transfer agents for which the Commission is the ARA and would create a one time collection of information burden. We estimate that each transfer agent that is required to refile the information on Form TA-1 wouls need approximately two hours to do so, for an increase to the total burden for the first year of 1,038 hours.

In sum, we estimate that the amendments will increase the collection of information hour burden for Form TA-1 by a total of 2,076 hours and for Form TA-2 of a total of 532 hours for the first electronic filing only.[46] After the first electronic filing, the estimated burden will return to its current level.

V. COSTS AND BENEFITS OF THE PROPOSED RULEMAKING

The Commission is sensitive to the costs and benefits of our rule implementing an electronic filing system for transfer agent forms. We believe that the amendments will benefit transfer agents

[46] Based on an estimated average administrative labor cost of $31.50 per hour, the Commission's staff estimates that the total labor cost to the transfer agent industry for complying with the proposed amendments would be $98,910.

and investors by improving the efficiency and quality of the information filed with the Commission, which is available to the public. We also believe that the amendments will result in certain costs to most transfer agents because they may need to purchase computer software and possibly hardware and will need to train personnel to create forms in the EDGARLite™ application and to file the forms on EDGAR. The Commission received three comment letters which discuss the costs and benefits of the proposal.[47] These commenters believed the benefits of the proposal are mainly to the Commission and that the costs of the proposal to small transfer agents are too high. One commenter also stated that the information on the forms does not need to be disseminated on EDGAR because the public does not have use for the information reported on the forms.[48]

A. Benefits

An electronic filing system will improve the efficiency of the filing process for transfer agents and would also improve the public dissemination of the information on the forms. The electronic filing system will eliminate the burdens associated with the paper forms and the possibility of the forms being lost or misdirected. By performing data validation checks, the EDGARLite application will help to ensure that transfer agents fill the forms out completely and in the appropriate format. It will also provide transfer agents with email notification that a form has been accepted or suspended by the Commission.

The rule will benefit the public because it will make the information on transfer agent forms, which is publicly available information, more easily accessible and available in a more timely manner in EDGAR than it currently is through the Commission's public reference room. The new system would also improve the Commission's ability to maintain, review, and analyze transfer agent

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[47] Kevin Kopaunik, Fidelity Transfer Company, dated August 31, 2006; Loren K. Hanson, Director, Investor Relations, Otter Tail Corporation, dated August 31, 2006; and Loren K. Hanson, Assistant Secretary, Otter Tail Corporation, dated October 4, 2006.

[48] Kevin Kopaunik, Fidelity Transfer Company, dated August 31, 2006

forms by collecting and storing all of the information on the forms in a single, centralized database. The database will be updated immediately upon the receipt of new filings and will help the Commission identify delinquent filers. It will also allow for analytic tools such as data aggregation, statistical analysis, and report generation. Additionally, the information will be disseminated as submitted by filers so there will be no risk of transcription error as there is with information that is submitted in hardcopy and manually entered into the database.

The Commission received one comment letter that discusses the benefits of the proposal. The commenter stated that it believes the proposal will not be beneficial to any entity other than the Commission.[49] First, the commenter stated that much of the investing public does not have an interest in transfer agent data and that the few people who would like the data can request it directly from the transfer agents themselves. Second, the commenter stated that electronic filing will cause a lot of expense and labor for the transfer agents but will only benefit the Commission. The commenter recommended that electronic filing should therefore be optional and not mandatory.

While we appreciate the commenter's concerns, we believe that the proposal does benefit the investing public and transfer agents. Transfer agents act as the agents of issuers of securities and oversee such functions as stock transfers and dividend payments. We frequently receive requests for transfer agent data from issuers, who may be interested in hiring a transfer agent, and from investors, who may be seeking to contact the transfer agent or who want assurance that the transfer agent is registered and is current in all its filings with the Commission. Additionally, although electronic filing will substantially improve the Commission's ability to monitor and regulate transfer agent activities, this benefit to the Commission will benefit the investing public as a whole because it will help to ensure that they are registered and are operating in conformance with the requirements under Section 17A of the Act.

[49] Kevin Kopaunik, Fidelity Transfer Company, dated August 31, 2006.

B. Costs

Transfer agents will incur initial and ongoing costs with respect to the electronic filing system. The Commission believes that most of the cost burden will be in terms of initial costs and will be in terms of using the electronic filing system. The Commission does not believe that transfer agents will incur additional costs in the first year as a result of completing the forms in electronic format versus in paper format because, other than amendments to Question 4 of Form TA-2 to request the number of individual securityholder accounts and to Questions 6 and 7 of Form TA-1 to request the file number of service companies and named transfer agents, the substance of the transfer agent forms is not changing. However, transfer agents that are registered with the Commission will incur additional costs with respect to completing the forms because they will be required to prepare and file an electronic amendment to their original registration on Form TA-1 and submit it to EDGAR for the first year of electronic filing before they can submit their annual report on Form TA-2.

In order to file electronic transfer agent forms in EDGAR, transfer agents will need the computer system requirements necessary to access EDGAR and will have to train personnel to prepare forms using EDGARLite. We believe that most transfer agents currently have the necessary computer system requirements as well as access to the Internet as part of their current businesses. However, the Commission believes that many transfer agents will choose to purchase MS Infopath™ which is needed to view and enter data in EDGARLite forms.

To estimate the impact of the proposal on transfer agents, the Commission staff reviewed the filings submitted by transfer agents to the Commission and communicated with several small and mid-size transfer agents regarding their computer systems, personnel, and familiarity with EDGAR. Many transfer agents are entities or are affiliated with entities, such as publicly traded companies or investment companies, which submit filings to the

Commission electronically in EDGAR. These transfer agents have the necessary computer system requirements and personnel to file the transfer agent forms in EDGAR, but many do not have the MS InfoPath™ software necessary to construct forms in EDGARLite. Transfer agents that have purchased Microsoft Office 2000 Professional Enterprise Edition™ have MS InfoPath™ included as part of their operating system; however, most of these transfer agents are not familiar with MS InfoPath™ and would have to train their personnel to use the software. Of the transfer agents that do not currently file forms electronically in EDGAR, most have the computer system requirements to file in EDGAR, but would need to purchase MS InfoPath™, train personnel to construct forms using EDGARLite, and submit forms electronically to EDGAR. In addition, some transfer agents may not have the necessary system requirements to file in EDGAR and will need to purchase upgrades to their computer systems as well as incur the costs related to purchasing the MS InfoPath™ software and training personnel to file forms in EDGAR using EDGARLite.

From the above information, the Commission believes that the cost to transfer agents of the electronic filing could range from only the cost of training personnel to create forms in EDGARLite to the cost of upgrading systems, purchasing MS InfoPath™ and training personnel to use the EDGAR system and EDGARLite. The EDGARLite application is designed to be easy to use and the MS InfoPath™ software is a relatively low-cost software package that is readily available. The EDGAR Filer Manual will provide instructions for installing MS InfoPath™ and for using EDGARLite. Based on this, the Commission believes that any training for personnel with respect to electronic filing will be two hours for each registered transfer agent. Additionally, the Commission believes that transfer agents registered with the Commission will require an additional two hours to refile the information on Form TA-1 as an amended Form TA-1. The Commission believes a cost of

$31.50 per hour and that the total labor cost to the transfer agent industry for complying with the proposed amendments will be $98,910.[50]

Alternatively, transfer agents or a third party could prepare the forms without MS InfoPath™ by creating an XML tagged version of the filing as an ASCII document using technical specifications that will be available on the Commission's public Web site.[51] The Commission will integrate the XML tags with the form template to create a structured form that is identical to the form created in EDGARLite for the purpose of viewing the form in EDGAR. This filing method would require some technical expertise on the part of the filer, however. Transfer agents could also hire a third party filer to prepare and submit the forms on their behalf using MS InfoPath.™ Third parties generally charge separate fees for preparation and submission of EDGAR filings, and they either charge a fee per page of a filing or, for some forms, offer a flat rate per form. Based on the published cost structures of some of the larger third party filers, we estimate that the cost of hiring a third party filer to fill out a single transfer agent form would be in the range of $150 to $200.

The Commission believes that transfer agents will incur a small amount of ongoing costs with respect to the amendments, such as purchasing upgrades to MS InfoPath™ software and maintaining access to the Internet. Additionally, transfer agents will have to have personnel that are familiar with the EDGAR system to file Form TA-2 each year and amendments to Form TA-1 whenever the information on the form becomes inaccurate, misleading, or incomplete.

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[50] The cost per hour is based on the estimated per hour salary of a senior computer operator using the Securities Industry Association's Office Salary Data for 2003, adjusted for inflation.

[51] See note 10.

The Commission received four comment letters from three commenters that discussed the costs of the proposal.[52] The commenters stated that the proposal requires skills and computer software that they do not have and could require additional software upgrades. One commenter stated that small in-house transfer agents cannot pass their expenses on to investors and that any additional expenses, such as the one in the current proposal, could lead them to outsource their functions to large, commercial transfer agents.[53]

The Commission is aware that the proposal will impose some level of cost on many transfer agents and that those transfer agents that are small entities may be more affected than other transfer agents. Therefore, we are allowing transfer agents to apply for a hardship exemption under Rule 202 of Regulation S-T. This would allow them to continue to file the forms in paper format. The Commission will review each application on a case by case basis and in its discretion may grant an exemption if it determines that electronic filing is unduly burdensome and that granting the exemption is appropriate and consistent with the public interest and protection of investors.

VI. CONSIDERATION OF THE BURDEN ON COMPETITION, PROMOTION OF EFFICIENCY, AND CAPITAL FORMATION

Section 3(f) of the Act[54] requires the Commission, whenever it engages in rulemaking and is required to consider or to determine whether an action is necessary or appropriate in the pubic interest, to consider whether the action will promote efficiency, competition, and capital formation.

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[52] Kevin Kopaunik, Fidelity Transfer Company, dated August 31, 2006; Loren K. Hanson, Director, Investor Relations, Otter Tail Corporation, dated August 31, 2006; Loren K. Hanson, Assistant Secretary, Otter Tail Corporation, dated October 4, 2006; and Christeena G. Naser, Senior Counsel for Regulatory and Trust Affairs, American Banker Association, dated November 2, 2006.

[53] Loren K. Hanson, Assistant Secretary, Otter Tail Corporation, dated October 4, 2006.

[54] 15 U.S.C. 78c(f).

In addition, Section 23(a)(2) of the Act[55] requires the Commission, when promulgating rules under the Act, to consider the impact any such rules would have on competition. Section 23(a)(2) further provides that the Commission may not adopt a rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Act.

A transfer agent is any entity that engages on behalf of an issuer of securities or on behalf of itself as an issuer of securities in: (1) countersigning such securities upon issuance; (2) monitoring the issuance of such securities with a view to preventing unauthorized issuance, a function commonly performed by a person called a registrar; (3) registering the transfer of such securities; (4) exchanging or converting such securities; and (5) transferring record ownership of securities by bookkeeping entry without physical issuance of securities certificates.[56] Transfer agents are regulated by the Commission pursuant to Section 17A of the Act. All transfer agents file an annual report with the Commission on Form TA-2. Non-bank transfer agents file registrations on Form TA-1 and withdrawals from registration on Form TA-W with the Commission. These forms are currently filed with the Commission in paper format.

The amendments to Regulation S-T, Rules 17Ac2-1, 17Ac2-2, and 17Ac3-1 and to Forms TA-1, TA-2, and TA-W and the instructions to the forms will require that transfer agent forms be filed electronically using the Commission's EDGAR system. The Commission has designed a new application in EDGAR, EDGARLite, that uses form templates with a commercial off-the-shelf software package, MS InfoPath,™ to allow filers to easily complete electronic forms for submission

[55] 15 U.S.C. 78w(a)(2).

[56] 15 U.S.C. 78c(a)(25).

to the Commission. However, filers will not be required to use EDGARLite and could submit the information reported on the forms to the Commission in ASCII text characters.[57]

An electronic filing system will eliminate the burdens associated with the paper forms and the possibility of the forms being lost or misdirected. The EDGARLite application will perform data validation checks, which will help to ensure that transfer agents fill the forms out completely and in the appropriate format. It will also provide transfer agents with email notification that a form has been accepted or suspended by the Commission. Accordingly, the implementation of the electronic filing system should promote efficiency. The electronic filing system should also promote accuracy because the information reported on the forms will be submitted in electronic format by transfer agents so there will be no risk of transcription error as there is with information that is submitted in hardcopy and is manually entered into EDGAR or another Commission database. The amendments will apply to all transfer agents and the EDGARLite application is intended to be a program that is easy to use at a reasonable cost. Most transfer agents will be able to comply with an electronic filing requirement without difficulty; however, the amendments will allow transfer agents to apply for a continuing hardship exemption under Rule 202 of Regulation S-T if the electronic filing requirement would cause undue burden or cost and the Commission determines that such exemption is appropriate and consistent with the public interest and the protection of investors. As a result, the amendments are not expected to adversely impact a transfer agent's ability to file transfer agent forms and, accordingly, likely will not have an adverse impact on competition. The amendments are not expected to affect the operations of transfer agents and will not materially change the information that is required to be reported to the Commission on the forms. The amendments will

[57] See note 10.

change the filing method of the forms from paper format to electronic format. Accordingly, the amendments are not expected to have an impact on capital formation.

We received one comment letter that stated the proposal could have an adverse impact on competition because the expense of meeting the electronic filing requirement could lead in-house transfer agents, which cannot pass regulatory expenses on to issuer clients, to outsource their functions to large, commercial transfer agents.[58] While we appreciate the commenter's concerns, we do not believe the costs to transfer agents as a result of the proposal will rise to that level. Additionally, as noted above, transfer agents may apply for a hardship exemption under Rule 202 of Regulation S-T which would allow them to continue filing in paper format.

VII. FINAL REGULATORY FLEXIBILITY ANALYSIS

The Commission has prepared a Final Regulatory Flexibility Analysis ("FRFA") pursuant to the Regulatory Flexibility Act[59] regarding the amendments to Regulation S-T, Rules 17Ac2-1, 17Ac2-2, and 17Ac3-1 and to Form TA-1, Form TA-2, and Form TA-W and the instructions to the forms.

A. Need for the Amendments

The Commission receives over a thousand transfer agent forms year. An electronic filing system will eliminate the burdens associated with paper forms and streamline the filing process. It will help to ensure that transfer agents fill the forms out completely and in the appropriate format. It will also provide transfer agents with email notification that a form has been accepted or suspended by the Commission.

B. Significant Issues Raised by Public Comment

[58] Loren K. Hanson, Assistant Secretary, Otter Tail Corporation, dated October 4, 2006.

[59] 5 U.S.C. 603(a).

The Initial Regulatory Flexibility Act Analysis ("IRFA") appeared in the proposing release. We requested comment on any aspect of the IRFA and we received two comment letters from persons who object to the amendments because the expense of meeting an electronic filing requirement competitively disadvantages small transfer agents.[60] These commenters also stated that although they find electronic filing on EDGAR to be burdensome, a PDF attachment or an internet based form that does not require special software would be feasible. One commenter also expressed concerns about necessary software upgrades and any associated costs.[61]

The Commission is very sensitive to the cost concerns of small transfer agents. The EDGARLite program was designed to keep the costs to filers low and, while electronic filing may require EDGAR skills and computer systems that all transfer agents do not currently have, we believe any costs transfer agents may be required to incur are reasonable. The amendments to mandate electronic filing are necessary to ensure that the information reported by transfer agents is complete, accurate, and stored in a single, centralized database and that the information is publicly available in an easily searchable format. To achieve this goal, electronic submissions must be formatted as XML data tags and submitted on EDGAR. Forms submitted as PDF attachments are not usable for analytical tools such as data aggregation, statistical analysis, and report generation. The Commission designed EDGARLite to utilize commercial software because it was the most cost-efficient way to allow information reported on a relatively small number of forms to be filed on EDGAR as tagged data in XML format. It would not be economically feasible for the Commission to develop an EDGAR application for transfer agent forms without using

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[60] Loren K. Hanson, Assistant Secretary, Otter Tail Corporation, dated October 4, 2006 and Christeena G. Naser, Senior Counsel for Regulatory and Trust Affairs, American Banker Association, dated November 2, 2006.

[61] Christeena G. Naser, Senior Counsel for Regulatory and Trust Affairs, American Banker Association, dated November 2, 2006.

commercial software or for the Commission to develop more than one electronic filing system for transfer agent forms. The Commission considered the costs of the commercial software very carefully and chose software that we believed would best meet our needs for the EDGARLite functionality, including ease of use and data validation, and that we believed would be affordable for all filers. There may occasionally be upgrades to the software; however, transfer agents would only have to purchase upgraded software if the Commission makes changes to the EDGARLite application that use the features of the upgraded version of the software. Transfer agents who have not filed on EDGAR before will have to train staff to file the transfer agent forms on EDGAR, however, the EDGAR Filer Manual provides detailed instructions for each step of the filing process. Transfer agents will also have the option of applying for a continuing hardship exemption under Rule 202 of Regulation S-T to file in paper format if they believe the electronic filing requirement would cause them undue burden or expense.

For these reasons, we believe that any additional costs the electronic filing requirement may impose on transfer agents are necessary and reasonable in order to improve and modernize the Commission's filing program for transfer agent forms.

C. Small Entities Subject to the Amendments

The FRFA also discusses the effect of the proposal on transfer agents that are small entities under Rule 0-10(h) under the Act.[62] Rule 0-10(h) defines the term "small business" or "small organization" to include any transfer agent that: (1) received less than 500 items for transfer and less than 500 items for processing during the preceding six months (or in the time that it has been in business, if shorter); (2) transferred items only of issuers that would be deemed "small businesses" or

[62] 17 CFR 240.0-10(h).

"small organizations" as defined in this section; (3) maintained master shareholder files that in the aggregate contained less than 1,000 shareholder accounts or was the named transfer agent for less than 1,000 shareholder accounts at all times during the preceding fiscal year (or the time that it has been in business, if shorter); and (4) is not affiliated with any person, other than a natural person, that is not a small business or small organization under Rule 0-10.

The Commission estimates that there are 310 registered transfer agents that are "small entities" under Rule 0-10. Of these, 170 are registered with the Commission and 140 are registered with the other ARAs.

D. Projected Reporting, Recordkeeping, and Other Compliance Requirements

The amendments require that all transfer agents apply for access to the EDGAR system and file all transfer agent forms that they file with the Commission electronically on EDGAR. The amendments also amend Form ID, Uniform Application for Access Codes to File on EDGAR, to add "transfer agent" to the check-the-box list of applicant types (the form currently has boxes for "filer," "filing agent," "trainer," or "individual"). Transfer agents are expected, but not required, to complete the electronic forms by using the EDGARLite application. All transfer agents filing electronically will need a computer system that meets the EDGAR software and hardware requirements. Additionally, all transfer agents that have previously filed a Form TA-1 with the Commission will have to file an amended Form TA-1 electronically, of which approximately 170 are small entities within the definition in Rule 0-10. The FRFA states that the incremental burden on all "small entities" is approximately 960 hours and $30,240 for all entities. The FRFA also states that the proposed amendments will not impose any other reporting, recordkeeping, or compliance requirements, and that the Commission believes that there are no rules that duplicate, overlap, or conflict with the proposed amendments.

E. Agency Action to Minimize Effect on Small Entities

The FRFA discusses the alternatives considered by the Commission in connection with the proposed amendments to Regulation S-T, Rules 17Ac2-1, 17Ac2-2, and 17Ac3-1 and to Forms TA-1, TA-2, and TA-W and the instructions to the forms. The purpose of electronic filing is to have all filings required to be filed with the Commission received in a timely and efficient manner and for the data filed on the forms to be stored in a single, centralized database. Any forms filed on paper could be subject to loss, inaccuracies, and delayed reporting, which would affect the integrity of the database and affect the Commission's ability to perform its oversight role with respect to transfer agents. Accordingly, we have determined that it would not be appropriate to allow any transfer agents to continue to file the forms in paper form unless the Commission were to grant the transfer agent a continuing hardship exemption under Rule 202 of Regulation S-T.

As an alternative to creating the electronic forms in EDGARLite, which requires the filer to purchase MS InfoPath™ software, transfer agents or a third party can prepare the forms outside of EDGARLite by creating an XML tagged version of the filing as an ASCII document using technical specifications that will be available on the Commission's public Web site.[63] It should be noted that this filing method requires some technical expertise on the part of the filer and the Commission does not anticipate that transfer agents or third parties will find it worth the cost savings to develop the transfer agent forms outside of EDGARLite.

The Commission also considered whether entities can file the forms with the Commission by using public computer services, such as an internet cafe or a public library, and therefore avoid the expense of any required hardware, software, or internet access. Commission staff contacted public computer service providers in 2004 and determined that it was unlikely that these facilities would have the necessary MS Infopath™ software requirement for using the EDGARLite templates.

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[63] See note 10.

However, transfer agents will be free to use a public facility if the facility has the necessary computer system requirements. Additionally, filers can prepare their filings by creating an ASCII document as described above, which should be possible on many public computer service facilities.

Finally, the Commission can grant a transfer agent a continuing hardship exemption from the electronic filing requirement under Rule 202 of Regulation S-T if the transfer agent demonstrates that the electronic filing requirement would cause it undue burden or expense and the Commission determines that a grant of the exemption is appropriate and consistent with the public interest and the protection of investors. A transfer agent that was granted such an exemption would continue to file the forms in paper and thus would not be economically impacted by the electronic filing requirement.

VIII. STATUTORY BASIS AND TEXT OF THE AMENDMENTS

We are adopting the amendments to Regulation S-T and Form ID under the authority in Section 19(a)[64] of the Securities Act of 1933, Sections 13(a),[65] 23(a),[66] and 35A[67] of the Exchange Act, Section 319[68] of the Trust Indenture Act of 1939, and Sections 30[69] and 38[70] of the Investment Company Act of 1940. We are adopting the amendments to Rule 17Ac2-1, Rule 17Ac2-2, and Rule

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[64] 15 U.S.C. 77s(a).

[65] 15 U.S.C. 78m(a).

[66] 15 U.S.C. 78w(a).

[67] 15 U.S.C. 78ll.

[68] 15 U.S.C. 77sss.

[69] 15 U.S.C. 80a-29.

[70] 15 U.S.C. 80a-37.

17Ac3-1, and to Forms TA-1, TA-2, and TA-W under the authority in Section 19(a) of the Securities Act and Sections 17(a),[71] 17A(c),[72] 23(a), and 35A of the Act.

Text Rule Amendments

List of Subjects

17 CFR Parts 232, 239, 240, 249, 249b, 269, and 274

Reporting and recordkeeping requirements, Securities.

In accordance with the foregoing, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

PART 232—REGULATION S-T—GENERAL RULES AND REGULATIONS FOR ELECTRONIC FILINGS

1. The general authority citation for part 232 is revised to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a), 77sss(a), 78c(b), 78l, 78m, 78n, 78o(d), 78w(a), 78ll(d), 80a-8, 80a-29, 80a-30, 80a-37, and 7201 et seq.; and 18 U.S.C. 1350.

* * * * *

2. Amend § 232.101 by:

a. Removing the word "and" at the end of paragraph (a)(1)(x);

b. Removing the period at the end of paragraph (a)(1)(xi) and in its place adding "; and"; and

c. Adding paragraph (a)(1)(xii).

The addition reads as follows.

§232.101 Mandated electronic submissions and exceptions.

(a) * * *

[71] 15 U.S.C. 78q(a).

[72] 15 U.S.C. 78q-1(c).

(1) * * *

(xii) Form TA-1 (§ 249.100 of this chapter), Form TA-2 (§ 249.102 of this chapter), and Form TA-W (§ 249.101 of this chapter).

* * * * *

3. Revise § 232.104 paragraph (a) to read as follows.

§ 232.104 Unofficial PDF copies included in an electronic submission.

(a) An electronic submission, other than a Form 3 (§ 249.103 of this chapter), a Form 4 (§ 249.104 of this chapter), a Form 5 (§ 249.105 of this chapter), a Form ID (§§ 239.63, 249.446, 269.7 and 274.402 of this chapter), a Form TA-1 (§ 249.100 of this chapter), a Form TA-2 (§ 249.102 of this chapter), or a Form TA-W (§ 249.101 of this chapter), may include one unofficial PDF copy of each electronic document contained within that submission, tagged in the format required by the EDGAR Filer Manual.

* * * * *

4. Section 232.201 is amended by revising the introductory text of paragraph (a) to read as follows.

§ 232.201 Temporary hardship exemption.

(a) If an electronic filer experiences unanticipated technical difficulties preventing the timely preparation and submission of an electronic filing other than a Form 3 (§ 249.103 of this chapter), a Form 4 (§ 249.104 of this chapter), a Form 5 (§ 249.105 of this chapter), a Form ID (§§ 239.63, 249.446, 269.7 and 274.402 of this chapter), a Form TA-1 (§ 249.100 of this chapter), a Form TA-2 (§ 249.102 of this chapter), or a Form TA-W (§ 249.101 of this chapter), the electronic filer may file the subject filing, under cover of Form TH (§§ 239.65, 249.447, 269.10 and 274.404 of this chapter), in paper format no later than one business day after the date on which the filing was to be made.

* * * * *

PART 239—FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

5. The general authority citation for Part 239 is revised to read as follows.

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77sss, 78c, 78l, 78m, 78n, 78o(d), 78u-5, 78w(a), 78ll(d), 78mm, 80a-2(a), 80a-3, 80a-8, 80a-9, 80a-10, 80a-13, 80a-24, 80a-26, 80a-29, 80a-30, and 80-37, unless otherwise noted.

* * * * *

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

6. The general authority citation for Part 240 is revised to read as follows.

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

7. Amend § 240.17Ac2-1 by:

a. Revising paragraph (c);

b. Redesignating paragraph (d) as paragraph (e); and

c. Adding new paragraph (d).

The revision and addition reads as follows.

§ 240.17Ac2-1 Application for registration of transfer agents.

* * * * *

(c) If any of the information reported on Form TA-1 (§ 249b.100 of this chapter) becomes inaccurate, misleading, or incomplete, the registrant shall correct the information by

filing an amendment within sixty days following the date on which the information becomes inaccurate, misleading, or incomplete.

(d) Every registration and amendment filed pursuant to this section shall be filed with the Commission electronically in the Commission's EDGAR system. Transfer agents should refer to Form TA-1 and the instructions to the form (§ 249b.100 of this chapter) and to the EDGAR Filer Manual (§ 232.301 of this chapter) for the technical requirements and instructions for electronic filing. Transfer agents that have previously filed a Form TA-1 with the Commission must refile the information on their Form TA-1, as amended, in electronic format in EDGAR as an amended Form TA-1.

* * * * *

8. Amend § 240.17Ac2-2 by:

a. Adding two sentences to the end of the introductory text of paragraph (a); and

b. Revising paragraph (c).

The addition and revision reads as follows.

§ 240.17Ac2-2 Annual reporting requirement for registered transfer agents.

(a) * * * A transfer agent may file an amendment to Form TA-2 pursuant to the instructions on the form to correct information that has become inaccurate, incomplete, or misleading. A transfer agent may file an amendment at any time; however, in order to be timely filed, all required portions of the form must be completed and filed in accordance with this section and the instructions to the form by the date the form is required to be filed with the Commission.

* * * * *

(c) Every annual report and amendment filed pursuant to this section shall be filed with the Commission electronically in the Commission's EDGAR system. Transfer agents

should refer to Form TA-2 and the instructions to the form (§ 249b.102 of this chapter) and the EDGAR Filer Manual (§ 232.301 of this chapter) for further information regarding electronic filing. Every registered transfer agent must file an electronic Form TA-1 with the Commission, or an electronic amendment to its Form TA-1 if the transfer agent previously filed a paper Form TA-1 with the Commission, before it may file an electronic Form TA-2 or Form TA-W with the Commission.

9. Amend § 240.17Ac3-1 by:

a. Removing the authority citations at the end of the section;

b. Removing from paragraph (a) and the first sentence of paragraph (b) the term "17A(c)(3)(C)" and in its place adding "17A(c)(4)";

c. Removing from paragraph (b) the term "17A(c)(3)(A)" and in its place adding "17A(c)(3)";

d. Redesignating paragraph (c) as paragraph (d); and

e. Adding new paragraph (c).

The addition reads as follows.

§ 240.17Ac3-1 Withdrawal from registration with the Commission.

* * * * *

(c) Every withdrawal from registration filed pursuant to this section shall be filed with the Commission electronically in the Commission's EDGAR system. Transfer agents should refer to Form TA-W and the instructions to the form (§ 249b.101 of this chapter) and the EDGAR Filer Manual (§ 232.301 of this chapter) for further information regarding electronic filing.

* * * * *

PART 249—FORMS, SECURITIES EXCHANGE ACT OF 1934

10. The authority citation for Part 249 continues to read in part as follows.

Authority: 15 U.S.C. 78a et seq., and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

PART 249b– FURTHER FORMS, SECURITIES EXCHANGE ACT OF 1934

11. The authority citation for Part 249b continues to read in part as follows.

Authority: 15 U.S.C. 78a et seq., unless otherwise noted;

* * * * *

12. Form TA-1 (referenced in § 249b.100), Form TA-W (referenced in § 249b.101), and Form TA-2 (referenced in § 249b.102) are revised to read as set forth in the attached Appendices B, C, and D.

PART 269—FORMS PRESCRIBED UNDER THE TRUST INDENTURE ACT OF 1939

13. The authority citation for Part 269 continues to read as follows:

Authority: 15 U.S.C. 77ddd(c), 77eee, 77ggg, 77hhh, 77iii, 77jjj, 77sss, 78ll(d), unless otherwise noted.

PART 239—FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

PART 249—FORMS, SECURITIES EXCHANGE ACT OF 1934

PART 269—FORMS PRESCRIBED UNDER THE TRUST INDENTURE ACT OF 1939

PART 274—FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940

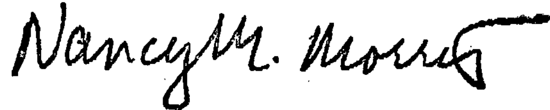
14. The authority citation for Part 274 continues to read in part as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78l, 78m, 78n, 78o(d), 80a-8, 80a-24, 80a-26, and 80a-29, unless otherwise noted.

* * * * *

15. Form ID (referenced in § 239.63, § 249.446, § 269.7, and § 274.402) is revised as set forth in Appendix A.

By the Commission.



Nancy M. Morris
Secretary

Date: December 4, 2006

Note: The following Appendices A, B, C, and D will not appear in the Code of Federal Regulations.

APPENDIX A

United States
Securities and Exchange Commission
Washington, D.C. 20549

OMB APPROVAL
OMB Number: 3235-0328
Expires: April 30, 2009
Estimated average burden
hours per response: . .0.15

FORM ID

UNIFORM APPLICATION FOR ACCESS CODES TO FILE ON EDGAR

PART I — APPLICATION FOR ACCESS CODES TO FILE ON EDGAR

Name of applicant (applicant's name as specified in its charter, except, if individual, last name, first name, middle name, suffix (e.g., "Jr.")

Mailing Address or Post Office Box No.

City State or Country Zip

Telephone number (Include Area and, if Foreign, Country Code) (   )

Applicant is (see definitions in the General Instructions)

☐ Filer ☐ Filing Agent ☐ Training Agent ☐ Transfer Agent ☐ Individual (if you check this box, you must also check either Filer, Filing Agent, Training Agent or Transfer Agent box)

PART II — FILER INFORMATION (To be completed only by filers that are not individuals)

Filer's Tax Number or Federal Identification Number (Do Not Enter a Social Security Number)

Doing Business As

Foreign Name (if Foreign Issuer Filer and applicable)

Primary Business Address or Post Office Box No. (if different from mailing address)

City | State or County | Zip

State of Incorporation | Fiscal Year End (mm/yy)

PART III — CONTACT INFORMATION (To be completed by all applicants)

Person to receive EDGAR Information, Inquiries and Access Codes

Telephone Number (Include Area and, if foreign, Country Code) (   )

Mailing Address or Post Office Box No. (if different from applicant's mailing address)

City | State or Country | Zip

E-Mail Address

PART IV — ACCOUNT INFORMATION (To be completed by filers and filing agents only)

Person to receive SEC Account Information and Billing Invoices

Telephone Number (Include Area and, if Foreign, Country Code) (   )

Mailing Address or Post Office Box No. (if different from applicant's mailing address)

City | State or Country | Zip

PART V — SIGNATURE (To be Completed by all Applicants)

Signature: | Type or Print Name:

Position or Title: | Date:

Intentional misstatements or omissions of facts constitute federal criminal violations. See 18 U.S.C. 1001.

Section 19(a) of the Securities Act of 1933 (15 U.S.C. 77s(a)), sections 13(a) and 23(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(a) and 78w(a)), section 319 of the Trust Indenture Act of 1939 (15 U.S.C. 77sss), and sections 30 and 38 of the Investment Company

Act of 1940 (15 U.S.C. 80a-29 and 80a-37) authorize solicitation of this information. We will use this information to assign system identification to filers, filing agents, and training agents. This will allow the Commission to identify persons sending electronic submissions and grant secure access to the EDGAR system.

SEC 2084 (05-06) Previous form obsolete

Persons who potentially are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB control number.

FORM ID
GENERAL INSTRUCTIONS

USING AND PREPARING FORM ID

Form ID must be filed by registrants, third party filers, or their agents, to whom the Commission previously has not assigned a Central Index Key (CIK) code, to request the following access codes to permit filing on EDGAR:

- Central Index Key (CIK) - The CIK uniquely identifies each filer, filing agent, and training agent. We assign the CIK at the time you make an initial application. You may not change this code. The CIK is a public number.

- CIK Confirmation Code (CCC) - You will use the CCC in the header of your filings in conjunction with your CIK to ensure that you authorized the filing.

- Password (PW) - The PW allows you to log onto the EDGAR

system, submit filings, and change your CCC.

• Password Modification Authorization Code (PMAC) - The PMAC allows you to change your password.

An applicant must file this Form in electronic format via the Commission's EDGAR Filer Management Web site. Please see Regulation S-T (17 CFR Part 232) and the EDGAR Filer Manual for instructions on how to file electronically, including how to use the access codes.

An applicant also must file in paper by fax within two business days before or after filing electronically Form ID the notarized document, manually signed by the applicant over the applicant's typed signature, required by Regulation S-T Rule 10(b)(2) that includes the information contained in the Form ID filed or to be filed, confirms the authenticity of the Form ID and, if filed after electronically filing the Form ID, includes the accession number assigned to the electronically filed Form ID as a result of its filing. The applicant must fax the authenticating document to the Branch of Filer Support of the Office of Filings and Information Services at (202) 504-2474 or (703) 914-4240. If the fax is not received timely, the application for access codes will not be processed. The applicant will receive an e-mail message at the contact's e-mail address informing the applicant of the staff's response to the application and providing further guidance. If the application is not processed, the message will state why.

For assistance with technical questions about electronic filing, call the Branch of Filer Support at (202) 551-8900 or see the EDGAR Filer Manual Volume I, Section 2.6, Getting Help with EDGAR.

You must complete all items in any parts that apply to you. If any item in any part does not apply to you, please leave it blank.

PART I - APPLICANT INFORMATION (to be completed by all applicants)

Provide the applicant's name in English.

Please check one of the boxes to indicate whether you will be sending electronic submissions as a filer, filing agent, or training agent. Mark only one of these boxes per application. If you are an individual, however, also mark the "Individual" box.

- "Filer" - Any individual or entity on whose behalf an electronic filing is made.
- "Filing Agent" - A financial printer, law firm, or other party, which will be using these access codes to send a filing or portion of a filing on behalf of a filer.
- "Training Agent" - Any individual or entity that will be sending only test filings in conjunction with training other persons.
- "Transfer Agent" - Any individual or entity planning to register as a Transfer Agent on whose behalf an electronic filing is made.
- "Individual" – A natural person.

PART II - FILER INFORMATION (to be completed only by filers that are not individuals)

The filer's tax or federal identification number is the number issued by the Internal Revenue Service. This section does not apply to individuals. Accordingly, do not enter a Social Security number. If an investment company filer is organized as a series company, the investment company may use the tax or federal identification number of any one of its constituent series. Issuers that have applied for but not yet received their tax or federal identification number and foreign issuers that do not have a tax or federal identification number must include all zeroes. A "foreign issuer" is an entity so defined by the Securities Act of 1933 (15 U.S.C. 77a et seq.) Rule 405 (17 CFR 230.405) and the Securities Exchange

Act of 1934 (15 U.S.C. 78a et seq.) Rule 3b-4(b) (17 CFR 240.3b-4(b)). Foreign issuers should include their country of organization.

A foreign issuer filer must provide its "doing business as" name in the language of the name under which it does business and must provide its foreign language name, if any, in the space so marked.

If the filer's fiscal year does not end on the same date each year (e.g., falls on the last Saturday in December), the filer must enter the date the current fiscal year will end.

PART III - CONTACT INFORMATION (to be completed by all applicants)

In this section, identify the individual who should receive the access codes and other EDGAR-related information. Please include an e-mail address that will become your default notification address for EDGAR filings; it will be stored in the Company Contact Information on the EDGAR Database. EDGAR will send all subsequent filing notifications automatically to that address. You can have one e-mail address in the EDGAR Company Contact Information. For information on including additional e-mail addresses on a per filing basis, refer to Volume 1, Section 3.2.2 of the EDGAR Filer Manual.

PART IV - ACCOUNT INFORMATION (to be completed by filers and filing agents only)

Identify in this section the individual who should receive account information and/or billing invoices from us. We will use this information to process electronically fee payments and billings. If the address changes, update it via the EDGAR filing Web site, or your account statements may be returned to us as undeliverable.

PART V - SIGNATURE (to be completed by all applicants)

If the applicant is a corporation, partnership, trust or other entity, state the capacity in which the representative individual, who must be duly authorized, signs the Form on behalf of the applicant.

If the applicant is an individual, the applicant must sign the Form.

If another person signs on behalf of the representative individual or the individual applicant, confirm the authority of the other person to sign in writing in an electronic attachment to the Form. The confirming statement need only indicate that the representative individual or individual applicant authorizes and designates the named person or persons to file the Form on behalf of the applicant and state the duration of the authorization.

APPENDIX B

OMB Approval
OMB Number: 3235-0084
Expires: June 30, 2009
Estimated average burden hours per response 2.00

UNITED STATES
SECURITIES AND
EXCHANGE COMMISSION
Washington, D.C. 20549

FORM TA-1

UNIFORM FORM FOR REGISTRATION AS A TRANSFER AGENT AND FOR AMENDMENT TO REGISTRATION PURSUANT TO SECTION 17A OF THE SECURITIES EXCHANGE ACT OF 1934

GENERAL: Form TA-1 is to be used to register or amend registration as a transfer agent with the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation or the Securities and Exchange Commission pursuant to Section 17A of the Securities Exchange Act of 1934.
Read all instructions before completing this form. Please print or type all responses.

Form Version: 1.0.0 ☑Check to show blank form for printing

1(a).Filer CIK: 1(b).Filer CCC:

1(c). Live/Test Filing? ○ Live ○ Test

1(d). Return Copy ☐ Yes

1(e). Is this filing an amendment to a previous filing? ☐ Yes

1(e)(i). File Number: 084 -

1(f)(i). Contact Name: 1(f)(ii). Contact Phone Number: 1(f)(iii). Contact E-mail Address:

1(g). Notification E-mail Address:

2. Appropriate regulatory agency (check one):

- ⦿ Securities and Exchange Commission
- ○ Board of Governors of the Federal Reserve System
- ○ Federal Deposit Insurance Corporation
- ○ Comptroller of the Currency

3(a). Full Name of Registrant:

3(a)(i). Previous name, if being amended:

3(b). Financial Industry Number Standard (FINS) number:

3(c). Address of principal office where transfer agent activities are, or will be, performed:

3(c)(i). Address 1

3(c)(ii). Address 2

3(c)(iii). City

3(c)(iv). State or Country

3(c)(v). Postal Code

3(d). Is mailing address different from response to Question 3(c)?	Yes	No
If "yes," provide address(es):	○	○

3(d)(i). Address 1

3(d)(ii).Address 2

3(d)(iii).City

3(d)(iv).State or Country

3(d)(v).Postal Code

3(e). Telephone Number
(Include Area Code)

4. Does registrant conduct, or will it conduct, transfer agent activities at any location other than that given in Question 3(c) above? Yes ○ No ○

If "yes," provide address(es):

4(a)(i). Address #1

4(a)(ii). Address #2

4(a)(iii). City

4(a)(iv). State or Country

4(a)(v). Postal Code

5. Does registrant act, or will it act, as a transfer agent solely for its own securities and/or securities of an affiliate(s)? Yes ○ No ○

6. Has registrant, as a named transfer agent, engaged, or will it engage, a service company to perform any transfer agent functions? Yes ○ No ○

If "yes," provide the name(s) and address(es) of all service companies engaged, or that will be engaged, by the registrant to perform its transfer agent functions:

6(a). Name:

6(b). File Number: -

6(c)(i). Address 1

6(c)(ii). Address 2

6(c)(iii). City

6(c)(iv). State or Country

6(c)(v). Postal Code

7. Has registrant been engaged, or will it be engaged, as a service company by a named transfer agent to perform transfer agent functions?

Yes ○ No ○

If "yes," provide the name(s) and File Number(s) of the named transfer agent(s) for which the registrant has been engaged, or will be engaged, as a service company to perform transfer agent functions:

7(a). Name:

7(b). File Number: -

7(c)(i). Address 1

7(c)(ii). Address 2

7(c)(iii). City

7(c)(iv). State or Country

7(c)(v). Postal Code

Completion of Question 8 on this form is required by all independent, non-issuer registrants whose appropriate regulatory authority is the Securities and Exchange Commission. Those registrants who are not required to complete Question 8 should select "Not Applicable."

8. Is registrant a:

- ○ Corporation
- ○ Partnership
- ○ Sole Proprietorship
- ○ Other
- ○ Not Applicable

Section for Initial Registration and for Amendments Reporting Additional Persons. (Corporation or Partnership)

8(a)(i). Full Name

8(a)(ii). Relationship Start Date

8(a)(iii). Title or Status

8(a)(iv). Ownership Code

- ○ NA - 0 to 5%
- ○ A - 5% up to 10%
- ○ B - 10% up to 25%
- ○ C - 25% up to 50%
- ○ D - 50% up to 75%
- ○ E - 75% up to 100%

8(a)(v). Control Person ☐

8(a)(vi). Relationship End Date

Section for Initial Registration and for Amendments Reporting Additional Persons. (Sole Proprietorship or Other)

8(a)(i). Full Name

8(a)(ii). Relationship Start Date

8(a)(iii). Title or Status

8(a)(iv). Description of Authority

8(a)(v). Relationship End Date

9. **Does any person or entity not named in the answer to Question 8:**

9(a). directly or indirectly, through agreement or otherwise exercise or have the power to exercise control over the management or policies of applicant; or . . . .   Yes ○   No ○

9(a)(i). Exact name of each person or entity

9(a)(ii). Description of the Agreement or other basis

9(b). wholly or partially finance the business of applicant, directly or indirectly, in any manner other than by a public offering of securities made pursuant to the Securities Act of 1933 or by credit extended in the ordinary course of business by suppliers, banks and others ? . . . .   Yes ○   No ○

9(b)(i). Exact name of each person or entity

9(b)(ii). Description of the Agreement or other basis

10. **Applicant and Control Affiliate Disciplinary History:**

The following definitions apply for purposes of answering this Question 10

Control affiliate	- An individual or firm that directly or indirectly controls, is under common control with, or is controlled by applicant. Included are any employees identified in 8(a), 8(b), 8(c) of this form as exercising control. Excluded are any employees who perform solely clerical, administrative support of similar functions, or who, regardless of title, perform no executive duties or have no senior policy making authority.
Investment or investment related	- Pertaining to securities, commodities, banking, insurance, or real estate (including, but not limited to, acting as or being associated with a broker-dealer, investment company, investment adviser, futures sponsor, bank, or savings and loan association).
Involved	- Doing an act of aiding, abetting, counseling, commanding, inducing, conspiring with or failing reasonably to supervise another in doing an act.

10(a). In the past ten years has the applicant or a control affiliate been convicted of or plead guilty or nolo contender ("no contest") to:

10(a)(1). a felony or misdemeanor involving: investments or an investment-related business, fraud, false statements or omissions, wrongful taking of property, or bribery, forgery, counterfeiting or extortion? . . . . Yes ○ No ○

10(a)(1)(i). The individuals named in the Action

10(a)(1)(ii). Title of Action

10(a)(1)(iii). Date of Action

10(a)(1)(iv). The Court or body taking the Action and its location

10(a)(1)(v). Description of the Action

10(a)(1)(vi). The disposition of the proceeding

10(a)(2). any other felony? . . . . Yes ○ No ○

10(a)(2)(i). The individuals named in the Action

10(a)(2)(ii). Title of Action

10(a)(2)(iii). Date of Action

10(a)(2)(iv). The Court or body taking the Action and its location

10(a)(2)(v). Description of the Action

10(a)(2)(vi). The disposition of the proceeding

10(b). Has any court in the past ten years:

10(b)(1). enjoined the applicant or a control affiliate in connection with any investment-related activity? . . . . Yes ○ No ○

10(b)(1)(i). The individuals named in the Action

10(b)(1)(ii). Title of Action

10(b)(1)(iii). Date of Action

10(b)(1)(iv). The Court or body taking the Action and its location

10(b)(1)(v). Description of the Action

10(b)(1)(vi). The disposition of the proceeding

10(b)(2). found that the applicant or a control affiliate was involved in a violation of investment-related statutes or regulations? . . . . . Yes ○ No ○

10(b)(2)(i). The individuals named in the Action

10(b)(2)(ii). Title of Action

10(b)(2)(iii). Date of Action

10(b)(2)(iv). The Court or body taking the Action and its location

10(b)(2)(v). Description of the Action

10(b)(2)(vi). The disposition of the proceeding

10(c). Has the U.S. Securities and Exchange Commission or the Commodity Futures Trading Commission ever:

	Yes	No
10(c)(1). found the applicant or a control affiliate to have made a false statement or omission?	○	○

10(c)(1)(i). The individuals named in the Action

10(c)(1)(ii). Title of Action

10(c)(1)(iii). Date of Action

10(c)(1)(iv). The Court or body taking the Action and its location

10(c)(1)(v). Description of the Action

10(c)(1)(vi). The disposition of the proceeding

	Yes	No
10(c)(2). found the applicant or a control affiliate to have been involved in a violation of its regulations or statutes?	○	○

10(c)(2)(i). The individuals named in the Action

10(c)(2)(ii). Title of Action

10(c)(2)(iii). Date of Action

10(c)(2)(iv). The Court or body taking the Action and its location

10(c)(2)(v). Description of the Action

10(c)(2)(vi). The disposition of the proceeding

	Yes	No
10(c)(3). found the applicant or a control affiliate to have been a cause of an investment-related business having its authorization to do business denied, suspended, revoked or restricted?	○	○

10(c)(3)(i). The individuals named in the Action

10(c)(3)(ii). Title of Action

10(c)(3)(iii). Date of Action

10(c)(3)(iv). The Court or body taking the Action and its location

10(c)(3)(v). Description of the Action

10(c)(3)(vi). The disposition of the proceeding

10(c)(4). entered an order denying, suspending or revoking the applicant's or a control affiliate's registration or otherwise disciplined it by restricting its activities? . . . . Yes ○ No ○

10(c)(4)(i). The individuals named in the Action

10(c)(4)(ii). Title of Action

10(c)(4)(iii). Date of Action

10(c)(4)(iv). The Court or body taking the Action and its location

10(c)(4)(v). Description of the Action

10(c)(4)(vi). The disposition of the proceeding

10(d). Has any other Federal regulatory agency or any state regulatory agency:

10(d)(1). ever found the applicant or a control affiliate to have made a false statement or omission or to have been dishonest, unfair, or unethical? . . . . Yes ○ No ○

10(d)(1)(i). The individuals named in the Action

10(d)(1)(ii). Title of Action

10(d)(1)(iii). Date of Action

10(d)(1)(iv). The Court or body taking the Action and its location

10(d)(1)(v). Description of the Action

10(d)(1)(vi). The disposition of the proceeding

10(d)(2). ever found the applicant or a control affiliate to have been involved in a violation of investment-related regulations or statutes? . . . . Yes ○ No ○

10(d)(2)(i). The individuals named in the Action

10(d)(2)(ii). Title of Action

10(d)(2)(iii). Date of Action

10(d)(2)(iv). The Court or body taking the Action and its location

10(d)(2)(v). Description of the Action

10(d)(2)(vi). The disposition of the proceeding

10(d)(3). ever found the applicant or a control affiliate to have been a cause of an investment-related business having its authorization to do business denied, suspended, revoked, or restricted? . . . . . . Yes ○ No ○

10(d)(3)(i). The individuals named in the Action

10(d)(3)(ii). Title of Action

10(d)(3)(iii). Date of Action

10(d)(3)(iv). The Court or body taking the Action and its location

10(d)(3)(v). Description of the Action

10(d)(3)(vi). The disposition of the proceeding

10(d)(4). in the past ten years entered an order against the applicant or a control affiliate in connection with investment-related activity? . . . . Yes ○ No ○

10(d)(4)(i). The individuals named in the Action

10(d)(4)(ii). Title of Action

10(d)(4)(iii). Date of Action

10(d)(4)(iv). The Court or body taking the Action and its location

10(d)(4)(v). Description of the Action

10(d)(4)(vi). The disposition of the proceeding

10(d)(5). ever denied, suspended, or revoked the applicant's or a control affiliate's registration or license, or prevented it from associating with an investment-related business, or otherwise disciplined it by restricting its activities? . . . . Yes ○ No ○

10(d)(5)(i). The individuals named in the Action

10(d)(5)(ii). Title of Action

10(d)(5)(iii). Date of Action

10(d)(5)(iv). The Court or body taking the Action and its location

10(d)(5)(v). Description of the Action

10(d)(5)(vi). The disposition of the proceeding

10(d)(6). ever revoked or suspended the applicant's or a control affiliate's license as an attorney or accountant? . . . . Yes ○ No ○

10(d)(6)(i). The individuals named in the Action

10(d)(6)(ii). Title of Action

10(d)(6)(iii). Date of Action

10(d)(6)(iv). The Court or body taking the Action and its location

10(d)(6)(v). Description of the Action

10(d)(6)(vi). The disposition of the proceeding

10(e). Has any self-regulatory organization or commodities exchange ever:

10(e)(1). found the applicant or a control affiliate to have made a Yes ○ No ○

10(e)(1)(i). The individuals named in the Action

10(e)(1)(ii). Title of Action

10(e)(1)(iii). Date of Action

10(e)(1)(iv). The Court or body taking the Action and its location

10(e)(1)(v). Description of the Action

10(e)(1)(vi). The disposition of the proceeding

10(e)(2). found the applicant or a control affiliate to have been Yes No

10(e)(2)(i). The individuals named in the Action

10(e)(2)(ii). Title of Action

10(e)(2)(iii). Date of Action

10(e)(2)(iv). The Court or body taking the Action and its location

10(e)(2)(v). Description of the Action

10(e)(2)(vi). The disposition of the proceeding

	Yes	No
10(e)(3). found the applicant or a control affiliate to have been the cause of an investment-related business losing its authorization to do business?	○	○

10(e)(3)(i). The individuals named in the Action

10(e)(3)(ii). Title of Action

10(e)(3)(iii). Date of Action

10(e)(3)(iv). The Court or body taking the Action and its location

10(e)(3)(v). Description of the Action

10(e)(3)(vi). The disposition of the proceeding

	Yes	No
10(e)(4). disciplined the applicant or a control affiliate by expelling or suspending it from membership, by barring or suspending its association with other members, or by otherwise restricting its activities?	○	○

10(e)(4)(i). The individuals named in the Action

10(e)(4)(ii). Title of Action

10(e)(4)(iii). Date of Action

10(e)(4)(iv). The Court or body taking the Action and its location

10(e)(4)(v). Description of the Action

10(e)(4)(vi). The disposition of the proceeding

10(f). Has any foreign government, court, regulatory agency, or exchange ever entered an order against the applicant or a control affiliate related to investments or fraud? . . . . Yes ○ No ○

10(f)(1)(i). The individuals named in the Action

10(f)(1)(ii). Title of Action

10(f)(1)(iii). Date of Action

10(f)(1)(iv). The Court or body taking the Action and its location

10(f)(1)(v). Description of the Action

10(f)(1)(vi). The disposition of the proceeding

10(g). Is the applicant or a control affiliate now the subject of any proceeding that could result in a yes answer to questions 10(a) - 10(f)? Yes ○ No ○

10(g)(1)(i). The individuals named in the Action

10(g)(1)(ii). Title of Action

10(g)(1)(iii). Date of Action

10(g)(1)(iv). The Court or body taking the Action and its location

10(g)(1)(v). Description of the Action

10(g)(1)(vi). The disposition of the Proceeding

10(h). Has a bonding company denied, paid out on, or revoked a bond for the applicant or a control affiliate? . . . . Yes ○ No ○

10(h)(1)(i). The individuals named in the Action

10(h)(1)(ii). Title of Action

10(h)(1)(iii). Date of Action

10(h)(1)(iv). The Court or body taking the Action and its location

10(h)(1)(v). Description of the Action

10(h)(1)(vi). The disposition of the Proceeding

10(i). Does the applicant or a control affiliate have any unsatisfied judgments or liens against it? . . . . Yes ○ No ○

10(i)(1)(i). The individuals named in the Action

10(i)(1)(ii). Title of Action

10(i)(1)(iii). Date of Action

10(i)(1)(iv). The Court or body taking the Action and its location

10(i)(1)(v). Description of the Action

10(i)(1)(vi). The disposition of the proceeding

ATTENTION: INTENTIONAL MISSTATEMENTS OR OMISSIONS OF FACT CONSTITUTE FEDERAL CRIMINAL VIOLATIONS. See 18 U.S.C. 1001 and 15 U.S.C. 78ff(a)

SIGNATURE: The registrant submitting this form, and as required, the SEC supplement and Schedules A-D,
And the executing official hereby represent that all the information contained herein is true, correct and complete.

11(a). Signature of Official responsible for Form:	11(b). Telephone Number:
11(c). Title of Signing Officer:	11(d).Date Signed (Month/Day/Year):

12. Related Documents/Attachments

12(a). File Name:

12(b). Type of Attachment:

- ○ COVER
- ○ CORRESP
- ○ GRAPHIC

12(c). Type of Attachment Additional Description:

12(d). Attachment Description:

12(e). File:

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

Instructions for Use of Form TA-1

Application for Registration and Amendment to Registration as a Transfer Agent Pursuant to Section 17A of the Securities Exchange Act of 1934

ATTENTION: This electronic Form TA-1 is to be filed only by SEC registrants. All other registrants file Form TA-1 in paper format with their Appropriate Regulatory Authority and should obtain the form from such authority.

Certain sections of the Securities Exchange Act of 1934 applicable to transfer agents are referenced or summarized below. Registrants are urged to review all applicable provisions of the Securities Exchange Act of 1934, the Securities Act of 1933 and the Investment Company Act of 1940, as well as the applicable rules promulgated by the SEC under those Acts.

I. General Instructions for Filing and Amending Form TA-1.

A. Terms and Abbreviations. The following terms and abbreviations are used throughout these instructions:

1. "Act" refers to the Securities Exchange Act of 1934.
2. "ARA" refers to the appropriate regulatory agency, as defined in Section 3(a)(34)(B) of the Act. See General Instruction D below.
3. "Form TA-1" is the Form filed as a registration and includes the Form and any attachments to that Form.
4. "Registrant" refers to the entity on whose behalf Form TA-1 is filed.
5. "SEC" or "Commission" refers to the U.S. Securities and Exchange Commission.

6. "Transfer agent" is defined in Section 3(a)(25) of the Act as any person who engages on behalf of an issuer of securities or on behalf of itself as an issuer in at least one of the functions enumerated therein.

7. "Independent, Non-Issuer Transfer Agent" refers to an entity which acts as a transfer agent for other than its own securities or securities of an affiliate.

8. "Regulation S-T" is the SEC's regulation containing the rules related to filing electronic documents in EDGAR. 17 CFR 232 et seq.

9. "EDGAR" (Electronic Data Gathering, Analysis, and Retrieval) is the computer system for the receipt, acceptance, review, and dissemination of documents submitted to the Commission in electronic format.

10. "EDGAR Filer Manual" is the manual prepared by the SEC setting out the technical format requirements for an electronic submission to EDGAR.

11. "EDGARLite" is an application in EDGAR that registrants may use to create the electronic Form TA-1 for submission to EDGAR.

B. Who Must File. Pursuant to Section 17A(c)(1) of the Act, it is unlawful for a transfer agent to perform any transfer agent function with respect to any qualifying security unless that transfer agent is registered with its ARA. A qualifying security is any security registered under Section 12 of the Act. Thus, qualifying securities including securities registered on a national securities exchange pursuant to Section 12(b) of the Act as well as equity securities registered pursuant to Section 12(g)(1) of the Act for issuers that have total assets exceeding $3,000,000 and a class of equity securities (other than exempted securities) held of record by 500 or more persons. In addition, qualifying securities include equity securities of registered investment companies and certain insurance companies that would be required to be registered under Section 12(g) except for the

exemptions provided by paragraphs (g)(2)(B) and (g)(2)(G), respectively, of Section 12, i.e., when the asset and shareholder criteria of Section 12(g)(1)(B) are met.

C. When to File. Before a transfer agent may perform any transfer agent function for a qualifying security, it must apply for registration on Form TA-1 with its ARA and its registration must become effective. Instructions for amending Form TA-1 appear at General Instruction H.

D. How to File. Registrants file electronically in EDGAR. Registrants should refer to the EDGAR Filer Manual, which is available on the SEC's Web site, www.sec.gov, for the instructions for preparing forms in EDGARLite™ and filing forms in EDGAR as well as for the computer hardware and software requirements for electronic filing. A Form TA-1 or an amended Form TA-1 which is not completed properly may be suspended as not acceptable for filing. Acceptance of this form, however, does not mean that the Commission has found that it has been filed as required or that the information submitted therein is true, correct or complete.

Registrants that are granted a hardship exemption from electronic filing under Rule 202 of Regulation S-T, 17 CFR 232.202, will be provided with instructions on how and where to file a paper Form TA-1.

A registrant that wishes to include a cover letter or other correspondence may do so by including the document as an attachment to the Form.

E. EDGAR Access. Before registrants may prepare the Form in EDGARLite™ or file the Form in EDGAR they must apply for access to EDGAR. Registrants should refer to the EDGAR Filer Manual, Volume I (General Instructions) for information on accessing EDGAR.

F. Records. Each registrant must keep an exact copy of any filing for its records.

Registrants should refer to 17 CFR 240.17Ad-6 and 240.17Ad-7 for information regarding the recordkeeping rules for transfer agents.

G. Effective Date. Registration of a transfer agent becomes effective thirty days after receipt by the ARA of the application for registration unless the filing does not comply with applicable requirements or the ARA takes affirmative action to accelerate, deny, or postpone registration in accordance with the provisions of Section 17A(c) of the Act.

H. Amending Registration. Each registrant must amend Form TA-1 within sixty calendar days following the date on which information reported therein becomes inaccurate, incomplete, or misleading.

1. Registrants amend Form TA-1 by responding "Yes" to Question 1(e).
2. All fields that are required to be completed on the registrant's Form TA-1 must be completed on the amended Form TA-1. The transfer agent may use a saved electronic version of a previously filed Form TA-1 or amended Form TA-1 as a template for the amended filing and create the amended form by revising the responses for which the information has become inaccurate, incomplete, or misleading. (For instructions on using a saved form as a template for an amended filing, registrants should refer to the EDGAR Filer Manual.)

II. Special Instructions for Filing and Amending Form TA-1.

A. Electronic Filing. Beginning [effective date of the proposed rule], all transfer agent forms (Form TA-1, Form TA-2, and Form TA-W) filed with the SEC must be filed electronically in EDGAR. Transfer agents that are registered with the SEC must refile electronically the information on their Form TA-1, as amended, with the SEC on an amended Form TA-1. The SEC will not accept any other transfer agent form from such transfer agents until they have filed an electronic amended Form TA-1.

B. Exemptions from Electronic Filing. The SEC may in limited cases grant an exemption from electronic filing where the filer can show that an electronic filing requirement creates an unreasonable burden or expense. Registrants should refer to Rule 202 of Regulation S-T, 17 CFR 232.202, and the SEC's Web site, www.sec.gov, for information on applying for a hardship exemption.

C. Registration. Registrants must provide full and complete responses in the appropriate format.

1. Information relating to electronic filing. As an EDGAR filer, a registrant is required to provide the following:

   a. Whether the form is a "live" or "test" filing submission;

   b. Whether the registrant would like a Return Copy of the filing;

   c. The registrant's CIK;

   d. The registrant's CCC; and

   e. The contact e-mail address for the registrant;

   f. The notification e-mail address(es) for the registrant regarding the status of the submission.

Detailed instructions regarding the above are provided in the EDGAR Filer Manual, Volume 1 (General Requirements). A registrant that is granted a continuing hardship exemption from electronic filing pursuant to Rule 202 of Regulation S-T, 17 CFR 232.202, need only to provide its CIK.

2. In answering Question 3.b. of Form TA-1, the term Financial Industry Number Standard (FINS number) means a six digit number assigned by The Depository Trust Company (DTC) upon request to financial institutions engaged in activities involving securities. Registrants that do not have a FINS number may obtain one by requesting

it following the steps described on the DTC Web site (www.dtc.org).

3. State in Question 3.c. the full address of the registrant's principal office where transfer agent activities are, or will be, performed; a post office box number is not acceptable. State in response to Question 3.d. the registrant's mailing address if different from the response to Question 3.c. You may provide a post office box number in response to Question 3.d.

4. For the purpose of answering Question 5, a transfer agent is an affiliate of, or affiliated with, a person, if the transfer agent directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, that person.

5. In answering Questions 6 and 7, a "named transfer agent" is a transfer agent engaged by the issuer to perform transfer agent functions for an issue of securities. There may be more than one named transfer agent for a given security issue (e.g., principal transfer agent, co-transfer agent or outside registrar).

D. Questions 8 through 10. Only independent, non-issuer registrants are required to complete Questions 8 through 10.

E. Execution of Form TA-1 and Amendments Thereto. A duly authorized official or a principal of the registrant must execute Form TA-1 and any amendments thereto on behalf of that registrant. For a corporate registrant, the term official includes the chairman or vice-chairman of the board of directors, the chairman of the executive committee, or any officer of the corporation who is authorized by the corporation to sign Form TA-1 on its behalf. For a non-corporate registrant, duly authorized principal means a principal of the registrant who is authorized to sign Form TA-1 on its behalf. The official or principal of the registrant shall execute Form TA-1 by providing an electronic signature pursuant

to Rule 301, Signatures, of Regulation S-T, 17 CFR 232.301. The official or principal of the registrant must provide his or her full name in typed format in the signature box of the form and must manually sign a signature page or other document authenticating, acknowledging, or otherwise adopting his or her signature that appears in typed form within the electronic filing. The signature page or other such document shall be signed at or before the time the electronic filing is made, shall be retained by the transfer agent for a period of five years, and shall be made available to the Commission or its staff upon request.

By executing Form TA-1, the registrant agrees and consents that notice of any proceeding under the Act by the SEC involving the registrant may be given by sending such notice by registered or certified mail to the registrant, "Attention Officer in Charge of Transfer Agent Activities," at its principal office for transfer agent activities as given in response to Question 3.c. of Form TA-1.

III. Notice

Under Sections 17, 17A(c) and 23(a) of the Act and the rules and regulations thereunder, the SEC is authorized to solicit from applicants for registration as a transfer agent and from registered transfer agents the information required to be supplied by Form TA-1. Disclosure to the SEC of the information requested in Form TA-1 is a prerequisite to the processing of Form TA-1. The information will be used for the principal purpose of determining whether the SEC should permit an application for registration to become effective or should deny, accelerate or postpone registration of an applicant. The information supplied herein may also be used for all routine uses of the SEC. Information supplied on this Form will be included routinely in the public files of the SEC and will be available for inspection by any interested person.

APPENDIX C

OMB Approval
OMB Number: 3235-0151
Expires: July 31, 2008
Estimated average burden hours per response 0.5

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM TA-W

NOTICE OF WITHDRAWAL FROM REGISTRATION AS TRANSFER AGENT PURSUANT TO SECTION 17A OF THE SECURITIES EXCHANGE ACT OF 1934

Form Version: 1.0.0

☑ Check to show blank box for printing

1(a).Filer CIK: 1(b).Filer CCC:

1(c). Live/Test Filing? ○ Live ○ Test

1(d). Return Copy? ☐ Yes

The registrant may provide a single e-mail address for contact purposes.

1(e)(i). Contact Name: 1(e)(ii).Contact phone Number: 1(e)(iii).Contact E-mail Address:

The registrant may provide additional e-mail addresses for those persons the filer would like to receive notification e-mails regarding the filing.

1(f).Notification E-mail Address:

2. Transfer Agent File No.: 084 -

3. Full name of registrant:

4. Name under which transfer agent activities are conducted, if different from above:

5. Address of registrants principle place of business:

5(a).Address1

5(b).Address2

5(c).City

5(d).State or Country

5(e).Postal Code

6. Furnish registrant's reasons for ceasing the performance of transfer agent functions or for otherwise requesting withdrawal of its registration:

7. Furnish the last date registrant performed transfer agent functions as defined by Section 3(a)(25) of the Act for any security, including debt and equity, registered under Section 12 of the Act or which would be required to be registered except for the exemption from registration provided by paragraph (g)(2)(B) or (g)(2)(G) of that section.

7(a). Does registrant have any intention of performing in the near future a transfer agent function for any such security?

○ Yes ○ No

8. Is registrant directly or indirectly involved in any legal actions or proceedings or aware of any potential claims against it in connection with its performance of transfer agent functions for any security?

○ Yes ○ No

8(a). If so, furnish complete information with respect to each:

8(a)(i). Individual named in the action or claim:

8(a)(ii). Title of the action or claim:

8(a)(iii). Action date:

8(a)(iv). Court or body name and location:

8(a)(v). Description of the action or claim:

8(a)(vi). Disposition of action or claim:

9. Are there any unsatisfied judgments or liens against registrant arising out of its performance of transfer agent functions for any security?

○ Yes ○ No

9(a). If so, furnish complete information regarding each judgment or lien.
9(a)(i). Individual named in the action or claim:

9(a)(ii). Title of the action or claim: **9(a)(iii).** Action date:

9(a)(iv). Court or body name and location:

9(a)(v). Description of the action or claim:

9(a)(vi). Disposition of action or claim:

10. For each issue for which registrant acted as transfer agent and for any issues for which registrant assumed transfer agent functions since the last amendment to Form TA-1, furnish:

10(a). Is there a successor transfer agent?

○ Yes ○ No

10(b). Name of successor transfer agents:

10(c). Address:
10(c)(i). Address 1

10(c)(ii). Address 2

10(c)(iii). City

10(c)(iv). State or Country

10(c)(v).Postal Code

10(d). Is the successor transfer agent registered as a transfer agent pursuant to the Act?

○ Yes ○ No

11. For each issue for which registrant acted as transfer agent and for any issues for which registrant assumed transfer agent functions since the last amendment to Form TA-1, furnish: name(s) and address(es) of the person(s) who has or will have custody or possession of the books and records which the registrant maintained in connection with its performance of transfer agent functions.

11(a). Name of Custodian

11(b). Address:

11(b)(i).Address 1

11(b)(ii).Address 2

11(b)(iii).City

11(b)(iv).State or Country

11(b)(v).Postal Code

12. Furnish the name(s) and address(es), if different from Item 11, where such books and records will be located.

12(a). Name of Custodian

12(b). Address:

12(b)(i).Address 1

12(b)(ii).Address 2

12(b)(iii).City

12(b)(iv).State or Country

12(b)(v).Postal Code

SIGNATURE: The registrant submitting this Form and its attachments and the person executing it represent that it and all materials filed in connection with it contain a true, correct and complete statement of all required information. Registrant also consents to make the books and records it is required to preserve by Rules 17Ad-6 and 17Ad-7 under the Securities Exchange Act of 1934 (17 CFR 240.17Ad-6 and 240.17Ad-7) available for examination by authorized representatives of the Commission during the period the rules require registrant to preserve such books and records and authorizes the person having custody of such books and records to make them available to such representatives.

13(a).Signature of Official responsible for Form:	13(b).Telephone number:
13(c).Title of Signing Officer:	13(d).Date signed (Month/Day/Year):

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM TA-W

Instructions for Use of Form TA-W

Notice of Withdrawal from Registration as a Transfer Agent Pursuant to Section 17A of the Securities Exchange Act of 1934

ATTENTION: This electronic Form TA-W is to be filed only by SEC registrants. All other registrants withdraw from registration as a transfer agent with their appropriate regulatory authority and should obtain instructions on withdrawal from registration as a transfer agent from such authority.

Certain sections of the Securities Exchange Act of 1934 applicable to transfer agents are referenced or summarized below. Registrants are urged to review all applicable provisions of the Securities Exchange Act of 1934, the Securities Act of 1933, and the Investment Company Act of 1940, as well as the applicable rules promulgated by the SEC under those Acts.

I. General Instructions for Filing Form TA-W

A. Terms and Abbreviations. The following terms and abbreviations are used throughout these instructions:

1. "Act" refers to the Securities Exchange Act of 1934.
2. "ARA" refers to the appropriate regulatory agency, as defined in Section 3(a)(34)(B) of the Act. See General Instruction D below.
3. "Form TA-1" is the Form filed as a registration and includes the Form and any attachments to that Form.
4. "Registrant" refers to the entity on whose behalf Form TA-1 is filed.
5. "SEC" or "Commission" refers to the U.S. Securities and Exchange Commission.

6. "Transfer agent" is defined in Section 3(a)(25) of the Act as any person who engages on behalf of an issuer of securities or on behalf of itself as an issuer in at least one of the functions enumerated therein.

7. "Independent, Non-Issuer Transfer Agent" refers to an entity which acts as a transfer agent for other than its own securities or securities of an affiliate.

8. "Regulation S-T" is the SEC's regulation containing the rules related to filing electronic documents in EDGAR. 17 CFR 232 et seq.

9. "EDGAR" (Electronic Data Gathering, Analysis, and Retrieval) is defined in Rule 11 of Regulation S-T, 17 CFR 232.11, as the computer system for the receipt, acceptance, review, and dissemination of documents submitted to the Commission in electronic format.

10. "EDGAR Filer Manual," is the manual prepared by the SEC setting out the technical format requirements for an electronic submission to EDGAR.

11. "EDGARLite" is an application in EDGAR that registrants may use to create the electronic Form TA-W for submission to EDGAR.

B. Who Must File. Pursuant to Section 17A(c)(4)(B) of the Act, a registered transfer agent may, upon such terms and conditions as the ARA for such transfer agent deems necessary or appropriate in the public interest, for the protection of investors, or in furtherance of the purposes of Section 17A the Act, withdraw from registration by filing a written notice of withdrawal with such ARA.

C. When to File. Before a registrant may withdraw from registration as a transfer agent, it must file a notice of withdrawal from registration as a transfer agent with the Commission on Form TA-W.

D. How to File. Registrants file electronically in EDGAR. Registrants may prepare the Form using EDGARLite and should refer to the EDGAR Filer Manual, which is available on the SEC's Web site at www.sec.gov for instructions for preparing and submitting electronic forms as well as for the technical requirements for filing in EDGAR. A Form TA-W which is not completed properly may be suspended as not acceptable for filing. Acceptance of this Form, however, does not mean that the Commission has found that it has been filed as required or that the information submitted therein is true, correct or complete.

Registrants that are granted a hardship exemption from electronic filing under Rule 202 of Regulation S-T, 17 CFR 232.202, will be provided with instructions on how and where to file a paper Form TA-W.

E. Records. Each registrant must keep an exact copy of any filing for its records. Registrants should refer to 17 CFR 240.17Ad-6 and 240.17Ad-7 for information regarding the recordkeeping rules for transfer agents.

F. Effective Date. In accordance with the rules adopted by the Commission, notice to withdraw from registration filed by a transfer agent shall become effective on the 60th day after the filing thereof with the Commission or within such shorter period of time as the Commission may determine. If a notice to withdraw from registration is filed with the Commission any time subsequent to the date of issuance of an order instituting proceedings pursuant to Section 17A(c)(3)(A), or if prior to the effective date of the notice of withdrawal the Commission institutes such a proceeding or a proceeding to impose terms and conditions upon such withdrawal, the notice of withdrawal shall not become effective except at such time and upon such terms and conditions as the

Commission deems necessary or appropriate in the public interest, for the protection of investors, or in furtherance of the purposes of Section 17A.

II. Special Instructions for Filing Form TA-W

A. Electronic Filing. Beginning [insert effective date of the rule], all transfer agent forms (Form TA-1, Form TA-2, and Form TA-W) filed with the SEC must be filed electronically in EDGAR.

B. Exemptions from Electronic Filing. The SEC may, in limited cases, grant an exemption from electronic filing where the filer can show that an electronic filing requirement creates an unreasonable burden or expense. Registrants should refer to Rule 202 of Regulation S-T, 17 CFR 232.202, and to the SEC's Web site, www.sec.gov, for information on applying for a hardship exemption.

C. Withdrawal from Registration. Registrants must provide full and complete responses in the appropriate format.

1. Information relating to electronic filing. As EDGAR filers, registrants are required to provide the following:

   a. Whether the Form is a “live” or “test” filing submission;

   b. Whether the registrant would like a Return Copy of the filing;

   c. The registrant’s CIK;

   d. The registrant’s CCC;

   e. The contact e-mail address for the registrant; and

   f. The notification e-mail address(es) for the registrant regarding the status of the submission.

   For more information regarding the above requirements see the EDGAR Filer Manual, Volume I (General Requirements). A registrant that is granted a continuing

hardship exemption pursuant to Rule 202 of Regulation S-T, 17 CFR 232.202, need only provide its CIK.

2. All items on the Form must be answered in full. Individuals' names must be given in full.

D. Execution of Form TA-W. A duly authorized official or a principal of the registrant must execute Form TA-W and any amendments thereto on behalf of that registrant. For a corporate registrant, the term official includes the chairman or vice-chairman of the board of directors, the chairman of the executive committee, or any officer of the corporation who is authorized by the corporation to sign Form TA-W on its behalf. For a non-corporate registrant, duly authorized principal means a principal of the registrant who is authorized to sign Form TA-W on its behalf.

The official or principal of the registrant shall execute Form TA-W by providing an electronic signature pursuant to Rule 302, Signatures, of Regulation S-T, 17 CFR 232.302. The official or principal of the registrant must provide his or her full name in typed format in the signature box of the Form and must manually sign a signature page or other document authenticating, acknowledging, or otherwise adopting his or her signature that appears in typed Form within the electronic filing. The signature page or other such document shall be signed at or before the time the electronic filing is made, shall be retained by the transfer agent for a period of five years, and shall be made available to the Commission or its staff upon request.

By executing Form TA-W, the registrant agrees and consents that notice of any proceeding under the Act by the SEC involving the registrant may be given by sending such notice by registered or certified mail to the registrant, "Attention Officer in Charge of Transfer Agent Activities," at its principal office for transfer agent activities as given in response to Question

3.c. of Form TA-1.

III. Notice

Under Sections 17, 17A(c) and (23)(a) of the Act and the rules and regulations thereunder, the Commission is authorized to solicit from registered transfer agents the information required to be supplied by this Form. Disclosure to the Commission of the information requested in Form TA-W is a prerequisite to the processing of a notice of withdrawal of registration as a transfer agent. The information will be used for the principal purpose of enabling the Commission to determine whether it is necessary or appropriate in the public interest, for the protection of investors, or in furtherance of the purposes of Section 17A of the Act that the withdrawal be denied, postponed or subject to specific terms and conditions. Information supplied on this Form will be included routinely in the public files of the Commission and will be available for inspection by any interested person.

APPENDIX D

OMB Approval
OMB Number: 3235-0337 Expires: September 30, 2009 Estimated average burden hours per response .... 6.00 Estimated average burden hours per intermediate response... 1.50 Estimated average burden hours per minimum response......... .50

File Number:	
-	
For the reporting period ended December 31,	

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM TA-2

FORM FOR REPORTING ACTIVITIES OF TRANSFER AGENTS REGISTERED PURSUANT TO SECTION 17A OF THE SECURITIES EXCHANGE ACT OF 1934

ATTENTION: INTENTIONAL MISSTATEMENTS OR OMISSIONS OF FACT CONSTITUTE FEDERAL CRIMINAL VIOLATIONS. See 18 U.S.C. 1001 and 15 U.S.C. 78ff(a)

Form Version: 1.0.0 ☑ Check to show blank form for printing

1(a).Filer CIK: 1(b).Filer CCC:

1(c). Live/Test Filing? ○ Live ○ Test

1(d). Return Copy ☐ Yes

1(e). Is this filing an amendment to a previous filing? ☐ Yes

The registrant may provide a single e-mail address for contact purposes.

1(f)(i). Contact Name: 1(f)(ii). Contact Phone Number: 1(f)(iii). Contact E-mail Address:

The registrant may provide additional e-mail addresses for those persons the filer would like to receive notification e-mails regarding the filing.

1(g). Notification E-mail Address:

1(h). Full Name of Registrant as stated in Question 3 of Form TA-1:

2(a). During the reporting period, has the Registrant engaged a service company to perform any of its transfer agent functions?

○ All ○ Some ○ None

2(b). If the answer to subsection (a) is all or some, provide the name(s) and transfer agent file number(s) of all service company(ies) engaged:

Name of Transfer Agent(s):	File Number:
	-
	-
	-
	-
	-

2(c). During the reporting period, has the Registrant been engaged as a service company by a named transfer agent to perform transfer agent functions?

○ Yes ○ No

2(d). If the answer to subsection (c) is yes, provide the name(s) and file number(s) of the named transfer agent(s) for which the Registrant has been engaged as a service company to perform transfer agent functions:

Name of Transfer Agent(s):	File Number:
	-
	-
	-
	-
	-

3(a). Registrant's appropriate regulatory agency (ARA):

3(b). During the reporting period, has the Registrant amended Form TA-1 within 60 calendar days following the date on which information reported therein became inaccurate, incomplete, or misleading?

- ○ Yes, filed amendment(s)
- ○ No, failed to file amendment(s)
- ○ Not applicable

3(c). If the answer to subsection (b) is no, provide an explanation:

If the response to any of questions 4-11 below is none or zero, enter "0."

4(a). Number of items received for transfer during the reporting period:

4(b). Number of individual securityholder accounts for which the TA maintained master securityholder files:

5(a). Total number of individual securityholder accounts, including accounts in the Direct Registration System (DRS), dividend reinvestment plans and/or direct purchase plans as of December 31:

5(b). Number of individual securityholder dividend reinvestment plan and/or direct purchase plan accounts as of December 31:

5(c). Number of individual securityholder DRS accounts as of December 31:

5(d). Approximate percentage of individual securityholder accounts from subsection (a) in the following categories as of December 31:

5(d)(i) Corporate Equity Securities	5(d)(ii) Corporate Debt Securities	5(d)(iii) Open-End Investment Company Securities	5(d)(iv) Limited Partnership Securities	5(d)(v) Municipal Debt Securities	5(d)(vi) Other Securities

6. Number of securities issues for which Registrant acted in the following capacities, as of December 31:

Corporate Securities		Open-End Investment Company Securities	Limited Partnership Securities	Municipal Debt Securities	Other Securities
Equity	Debt				

6(a). Receives items for transfer and maintains the master securityholder files:	6(a)(i)	6(a)(ii)	6(a)(iii)	6(a)(iv)	6(a)(v)	6(a)(vi)
6(b). Receives items for transfer but does not maintain the master securityholder files:	6(b)(i)	6(b)(ii)	6(b)(iii)	6(b)(iv)	6(b)(v)	6(b)(vi)
6(c). Does not receive items for transfer but maintains the master securityholder files:	6(c)(i)	6(c)(ii)	6(c)(iii)	6(c)(iv)	6(c)(v)	6(c)(vi)

7. Scope of certain additional types of activities performed:

7(a). Number of issues for which dividend reinvestment plan and/or direct purchase plan services were provided, as of December 31:

7(b). Number of issues for which DRS services were provided, as of December 31:

7(c). Dividend disbursement and interest paying agent activities conducted during the reporting period:

7(c)(i). number of issues

7(c)(ii). amount (in dollars)

8(a). Number and aggregate market value of securities aged record differences, existing for more than 30 days, as of December 31:

	Prior Transfer Agent(s) (If applicable)	Current Transfer Agent
8(a)(i). Number of issues		
8(a)(ii). Market value (in dollars)		

8(b). Number of quarterly reports regarding buy-ins filed by the registrant with its ARA (including the SEC) during the reporting period pursuant to Rule 17Ad-11(c)(2) of the Act:

8(c). During the reporting period, did the Registrant file all quarterly reports

regarding buy-ins with its ARA (including the SEC) required by Rule 17Ad-11(c)(2) of the Act?

○ Yes ○ No ○ Not Applicable

8(d). If the answers to subsection (c) is no, provide an explanation for each failure to file:

9(a). During the reporting period, has the Registrant always been in compliance with the turnaround time for routine items as set forth in Rule 17Ad-2 of the Act?

○ Yes ○ No ○ Not Applicable

If the answer to subsection (a) is no, complete subsections (i) through (ii).

9(a)(i). Provide the number of months during the reporting period in which the Registrant was not in compliance with the turnaround time for routine items according to Rule 17Ad-2 of the Act:

9(a)(ii). Provide the number of written notices Registrant filed during the reporting period with the SEC and with its ARA that reported its noncompliance with turnaround time for routine items according to Rule 17Ad-2 of the Act:

10. Number of open-end investment company securities purchases and redemptions (transactions) excluding dividend, interest and distribution postings, and address changes processed during the reporting period:

10(a). Total number of transactions processed:

10(b). Number of transactions processed on a date other than date of receipt of order (as ofs):

11(a). During the reporting period, provide the date of all database searches conducted for lost securityholder accounts listed on the transfer agent's master securityholder files, the number of lost securityholder accounts for which a database search has been conducted, and the number of lost securityholder accounts for which a different address has been obtained as a result of a database search:

11(a)(i) Date of Database Search	**11(a)(ii)** Number of Lost Securityholder Accounts Submitted for Database Search	**11(a)(iii)** Addresses Obtained from Database Search

11(b). Number of lost securityholder accounts that have been remitted to states during the reporting period:

SIGNATURE: The Registrant submitting this Form, and the person signing the Form, hereby represent that all the information contained in the Form is true, correct, and complete.

12(a). Signature of Official responsible for Form:	**12(b).** Telephone Number:
12(c). Title of Signing Officer:	**12(d).** Date Signed (Month/Day/Year):

13. Related Documents/Attachments

13(a). File Name:

13(b). Type of Attachment:

- O COVER
- O CORRESP
- O GRAPHIC

13(c). Type of Attachment Additional Description:

13(d). Attachment Description:

13(e). File:

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

Instructions for Use of Form TA-2

Form for Reporting Transfer Agent Activities Pursuant to Section 17A of the Securities Exchange Act of 1934

ATTENTION: All transfer agents, whether they are registered with the SEC or with another regulatory authority, must file an annual report on Form TA-2 in electronic format with the SEC.

Certain sections of the Securities Exchange Act of 1934 applicable to transfer agents are referenced below. Transfer agents are urged to review all applicable provisions of the Securities Exchange Act of 1934, the Securities Act of 1933, and the Investment Company Act of 1940, as well as the applicable rules promulgated by the SEC under those Acts.

I. General Instructions for Filing and Amending Form TA-2.

A. Terms and Abbreviations. The following terms and abbreviations are used throughout these instructions:

1. "Act" means the Securities Exchange Act of 1934, 15 U.S.C. 78a et seq.
2. "Aged record difference," as defined in Rule 17Ad-11(a)(2), 17 CFR 240.17Ad-11(a)(2), means a record difference that has existed for more than 30 calendar days.
3. "ARA," as defined in Section 3(a)(34)(B) of the Act, 15 U.S.C. 78c(a)(34)(B), means the appropriate regulatory agency.
4. "Direct Registration System" or "DRS" means the system, as administered by The Depository Trust Company, that allows investors to hold their securities in electronic book-entry form directly on the books of the issuer or its transfer agent.

5. "Form TA-2" includes the Form TA-2 and any attachments.
6. "Lost securityholder," as defined in Rule 17Ad-17, 17 CFR 240.17Ad-17, means a securityholder: (i) to whom an item of correspondence that was sent to the securityholder at the address contained in the transfer agent.s master securityholder file has been returned as undeliverable; provided, however, that if such item is re-sent within one month to the lost securityholder, the transfer agent may deem the securityholder to be a lost securityholder as of the day the re-sent item is returned as undeliverable; and (ii) for whom the transfer agent has not received information regarding the securityholder's new address.
7. "Named transfer agent," as defined in Rule 17Ad-9(j), 17 CFR 240.17Ad-9(j), means a registered transfer agent that has been engaged by an issuer to perform transfer agent functions for an issue of securities but has engaged a service company (another registered transfer agent) to perform some or all of those functions.
8. "Record difference" means any of the imbalances described in Rule 17Ad-9(g), 17 CFR 240.17Ad-9(g).
9. "Reporting period" means the calendar year ending December 31 of the year for which Form TA-2 is being filed.
10. "SEC" or "Commission" means the United States Securities and Exchange Commission.
11. "Service company," as defined in Rule 17Ad-9(k), 17 CFR 240.17Ad-9(k), means the registered transfer agent engaged by a named transfer agent to perform transfer agent functions for that named transfer agent.
12. "Transfer agent,"as defined in Section 3(a)(25) of the Act, 15 U.S.C. 78c(a)(25),

means any person who engages on behalf of an issuer of securities or on behalf of itself as an issuer in at least one of the functions enumerated therein.

13. "Regulation S-T," 17 CFR 232, is the SEC's regulation that sets forth the rules related to filing electronic documents in EDGAR.

14. "EDGAR," Electronic Data Gathering, Analysis, and Retrieval, is defined in Rule 11 of Regulation S-T, 17 CFR 232.11, as the computer system for the receipt, acceptance, review, and dissemination of documents submitted in electronic format.

15. "EDGAR Filer Manual," as defined in Rule 11 of Regulation S-T, 17 CFR 232.11, is the manual prepared by the SEC setting out the technical format requirements for an electronic submission to EDGAR.

16. "EDGARLite" is an EDGAR application described in the EDGAR Filer Manual that transfer agents may use to create the electronic Form TA-2 for submission to EDGAR.

B. Who Must File; When to File.

1. Every transfer agent that is registered on December 31 must file Form TA-2 in accordance with the instructions contained therein by the following March 31. Before an SEC registered transfer agent may file a Form TA-2 on EDGAR it must have filed a Form TA-1 or an amended Form TA-1 on EDGAR. SEC transfer agents should refer to the instructions to 240 CFR 17Ac2-1 and Form TA-1 for more information.

   a. A registered transfer agent that received fewer than 1,000 items for transfer during the reporting period **and** that did not maintain master securityholder files for more than 1,000 individual securityholder accounts as of December 31

of the reporting period is required to complete Questions 1 through 5, 11, and the signature section of Form TA-2.

b. A named transfer agent that engaged a service company to perform **all** of its transfer agent functions during the reporting period is required to complete Questions 1 through 3 and the signature section of Form TA-2.

c. A named transfer agent that engaged a service company to perform **some but not all** of its transfer agent functions during the reporting period must complete all of Form TA-2 but should enter zero (0) for those questions that relate to functions performed by the service company on behalf of the named transfer agent.

2. The date on which any filing is actually received by the SEC is the transfer agent's filing date provided that the filing complies with all applicable requirements. A Form TA-2 or an amended Form TA-2 which is not completed properly may be suspended as not acceptable for filing. Acceptance of this Form, however, does not mean that the Commission has found that it has been filed as required or that the information submitted therein is true, correct or complete.

C. How to File. Transfer agents file Form TA-2 electronically on EDGAR. Transfer agents should refer to the EDGAR Filer Manual, which is available on the SEC's Web site www.sec.gov, for the technical instructions for preparing forms using EDGARLite™ and for filing on EDGAR as well as for the computer hardware and software requirements. Transfer agents that are granted a hardship exemption from electronic filing under Rule 202 of Regulation S-T, 17 CFR 232.202, will be provided with instructions on how and where to file a paper Form TA-2.

A transfer agent that wishes to include a cover letter or other correspondence may do so

by including the document as an electronic attachment to the form.

D. EDGAR Access. Before transfer agents file on EDGAR they must obtain access to EDGAR. Transfer agents should refer to the EDGAR Filer Manual, Volume I (General Instructions) for information on accessing EDGAR.

E. Amending Form TA-2. Transfer agents may amend Form TA-2 at any time to correct errors in the information reported therein.

1. A transfer agent may amend Form TA-2 by selecting the submission type "Amendment" on Form TA-2. The transfer agent may use a saved electronic version of a previously filed Form TA-2 or an amended Form TA-2 as a template for the amended filing. For instructions on using a saved form as a template for an amended filing transfer agents should refer to the EDGAR Filer Manual.

2. All fields that are required to be completed on the transfer agent's Form TA-2 must be completed on the amended Form TA-2 with the transfer agent amending only those answers for which it needs to correct an error.

F. Records. Each transfer agent must keep an exact copy of any filing for its records. Transfer agents should refer to 17 CFR 240.17Ad-6 and 240.17Ad-7 for information regarding the recordkeeping rules for transfer agents.

G. Execution of Form TA-2 and Amendments Thereto. A duly authorized official or a principal of the transfer agent shall execute Form TA-2 by providing an electronic signature pursuant to Rule 301, Signatures, of Regulation S-T, 17 CFR 301. The official or principal of the transfer agent must provide his or her full name in typed format in the signature box of the form and must manually sign a signature page or other document authenticating, acknowledging, or otherwise adopting his or her signature that appears in typed form within the electronic filing. The signature page or other such document shall

be signed at or before the time the electronic filing is made, shall be retained by the transfer agent for a period of five years, and shall be made available to the Commission or its staff upon request.

II. Special Instructions for Filing Form TA-2.

A. Electronic Filing. Beginning [insert effective date of the rule], all transfer agent forms (Form TA-1, Form TA-2, and Form TA-W) filed with the SEC must be filed electronically on EDGAR. Transfer agents that are registered with the SEC must refile electronically the information on their Form TA-1, as amended, with the SEC on an amended Form TA-1. The SEC will not accept a Form TA-2 from transfer agents that are registered with the SEC until such transfer agents have filed an electronic amended Form TA-1.

B. Exemptions from Electronic Filing. The SEC may in limited cases grant an exemption from electronic filing where the filer can show that an electronic filing requirement creates an unreasonable burden or expense. Transfer agents should refer to Rule 202 of Regulation S-T, 17 CFR 232.202, and to the SEC's Web site for information on applying for a hardship exemption.

C. Report of Transfer Agent Activities. Transfer agents must provide full and complete responses in the appropriate format.

1. Information relating to electronic filing. As an EDGAR filer, the transfer agent is required to provide the following:

    a. Whether the form is a "live" or "test" filing submission;

    b. Whether the transfer agent would like a Return Copy of the filing;

    c. The transfer agent's CIK;

    d. The transfer agent's CCC;

e. The contact e-mail address for the transfer agent; and

f. The notification e-mail address(es) for the transfer agent regarding the status of the submission.

For more information regarding the above requirements see the EDGAR Filer Manual, Volume 1 (General Requirements). A transfer agent that is granted a continuing hardship exemption pursuant to Rule 202 of Regulation S-T, 17 CFR 232.202, need only provide its CIK.

2. Indicate the calendar year for which Form TA-2 is filed. A transfer agent registered on December 31 shall file Form TA-2 by the following March 31 even if the transfer agent conducted business for less than the entire reporting period.

3. In answering Question 4.a., indicate the number of items received for transfer during the reporting period. Omit the purchase and redemption of open-end investment company shares. Report those items in response to Question 10.

4. In answering Questions 5 and 6, include closed-end investment company securities in the corporate equity securities category.

   a. In answering Question 5.a., include Direct Registration System, dividend reinvestment plan and/or direct purchase plan accounts in the total number of individual securityholder accounts maintained.

   b. In answering Question 5.b., include dividend reinvestment plan and/or direct purchase plan accounts only.

   c. In answering Question 5.c., include Direct Registration System accounts only.

   d. In answering Question 5.d., include American Depositary Receipts (ADRs) in the corporate equity or corporate debt category, as appropriate, and include dividend reinvestment plan and/or direct purchase plan accounts in the corporate equity or

open-end investment company securities category.

e. In answering Question 6, debt securities are to be counted as one issue per CUSIP number. Open-end investment company securities portfolios are to be counted as one issue per CUSIP number.

5. In answering Question 7.c., exclude coupon payments and transfers of record ownership as a result of corporate actions.
6. In answering Question 10, exclude non-value transactions such as name or address changes.
7. In answering Question 11.b., include only those accounts held by securityholders that are defined as lost by Rule 17Ad-17, 17 CFR 240.17Ad-17, when the underlying securities (i.e., not just dividends and interest) have been remitted to the states.

III. Notice

SEC's Collection of Information: An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. Under Sections 17, 17A(c) and 23(a) of the Act and the rules and regulations thereunder, the SEC is authorized to solicit from registered transfer agents the information required to be supplied on Form TA-2. The filing of this Form is mandatory for all registered transfer agents. The information will be used for the principal purpose of regulating registered transfer agents but may be used for all routine uses of the SEC or of the ARAs. Information supplied on this Form will be included routinely in the public files of the ARAs and will be available for inspection by any interested person. Any member of the public may direct to the SEC any comments concerning the accuracy of the burden estimate on the application facing page of this Form, and any suggestions for reducing this burden. The Office of Management and Budget has reviewed this collection of information in accordance

with the clearance requirements of 44 U.S.C. 3507.

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 242

[Release No. 34-54888; File No. S7-20-06]

RIN 3235-AJ75

SHORT SELLING IN CONNECTION WITH A PUBLIC OFFERING

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission ("Commission") is proposing amendments to Regulation M concerning the anti-manipulation rules for securities offerings that would further safeguard the integrity of the capital raising process and protect issuers from manipulative activity that can reduce issuers' offering proceeds and dilute security holder value. The proposal would prevent a person from effecting a short sale during a limited time period, shortly before pricing, and then purchasing, including entering into a contract of sale for, such security in the offering.

DATES: Comments should be received on or before [insert date 60 days after publication in the Federal Register.]

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

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml); or
- Send an e-mail to rule-comments@sec.gov.

  Please include File No. S7-20-06 on the subject line; or

Document 11 of 58

- Use the Federal eRulemaking Portal (http://www.regulations.gov). Follow the instructions for submitting comments.

Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-20-06. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (http://www.sec.gov/rules/proposed.shtml). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available.

FOR FURTHER INFORMATION CONTACT: James A. Brigagliano, Acting Associate Director, Josephine Tao, Branch Chief, Elizabeth Sandoe, Victoria Crane, and Marlon Quintanilla Paz, Special Counsels, (202) 551-5720, Office of Trading Practices and Processing, Division of Market Regulation, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-6628.

SUPPLEMENTARY INFORMATION: The Commission is requesting public comment on proposed amendments to Rule 105 of Regulation M [17 CFR 242.105].

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I. Introduction

A fundamental goal of Regulation M, Anti-manipulation Rules Concerning Securities Offerings, is protecting the independent pricing mechanism of the securities markets so that offering prices result from the natural forces of supply and demand unencumbered by artificial forces.[1] Price integrity is essential in the offering process. Regulation M is intended to foster

[1] Securities Exchange Act of 1934 ("Exchange Act") Release No. 38067 (Dec. 20, 1996), 62 FR 520 (Jan. 3, 1997) ("Regulation M Adopting Release").

price integrity by prohibiting activity that interferes with independent market dynamics, prior to pricing offerings, by persons with a heightened incentive to manipulate.

Regulation M consists of a definitional rule, Rule 100, and five additional rules, Rules 101 through 105.[2] Rule 105, Short Selling In Connection With A Public Offering, prohibits a person from covering a short sale[3] with securities sold in the offering, if such person sold short within five days prior to pricing or the period beginning with the filing of the registration statement and ending with pricing, whichever is shorter. This short selling can artificially depress market prices which can lead to lower than anticipated offering prices, thus causing an issuer's offering proceeds to be reduced.[4]

We are aware of non-compliance with current Rule 105, and in some cases, strategies used to disguise Rule 105 violations.[5] Despite interpretive guidance regarding the application of Rule 105,[6] we have witnessed continued violations of the rule, including a proliferation of trading strategies and structures attempting to accomplish the economic equivalent of the activity that the rule seeks to prevent.

We propose amending Rule 105 to make it unlawful for a person to effect a short sale during the Rule 105 restricted period and then purchase, including enter into a contract of sale for, such security in the offering. The proposal, like the current rule, provides a bright line test for Rule 105 compliance consistent with the prophylactic nature of Regulation M. In light of evidence of non-compliance with the current rule, we believe the proposal would promote

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[2] 17 CFR 242.100 through 242.105.

[3] A short sale is the sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller. See 17 CFR 242.200 (2006).

[4] See Regulation M Adopting Release, 62 FR at 538.

[5] See infra n.18.

[6] See Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008, 48020-21 (Aug. 6, 2004) ("Regulation SHO Adopting Release").

investor and issuer confidence in pricing integrity and in the offering process, which should facilitate capital formation. In addition, the elimination of the current rule's covering component is intended to address attempts to restructure transactions in an effort to evade Rule 105.

The proposal is narrowly tailored to address short sales prior to pricing that can reduce issuers' offering proceeds without restricting other short sales before the offering.[7] Like the current rule, the proposal would permit persons that effect short sales prior to the restricted period to purchase, including to enter into a contract of sale for, such security in the offering and would permit persons to sell short during the restricted period if they do not purchase, including enter into a contract of sale for, such security in the offering.

We solicit specific comment on our approach and the specific proposals. We encourage commenters to present data on our proposals and any suggested alternative approaches.

II. Background

The Commission has long been concerned that short sales effected prior to certain offerings that are covered with offering securities can be manipulative conduct harmful to the market and can have a substantial impact on issuers or selling security holders. Rule 10b-21,[8] the predecessor to Rule 105, prohibited covering short sales with offering securities if the short sale took place during the period beginning at the time that the registration statement or Form 1-A was filed and ending at the time that sales may be made pursuant to the registration statement

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[7] If the registered offering is on behalf of selling security holders, the proceeds of such selling security holders can be similarly reduced.

[8] Rule 10b-21 was rescinded with the adoption of Regulation M. Regulation M Adopting Release, 62 FR at 520.

or Form 1-A.[9] The Commission stated that Rule 10b-21 would "help deter a practice that the Commission views as manipulative and destructive of issuers' capital raising activities."[10]

Prior to Rule 10b-21's adoption, the Commission noted the staff's view about short selling prior to an offering, stating that "it appears that such short selling prior to the offering date has had a substantial adverse impact on the market price of the securities and in some instances has caused the offerings to be postponed temporarily, to be abandoned completely, or to be made at prices lower than originally intended – prices which do not reflect the market value of the securities, undistorted by artificial factors."[11]

Generally, the offering prices of follow-on and secondary offerings[12] are priced at a discount to a stock's closing price (depending on the exchange, the closing transaction price, closing bid price, or last sale price) prior to pricing. This discount provides a motivation for a

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9 Exchange Act Release No. 33702 (Mar. 2, 1994), 59 FR 10984 (Mar. 9, 1994) ("Rule 10b-21 Adopting Release"). Rule 10b-21(T) was initially adopted on a temporary basis. Exchange Act Release No. 26028 (Aug. 31, 1988), 53 FR 33455(Aug. 31, 1988). The Commission proposed the rule for public comment in 1987. Exchange Act Release No. 24485 (May 20, 1987), 52 FR 19885 (May 28, 1987) ("1987 Proposing Release'). The Commission proposed three versions of Rule 10b-21 prior to the 1987 Proposing Release. See Exchange Act Release No. 10636 (Feb. 11, 1974), 39 FR 7806 (Feb. 28, 1974); Exchange Act Release No. 11328 (Apr. 2, 1975), 40 FR 16090 (Apr. 9, 1975); Exchange Act Release No. 13092 (Dec. 21, 1976), 41 FR 56542 (Dec. 28, 1976).

Rule 10b-21 provided that, "It shall be unlawful for any person who effects one or more short sales of equity securities of the same class as securities offered for cash pursuant to a registration statement filed under the Securities Act of 1933 ('Securities Act') or pursuant to a notification on Form 1-A under the Securities Act ('offered securities'), to cover such short sale or sales with offered securities purchased from an underwriter or broker or dealer participating in the offering, if such short sales or sale took place during the period beginning at the time that the registration statement or Form 1-A is filed and ending at the time that sales may be made pursuant to the registration statement or Form 1-A." Former Rule 10b-21(a).

10 53 FR at 33456.

11 Exchange Act Release No. 9824 (Oct. 25, 1972), 37 FR 22796 (Oct. 25, 1972). In addition, the Commission noted the staff's view that "Such investors and broker-dealers, desiring to participate in so-called 'hot' issue offerings, agree to accommodate the underwriters and therefore participate in the so-called 'cold' issue. Such persons reportedly then attempt to protect themselves against losses by selling the securities short prior to the distribution, intending to cover their position with the securities being offered." 37 FR at 22796.

12 The first time an issuer conducts a public offering of its securities, the offering is referred to as an initial public offering ("IPO"). Subsequent offerings by the issuer are referred to as follow-on offerings or repeat offerings. A secondary offering is an offering of securities held by security holders, for which there already exist trading markets for the same class of securities as those being offered. See Exchange Act Release No 10636 (Feb. 11, 1974), 39 FR 7806 n.1 (Feb. 28, 1974). Of course, IPOs also may include secondary offerings by selling security holders.

person who has a high expectation of receiving offering shares to capture this discount by aggressively short selling just prior to pricing and then covering the person's short sales at the lower offering price with securities received through an allocation. Covering the short sale with a specified amount of registered offering securities at a fixed price allows a short seller largely to avoid market risk and usually guarantee a profit.[13] Short sales during the period immediately preceding pricing an offering can exert downward pressure upon a stock's price that can result in lower offering prices.

Some persons may decide to sell short prior to the pricing of an offering because they believe the security is overpriced. This activity provides a true price discovery mechanism for the market and should be encouraged. Persons who are attempting to capture the offer price discount are not selling short the security because the security is overpriced; thus, they do not contribute to true pricing efficiency.[14] Instead, by selling the security short with the knowledge that they are very likely to be able to cover their short positions with offering shares that they are allocated, these persons may drive down the price despite their true belief regarding the appropriate price for that security. The likelihood of being allocated offering shares provides these persons with an advantage over other persons, which they may exploit to the detriment of pricing efficiency. Not only is this conduct harmful to the market and current security holders,

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[13] Of course, there are additional risks including execution risk, quantity risk and litigation risk that the short seller might consider. Based on our experience, it would appear that many investors perceive these risks as minimal because they do not appear to deter this shorting strategy. The shorting strategy is detailed in a number of enforcement cases concerning Rule 105. See infra n.18.

[14] "The Commission has also cautioned that 'any person intending to purchase securities in any registered secondary offering should be on notice that his selling short the same securities prior to the offering may be subject to the registration requirements of Section 5 of the Securities Act [15 U.S.C. 77e] as well as other applicable statutes and rules.' Exchange Act Release No. 10636 (Feb. 11, 1974). Accord, Exchange Act Release Nos. 11328 n. 1 (Apr. 2, 1975) and 9824 (Oct. 16, 1972)." Exchange Act Release No. 26028 (Aug. 25, 1988), 53 FR 3345, 33457 (Aug. 31, 1988).

but it can reduce the proceeds the issuer or the selling security holder receives from the securities offering.

To facilitate true price discovery, Rule 105 governs short sales immediately prior to pricing follow-on and secondary offerings where the short sales are covered with offering securities.[15] Currently, Rule 105 prohibits persons from covering a short sale with offering securities if the short sale occurred during a Rule 105 restricted period. Typically, the Rule 105 restricted period begins five business days before the pricing of the offering and ends with pricing.[16] Rule 105 is prophylactic. Thus, its prohibitions apply irrespective of a short seller's intent.[17] Rule 105 does not ban short sales because certain short sales may be motivated by a short seller's evaluation of a security's future performance and contribute to pricing efficiency and price discovery. The rule does not unduly restrict short selling, and thus does not hamper true price discovery, because persons are not prohibited from short selling and persons expecting to receive allocation of offering shares can effect short sales prior to the Rule 105 restricted period. In addition, short sales can be made during the restricted period if the seller does not cover with shares it receives in the offering.

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[15] 17 CFR 242.105. Short selling in connection with a public offering. (a) Unlawful Activity. In connection with an offering of securities for cash pursuant to a registration statement or a notification on Form 1-A (§239.90 of this chapter) filed under the Securities Act, it shall be unlawful for any person to cover a short sale with offered securities purchased from an underwriter or broker or dealer participating in the offering, if such short sale occurred during the shorter of: (1) The period beginning five business days before the pricing of the offered securities and ending with such pricing; or (2) The period beginning with the initial filing of such registration statement or notification on Form 1-A and ending with such pricing.

[16] See id.

[17] See Exchange Act Release No. 48795 (Nov. 17, 2003), 68 FR 65820, 65822 n.22 (Nov. 21, 2003) (stating that Rule 105 does not require a showing of scienter). Short sales effected during the Rule 105 restricted period can depress market prices and reduce an issuer's offering proceeds even if the short seller has no manipulative intent.

There has been non-compliance with Rule 105 and examples are detailed in numerous recent Commission enforcement cases.[18] We have seen patterns where persons engage in strategies to avoid the appearance that offering shares they were allocated are used to cover Rule 105 restricted period short sales. Whether trading strategies are the product of attempts to avoid application of the rule or attempts to conceal Rule 105 violations, they indicate the presence of activity that the rule is designed to prevent.

Certain of the cases illustrate activity meant to obfuscate the prohibited covering. One method of obscuring a Rule 105 violation involves post-offering sales and purchases undertaken to give the appearance that the restricted period short sales were covered with shares other than the offering allocation. For example, a person (1) effects a short sale of 5,000 shares during a Rule 105 restricted period, (2) purchases, including enters into a contract of sale for, 5,000 shares of the security in the offering, (3) following the purchase, or entry into the contract of sale, sells 5,000 shares and (4) contemporaneously or nearly contemporaneously purchases 5,000 shares. The Rule 105 violation may be complete when the restricted period short sale is covered with offering shares at step number 2 above. Once the restricted period short sale is executed and the person purchases, including enters into a contract of sale for, the offered securities, the position is economically flat. A contemporaneous or nearly contemporaneous post-offering purchase and sale does not undo the Rule 105 violation.[19] In that situation, a person may violate Rule 105

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[18] See, e.g., SEC v. Solar Group S.A. and James J. Todd, No. 06-CV-12936 (SDNY Nov. 6, 2006), Litigation Release No. 19899 (Nov. 6, 2006); SEC v. Graycort Financial, LLC, No. C 06-6033 (NDCA Sept. 28, 2006), Litigation Release No. 19851 (Sept. 28, 2006); SEC v. Compania Internacional Financiera SA and Yomi Rodrig, No. 05-CV-10634 (SDNY Dec. 20, 2005), Litigation Release No. 19501 (Dec. 20, 2005); SEC v. Galleon Management, L.P., Litigation Release No. 19228 (May 19, 2005); DB Investment Managers, Inc., Exchange Act Release No. 51707 (May 19, 2005); Oaktree Capital Management LLC, Exchange Act Release No. 51709 (May 19, 2005); SEC v. Joseph X. Crivelli, Exchange Act Release No. 50092 (July 27, 2004); Ascend Capital, LLC, Exchange Act Release No. 48188 (July 17, 2003); and SEC v. Ethan H. Weitz and Robert R. Altman, Litigation Release No. 18121 (Apr. 30, 2003).

[19] The Commission issued interpretive guidance regarding transactions that are engineered to obfuscate a Rule 105 violation. 69 FR at 48021.

despite his or her claim that the market purchase following the offering, rather than the shares acquired in the offering, covered the short position because there is no legitimate economic purpose or substance to the contemporaneous purchase and sale, no genuine change in beneficial ownership, and/or little or no market risk.

Certain Commission enforcement cases illustrate variations of this tactic. The following examples illustrate attempted concealments of covering through the use of crossed limit orders and the use of market orders. Persons may claim that a post-allocation shares purchase, rather than the shares from the offering allocation, are used to cover the restricted period short sale. However, this post offering activity may be an attempt to conceal the prohibited covering after the Rule 105 violation has occurred.

The Commission has settled proceedings in which respondents covered restricted period short positions in violation of Rule 105 and placed post-offering limit orders to sell and purchase the offered security at the same price and in the same quantity.[20] For example, 1,000 shares of an issuer's common stock were sold short during the restricted period. Next, the person purchased, including entered into a contract of sale for, 1,000 shares of the security in the offering. Thereafter, buy and sell limit orders were placed to "cross" 1,000 shares of the issuer within the same account. Subsequently, the Commission has settled cases in which the respondents effected a post-offering sale and purchase of securities with market orders filled at nearly the same price.[21]

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[20] See, e.g., SEC v. Graycort Financial, LLC, No. C 06-6033 (NDCA Sept. 28, 2006); Litigation Release No. 19851 (Sept. 28, 2006); Ascend Capital, LLC, Exchange Act Release No. 48188 (July 17, 2003).

[21] See, e.g., SEC v. Graycort Financial, LLC, No. C 06-6033 (NDCA Sept. 28, 2006); SEC v. Galleon Management, L.P., Litigation Release No. 19228 (May 19, 2005); Oaktree Capital Management LLC, Exchange Act Release No. 51709 (May 19, 2005).

Another strategy to obfuscate the prohibited covering is a practice known as "collapsing the box." In one Commission settled case, for example, a person created "boxed" positions by maintaining a short position established during the restricted period while simultaneously maintaining a long position in the security with the shares acquired in a follow-on offering.[22] To cover the short sales, the person instructed its prime broker to make journal entries that cancelled out the long and short positions through the use of riskless, offsetting journal entries.[23] Consequently, the offering shares were used to cover the restricted period short sale.

Each of these structures or strategies we have observed seeks to replicate the economic equivalent of the activity that Rule 105 seeks to prevent. Additional examples of strategies that have developed over the years to conceal conduct prohibited by Rule 105 include arrangements to purchase from third parties and married puts. The Commission reiterated guidance initially issued under Rule 10b-21(T),[24] the predecessor to Rule 105, concerning attempts to obscure violations through indirect covering purchases using an intermediary.[25] In this situation, a short sale is effected during the restricted period and covered with offering securities obtained through an arrangement with a third party who acquires the securities in the offering. Through these types of transactions, the trader is attempting to do indirectly what he cannot do directly, i.e., the

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22 See id.

23 Id. (alleging Galleon established a 63,310 share short position during the restricted period, received a 95,000 share offering allocation, sold 31,690 shares, leaving a 63,310 share boxed position, and thereafter instructed its prime broker to collapse the 63,310 share box).

24 See supra n.9.

25 Regulation SHO Adopting Release, 69 FR at 48021 (stating "[in] this transaction, the trader is attempting to accomplish indirectly what he or she cannot do directly, i.e., a type of short sale transaction prohibited by Rule 105."); See also, Exchange Act Release No. 26028 (Aug. 25, 1988), 53 FR 33455, 33458 (Aug. 31, 1988) (stating that "covering purchases effected by prearrangement or other understanding through other purchasers in the primary offering are proscribed through the operation of section 20(b) of the Exchange Act, which prohibits a person from doing indirectly any act that he is prohibited from doing directly by the Exchange Act or any rule thereunder.").

covering prohibited by Rule 105.[26] Section 20(b) of the Exchange Act makes it "unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do . . . through or by means of any other person."[27]

Further, the Commission noted its concern about the abusive use of married puts as part of trading strategies designed to hide activity that violates Rule 105. In this strategy, a married put[28] is used to conceal the fact that the sale effected during the restricted period is a short sale. Essentially, this technique is used to give the appearance that the restricted period sale was a long sale, when in fact it was a short sale.[29]

This proposal is designed to further provide confidence to issuers and investors that offering prices would be determined through the natural forces of supply and demand and would not be reduced by potentially manipulative activity. Moreover, the proposal should further provide confidence to persons that they are making investment decisions based on market prices and offering prices unencumbered by artificial forces.

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[26] Id.

[27] 15 U.S.C. 78t(b).

[28] The term "married put" is used to describe the underlying transaction, i.e., the linked purchase of securities and a put option to sell an equivalent number of securities.

[29] Commission Guidance on Rule 3b-3 and Married Put Transactions, Exchange Act Release No. 48795 (Nov. 17, 2003), 68 FR 65820 (Nov. 21, 2003) ("Married Puts Release") (stating "Most recently, we have become aware of certain strategies in which traders may acquire married puts as part of what may be an effort to circumvent the application of Rule 105. In these schemes traders enter into married put transactions during the restricted period 5 days before (or, sometimes, on the day of) pricing in a 'secondary' or 'repeat' offering. Thereafter, the traders aggressively sell the stock portion of the married put as 'long' sales, exercise the puts at the end of the day they are obtained, and then use securities obtained in the offering (sometimes obtained at a discount to the closing price) to cover their restricted period sales. This activity often enables the traders receiving offering shares to profit from the difference between the sales prices and the offering price, where the sales lowered the market price and, as a consequence, the market-based offering price. Not only is this manipulative conduct harmful to the market, but it also may have a substantial impact on the issuer and its security holders that receive reduced offering proceeds as a result of the lower offering price. We find the use of married put transactions as a part of these strategies particularly troubling because they represent an attempt to facilitate the very kind of abuse that" Rule 105 is designed to prevent.).

III. Discussion of Proposed Amendments

In light of non-compliance with Rule 105, and the various strategies designed to conceal conduct prohibited by Rule 105, we propose to amend Rule 105 to prohibit any person from effecting a restricted period short sale and then purchasing, including entering into a contract of sale for, the security in the offering. A short sale is the sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller.[30] As we have noted before, a person purchases, including entering into a contract of sale for, a security when the person becomes irrevocably committed to purchase the security.[31]

Currently, Rule 105 makes it unlawful for a person to cover a restricted period short sale with offered securities. Eliminating the covering component is designed to end the progression of schemes and structures engineered to camouflage prohibited covering. Otherwise, we would have to continue to address each variation on a case-by-case basis, which could increase uncertainty in the marketplace. The proposal fosters the goals of Rule 105 and would be consistent with the objectives of Regulation M – the prevention of manipulation and the facilitation of offering prices based on the natural forces of supply and demand unencumbered by artificial influence. The proposal would promote market integrity by precluding conduct that can be manipulative around the time an offering is priced so that market prices can be fairly determined by supply and demand. It would promote price movements that result from natural market forces, undistorted by artificial forces. This would bolster investor confidence in the

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[30] See 17 CFR 242.200. Although this definition would remain unchanged for purposes of the proposed amendment, for ease of reference, the proposed rule text includes a reference to Regulation SHO. We also removed the phrase "from an underwriter or broker or dealer participating in the offering" because Rule 105 now covers shelf offerings and the phrase is no longer necessary.

[31] See Securities Offering Reform, Exchange Act Release No. 52056 (July 19, 2005), 70 FR 44722, 44765 n.391 (Aug. 3, 2005).

capital raising process. Further, the proposal would protect issuers and selling security holders from a specific and demonstrated type of activity that can reduce their offering proceeds.

As with the current rule, the proposal would not ban short selling. The proposal, like the current rule, would allow short sales based on a person's view of a security's future performance: persons could effect short sales before the restricted period and still purchase, including enter into a contract of sale for, the security in the offering, and persons could effect short sales during the restricted period and not purchase, including enter into a contract of sale for, the security in the offering. However, the proposal does not provide an exception to allow those that close-out restricted period short sales prior to pricing to participate in the offering.

Finally, the proposal restructures the rule in an effort to promote compliance consistent with the prophylactic nature of Regulation M.

As with current Rule 105, responsibility for compliance with the proposal would rest with the person that effects a short sale during the restricted period and purchases, including enters into a contract of sale for, the security in the offering allocation. However, as with any securities law, rule or regulation, broker-dealers may be charged, depending on the facts and circumstances, for aiding and abetting or causing securities law violations by their customers.[32] We encourage commenters to discuss compliance issues, including but not limited to, the costs of compliance as well as any other costs.

IV. Derivatives

In adopting Rule 105, the Commission stated that Rule 105 does not apply to short sales of derivative securities, "because an extension of the rule's prohibitions to derivative securities would be inconsistent with the approach of Regulation M, which is to focus on those securities

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[32] See, generally, Exchange Act §§ 15(b)(4), 20(a), 20(e), and 21C. See also Sharon M. Graham and Stephen C. Voss v. SEC, 222 F.3d 994, 1007 (D.C. Cir. 2000).

having the greatest manipulative potential."[33] Nonetheless, we understand that persons may use options or other derivatives in ways that may cause the harm that Rule 105 is intended to prevent. We request comment on trading strategies involving derivatives that may produce similar effects (e.g., depress the market prices of the underlying equity security and result in lower offering prices) in ways not covered by the current or proposed rule. Please provide specific detail regarding the derivatives used, the transactions employed, as well as the roles of the various parties to the transactions. Please describe whether a regulatory approach that covers derivatives is over inclusive or under inclusive and provide alternative suggestions.

As with other rules, we note that the use of derivatives as a part of trading strategies designed to evade the application of Rule 105 does not comply with Commission rules.[34] For example, persons may attempt to circumvent Rule 105 by claiming to have a position in a security by virtue of having entered into a "married put" transaction when in fact their transactions were the equivalent of short sales, for which they used shares acquired in the offering to close-out their restricted period sales.[35] Such conduct is proscribed through the operation of section 20(b) of the Exchange Act.[36] The Commission has also noted that, "purchases effected by prearrangement or other understanding through other purchasers in the primary offering are proscribed through the operation of section 20(b) of the Exchange Act, which prohibits a person from doing indirectly any act that he is prohibited from doing directly by the Exchange Act or any rule thereunder."[37]

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[33] Reg. M Adopting Release, 62 FR at 538.

[34] See, e.g., Reg. M Adopting Release, 63 FR 538 (citing to Rule 10b-21 Adopting Release, 53 FR at 33457); Married Puts Release, 68 FR at 65820.

[35] Married Puts Release, 68 FR at 65822 (discussing the operation of Rule 3b-3 with respect to sellers who may claim to have a position in a security by virtue of having entered into a "married put" transaction).

[36] 15 U.S.C. 78t(b); see also, supra n.25.

[37] Rule 10b-21 Adopting Release, 53 FR at 33458.

V. Request for Comment

Q. The proposal provides that a person who effects a restricted period short sale cannot purchase, including enter into a contract of sale for, the security in the offering. As proposed, the rule does not provide an exception to allow those that cover restricted period short sales prior to pricing to participate in the offering. Should the proposed rule provide an exception to allow a person who effects a restricted period short sale to purchase, including enter into a contract of sale for, the security in the offering if, after effecting the restricted period short sale but before pricing of the offering, the person closes-out the entire short position in an offered security with an open market purchase during regular trading hours that is reflected on the consolidated tape or other reporting media? Please discuss any alternatives, including whether the rule should provide an exception to allow a person who effects a restricted period short sale to purchase, including enter into a contract of sale for, the security in the offering if, after effecting the restricted period short sale but before pricing of the offering, the person can demonstrate, using required books and records, that the person closed-out the restricted period short sales (but not necessarily the person's entire short position) with an open market purchase during regular trading hours that is reflected on the consolidated tape or other reporting media. What would be the appropriate time period in which to close-out a person's entire or restricted period short position, i.e., 2 business days before pricing? Would a shorter or longer period be appropriate? If so, please explain. Would such an alternative address the abuses that the rule is designed to prevent? Would such an alternative prevent potential transactions designed to disguise rule violations? What is the frequency of such trading? What difficulties would be presented by not providing an exception to allow persons to close-out the short position? If the proposed rule provides for such an exception, should it also require that the person claiming the exception be

able to demonstrate compliance? Are there other ways, instead of an open market purchase executed during regular trading hours that is reflected on the consolidated tape or other reporting media that a person could use to close-out their entire or restricted period short position that would be transparent to the market prior to pricing and should be considered? What are the benefits of allowing a person to close-out his entire or restricted period short position after effecting a restricted period short sale but prior to pricing of the offering?

Q. Is the restricted period sufficient to dissipate the effects of any manipulative short selling on the price of the offered security? Is there a longer or shorter time frame or alternative measure that would be more effective?

Q. Should the Rule 105(b) exception for offerings that are not conducted on a firm commitment basis be eliminated or retained? If you believe that the exception should be retained, please describe why the manipulative abuse that Rule 105 is designed to prevent is not present in offerings conducted on other than a firm commitment basis.

Q. In recent cases involving "Private Investment in Public Equity" ("PIPEs") transactions, persons are alleged to have agreed to invest in PIPE offerings, sold short the issuer's securities, and closed-out the short position using shares acquired from the issuer in the PIPE transaction that are registered for resale by such persons. Should the Rule address short sales effected during the period following the entering into of a PIPE transaction and before a registration statement for resale of the restricted securities acquired in the PIPE transaction is declared effective, or short sales that are effected at any time in connection with the PIPE transaction? Is there an alternative period for which the Rule should restrict short sales that persons intend to close-out by using shares acquired from the issuer in PIPE transactions? What would be the impact on issuers concerning short sales effected in connection with PIPE

transactions if the Rule applied to securities registered for resale in connection with PIPEs transactions? For example, what would be the effect on issuers' ability to attract PIPE investors and the effect on the market for the issuers' securities?

Q. We are aware that short sales effected prior to the exercise of conversion rights, such as those under a convertible debenture, can depress stock prices and result in the issuance of more shares upon the exercise of the conversion rights. For example, a convertible security such as a convertible debenture may grant an investor the right to convert all or a portion of the debenture into common stock based on a formula using the price of the common stock at the time of conversion with the investor receiving more shares on conversion if the market price of the common stock declines. A person may be liable under the anti-fraud provisions of the federal securities laws if that person seeks to manipulate the stock price downward to enhance the economic interests in a convertible security.[38] Should Rule 105 address short sales effected prior to the exercise of conversion rights?

Q. Should Rule 105 apply to issuances of rights to an issuer's existing security holders to buy a proportional number of additional securities at a given price (usually at a discount) within a fixed period (a rights offering). Is there a similar potential for persons to influence the offer price through a rights offering?

Q. Should the Rule address short sales effected in connection with equity line financing arrangements in which an investor and a company enter into a written agreement under which the company has the right to put its securities to the investor in an offering in which the securities are registered for sale or resale?

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[38] See, e.g., SEC v. Rhino Advisors, Inc. and Thomas Badian, No. 03-CIV-1310 (SDNY 2003), Litigation Release No. 18003 (Feb. 27, 2003).

Q. Under the current and proposed rule, an investor with a long position can legally sell all or part of the position during the five days prior to the offer and still purchase shares in the offering. We request comment on whether an investor with a long position may have the same economic incentives to attempt this arbitrage or to manipulate the price of the offer as a short seller. Aside from legal risk, are the risks and returns of the long strategy any different from the risks and returns of the short strategy? Can this strategy harm issuers? Should the Commission consider broadening Rule 105 to include long sales?

Q. Rule 200(a) defines the term "short sale" as any sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller. Should the Commission consider modifying this definition in order to further the goals of this proposal?

Q. Should Rule 105 apply to offerings not made pursuant to a registration statement on Form 1-A?

Q. Regulation E under the Securities Act of 1933 provides certain small business investment companies and business development companies with a registration exemption that is similar to Regulation A. Should Rule 105 apply to offerings made pursuant to Form 1-E, Notification under Regulation E?

Q. Would this proposal be more effective than the existing rule in deterring attempts to obscure violations of Rule 105 and limiting manipulation of offering prices?

Q. Rule 200(c) of Regulation SHO states that, "[a] person shall be deemed to own securities only to the extent that he has a net long position in such securities." In order to determine the net long position, a seller of an equity security must aggregate all of that person's positions in that security. Under Rule 200(f) of Regulation SHO, however, a registered broker-

dealer may qualify for independent trading unit aggregation. We seek comment about the application of the aggregation principles in the context of Rule 105 to non-broker-dealers, including, for example, investment companies. Should non-broker-dealers be provided an exception similar to that provided to broker-dealers under Rule 200(f) of Regulation SHO based on these aggregation principles, e.g., should there be a requirement that the non-broker dealer be a registered investment adviser, or be a client of a registered investment adviser for purposes of the excepted transaction? If so, what criteria would be appropriate?

Q. Are there alternative approaches to revising Rule 105 that should be considered?

Q. Beyond selling short, are there other types of trading strategies that Rule 105 should address that similarly exert untoward downward pressure on a stock's market price and thus lower market prices prior to the pricing of follow-on and secondary offerings? How should such trading strategies be addressed?

Q. Should potential investors in an offering be required to give an underwriter a certification that they have not effected and will not effect a short sale during the Rule 105 restricted period? What are the costs and benefits of such a requirement for investors and underwriters? Would this impact the costs of underwriting? Should any such certification instead be provided to the broker-dealer through which the person is purchasing the shares?

Q. We request comment on any liquidity or market efficiency impact that the proposal may raise.

Q. Empirical evidence shows that, on average, issuers decline in value by about 3% when they announce an impending public equity offering. Later, issuers' value declines another 1% to 3% in the five days prior to the offer. Following the offer, issuers' value recovers but the

value five days after the offer is still about ½% lower than the value five days before the offer.[39] We request comment on any effect the proposal will have on such price patterns, i.e., the price of a security declining prior to an offering and not fully recovering. Is this price pattern due to a type of evasion of Rule 105 that the proposed amendment would eliminate? Would these price patterns change as a result of the proposal? Can the ½% loss in issuers' value be considered an economic benefit of the proposed amendment to Rule 105? Can any of the 3% value decline at the announcement of a public equity offer be considered an economic benefit of the proposed amendment to Rule 105?

Q. We request comment on any impact the proposal may have on trading and trading strategies.

Q. We request comment on any impact the proposal may have on dynamic hedging activities.

Q. To what extent, if any, will the proposal increase or decrease the potential for other types of manipulation?

Q. Are there any technical or operational challenges that would arise in complying with the proposal?

Q. Does the proposal present any special compliance difficulties or other issues?

Q. How much would the amendments affect specific compliance costs or other costs for small, medium and large entities?

Q. We request comment concerning any effects that the proposal may have on market participants, including underwriters as well as specific effects that the proposal may have on the underwriting process.

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[39] Several empirical studies report these price patterns both before and after the application of Rule 10b-21. See, e.g., Shane A. Corwin, The Determinants of Underpricing for Seasoned Equity Offers, 58 J. Fin. 2249 (Oct. 2003).

Q. We request comment concerning any effects that the proposal may have on issuers, including the ability of issuers to attract investors to their securities offerings and the costs to issuers of completing offerings.

Q. Would the proposed amendment create additional costs for or otherwise impact short sellers, issuers, investors, underwriters, or others?

Q. What are the economic costs or other costs associated with the proposal?

General Request for Comments

The Commission seeks comment generally on all aspects of the proposed amendment to Rule 105 of Regulation M. Any interested persons wishing to submit written comments on the proposal, as well as other matters that might have an impact on the proposal, are requested to do so. Commenters are requested to provide empirical data to support their views and arguments related to the proposal herein. In addition to the questions posed above, commenters are welcome to offer their views on any other matter raised by the proposed amendment to Rule 105. With respect to any comments, we note that they are of the greatest assistance to our rulemaking initiative if accompanied by supporting data and analysis of the issues addressed in those comments and by alternatives to our proposal where appropriate.

VI. Paperwork Reduction Act

We have not prepared a submission to the Office of Management and Budget regarding the amendments to Rule 105 of Regulation M because the proposals do not contain a collection of information requirement within the meaning of the Paperwork Reduction Act of 1995.

VII. Consideration of Proposed Amendments to Rule 105 of Regulation M's Costs and Benefits

The Commission is considering the costs and benefits of the proposed amendments to Rule 105. The Commission is sensitive to costs and benefits, requests data to quantify the costs

and the value of the benefits provided, and encourages commenters to discuss any additional costs or benefits or reductions in costs beyond those discussed here. Commenters should provide analysis and data to support their views on the costs and benefits associated with the proposed amendment. If applicable, the Commission requests comments on the potential costs for any modification to computer systems and surveillance mechanisms as well as any potential benefits resulting from the proposal for issuers, investors, broker or dealers, other securities industry professionals, regulators or other market participants.

A. Benefits

The proposal is intended to further safeguard the integrity of the capital raising process and protect issuers from potentially manipulative activity that can reduce issuers' offering proceeds. The proposal also is designed to provide confidence to persons that they are making investment decisions based on market prices and offering prices unencumbered by artificial forces. Specifically, the proposal would prohibit a person who effects a short sale during the Rule 105 restricted period from purchasing, including entering into a contract of sale for, the security in an offering. The benefits of the proposed modifications to Rule 105 would be realized by many market participants, including investors, issuers, selling security holders, underwriters, short sellers and regulators.

The proposed amendments to Rule 105 are intended to further facilitate market prices and offering prices that can be fairly determined by the natural forces of supply and demand undistorted by artificial forces. Currently, Rule 105 makes it unlawful for a person to cover a short sale effected during the Rule's restricted period with certain offering securities. The proposed amendment would eliminate the covering component and instead prohibit a person who effects a short sale during the Rule's restricted period from purchasing, including entering into a contract of sale for, the security in an offering. The proposal is intended to halt schemes

designed to conceal the prohibited covering. It also provides a bright line demarcation of prohibited activity consistent with the prophylactic nature of Regulation M.

Issuers and selling security holders should benefit from the proposal because it is designed to promote the goals of the current rule, enhancing market integrity by precluding conduct that can be manipulative around the time an offering is priced so that market prices can be fairly determined by supply and demand. The proposal should help issuers and selling security holders realize proceeds that are not artificially low due to short selling. The proposal also would promote investor confidence in the offering process, which should foster capital formation. In turn, these benefits should encourage issuers to conduct capital formation in the U.S. market.

Moreover, the proposed Rule 105 modifications retain much of the flexibility of the current rule for traders because persons continue to be able to sell short during the restricted period if they do not purchase, including enter into a contract of sale for, the securities. Persons also retain the ability to sell short prior to the Rule 105 restricted period and then purchase, including enter into a contract of sale for, the securities.

We believe the proposed modification may reduce activity designed to disguise rule violations. We believe this would lead to a reduction in the number of instances of aggressive short sellers attempting to place artificial downward pressure on market prices. Therefore, the proposal would strengthen the ability of underwriters to set offering prices without being encumbered by artificial activities in the market.

We believe short sellers would benefit from the proposal because it provides a bright line test for Rule 105 compliance consistent with the prophylactic nature of Regulation M. The proposal does not ban short selling. Indeed, it would allow short sales that may contribute to

pricing efficiency and price discovery. The bright line demarcation is important because it would provide clear guidance for short sellers seeking to comply with Rule 105.

We believe the proposal may decrease the level of non-compliance with the Rule. The proposed elimination of the Rule's covering component should reduce attempts to disguise the covering activity through convoluted trading structures. This would save significant regulatory resources that would otherwise be spent pursuing evolving strategies to disguise conduct that violates the Rule.

B. Costs

In complying with the proposed modifications to Rule 105, a person that effects a short sale during a defined period could not purchase, including enter into a contract of sale for, the security in the offering. Under current Rule 105, persons that effect short sales during a restricted period cannot cover their short position with the offering securities. Thus, we believe any costs currently associated with persons reviewing their restricted period short sales would remain the same, as a person would use the current systems and surveillance mechanisms for information gathering, management, and recordkeeping systems or procedures. Indeed this proposal is intended to provide a more straightforward means of compliance.

As an aid in evaluating costs and reductions in costs associated with the proposed Rule 105 modifications, the Commission requests the public's views and any supporting information. The Commission believes that the proposed amendments would impose negligible costs, if any, on traders and issuers and that the proposed amendments are appropriate for the protection of investors and issuers and to promote the integrity of the capital raising process.

The Commission staff has noted that investors desiring to participate in hot issue offerings may improperly accommodate an underwriter by participating in a cold issue. Investors may attempt to protect themselves against losses in a cold issue by selling securities

short in the Rule 105 restricted period intending to cover with offering securities in violation of Rule 105.[40] We seek comment about any impact the proposal may have on the underwriting process. If the proposal impacts the underwriting process, would it make it easier or more difficult for underwriters to sell offerings and what, if any, impact would there be on efficiency of the pricing of an offering or competition among underwriters?

The Commission encourages commenters to discuss all costs. In particular, the Commission requests comment on the potential costs for any modification to systems and surveillance mechanisms, and for information gathering, management, and recordkeeping systems or procedures. Commenters should provide analysis and data to support their views on any costs associated with the proposed amendment.

VIII. Consideration of Burden on Competition and Promotion of Efficiency, Competition, and Capital Formation

Section 3(f) of the Exchange Act requires the Commission, whenever it engages in rulemaking that requires it to consider or determine if an action is necessary or appropriate in the public interest, to consider whether the action would promote efficiency, competition, and capital formation.[41] In addition, Section 23(a)(2) of the Exchange Act requires the Commission, in adopting rules under the Exchange Act, to consider the anti-competitive effects of any rules it adopts.[42] Exchange Act Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

The Commission preliminarily believes that the proposed amendment would promote capital formation through improved integrity of the U.S. securities markets by precluding

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[40] See supra n.11.

[41] 15 U.S.C. 78c(f).

[42] 15 U.S.C. 78w(a)(2).

conduct that can depress security prices during a critical period of time in the capital raising process. Preventing the type of potentially manipulative activity targeted by the proposed amendment would help protect the pricing process so that the forces of supply and demand are not undermined. The proposal would promote price determinations and movements that result from natural market forces, undistorted by artificial influences. We request comment on the impact of the amendment on capital formation.

Short sales based upon a person's evaluation of the issuer's fundamentals (products, earnings, management, etc.) and a security's future performance may contribute to pricing efficiency and price discovery. Such short sales reflect the value that a trader assigns to an issuer's security. However, short sales prior to pricing an offering by a person who expects an offering allocation and anticipates making a quick profit from effecting the short sale and then purchasing, including entering into a contract of sale for, the security in the offering, may not similarly reflect the trader's evaluation of the issuer's fundamental value.

The Commission staff has noted that investors desiring to participate in hot issue offerings may improperly accommodate an underwriter by participating in a cold issue. Investors may attempt to protect themselves against losses in a cold issue by selling securities short in the Rule 105 restricted period intending to cover with offering securities in violation of Rule 105.[43] We seek comment about any impact the proposal may have on the underwriting process. If the proposal impacts the underwriting process, would it make it easier or more difficult for underwriters to sell offerings and what, if any, impact would there be on efficiency of the pricing of an offering or competition among underwriters?

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[43] See supra n.11.

The Commission has considered the proposal in light of the standards cited in Section 23(a)(2) and believes preliminarily that, if adopted, the proposed amendments would not impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. Specifically, the proposed version of the Rule would continue to allow short sales based on a person's view of a security's future performance. Traders could sell short before the restricted period. Alternatively, traders could sell short during the restricted period if they do not purchase, including enter into a contract of sale for, the securities. The proposal would provide a bright line approach designed to prevent improper conduct and to provide a bright line demarcation regarding conduct that is prohibited for persons wishing to comply with the rule.

The Commission generally requests comment on the competitive or anticompetitive effects of the proposed amendments to Rule 105. The Commission also requests comment on what impact the proposed amendments to Rule 105 would have on efficiency and capital formation. Commenters should provide analysis and empirical data to support their views on the costs and benefits associated with the proposal.

IX. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or (SBREFA),[44] we must advise the Office of Management and Budget as to whether the proposed amendments constitute a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in:

- An annual effect on the economy of $100 million or more (either in the form of an increase or a decrease);

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

- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effect on competition, investment, or innovation.

If a rule is "major," its effectiveness will generally be delayed for 60 days pending Congressional review. We request comment on the potential impact of the proposed amendments on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

X. Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis (IRFA), in accordance with the provisions of the Regulatory Flexibility Act (RFA)[45] regarding the proposed amendment to Rule 105 of Regulation M.

A. Reasons for the Proposed Action

The proposal is intended to safeguard the integrity of the capital raising process and further protect issuers from potentially manipulative activity that can reduce issuers' offering proceeds. There have been a number of Rule 105 cases brought by the Commission over the last few years.[46] The proposal would provide a bright line test for Rule 105 compliance, which would be consistent with the prophylactic nature of Regulation M. The bright line demarcation is important because it provides clear guidance for persons seeking to comply with Rule 105. We believe the proposed bright line demarcation would reduce Rule 105 violations.

Certain of the Commission's recent cases involved violations of Rule 105 that involved a complex series of trading activity designed to obfuscate the prohibited covering of restricted period short positions with offered shares. We have observed continuously evolving strategies to obscure conduct prohibited under Rule 105. Each scheme seeks to replicate the economic

[45] 5 U.S.C. 603.

[46] See supra n.17.

equivalent of the activity that Rule 105 seeks to prevent. We believe it is important to eliminate the covering component of the rule to cut off the likely future development of more complex attempts to disguise violations of the Rule.

B. Objectives

The proposed amendments to Rule 105 would prohibit a person who effects a short sale in the restricted period from purchasing, including entering into a contract of sale for, the security in an offering. The proposal is designed to promote the goals of the current rule, enhancing market integrity by precluding conduct that can be manipulative around the time an offering is priced so that market prices can be fairly determined by supply and demand. The proposal would promote price movements that result from natural market forces, undistorted by artificial forces. Accordingly, we believe the proposal would further safeguard the integrity of the capital raising process and protect issuers from potentially manipulative activity that can reduce issuers' offering proceeds. The proposal also would promote investor confidence in the offering process, which should foster capital formation.

C. Legal Basis

The Commission is proposing to amend Rule 105 pursuant to the authority set forth in sections 7, 17(a), and19(a) of the Securities Act of 1933 [15 U.S.C. 77g, 77q(a), 77s(a)]; sections 2, 3, 7(c)(2), 9(a), 10, 11A(c), 12, 13, 14, 15(b), 15(c), 15(g), 17(a), 17(b), 17(h), 23(a), 30A, and 36 of the Securities Exchange Act of 1934 [15 U.S.C. 78b, 78c, 78g(c)(2), 78i(a), 78j, 78k-1(c), 78l, 78m, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd-1, 78mm]; and sections 23, 30, 38 of the Investment Company Act [15 U.S.C. 80a-23, 80a-29, and 80a-37].

D. Small Entities Subject to the Rule

The proposed rule applies to any person that effects a short sale during the restricted period. This is unchanged from the current rule. The entities covered by the proposed rule

would thus include small broker-dealers, small businesses, and any investor eligible to effect a short sale that qualifies as a small entity.

Generally, these entities are already subject to the current rule, which contains requirements similar to those in the proposed rule. As a result, the marginal cost of compliance with the proposed rule for these businesses is likely to be minimal.

Although it is impossible to quantify every type of small entity that may be able to effect a short sale in a security, Paragraph (c)(1) of Rule 0-10[47] states that the term "small business" or "small organization," when referring to a broker-dealer, means a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to § 240.17a-5(d); and is not affiliated with any person (other than a natural person) that is not a small business or small organization. As of 2005, the Commission estimates that there were approximately 910 broker dealers that qualified as small entities as defined above.[48]

Any business, however, regardless of industry, could be subject to the proposed rule if it effects a short sale. The Commission believes that, except for the broker-dealers discussed above, an estimate of the number of small entities that fall under the proposed rule is not feasible.

E. Reporting, Recordkeeping and Other Compliance Requirements

The proposed amendments to Rule 105 may impose limited new compliance requirements on any affected party, including broker-dealers that are small entities. Under the proposed amendments, market participants could not purchase, including enter into a contract of

[47] 17 CFR 240.0-10(c)(1).

[48] These numbers are based on the Office of Economic Analysis' review of 2005 FOCUS Report filings reflecting registered broker dealers. This number does not include broker-dealers that are delinquent on FOCUS Report filings.

sale for, the securities if they acquired a short position in the security during a restricted period. This proposal would not modify the measurement of restricted periods that apply, therefore, since the current rule also addresses conduct around short selling that occurs during a restricted period, the monitoring that would be required of market participants to ensure compliance with the amended Rule would not change. The proposal does not contain recordkeeping or reporting requirements for broker-dealers.

F. Duplicative, Overlapping or Conflicting Federal Rules

The Commission believes that there are no federal rules that duplicate, overlap or conflict with the proposed amendments.

G. Significant Alternatives

The RFA directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small issuers and broker-dealers. Pursuant to Section 3(a) of the RFA,[49] the Commission 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 Rule, or any part thereof, for small entities.

With respect to the proposed amendments to Rule 105, the Commission believes that, in order to preclude conduct that can be manipulative around the time an offering is priced so that market prices can be fairly determined by supply and demand, uniform rules applicable to all market participants (regardless of size) are necessary. The Commission believes that the

[49] 5 U.S.C. 603(c).

establishment of different requirements for small entities is neither practicable nor in the public interest because small entities can conduct the same type of manipulative trading as others. The proposed amendments would likely impose minimal additional costs, if any; therefore, establishing different compliance requirements or clarifying, consolidating, or simplifying compliance or reporting requirements for small entities would yield little or no additional benefit. With regard to the proposed amendments to Rule 105, and clarification of the application of the regulation, small entities would not be specifically exempted, since all securities may be subject to the type of manipulation the amendments seek to prevent. Finally, the proposed amendments to Rule 105 would impose performance standards rather than design standards.

H. Solicitation of Comments

The Commission encourages written comments on matters discussed in the IRFA. In particular, the Commission requests comments on (1) the number of persons that are subject to Rule 105 and the number of such persons that are small entities; (2) the nature of any impact the proposed amendments would have on small entities and empirical data supporting the extent of the impact (commenters are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact); and (3) how to quantify the number of small entities that would be affected by and/or how to quantify the impact of the proposed amendments. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed amendments are adopted, and will be placed in the same public file as comments on the proposed amendments themselves. As discussed above, for purposes of SBREFA, the Commission is also requesting information regarding the potential impact of the proposed amendments on the economy on an annual basis. Commenters should provide empirical data to support their views.

XI. Statutory Basis

The Commission is proposing to amend Rule 105 pursuant to the authority set forth in sections 7, 17(a), and 19(a) of the Securities Act of 1933 [15 U.S.C. 77g, 77q(a), 77s(a)]; sections 2, 3, 7(c)(2), 9(a), 10, 11A(c), 12, 13, 14, 15(b), 15(c), 15(g), 17(a), 17(b), 17(h), 23(a), 30A, and 36 of the Securities Exchange Act of 1934 [15 U.S.C. 78b, 78c, 78g(c)(2), 78i(a), 78j, 78k-1(c), 78l, 78m, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd-1, 78mm]; and sections 23, 30, 38 of the Investment Company Act [15 U.S.C. 80a-23, 80a-29, and 80a-37].

Text of Proposed Amendments

List of Subjects

17 CFR Part 242

Brokers, Fraud, Reporting and recordkeeping requirements, Securities.

In accordance with the foregoing, Title 17, Chapter II, Part 242 of the Code of Federal Regulations is proposed to be amended as follows:

PART 242 - REGULATIONS M, SHO, ATS, AC, AND NMS AND CUSTOMER MARGIN REQUIREMENTS FOR SECURITY FUTURES

1. The authority citation for part 242 continues to read as follows:

Authority: 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78g(c)(2), 78i(a), 78j, 78k-1(c), 78l, 78m, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd-1, 78mm, 80a-23, 80a-29, and 80a-37.

2. Section 242.105 is amended by revising paragraph (a) to read as follows:

§242.105 Short selling in connection with a public offering.

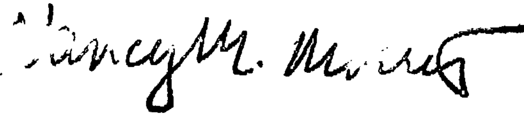
(a) Unlawful Activity. In connection with an offering of securities for cash pursuant to a registration statement or a notification on Form 1-A (§239.90 of this chapter) filed under the Securities Act of 1933, it shall be unlawful for any person to effect a short sale (as defined in §242.200) and then purchase, including enter into a contract of sale for, the security in the offering if that person effected such short sale in the offered security during the shorter of:

(1) The period beginning five business days before the pricing of the offered securities and ending with such pricing; or

(2) The period beginning with the initial filing of such registration statement or notification on Form 1-A and ending with the pricing.

* * * * *

By the Commission.



Nancy M. Morris
Secretary

Dated: December 6, 2006

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
December 6, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12499

In the Matter of Antares Resources Corp., East Coast Beverage Corp. (n/k/a North American Food & Beverage, Inc.), Hatco Holdings, Ltd., and V Formation, 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").

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Antares Resources Corp. ("Antares Resources") (CIK No. 65202) is an inactive New York corporation located in Boca Raton, Florida with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Antares Resources is delinquent in its periodic filings with the Commission, having not filed any periodic reports since a Form 10-KSB was filed for the period ended September 30, 1996. On June 22, 2004, creditors of the company filed an involuntary Chapter 11 petition against the company in the U.S. Bankruptcy Court for the Middle District of Florida. On April 26, 2005, a Chapter 11 Trustee was appointed for the company. As of

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November 9, 2006, the company's stock (symbol "ANRR") was traded on the over-the-counter markets.

2. East Coast Beverage Corp. ("East Coast Beverage") (n/k/a North American Food & Beverage, Inc.) (CIK No. 1031425) is a dissolved Colorado corporation located in The Villages, Florida with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). East Coast Beverage is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2000, which reported a net loss of $5,711,743. East Coast Beverage filed a Chapter 11 petition with the U.S. Bankruptcy Court for the Southern District of Florida in April 2002. Under the company's confirmed plan of reorganization, the company effected a 1 for 15 reverse split of its common shares and it changed its name to North American Food & Beverage, Inc. The company failed to notify the Commission of its name change as required by Commission rules. A final decree and discharge of trustee was entered in the bankruptcy on January 31, 2005. As of November 2, 2006, the company's stock (symbol "NFBC") was traded on the over-the-counter markets.

3 Hatco Holdings Ltd. ("Hatco Holdings") (CIK No. 1127879) is a dissolved Oregon corporation located in Ellicott City, Maryland with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Hatco Holdings is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended June 30, 2001, which reported a net loss of $3,174 for the prior six months.

4. V Formation Inc. ("V Formation") (CIK No. 1083277) is a New Jersey corporation located in Iselin, New Jersey with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). V Formation 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, 2003, which reported a net loss of $5,887,864 for the prior nine months.

B. DELINQUENT PERIODIC FILINGS

5. All of the Respondents, or their predecessors, are or were affiliated with another delinquent issuer, are delinquent in their periodic filings with the Commission (*see* Chart of Delinquent Filings, attached hereto as Appendix 1), 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 at their most recent address shown in their most recent filing with the Commission, or did not receive the letters because of their failure to keep an updated address on file with the Commission as required by Commission rules.

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 (Forms 10-K or 10-KSB), and Rule 13a-13 requires issuers to file quarterly reports (Forms 10-Q or 10-QSB).

7. As a result of their failure to file required periodic filings, 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 of this Order are true, and to afford the Respondents an opportunity to establish any defenses to such allegations; and

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months or to revoke the registrations of each class of securities registered pursuant to Exchange Act Section 12 of the Respondents identified in Section II.

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 each 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 a Respondent fails to file the directed Answer, or fails to appear at a hearing after being duly notified, the Respondent may be deemed in default and the proceedings may be determined against 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 each Respondent personally, by certified or registered mail, or by any other means permitted by the Commission's Rules of Practice.

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

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

By the Commission.

Nancy M. Morris
Secretary

Attachment

Appendix 1

Chart of Delinquent Filings

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Antares Resources Corp.					
	10-QSB	12/31/96	02/14/97	Not filed	117
	10-QSB	03/31/97	05/15/97	Not filed	114
	10-QSB	06/30/97	08/14/97	Not filed	111
	10-KSB	09/30/97	12/29/97	Not filed	107
	10-QSB	12/31/97	02/16/98	Not filed	105
	10-QSB	03/31/98	05/15/98	Not filed	102
	10-QSB	06/30/98	08/14/98	Not filed	99
	10-KSB	09/30/98	12/29/98	Not filed	95
	10-QSB	12/31/98	02/15/99	Not filed	93
	10-QSB	03/31/99	05/17/99	Not filed	90
	10-QSB	06/30/99	08/16/99	Not filed	87
	10-KSB	09/30/99	12/29/99	Not filed	83
	10-QSB	12/31/99	02/14/00	Not filed	81
	10-QSB	03/31/00	05/15/00	Not filed	78
	10-QSB	06/30/00	08/14/00	Not filed	75
	10-KSB	09/30/00	12/29/00	Not filed	71
	10-QSB	12/31/00	02/14/01	Not filed	69
	10-QSB	03/31/01	05/15/01	Not filed	66
	10-QSB	06/30/01	08/14/01	Not filed	63
	10-KSB	09/30/01	12/31/01	Not filed	59
	10-QSB	12/31/01	02/14/02	Not filed	57
	10-QSB	03/31/02	05/15/02	Not filed	54
	10-QSB	06/30/02	08/14/02	Not filed	51
	10-KSB	09/30/02	12/30/02	Not filed	47
	10-QSB	12/31/02	02/14/03	Not filed	45
	10-QSB	03/31/03	05/15/03	Not filed	42
	10-QSB	06/30/03	08/14/03	Not filed	39
	10-KSB	09/30/03	12/29/03	Not filed	35
	10-QSB	12/31/03	02/16/04	Not filed	33
	10-QSB	03/31/04	05/17/04	Not filed	30
	10-QSB	06/30/04	08/16/04	Not filed	27
	10-KSB	09/30/04	12/29/04	Not filed	23
	10-QSB	12/31/04	02/14/05	Not filed	21
	10-QSB	03/31/05	05/16/05	Not filed	18
	10-QSB	06/30/05	08/15/05	Not filed	15
	10-KSB	09/30/05	12/29/05	Not filed	11
	10-QSB	12/31/05	02/14/06	Not filed	9

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Antares Resources Corp.					
	10-QSB	03/31/06	05/15/06	Not filed	6
	10-QSB	06/30/06	08/14/06	Not filed	3
Total Filings	39				
East Coast Beverage Corp.					
	10-KSB	12/31/00	04/02/01	Not filed	67
	10-QSB	03/31/01	05/15/01	Not filed	66
	10-QSB	06/30/01	08/14/01	Not filed	63
	10-QSB	09/30/01	11/14/01	Not filed	60
	10-KSB	12/31/01	04/01/02	Not filed	55
	10-QSB	03/31/02	05/15/02	Not filed	54
	10-QSB	06/30/02	08/14/02	Not filed	51
	10-QSB	09/30/02	11/14/02	Not filed	48
	10-KSB	12/31/02	03/31/03	Not filed	44
	10-QSB	03/31/03	05/15/03	Not filed	42
	10-QSB	06/30/03	08/14/03	Not filed	39
	10-QSB	09/30/03	11/14/03	Not filed	36
	10-KSB	12/31/03	03/30/04	Not filed	32
	10-QSB	03/31/04	05/17/04	Not filed	30
	10-QSB	06/30/04	08/16/04	Not filed	27
	10-QSB	09/30/04	11/15/04	Not filed	24
	10-KSB	12/31/04	03/31/05	Not filed	20
	10-QSB	03/31/05	05/16/05	Not filed	18
	10-QSB	06/30/05	08/15/05	Not filed	15
	10-QSB	09/30/05	11/14/05	Not filed	12
	10-KSB	12/31/05	03/31/06	Not filed	8
	10-QSB	03/31/06	05/15/06	Not filed	6
	10-QSB	06/30/06	08/14/06	Not filed	3
	10-QSB	09/30/06	11/14/06	Not filed	0
Total Filings	24				
Hatco Holdings, Ltd.					
	10-QSB	09/30/01	11/14/01	Not filed	60
	10-KSB	12/31/01	04/01/02	Not filed	55
	10-QSB	03/31/02	05/15/02	Not filed	54
	10-QSB	06/30/02	08/14/02	Not filed	51

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Hatco Holdings, Ltd.					
	10-QSB	09/30/02	11/14/02	Not filed	48
	10-KSB	12/31/02	03/31/03	Not filed	44
	10-QSB	03/31/03	05/15/03	Not filed	42
	10-QSB	06/30/03	08/14/03	Not filed	39
	10-QSB	09/30/03	11/14/03	Not filed	36
	10-KSB	12/31/03	03/30/04	Not filed	32
	10-QSB	03/31/04	05/17/04	Not filed	30
	10-QSB	06/30/04	08/16/04	Not filed	27
	10-QSB	09/30/04	11/15/04	Not filed	24
	10-KSB	12/31/04	03/31/05	Not filed	20
	10-QSB	03/31/05	05/16/05	Not filed	18
	10-QSB	06/30/05	08/15/05	Not filed	15
	10-QSB	09/30/05	11/14/05	Not filed	12
	10-KSB	12/31/05	03/31/06	Not filed	8
	10-QSB	03/31/06	05/15/06	Not filed	6
	10-QSB	06/30/06	08/14/06	Not filed	3
	10-QSB	09/30/06	11/14/06	Not filed	0
Total Filings	21				
V Formation, Inc.					
	10-KSB	12/31/03	03/30/04	Not filed	32
	10-QSB	03/31/04	05/17/04	Not filed	30
	10-QSB	06/30/04	08/16/04	Not filed	27
	10-QSB	09/30/04	11/15/04	Not filed	24
	10-KSB	12/31/04	03/31/05	Not filed	20
	10-QSB	03/31/05	05/16/05	Not filed	18
	10-QSB	06/30/05	08/15/05	Not filed	15
	10-QSB	09/30/05	11/14/05	Not filed	12
	10-KSB	12/31/05	03/31/06	Not filed	8
	10-QSB	03/31/06	05/15/06	Not filed	6
	10-QSB	06/30/06	08/14/06	Not filed	3
	10-QSB	09/30/06	11/14/06	Not filed	0
Total Filings Delinquent	12				

Commissioner Nazareth
Not Participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 54878 / December 6, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12500

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

I.

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

II.

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

III.

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

A. Respondent

1. Utilitynetcom (CIK 1090456), also known as uData Net Corp., is a Texas corporation owned and controlled by Lindsey P. Vinson with its corporate offices in Fort Worth.

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Utilitynetcom's common stock is registered with the Commission under Section 12(g) of the Exchange Act. Utilitynetcom has made no filings since it filed its third quarter 1999 Form 10-QSB in May 2000. Utilitynetcom reported assets of $727,867, liabilities of $197,998, and net income of $77,840, for the three months ended March 31, 2000. Utilitynetcom's securities are not quoted on any U.S. stock exchange.

B. Delinquent Periodic Filings

Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder require issuers of securities registered pursuant to Section 12 of the Exchange Act to file periodic and other reports with the Commission. Based on each Respondent's failure to file the required periodic reports, the Respondent has failed to comply with Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13.

IV.

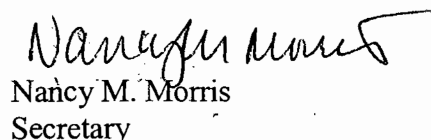
Section 12(j) of the Exchange Act provides as follows:

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

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

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

By the Commission.



Nancy M. Morris
Secretary

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 54892 / December 7, 2006

INVESTMENT COMPANY ACT OF 1940
Rel. No. 27593 / December 7, 2006

Admin. Proc. File No. 3-9615

In the Matter of

THE ROCKIES FUND, INC.,
STEPHEN G. CALANDRELLA,
CHARLES M. POWELL, and
CLIFFORD C. THYGESEN

OPINION OF THE COMMISSION

INVESTMENT COMPANY PROCEEDING

CEASE-AND-DESIST PROCEEDING

Redetermination of Sanctions Pursuant to Remand

The Court of Appeals affirmed Commission findings that investment company, its president, who was also a director, and two independent directors violated certain antifraud provisions by making untrue statements of material facts in the investment company's annual and quarterly reports. The Court remanded the issue of the appropriate sanctions to be imposed. Held, it is in the public interest to impose cease-and-desist orders on all respondents, to prohibit all individual respondents from associating with or acting as an affiliated person of an investment company, with right to reapply (after five years in the case of the president and after three years in the case of the independent directors), and to order president to pay a civil money penalty of $50,000 and each independent director to pay a civil money penalty of $20,000.

APPEARANCES:

Edward J. Meehan and David E. Carney, of Skadden, Arps, Slate, Meagher & Flom LLP, for Stephen G. Calandrella, Charles M. Powell, and Clifford G. Thygesen.

Robert M. Fusfeld, for the Division of Enforcement.

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Case remanded: January 13, 2006
Last brief received: March 29, 2006
Oral argument: September 20, 2006

I.

This proceeding is here on remand from the U.S. Court of Appeals for the District of Columbia Circuit. On October 2, 2003, we issued an opinion finding that The Rockies Fund, Inc. ("Fund"), a closed-end investment company, and its directors Stephen Calandrella, Charles Powell, and Clifford Thygesen (collectively "Respondents") violated antifraud provisions of the Securities Exchange Act of 1934 by filing quarterly and annual reports containing material misrepresentations between June 30, 1994 and December 31, 1995; that the Fund violated provisions of the Exchange Act and Calandrella, Powell, and Thygesen aided and abetted and were a cause of reporting violations by filing reports that were not in compliance with Generally Accepted Accounting Principles ("GAAP") and that contained material misrepresentations; that Calandrella and another individual violated antifraud provisions of the Exchange Act by manipulating the price of securities through matched orders and prearranged trades; and that Calandrella violated Investment Company Act Section 57(k)(1) and Exchange Act antifraud provisions by his improper acceptance of compensation. 1/ We prohibited Calandrella, who was the president of the Fund as well as one of its directors, 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 affiliate person of such investment adviser, depositor, or principal underwriter; prohibited Powell and Thygesen, independent directors of the Fund, from such service or action with a right to reapply after three years; issued cease-and-desist orders; and ordered Calandrella to pay a civil money penalty of $500,000 and Powell and Thygesen each to pay a civil money penalty of $160,000. 2/ On review, the Court of Appeals affirmed our findings of antifraud violations based on the filing of periodic reports containing material misrepresentations and related reporting violations, vacated our findings as to

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1/ The Rockies Fund, Securities Exchange Act Rel. No. 48590, 81 SEC Docket 703. We denied rehearing on June 1, 2004. The Rockies Fund, Exchange Act Rel. No. 49788, 82 SEC Docket 3764.

2/ This assessment was based on the findings of the law judge that a penalty should be imposed on Calandrella in an amount equal to $50,000 for each misstated filing and $100,000 for the manipulation, and on Thygesen and Powell in the amount of $20,000 each for each misstated filing.

manipulation and the acceptance of improper compensation, and remanded this matter for reconsideration of the sanctions we had imposed. 3/

II.

In affirming the Commission's findings that Respondents violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder 4/ by filing periodic reports that were not in compliance with GAAP and that contained material misrepresentations, the Court of Appeals found that those findings were based on substantial evidence. 5/ Neither the facts as found by the Commission and the Court that establish the violations in question nor the findings of violation themselves are at issue on remand; we merely summarize these factual findings here in order to provide the necessary background for our discussion of sanctions. 6/ The violations found by the Court, which serve as the basis for sanctions, are based on material misrepresentations, made with scienter, pertaining to the classification, value, and ownership of the shares of stock of Premier Concepts, Inc. ("Premier") held by the Fund. 7/

3/ The Rockies Fund, Inc. v. SEC, 428 F.3d 1088 (D.C. Cir. 2005).

4/ 15 U.S.C. § 78j and 17 C.F.R. § 240.10b-5. Section 10(b) and Rule 10b-5 make it unlawful for anyone, in connection with the purchase or sale of a security, "to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." 17 C.F.R. § 240.10b-5.

5/ Rockies Fund, 428 F.3d at 1090.

6/ See infra Section III. The ruling of the Court of Appeals is the law of this case. See, e.g., Key v. Sullivan, 925 F.2d 1056, 1060 (7th Cir. 1991) (stating that once an appellate court decides an issue, the decision will be binding on all subsequent proceedings in the same case, absent newly discovered evidence or an intervening change in the governing law); see also George Salloum, 52 S.E.C. 208, 216 n.37 (1995) (explaining the law of the case doctrine).

7/ A finding of violation of Section 10(b) and Rule 10b-5 requires a finding of scienter. Rockies Fund, 428 F.3d at 1093. With respect to scienter, the Court of Appeals found that the violations at issue could be established by a showing of "extreme recklessness," i.e., "'an extreme departure from the standards of ordinary care, . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.'" Id. (quoting SEC v. Steadman, 967 F.2d 636, 642 (D.C. Cir. 1992) (internal quotations omitted)). With respect to materiality, the Court of Appeals applied the standard articulated by the Supreme Court in (continued...)

Misclassification

At the time of the filings in question, the Fund held more than 100,000 restricted shares of Premier, as well as 750 unrestricted shares; together, the Court found, these Premier shares constituted between ten and forty percent of Fund assets. 8/ The restrictions on the vast majority of the Fund's holdings of Premier limited the Fund's ability to trade those shares, rendering them less valuable than unrestricted shares. In quarterly reports on Form 10-Q for the quarters ended June 30 and September 30, 1994 and January 31 and June 30, 1995, as well as an annual report on Form 10-K for the year ended December 31, 1994, the Fund stated that all of its holdings of Premier were unrestricted stock. 9/ The Court found that "[t]he Fund should have listed the shares as restricted in each filing; listed as unrestricted, the statements qualify as 'untrue' under Rule 10b-5." 10/ The Court rejected Respondents' argument on appeal that the misclassification of the Fund's holdings was not material, and affirmed the Commission's findings that

> [T]he misclassifications were material in two ways. First, the misclassifications affected the value of the Premier holdings – and, therefore, the Fund's financial statements. In addition, Premier occupied a large percentage of the Fund's total assets, magnifying the effect of any misinformation about Premier. Under these circumstances, a reasonable

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7/ (...continued)
Basic Inc. v. Levinson, holding that a misrepresentation or omission is material if there is a substantial likelihood that a reasonable investor would have viewed the misrepresentation or omission as having "significantly alter[ed] the total mix of information" made available. Id. at 1096 (quoting Basic, 485 U.S. 224, 231-32 (1988) (internal quotation marks and citation omitted)).

The Commission's findings as to reporting violations were based on its findings that the periodic reports at issue made untrue statements of material facts and did not comply with GAAP and Commission Regulation S-X, 17 C.F.R. § 210. The Court of Appeals held that these findings were supported by substantial evidence. The Rockies Fund, 428 F.3d at 1090.

8/ Rockies Fund, 428 F.3d at 1091-92; accord Rockies Fund, 81 SEC Docket at 718 n.33.

9/ The quarterly report for the quarter ended September 30, 1994 was also filed in an amended version on Form 10-Q/A. Thus, a total of six periodic reports contained this misclassification.

10/ Rockies Fund, 428 F.3d at 1096.

investor certainly would have viewed the misclassification as "significantly alter[ing] the 'total mix' of information." 11/

Concluding its analysis of the misrepresentations as to classification, the Court rejected Respondents' argument that they lacked the requisite scienter under Rule 10b-5. 12/ The Court noted the Commission's finding that it was "'implausible' that the Fund directors could have overlooked this kind of error in six separate filings." 13/ The Court found that, although "[t]he Fund weakly disputes the [Commission's] scienter determination, . . . the [Commission's] opinion has ample support. Premier represented a large part of the Fund's holdings – between ten and forty percent. An attentive director would have rectified the error absent extreme abdication of ordinary care." 14/ Furthermore, the Court found that "[i]n addition to the simple misclassification, each filing used valuation language only appropriate for unrestricted shares." 15/ Thus, the Court concluded, "substantial evidence supports the [Commission's] finding of reckless indifference and 'extreme recklessness.'" 16/

Valuation

The Court found that the Fund's 1983 prospectus ("the Prospectus"), which the Court found to be "the Fund's only public statement on valuation procedures," set forth four methods of valuing the securities held by the Fund. 17/ The Fund used none of those, the Court found, but

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11/ Id. (quoting Basic, 485 U.S. at 231-32).

12/ Id.

13/ Id.

14/ Id.

15/ Id.

16/ Id.

17/ Id. at 1097. Our earlier opinion made more detailed findings regarding the valuation methods set forth in the Prospectus, which can be summarized as follows (see generally 81 SEC Docket at 719-20): The Prospectus provided that securities would be valued either at market value or in good faith at fair value, and defined "fair value" as the amount the Fund could expect to realize from the current sale of the securities. The four valuation methods set forth in the Prospectus were, from most favored to least favored, the "public market method" (which used the "bid" price for those securities traded on a stock exchange; the Fund's Board was to value restricted shares at a discount from the

(continued...)

instead used the "quoted market price" as the value of its Premier holdings. 18/ Paraphrasing the Commission's opinion, the Court reiterated the Commission's finding that "unmoored from its prospectus, the Fund used an ad hoc process that mainly consisted of rubber-stamping Calandrella's recommendation." 19/ The Court, again paraphrasing, agreed with the Commission's conclusion that "the prospectus – and good accounting practice – would have directed a different approach: valuing restricted stock by discounting the shares from the unrestricted market price," and with the Commission's determination that "discounting would have resulted in an appreciably lower valuation." 20/ The Court affirmed the Commission's opinion as to these points, finding that Respondents "offered no evidence of a discernable reason for choosing market price as the appropriate value" and that "the [Commission's] overvaluation findings are supported by general accounting practice and the Fund's own prospectus." 21/ The use of "the quoted market price" or "quoted market value" and the resulting overvaluation of the Premier stock held by the Fund is found in the same six periodic reports that contained misrepresentations as to the classification of the Fund's Premier holdings, as well as the Fund's

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17/ (...continued)
market price for unrestricted shares of the same issuer and class), the "private market method" (which valued the stock on the basis of actual or proposed third-party transactions), the "appraisal method" (which directed the Board to value shares by an appraisal that considered events that occurred since the purchase of the stock), and finally, if no other method was feasible, the Prospectus directed the Board to value the shares at their cost to the Fund. As we previously found, "[t]hese valuation procedures described in the prospectus were the only procedures disclosed to the investing public." Rockies Fund, 81 SEC Docket at 720.

18/ Rockies Fund, 428 F.3d at 1097.

19/ Id. Cf. Rockies Fund, 81 SEC Docket at 720 ("The Fund did not follow [the valuation] procedures [described in the prospectus."); id. at 723 (stating that "[the] record establishes that the Board adopted Calandrella's proferred market price for Premier with little or no attention paid to the basis for Calandrella's recommendations"; valuation process used was "in reality . . . cursory and inconsistent").

20/ Rockies Fund, 428 F.3d at 1097. Cf. Rockies Fund, 81 SEC Docket at 723 ("The valuation of Premier at the market price resulted in the Premier valuations being materially overstated. The Board's valuation policy disclosed in the prospectus, as well as Accounting Series Release ("ASR") 113, require that restricted securities be valued at a discount from the market price for unrestricted securities. . . . We find that . . . the Premier shares should have been valued, at a minimum, at a discount from the bid price. We further find that the discount should have been substantially below the bid price.").

21/ Rockies Fund, 428 F.3d at 1097.

quarterly report for the quarter ended September 30, 1995 and its 1995 annual report, a total of eight periodic reports. 22/

The Court rejected Respondents' argument that, even if the Fund "technically overvalued" Premier stock, the overvaluation was not material and caused no actual harm. 23/ The Court found that materiality does not require a showing of actual harm to investors. 24/ The Court further found that

> the [Commission] supported its finding of materiality, concluding that an overvaluation of the Fund's largest asset would have been significant information for potential Fund investors. In addition, as the Fund's only public statement about valuation, the prospectus does contribute to the overvaluation's materiality. Because the Fund rejected its publicly stated valuation procedures and did not discount its largest holding, substantial evidence supports the [Commission's] finding. 25/

The Court noted that Respondents disputed the Commission's finding that their valuation method was "inconsistent and slipshod" by claiming that they relied on counsel for procedures adopted in 1994. 26/ The Court rejected Respondents' argument, finding that

> much of the testimony showed that the Fund used no set procedure – whether developed by counsel or not – for valuing its holdings, instead generally relying on Calandrella's recommendation to the board. Such a haphazard process for valuing the largest holding of the Fund constitutes an "extreme departure from the standards of ordinary care" that should have been obvious to all the Fund's directors. 27/

22/ See Rockies Fund, 81 SEC Docket at 719-21 (finding misstatements as to valuation in Fund's quarterly and annual reports from June 30, 1994 through December 31, 1995, including specifically in "[the] third quarter and annual reports for [1995] (the two reports that correctly classify Premier shares as restricted)").

23/ Id.

24/ Id. (citing Graham v. SEC, 222 F.3d 994, 1001 n.15 (D.C. Cir. 2000)).

25/ Id.

26/ Id. (paraphrasing Commission opinion, which found valuation process "haphazard, following no consistent methodology").

27/ Id.

Thus, the Court concluded that Respondents acted with scienter with respect to the misrepresentations regarding valuation.

Ownership

Finally, in the Form 10-Q filed by the Fund for the quarter ended September 30, 1995, the Fund reported ownership of 200,000 shares of Premier offered as part of a private placement. The purchase was not authorized by the Fund's Board of Directors until November 15, 1995, and the Fund did not pay for the shares or sign a written contract for them until December 1995. The Court rejected Respondents' argument on appeal that the Fund could properly report ownership of the shares in its September 1995 quarterly report pursuant to an oral agreement, finding that "the Fund did not establish ownership until its directors approved the purchase amount and price in November 1995, well after the September filing." 28/ The Court affirmed the Commission's finding as to materiality, finding that "[t]he 200,000 shares comprised 46% of the Fund's Premier holdings and 11% of its total securities holdings. The [Commission] substantiated its finding that the ownership error was material based on the magnitude of the impact such a purchase would have on the Fund." 29/ The Court of Appeals also affirmed the Commission's finding as to scienter: "Calandrella, as agent, personally participated in the negotiations and knew the status of the purchase agreement. When he approved the quarterly report and its associated misrepresentation, he acted with at least extreme recklessness. Accordingly, substantial evidence supports the [Commission's] finding of a Section 10(b) and Rule 10b-5 violation." 30/

III.

When we first considered this matter, we determined that it was in the public interest to prohibit Calandrella, Powell, and Thygesen from associating with or acting as an affiliated person of an investment company, while allowing Powell and Thygesen the right to reapply in three years; to impose civil money penalties against Calandrella, Powell, and Thygesen; and to issue cease-and-desist orders against all Respondents. Because the Court of Appeals reversed our determination as to certain violations by Calandrella, we now consider whether sanctions should be imposed on the basis of the remaining violations, which were affirmed by the Court.

In determining whether administrative sanctions serve the public interest, we are guided by factors such as the egregiousness of a respondent's actions, the isolated or recurrent nature of

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28/ Id. at 1098.

29/ Id.

30/ Id.

the violation, the degree of scienter, the sincerity of a respondent's assurances against future violations, the respondent's recognition that the conduct was wrongful, and the opportunity for recurring violations. 31/ Respondents' conduct with respect to the antifraud violations was egregious. Their misconduct involved multiple misrepresentations pertaining to factual issues that could easily have been described accurately. 32/ The violations were recurrent, involving misstatements repeated in periodic filings for more than a year. Although Respondents assert that they "voluntarily exited the line of business that involved the violations at issue here," there is nothing to preclude their entering the securities industry again at some future point.

Respondents' actions were, at the least, highly reckless. The Court of Appeals stated that Respondents acted with "reckless indifference and 'extreme recklessness'" with regard to the misrepresentations about classification; that Respondents' "haphazard process" for valuing the largest holding of the Fund constituted "an 'extreme departure from the standards of ordinary care' that should have been obvious to all the Fund's directors"; and that Calandrella acted "with at least extreme recklessness" in approving the September 1995 quarterly report and the misrepresentation it contained regarding the Fund's ownership of Premier shares. 33/

31/ See Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979), aff'd, 450 U.S. 91 (1981).

32/ The Court of Appeals noted our finding that it was implausible that Fund directors could have overlooked an error like the misrepresentation as to classification of the Fund's Premier holdings in six separate filings. Rockies Fund, 428 F.3d at 1096; see also id. at 1097 (stating that the valuation process was "ad hoc" and "haphazard").

33/ Rockies Fund, 428 F.3d at 1096 (classification); id. at 1097 (valuation) (citing Steadman, 967 F.2d at 641-42); id. at 1098 (ownership).

Respondents argue that their reliance on the advice of counsel and on the Fund's auditors should mitigate sanctions. As noted above, the Court of Appeals found that the "haphazard" valuation process used to value the Fund's premier holdings constituted "an 'extreme departure from the standards of ordinary care' that should have been obvious to all the Fund's directors." The Rockies Fund, 428 F.3d at 1097 (citing Steadman, 967 F.2d at 641-42). Respondents point to no record evidence showing that they received contemporary advice from attorneys or auditors that the valuations of Premier contained in the periodic reports in question were reasonable. Subsequent testimony that the valuations were, in the auditor's view, not unreasonable, cannot establish reliance. Under these circumstances, we see nothing in the interaction between respondents and their auditor or counsel that would mitigate the sanctions imposed on them. See also supra notes 26-27 and accompanying text.

The dissemination of false and misleading financial information, such as in the periodic reports at issue, causes serious harm to investors and the marketplace. Investors need accurate information so that they may sensibly evaluate past and potential investments. Thus, the dissemination of inaccurate information to the investing public via false and misleading public disclosures harms investors by compromising the quality of their decisionmaking. Additionally, revelation that inaccurate information has been disseminated erodes public confidence in the marketplace. 34/ Particularly where the disclosure of such false and misleading information has been occasioned by conduct with the high degree of recklessness found by the Court here, the protection of investors that the federal securities laws are designed to provide compels a sanction that send a strong message of deterrence to these Respondents, as well as other members of the securities industry.

By overvaluing the Premier holdings, the Respondents distorted the actual performance of the Fund. As we have previously stated, "It is critically important that an investment company properly value its portfolio securities. ... [A]ny distortion in the valuation of a restricted security held by an investment company will distort the price at which the shares of the investment company are sold or redeemed." 35/ Valuation of the Premier holdings was especially important because those holdings represented between ten and forty percent of the Fund's overall holdings. The Premier stock should have been discounted substantially below the bid price. Factors such as the poor financial condition of Premier and the uncertainty of the company's survival were not even considered in the valuation process. Premier was valued at prices substantially higher than the Fund's own recent acquisition costs, even though no new developments justified appreciation in that value. Assigning these higher values to stock that comprised such a large percentage of the Fund's holdings would have made the Fund more attractive to investors than it would have been if a more accurate valuation had been used.

Respondents argue that they have learned their lesson. However, they characterize the misrepresentations regarding classification and valuation as technical violations and contend that, because the Court of Appeals vacated some of our findings of violation, this proceeding is "merely a shadow of the original matter as instituted by the Commission." These attempts to downplay the seriousness of actions found by the Court of Appeals to constitute fraud fall far short of a recognition that the conduct in question was wrongful. Such attitudes do little to assure us that the likelihood of future violations is low.

34/ See, e.g., Dresser Indus., Inc. v. SEC, 628 F.2d 1368, 1377 (D.C. Cir. 1980).

35/ Restricted Securities, Accounting Series Release 113 (Oct. 21, 1969), at 3.

Based on these findings, we conclude that it is in the public interest to prohibit Calandrella from associating with or acting as an affiliated person of an investment company, subject to a right to reapply after five years, and to prohibit Powell and Thygesen from associating with or acting as an affiliated person of an investment company, subject to a right to reapply after three years. 36/

Section 9(d) of the Investment Company Act of 1940 authorizes the Commission to impose a civil money penalty when such a penalty is in the public interest. 37/ In determining whether a penalty is in the public interest, the statute provides that we may consider (1) whether the violation involved fraud or deceit, (2) the resulting harm to other persons, (3) any unjust enrichment, (4) the respondent's prior regulatory record, (5) the need to deter the respondent and other persons, and (6) such other matters as justice may require. 38/

As discussed above, Calandrella, Powell, and Thygesen repeatedly violated antifraud provisions by making multiple misrepresentations in a series of periodic reports over a period of more than a year. Respondents' level of scienter was at least extreme recklessness, as the Court of Appeals found with respect to each type of misrepresentation. 39/ Moreover, dissemination of false and misleading financial information by its nature causes serious harm to investors and the marketplace. As we have already found, there is a strong need for deterrence. We therefore find it in the public interest to impose civil money penalties.

Once a public interest determination is made, a three-tier system establishes the maximum civil money penalty that may be imposed for each violation found. 40/ During the relevant period, the first tier provided for a maximum penalty against an individual of $5,000 for each willful violation of the securities acts or rules thereunder. The second tier set a maximum penalty of $50,000 for each willful violation involving fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement. The third tier provided for a maximum of $100,000 for each willful violation if the conduct (a) involved fraud, deceit, manipulation, or

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36/ We originally imposed these prohibitions on October 2, 2003. The Court of Appeals issued its mandate on January 13, 2006, at which time the sanctions ceased to be effective. The time that the prohibitions were already in effect is to be counted towards the three- and five-year prohibitions we impose today.

37/ 15 U.S.C. § 80a-9(d).

38/ Investment Company Act Section 9(d)(3), 15 U.S.C. § 80a-9(d)(3).

39/ See supra notes 14, 16, 27, 30 & 33 and accompanying text.

40/ Investment Company Act Section 9(d)(2), 15 U.S.C. § 80a-9(d)(2).

deliberate or reckless disregard of a regulatory requirement and (b) resulted in, or created a significant risk of, substantial loss to others or resulted in substantial pecuniary gain to the person who committed the act or omission. Within the bounds of this system, we have discretion in setting the level of penalty.

As discussed above, the Court of Appeals affirmed our earlier findings that Respondents' conduct involved fraud, deceit, and a deliberate or reckless disregard of the antifraud provisions of the securities laws. The findings of violation of Section 10(b) and Rule 10b-5, antifraud provisions, were affirmed by the Court of Appeals, which also found Respondents' actions to constitute, at the least, extreme recklessness. 41/ As discussed above in connection with our consideration of the statutory factors underlying our analysis of the public interest, the conduct created a significant risk of substantial loss to those who traded on the basis of the misinformation. 42/

In an exercise of our discretion, we impose only a second-tier penalty. 43/ We find that imposing penalties of $20,000 each on Powell and Thygesen and a penalty of $50,000 on

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41/ See supra notes 14, 16, 27, 30 & 33 and accompanying text.

42/ Where conduct creates a significant risk of substantial loss to others, third-tier penalties may be imposed without a showing that the conduct in question resulted in substantial pecuniary gain to the person who committed the act or omission. Investment Company Act Section 9(d)(2)(C)(ii), 15 U.S.C. § 80a-9(d)(2)(C)(ii).

43/ Respondents' fraudulent conduct involved multiple instances of dissemination into the marketplace of numerical representations that were wholly lacking in factual basis. Such conduct, repeated as it was over the course of more than a year, by its nature created a significant risk of substantial loss to investors, even though no actual losses were proven. In our view, this type of conduct falls within the circumstances contemplated by Congress when it authorized the imposition of third-tier penalties.

Respondents contend that the Court of Appeals "categorically rejected the imposition of third-tier sanctions." This misstates the Court's opinion. The Court required us to explain more fully our reasoning, but it placed no restrictions on our choice of civil money penalties in this proceeding.

Calandrella is appropriate. 44/ These penalties are near the middle or at the top of the second tier, consistent with our discussion of the seriousness of the misconduct.

A combination of factors unique to this case militates, however, against the imposition of higher penalties. The violations at issue occurred more than ten years ago. The record fails to identify any actual losses to investors resulting from Respondents' misconduct; it similarly shows no unjust enrichment to Respondents. Moreover, although we made no explicit findings as to these facts in our previous opinion, the record contains Forms 10-K showing that the Fund was relatively small, with net assets of approximately $1.7 million as of December 31, 1994 and $1.3 million as of December 31, 1995, and counsel for Respondents stated in Respondents' brief and at oral argument, and the Division conceded in its brief, that the Fund was thinly traded. Additionally, the Forms 10-K show that Calandrella received a salary of only $48,000 annually in 1994 and 1995 for his service to the Fund, and Powell and Thygesen testified that they received only $500 for each quarterly meeting of the Fund's board of directors that they attended. Considered individually, none of these factors is dispositive, but considering them as a unique whole, we impose only the $20,000 and $50,000 penalties set forth above, without multiplying them by the number of filings that contained false and misleading financial information, as the law judge did, or by the total number of misrepresentations at issue. 45/

44/ These penalties correspond to the numbers used as the basis for the penalties we imposed in our October 2, 2003 opinion. To reach the penalties previously imposed, we multiplied those numbers by the number of filings containing misrepresentations, eight, resulting in penalties of $160,000 and $400,000. (The penalty imposed on Calandrella also included $100,000 for the manipulation we originally found.) Respondents argue that those original penalty amounts violate the Eighth Amendment, which prohibits, among other things, the imposition of excessive fines. U.S. Const. amend. VIII. To the extent they continue to advance this argument with reference to the lower penalties we now impose, we observe that the Supreme Court has held that, in determining whether a fine is excessive under the Eighth Amendment, substantial deference is granted to the legislature. See United States v. Bajakajian, 524 U.S. 321, 336 (1998). The three-tier structure for determining appropriate civil penalties was established by Congress, and, as noted, the penalties we impose are well within the limits set forth in the statute.

45/ In our assessment of sanctions, we have also taken into consideration Respondents' cooperation with the Commission's investigation which, they assert, should be regarded as a mitigating factor.

Respondents contend that the Court "appeared to reduce the number of filings at issue from eight to only six" (citing Rockies Fund, 428 F.3d at 1092, 1096-97). The Court's explicit references to six filings appear in discussions of the misrepresentations regarding

(continued...)

We find the imposition of a higher penalty on Calandrella warranted because he was the president of the Fund as well as a director. As a member of the Fund's management, he should have been thoroughly familiar with the classification and value of the Premier shares held by the Fund, yet he generated the misleading valuation figures and presented them to the other directors for approval. Moreover, we have found only Calandrella, not Powell or Thygesen, liable for the misstatement as to the Fund's ownership of the 200,000 Premier shares in the September 1995 quarterly report. 46/

Exchange Act Section 21C(a) authorizes the Commission to impose a cease-and-desist order upon any person who "is violating, has violated, or is about to violate" any provision of the Exchange Act or any rule or regulation thereunder, or against any person who "is, was, or would be a cause of [a] violation, due to an act or omission the person knew or should have known would contribute to such violation." 47/ In determining whether a cease-and-desist order is an appropriate sanction, we analyze the risk of future violations. 48/ The existence of a violation raises an inference that the violation will be repeated, and where the misconduct that results in

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45/ (...continued)
classification of the Fund's Premier shares. As set forth above, see supra note 9 and accompanying text, those misrepresentations appeared in only six filings. Misrepresentations as to valuation were made in those six plus two more, for a total of eight filings, one of which also contained the misrepresentation regarding the Fund's ownership of Premier shares. See supra notes 17-27 and accompanying text. The Court specifically affirmed the Commission's findings of violation regarding all the misrepresentations at issue.

46/ Respondents contend that the sanctions we initially imposed "were based on a misstated record of Calandrella's experience in the securities industry." They support this argument by citing only to the law judge's initial decision. Our earlier decision did not rely on the challenged assertions regarding Calandrella's experience in the securities industry, and we do not base these sanctions on those assertions.

As noted above, see supra text accompanying note 3, the Court of Appeals vacated our findings as to manipulation and the acceptance of improper compensation. Thus, the sanctions imposed here are based solely on our findings of antifraud violations based on the filing of periodic reports containing material misrepresentations and the related reporting violations, which were affirmed by the Court of Appeals.

47/ 15 U.S.C. § 78u-3(a).

48/ KPMG Peat Marwick, 54 S.E.C. 1135, 1185 (2001), reconsideration denied, 55 S.E.C. 1 (2001), petition for review denied, 289 F.3d 109 (D.C. Cir. 2002).

the violation is egregious, the inference is justified. 49/ We also consider whether other factors demonstrate a risk of future violations. Beyond the seriousness of the violation, these may include the isolated or recurrent nature of the violation, whether the violation is recent, the degree of harm to investors or the marketplace resulting from the violation, the respondent's state of mind, the sincerity of assurances against future violations, the opportunity to commit future violations, and the remedial function to be served by the cease-and-desist order in the context of any other sanctions sought in the proceeding. 50/ Not all of these factors need to be considered, and none of them, by itself, is dispositive.

We have already found that Respondents' conduct was egregious, justifying an inference of repeated violations. The antifraud violations were recurrent, affecting eight filings made over the course of more than a year. We have already discussed the harm to the marketplace caused by the type of conduct at issue here: Respondents' disregard of their obligations to the investing public allowed false and misleading information to be disseminated, causing serious harm to investors and to the marketplace. Respondents' state of mind was at least highly reckless. Their characterization of the misrepresentations as technical violations does not suggest that the likelihood of future violations is low. Respondents may enter the securities industry again at some future point, and although the Fund has terminated its registration status, it apparently continues to operate, so that opportunity to commit future violations is not foreclosed. Although

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49/ See Geiger v. SEC, 363 F.3d 481, 489 (D.C. Cir. 2004) and cases cited therein.

50/ KPMG Peat Marwick, 54 S.E.C. at 1192.

the violations are not recent, our weighing of this factor together with the others discussed above leads us to find that it is also in the public interest to order that Respondents cease and desist from committing or causing violations of the statutes they were found to have violated. 51/

An appropriate order will issue. 52/

By the Commission (Chairman COX and Commissioners ATKINS, CAMPOS, NAZARETH, and CASEY).

Nancy M. Morris
Secretary

51/ Respondents contend that the facts of this case are comparable to those in Parnassus Investments, Initial Decision Rel. No. 131 (Sept. 3, 1998), 67 SEC Docket 2760, and that the sanctions imposed here should therefore be commensurate with those imposed in Parnassus. We have consistently held that the appropriate sanction depends on the facts and circumstances of each case and cannot be precisely determined by comparison with action taken in other proceedings. See, e.g., Butz v. Glover Livestock Comm'n Co., 411 U.S. 182, 187 (1973); see also, e.g., Anthony A. Adonnino, Exchange Act Rel. No. 48618 (Oct. 9, 2003), 81 SEC Docket 981, 999; Jonathan Feins, 54 S.E.C. 366, 380 (1999). Moreover, in Parnassus the law judge found that the conduct in question "did not involve fraud, but rather violations of technical provisions of the securities laws." Parnassus Investments, 67 SEC Docket at 2789. In this case, in contrast, we found, as did the Court of Appeals, that respondents acted at least recklessly in violating antifraud provisions of the securities laws. See supra note 41 and accompanying text.

52/ We have considered all of the contentions advanced by the parties. We reject or sustain 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. 54892 / December 7, 2006

INVESTMENT COMPANY ACT OF 1940
Rel. No. 27593 / December 7, 2006

Admin. Proc. File No. 3-9615

In the Matter of

THE ROCKIES FUND, INC.,
STEPHEN G. CALANDRELLA,
CHARLES M. POWELL, and
CLIFFORD C. THYGESEN

ORDER IMPOSING REMEDIAL SANCTIONS

On the basis of the Commission's opinion issued this day, it is

ORDERED that Stephen G. Calandrella be, and he hereby is, prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter, subject to a right to reapply after five years; and it is further

ORDERED that Charles M. Powell and Clifford C. Thygesen be, and they hereby are, 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, subject to a right to reapply after three years; and it is further

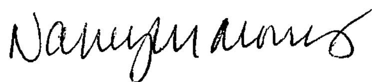
ORDERED that the Rockies Fund, Inc., Stephen G. Calandrella, Charles M. Powell, and Clifford C. Thygesen cease and desist from committing or causing any violations or future violations of Sections 10(b) and 13(a) of the Securities Exchange Act of 1934 and Rules 10b-5, 12b-20, 13a-1, and 13a-13 thereunder; and it is further

ORDERED that Stephen G. Calandrella is assessed a civil money penalty of $50,000; and it is further

ORDERED that Charles M. Powell and Clifford C. Thygesen each is assessed a civil money penalty of $20,000.

Payment of the civil money penalty shall be: (a) made by United States postal money order, certified check, bank cashier's check, or bank money order; (b) made payable to the Securities and Exchange Commission; (c) delivered by hand or courier to the Office of Financial Management, Securities and Exchange Commission, 6432 General Green Way, Alexandria VA 22312; and (d) submitted under cover letter that identifies the respondent in this proceeding, as well as the Commission's administrative proceeding file number. A copy of the cover letter and money order or check shall be sent to Robert M. Fusfeld, Counsel for the Division of Enforcement, Securities and Exchange Commission, Central Regional Office, 1801 California Street, Suite 4800, Denver, Colorado 80202-2648.

By the Commission.



Nancy M. Morris
Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR PARTS 240 and 242

[Release No. 34-54891; File No. S7-21-06]

RIN 3235-AJ76

Amendments to Regulation SHO and Rule 10a-1

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission ("Commission" or "SEC") is proposing to amend the short sale price test under the Securities Exchange Act of 1934 ("Exchange Act"). The proposed amendments are intended to provide a more consistent regulatory environment for short selling by removing restrictions on the execution prices of short sales ("price tests" or "price test restrictions"), as well as prohibiting any self-regulatory organization ("SRO") from having a price test. In addition, the Commission is proposing to amend Regulation SHO to remove the requirement that a broker-dealer mark a sell order of an equity security as "short exempt," if the seller is relying on an exception from a price test.

DATES: Comments should be received on or before [insert date 60 days after publication in the Federal Register].

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

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml); or

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- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-21-06 on the subject line; or

- Use the Federal eRulemaking Portal (http://www.regulations.gov). Follow the instructions for submitting comments.

Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-21-06. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (http://www.sec.gov/rules/proposed.shtml). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549. All comments received will be posted without change; 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: James A. Brigagliano, Acting Associate Director, Josephine J. Tao, Branch Chief, Lillian Hagen, Special Counsel, Victoria L. Crane, Special Counsel, Office of Trading Practices and Processing, Division of Market Regulation, at (202) 551-5720, at the Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-6628.

SUPPLEMENTARY INFORMATION: The Commission is requesting public comment on the removal of Rule 10a-1 [17 CFR 240.10a-1] and proposed amendments to Rules 200 and 201 of Regulation SHO [17 CFR 242.200 and 242.201] under the Exchange Act.

I. Introduction

Section 10(a) of the Exchange Act[1] gives the Commission plenary authority over short sales[2] of securities registered on a national securities exchange as necessary or appropriate in the public interest or for the protection of investors. The Commission originally adopted Rule 10a-1 in 1938 to restrict short selling in a declining market.[3]

The core provisions of Rule 10a-1 have remained virtually unchanged since its adoption almost 70 years ago. As discussed in more detail below, however, over the years, in response to changes in the securities markets, including changes in trading strategies and systems used in the marketplace, the Commission has added exceptions to Rule 10a-1 and granted numerous written requests for relief from the rule's restrictions. In addition, under current price test regulation, different price tests apply to securities trading in different markets. We also note that current price test restrictions apply generally only to large or more actively-traded securities. We believe that the increased demand for exemptions from the restrictions of Rule 10a-1, and the disparate application of current price test regulation, limit the reach of current price test restrictions, potentially

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[1] 15 U.S.C. 78j(a).

[2] Rule 200(a) of Regulation SHO defines a "short sale" as "any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller." 17 CFR 242.200(a).

[3] See Exchange Act Release No. 1548 (January 24, 1938), 3 FR 213 (January 26, 1938).

create an unlevel playing field among market participants, and allow for regulatory arbitrage.

In 2004, we adopted Rule 202T of Regulation SHO,[4] which established procedures for the Commission to temporarily suspend price tests so that the Commission could study the effectiveness of these tests.[5] Pursuant to the process established in Rule 202T of Regulation SHO, we issued an order ("First Pilot Order") creating a one year pilot ("Pilot") temporarily suspending the provisions of Rule 10a-1(a) and any price test of any exchange or national securities association for short sales of certain securities.[6]

The Pilot was designed to assist the Commission in assessing whether changes to current short sale regulation are necessary in light of current market practices and the purposes underlying short sale regulation.[7] The Commission stated in the Regulation SHO Adopting Release that conducting a pilot pursuant to Rule 202T would "allow us to

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[4] 17 CFR 242.202T.

[5] See id.; see also Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008, 48012-48013 (August 6, 2004) ("Regulation SHO Adopting Release").

[6] Exchange Act Release No. 50104 (July 28, 2004), 69 FR 48032 (August 6, 2004). Specifically, the First Pilot Order suspended price tests for: (1) short sales in the securities identified in Appendix A to the First Pilot Order; (2) short sales in the securities included in the Russell 1000 index effected between 4:15 p.m. EST and the open of the effective transaction reporting plan of the Consolidated Tape Association ("consolidated tape") on the following day; and (3) short sales in any security not included in paragraphs (1) and (2) effected in the period between the close of the consolidated tape and the open of the consolidated tape on the following day. In addition, the First Pilot Order provided that the Pilot would commence on January 3, 2005 and terminate on December 31, 2005, and that the Commission might issue further orders affecting the operation of the First Pilot Order. 69 FR at 48033. On November 29, 2004, we issued an order resetting the Pilot to commence on May 2, 2005 and end on April 28, 2006 to give market participants additional time to make systems changes necessary to comply with the Pilot. Exchange Act Release No. 50747 (November 29, 2004), 69 FR 70480 (December 6, 2004). On April 20, 2006, we issued an order ("Third Pilot Order") extending the termination date of the Pilot to August 6, 2007, the date on which temporary Rule 202T of Regulation SHO expires. Exchange Act Release No. 53684 (April 20, 2006), 71 FR 24765 (April 26, 2006). The purpose of the Third Pilot Order is to maintain the status quo with regard to price tests for Pilot securities while the staff completes its analysis of the Pilot data and the Commission conducts any additional short sale rulemaking.

[7] 69 FR at 48032.

obtain data on the impact of short selling in the absence of a price test to assist in determining, among other things, the extent to which a price test is necessary to further the objectives of short sale regulation, to study the effects of relatively unrestricted short selling on market volatility, price efficiency, and liquidity, and to obtain empirical data to help assess whether a price test should be removed, in part or in whole, for some or all securities, or if retained, should be applied to additional securities."[8] As noted in the Regulation SHO Adopting Release, the empirical data from the Pilot was to be obtained and analyzed "as part of [the Commission's] assessment as to whether the price test should be removed or modified, in part or whole, for actively-traded securities or other securities."[9]

Thus, the Commission's Office of Economic Analysis ("OEA") gathered the data made public during the Pilot, analyzed this data and provided the Commission with a draft summary report on the Pilot.[10] The OEA Staff's Draft Summary Pilot Report examined several aspects of market quality including the overall effect of price tests on short selling, liquidity, volatility and price efficiency. The Pilot data was also designed to

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[8] Regulation SHO Adopting Release at 48009.

[9] Regulation SHO Adopting Release at 48013. In the Regulation SHO Adopting Release we noted that "the purpose of the [P]ilot is to assist the Commission in considering alternatives, such as: (1) Eliminating a Commission-mandated price test for an appropriate group of securities, which may be all securities; (2) adopting a uniform bid test, and any exceptions, with the possibility of extending a uniform bid test to securities for which there is currently no price test; or (3) leaving in place the current price tests." Regulation SHO Adopting Release at 48010.

[10] See Office of Economic Analysis U.S. Securities and Exchange Commission, Economic Analysis of the Short Sale Price Restrictions Under the Regulation SHO Pilot (September 14, 2006) (the "OEA Staff's Draft Summary Pilot Report"), available at http://www.sec.gov/about/economic/shopilot091506/draft_reg_sho_pilot_report.pdf.

allow the Commission and members of the public to examine whether the effects of price tests are similar across stocks.[11]

In addition, the Commission encouraged outside researchers to examine the Pilot. In response to this request, the Commission has received three completed studies (the "Academic Studies") from outside researchers that specifically examine the Pilot data.[12] The Commission also held a public roundtable (the "Regulation SHO Roundtable") that focused on the empirical evidence learned from the Pilot data (the OEA Staff's Draft Summary Pilot Report, Academic Studies, and Regulation SHO Roundtable are referred to collectively herein as, the "Pilot Results").[13] The Pilot Results contained a variety of observations, which we considered in determining whether or not to propose removal of current price test restrictions. Generally, the Pilot Results urged removal of current price test restrictions. In addition, the empirical evidence did not support extending a price test to either small or thinly-traded securities.[14]

Based on our review of the Pilot Results and of the status of current price test restrictions, we are proposing to remove the tick test of Rule 10a-1 and add Rule 201 of

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[11] In the Regulation SHO Adopting Release, the Commission stated its expectation that data on trading during the Pilot would be made available to the public to encourage independent researchers to study the Pilot. See Regulation SHO Adopting Release at 48009, n.9. Accordingly, nine SROs began publicly releasing transactional short selling data on January 3, 2005. The nine SROs were the AMEX, ARCA, BSE, CHX, NASD, Nasdaq, National Stock Exchange, NYSE and Phlx. The SROs agreed to collect and make publicly available trading data on each executed short sale involving equity securities reported by the SRO to a securities information processor. The SROs published the information on a monthly basis on their Internet Web sites.

[12] See Karl Diether, Kuan Hui Lee and Ingrid M. Werner, It's SHO Time! Short-Sale Price-Tests and Market Quality, June 20, 2006 ("Diether, Lee and Werner"); Gordon J. Alexander and Mark A. Peterson, (How) Do Price Tests Affect Short Selling? May 23, 2006 ("Alexander and Peterson"); J. Julie Wu, Uptick Rule, short selling and price efficiency, August 14, 2006 ("Wu").

[13] A transcript from the roundtable ("the Roundtable Transcript") is available at http://www.sec.gov/about/economic/shopilottrans091506.pdf.

[14] The Pilot Results are discussed in more detail in Section II.D below.

Regulation SHO to provide that no price test, including any price test of any SRO, shall apply to short sales in any security. Rule 201 would also prohibit any SRO from having a price test. In addition, because we are proposing to remove all current price test restrictions, and prohibit any price test by any SRO, we are proposing to amend Rule 200(g) of Regulation SHO to remove the requirement that a broker-dealer mark a sell order of an equity security as "short exempt" if the seller is relying on an exception from the price test of Rule 10a-1, or any price test of any exchange or national securities association.[15]

We note that today's markets are characterized by high levels of transparency and regulatory surveillance. These characteristics greatly reduce the risk of abusive or manipulative short selling going undetected if we were to remove price test restrictions, and permit regulators to monitor the types of activities that Rule 10a-1 and other price tests are designed to prevent. The general anti-fraud and anti-manipulation provisions of the federal securities laws would also continue to prohibit activity that improperly influences the price of a security.[16]

II. Background

A. Short Selling and Its Market Uses and Effects

A short sale is the sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of,

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[15] This proposal affects price tests and related marking requirements only. It does not relate to other provisions of Regulation SHO. We note, however, that in a separate proposal we recently proposed amendments to provisions of Regulation SHO that would eliminate the "grandfather" provision and limit the options market maker exception. See Exchange Act Release No. 54154 (July 14, 2006), 71 FR 41710 (July 21, 2006) ("Regulation SHO Amendments Proposing Release"). This proposal does not alter the proposed amendments in the Regulation SHO Amendments Proposing Release.

[16] See, e.g., Securities Act of 1933 Section 17(a), Exchange Act Sections 9(a), 10(b), and 15(c) and Rule 10b-5 thereunder. See also Regulation M, Rule 105.

the seller.[17] In order to deliver the security to the purchaser, the short seller borrows the security, typically from a broker-dealer or an institutional investor. The short seller later closes out the position by purchasing equivalent securities on the open market, or by using an equivalent security it already owned, and returning the security to the lender. A short seller hopes to profit from the transaction by selling short at a higher price than the price at which it repurchases the securities to return to the lender. In general, short selling is used to profit from an expected downward price movement, to provide liquidity in response to unanticipated demand, or to hedge the risk of a long position in the same security or in a related security.

Short selling provides the market with at least two important benefits: market liquidity and pricing efficiency.[18] Market liquidity may be provided through short selling by market professionals, such as market makers (including specialists) and block positioners, to offset temporary imbalances in the buying and selling interest for securities. These short sales make stock available to purchasers and reduce the risk that the price paid by purchasers is artificially high because of a temporary contraction of selling interest. Short sellers covering their sales also may add to the buying interest of stock available to sellers.

In addition, short selling contributes to the pricing efficiency of the equities markets. Efficient markets require that prices fully reflect all buy and sell interest. Short sales reflect the view that the security is overvalued and the price of the security will fall, just as long purchases reflect the view that the security is undervalued and the price will

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[17] 17 CFR 242.200(a).

[18] See Owen A Lamont and Richard H Thaler, Can the Market Add and Subtract? Mispricing in Tech Stocks Carve-outs, Journal of Political Economy, May 2001.

rise. Both the long purchaser and the short seller hope to profit, or hedge against loss, by buying low and selling high, though the strategies differ in the sequence of transactions. Market participants who believe a stock is overvalued may engage in short sales in an attempt to profit from a perceived divergence of prices from true economic values. Such short sellers add to stock pricing efficiency because their transactions inform the market of their evaluation of future stock price performance. This evaluation is reflected in the resulting market price of the security.[19]

Although short selling serves useful market purposes, it also may be used to illegally manipulate stock prices.[20] One example is the "bear raid" where an equity security is actively sold short to drive down prices in the hope of convincing less informed investors of a negative material perception of the stock, triggering sell orders. Falling prices could also trigger margin calls and possibly forced liquidations of the security, depressing the price further.[21] This unrestricted short selling could exacerbate a declining market in a security by eliminating bids, and causing a further reduction in the price of a security by creating an appearance that the security's price is falling for fundamental reasons.

[19] Arbitrageurs also contribute to pricing efficiency by utilizing short sales to profit from price disparities between a stock and a derivative security, such as a convertible security or an option on that stock. For example, an arbitrageur may purchase a convertible security and sell the underlying stock short to profit from a current price differential between two economically similar positions.

[20] See, e.g., S.E.C. v. Gardiner, 48 S.E.C. Docket 811, No. 91 Civ. 2091 (S.D.N.Y. March 27, 1991) (alleged manipulation by sales representative by directing or inducing customers to sell stock short in order to depress its price); U.S. v. Russo, 74 F.3d 1383, 1392 (2nd Cir. 1996) (short sales were sufficiently connected to the manipulation scheme as to constitute a violation of Exchange Act Section 10(b) and Rule 10b-5).

[21] At that time, many people blamed "bear raids" for the 1929 stock market crash and the market's prolonged inability to recover from the crash. See 7 Louis Loss and Joel Seligman, Securities Regulation 3203-04, n.213 (3d ed. 2006).

B. Current Short Sale Regulation

One way short sales are regulated in the United States is through price tests, which regulate the execution prices of short sales. Current short sale regulation applies different price tests to securities trading in different types of markets. Section 10(a) of the Exchange Act gives the Commission plenary authority to regulate short sales of securities registered on a national securities exchange, as necessary or appropriate in the public interest for the protection of investors.[22] After conducting an inquiry into the effects of concentrated short selling during the market break of 1937, the Commission adopted the price test contained in Rule 10a-1 in 1938 to restrict short selling in a declining market.[23] The core provisions of the rule are largely the same today as when they were adopted.

Paragraph (a) of Rule 10a-1 covers short sales in securities registered on, or admitted to unlisted trading privileges ("UTP") on, a national securities exchange ("listed securities"), if trades of the security are reported pursuant to an "effective transaction reporting plan" and information regarding such trades is made available in accordance with such plan on a real-time basis to vendors of market transaction information.[24]

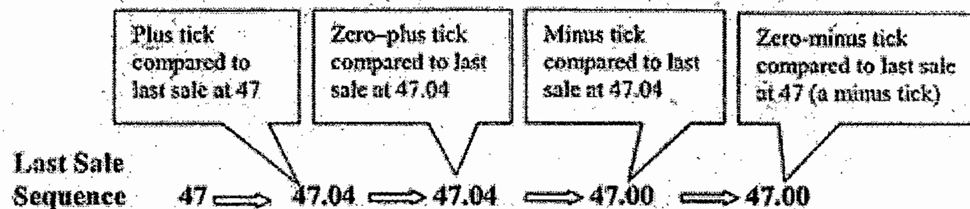
Rule 10a-1(a)(1) provides that, subject to certain exceptions, a listed security may be sold short (A) at a price above the price at which the immediately preceding sale was effected (plus tick), or (B) at the last sale price if it is higher than the last different price

[22] See 15 USC 78j(a).

[23] See supra n.3.

[24] Rule 10a-1 uses the term "effective transaction reporting plan" as defined in Rule 600 of Regulation NMS (17 CFR 242.600) under the Exchange Act. See 17 CFR 240.10a-1(a)(1)(i).

(zero-plus tick).[25] Short sales are not permitted on minus ticks or zero-minus ticks, subject to narrow exceptions. The operation of these provisions is commonly described as the "tick test." The following transactions illustrate the operation of the tick test:



The first execution at 47.04 is a plus tick since it is higher than the previous last trade price of 47.00. The next transaction at 47.04 is a zero-plus tick since there is no change in trade price but the last change was a plus tick. Short sales could be executed at 47.04 or above. The final two transactions at 47.00 are minus and zero-minus transactions, respectively. Subsequently, short sales would have to be effected at the next higher increment above 47.00 in order to comply with Rule 10a-1.

In adopting the tick test, the Commission sought to achieve three objectives: (i) allowing relatively unrestricted short selling in an advancing market; (ii) preventing short selling at successively lower prices, thus eliminating short selling as a tool for driving the market down; and (iii) preventing short sellers from accelerating a declining market by exhausting all remaining bids at one price level, causing successively lower prices to be established by long sellers.[26]

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[25] The last sale price is the price reported pursuant to an effective transaction reporting plan, *i.e.*, the consolidated tape, or to the last sale price reported in a particular marketplace. Under Rule 10a-1, the Commission gives market centers the choice of measuring the tick of the last trade based on executions solely on their own exchange rather than those reported to the consolidated tape. See 17 CFR 240.10a-1(a)(2).

[26] See Exchange Act Release No. 13091 (December 21, 1976), 41 FR 56530 (December 28, 1976).

Rule 10a-1 applies only to listed securities and, therefore, securities quoted on the over-the-counter bulletin board ("OTCBB") and pink sheets are not subject to Rule 10a-1. In addition, prior to January 13, 2006, before The NASDAQ Stock Market LLC ("Nasdaq") began operations as a national securities exchange, Nasdaq securities were not subject to Rule 10a-1.

In 1994, the Commission granted temporary approval to the National Association of Securities Dealers, Inc. ("NASD") to apply its own short sale rule, NASD Rule 3350 ("former NASD Rule 3350" or "former NASD Rule 3350's bid test"), to Nasdaq Global Market securities[27] on a pilot basis.[28] Under former NASD Rule 3350, Nasdaq Global Market securities traded over-the-counter ("OTC") and reported to an NASD facility were subject to former NASD Rule 3350's bid test.[29] In addition, Nasdaq Global Market securities traded on, or reported to, Nasdaq were subject to former NASD Rule 3350's bid test.

Former NASD Rule 3350 was, by its terms, inapplicable to Nasdaq Capital Market securities.[30] In addition, short sales in Nasdaq Global Market securities effected

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[27] Nasdaq Global Market securities were formerly known as Nasdaq National Market securities. In connection with Nasdaq commencing operations as a national securities exchange, the Nasdaq National Market was renamed the Nasdaq Global Market and Nasdaq National Market securities were renamed Nasdaq Global Market securities. See NASD Rule 4200(a)(6) (providing that the Nasdaq Global Market is the successor to the Nasdaq National Market); see also Exchange Act Release No. 54071 (June 29, 2006), 71 FR 38922 (July 10, 2006). In this release, references to Nasdaq Global Market securities includes Nasdaq National Market securities, as applicable.

[28] See Exchange Act Release No. 34277 (June 29, 1994), 59 FR 34885 (July 7, 1994). The NASD's short sale rule was originally approved on an eighteen-month pilot basis. The NASD proposed, and the Commission approved, extensions of former NASD Rule 3350 several times. See, e.g., Exchange Act Release No. 53093 (January 10, 2006), 71 FR 2966 (January 18, 2006).

[29] Former NASD Rule 3350's bid test provided that short sales in Nasdaq Global Market securities must not be effected at or below the current national best (inside) bid when the current national best (inside) bid is below the preceding national best (inside) bid.

[30] Nasdaq Capital Market securities were formerly known as Nasdaq SmallCap securities. See Exchange Act Release No. 34-52489 (September 21, 2005), 70 FR 56948 (September 29, 2005).

on any national securities exchange that traded Nasdaq Global Market securities on a UTP basis were not subject to former NASD Rule 3350.

On January 13, 2006, the Commission approved Nasdaq's application to become a national securities exchange.[31] Once Nasdaq's exchange application became effective, Rule 10a-1 would have applied to all Nasdaq securities wherever traded. In Nasdaq's exchange application, however, Nasdaq requested an exemption from Rule 10a-1 and proposed to adopt a short sale rule, Nasdaq Rule 3350 ("Nasdaq Rule 3350" or "Nasdaq's bid test"), similar to former NASD Rule 3350, so that it could continue to regulate short sales in Nasdaq Global Market securities under a bid test.[32] Nasdaq also requested to exempt Nasdaq Capital Market securities from Rule 10a-1's tick test.[33] In granting Nasdaq's requested exemptions, the Commission noted that it believed that it is important to maintain the status quo of short sale regulation during the Pilot in order to promote efficient regulation and to avoid unnecessarily burdening markets with the imposition of costs associated with implementing a price test that may be temporary.[34] Nasdaq Rule 3350 prohibits short sales in Nasdaq Global Market securities at or below the current best (inside) bid displayed in the National Market System when the current best (inside) bid is below the preceding best (inside) bid in the security.[35]

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[31] See SEC Order in the Matter of the Application of The Nasdaq Stock Market LLC for registration as a National Securities Exchange, Exchange Act Release No. 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006).

[32] Nasdaq Rule 3350 contains provisions similar to former NASD Rule 3350 regarding short sales in Nasdaq Global Market securities executed on, or reported to, Nasdaq. See Nasdaq Rule 3350. See also 71 FR at 3561.

[33] See id.

[34] See 71 FR at 3562.

[35] See Nasdaq Rule 3350.

Similarly, to maintain the status quo for Nasdaq Global Market securities traded OTC and reported to a NASD facility during the Pilot, we granted an exemption to the NASD to permit Nasdaq Global Market securities traded OTC and reported to a NASD facility to continue to be subject to a bid test similar to that contained in former NASD Rule 3350 rather than Rule 10a-1's tick test, and Nasdaq Capital Market securities traded OTC and reported to a NASD facility to continue to not be subject to any price test.[36] Thus, with respect to trades in Nasdaq Global Market securities reported to the NASD's Alternative Display Facility ("ADF")[37] or the Trading Reporting Facility ("TRF"),[38] NASD Rule 5100 prohibits short sales at or below the current national best (inside) bid when the current national best (inside) bid is below the previous best (inside) bid in the security.[39]

For these same reasons, we also granted an exemption for exchanges trading Nasdaq Global Market and Nasdaq Capital Market securities on a UTP basis to continue to do so without being subject to any price test until completion of the Pilot.[40]

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[36] See letter from James A. Brigagliano, Acting Associate Director, Division of Market Regulation to Marc Menchel, Executive Vice President and General Counsel, NASD, Inc. (June 26, 2006) (providing exemptive relief to allow (i) Nasdaq Global Market securities traded OTC and reported to a NASD facility to be subject to NASD Rule 5100 ("NASD Rule 5100" or "NASD's bid test") rather than Rule 10a-1, and (ii) Nasdaq Capital Market securities traded OTC and reported to a NASD facility to not be subject to either Rule 10a-1 or NASD Rule 5100).

[37] The ADF is a facility operated by NASD on a pilot basis for members that choose to quote or effect trades in Nasdaq securities otherwise than on an exchange. The ADF collects and disseminates quotations and trade reports, and compares trades. See NASD Rule 4100A.

[38] The TRF permits NASD members that internalize customer orders through the Nasdaq Stock Market facility of the NASD to continue to internalize such orders pursuant to NASD rules and to report trades to the TRF of the NASD. The TRF uses Nasdaq's technology, i.e., ACT, to accept OTC trade reports from NASD members in Nasdaq securities. See Exchange Act Release No. 54085 (June 30, 2006), 71 FR 38910 (July 10, 2006).

[39] See NASD Rule 5100.

[40] See letter from James A. Brigagliano, Acting Associate Director, Division of Market Regulation to David C. Whitcomb, Jr., Senior Vice President and Chief Regulatory Officer, the Chicago Stock Exchange, Inc. (July 20, 2006) (providing an exemption from any price test for exchanges trading Nasdaq securities on a UTP basis. Exchanges may, however, adopt a bid test to apply to trading in Nasdaq securities).

In summary, under the current market structure, Nasdaq Global Market securities traded on Nasdaq or the OTC market and reported to a NASD facility are subject to Nasdaq's or NASD's bid tests.[41] Other listed securities traded on an exchange, or otherwise, are subject to Rule 10a-1's tick test. Nasdaq securities traded on exchanges other than Nasdaq are not subject to any price test. In addition, many thinly-traded securities, such as Nasdaq Capital Market securities, and securities quoted on the OTCBB and pink sheets, are not subject to any price test wherever traded.

C. Current Price Test Exemptions

As noted above, the core provisions of Rule 10a-1 have remained essentially unchanged since the rule was adopted in 1938. Over the years, however, in response to changes in trading strategies and systems used in the marketplace, the Commission has added exceptions to Rule 10a-1[42] and granted numerous written requests for relief from the rule's restrictions. These requests for exemptive relief have increased dramatically in recent years in response to significant developments in the securities markets, such as decimalization and the spread of fully automated markets. Among others, the Commission has granted exemptions from Rule 10a-1: (i) for transactions in exchange

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[41] Recently, the Commission approved proposed rule changes by Nasdaq and the NASD to exempt securities comprising the Nasdaq-100 Index from Nasdaq Rule 3350 and NASD Rule 5100, respectively. See Exchange Act Release No. 54435 (September 13, 2006), 71 FR 55042 (September 20, 2006); Exchange Act Release No. 54558 (October 2, 2006), 71 FR 59573 (October 10, 2006).

[42] Paragraph (e) of Rule 10a-1 contains the exceptions to the rule. The exceptions to the tick test are designed to permit certain types of trading activities that are intended to benefit the markets or that are believed to carry little risk of the kind of manipulative or destabilizing trading that Rule 10a-1 was designed to address. See Exchange Act Release No. 48709 (October 28, 2003), 68 FR 62972 (November 6, 2003); 17 CFR 240.10a-1(e). In addition, in considering whether to propose removing the price tests of any exchange or national securities association for all securities, the Commission reviewed the exceptions to the NASD's and Nasdaq's bid tests, such as the bona-fide market maker exception contained in each of those rules. See NASD Rule 5100(c); Nasdaq Rule 3350(c).

traded funds ("ETFs");[43] (ii) to permit registered market makers and exchange specialists publishing two-sided quotes in a security to sell short to facilitate customer market and marketable limit orders at the consolidated best offer, regardless of the last trade price;[44] (iii) for certain transactions executed on a volume-weighted average price ("VWAP") basis;[45] (iv) to electronic trading systems that match and execute trades at independently derived prices during random times within specific time intervals;[46] and (v) to allow broker-dealers to fill customer orders, without the restrictions of the tick test, if: (a) a

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[43] See, e.g., letter from Racquel L. Russell, Esq., Branch Chief, Office of Trading Practices and Processing, Division of Market Regulation to George T. Simon, Esq., Foley & Lardner LLP (June 21, 2006); letter from James A. Brigagliano, Assistant Director, Division of Market Regulation, to Claire P. McGrath, Vice President and Special Counsel, AMEX (August 17, 2001). In granting such exemptions, the Commission noted that its decision was generally based on the fact that the market value of ETF shares would rise and fall based on changes in the net asset value of the component stocks in the particular index, and supply and demand. Each of the approvals for relief is conditioned on the ETF meeting certain enumerated conditions, either specific to certain products or included as part of a broader "class exemption."

[44] See letter from James A. Brigagliano, Assistant Director, Division of Market Regulation to Bernard L. Madoff, Chairman, Bernard L. Madoff Investment Securities LLC (February 9, 2001). This relief is strictly limited to the facilitation of customer market and marketable limit orders and is not available as a means of soliciting customer orders.

[45] See, e.g., letter from Larry E. Bergmann, Senior Associate Director, Division of Market Regulation to Soo Yim, Wilmer, Cutler & Pickering (December 7, 2000); letter from James A. Brigagliano, Assistant Director to Andre E. Owens, Esq., Schiff Hardin & Waite (March 30, 2001); letter from James A. Brigagliano, Assistant Director, Division of Market Regulation to Sam Scott Miller, Esq., Orrick, Herrington & Sutcliffe LLP (May 11, 2001); letter from James A. Brigagliano, Assistant Director, Division of Market Regulation to William W. Uchimoto, Esq., Vie Institutional Services (February 12, 2003); letter from James A. Brigagliano, Assistant Director, Division of Market Regulation to Amy N. Kroll, Esq., Foley & Lardner (March 16, 2004). Among other things, the relief is limited to VWAP transactions that are arranged or "matched" before the market opens at 9:30 a.m. but are not assigned a price until after the close of trading when the VWAP value is calculated. The Commission granted the exemptions based, in part, on the fact that these VWAP short sale transactions appear to pose little risk of facilitating the type of market effects that Rule 10a-1 was designed to prevent. In particular, the pre-opening VWAP short sale transactions do not participate in, or affect, the determination of the VWAP for a particular security. Moreover, the Commission stated that all trades used to calculate the day's VWAP would continue to be subject to Rule 10a-1.

[46] See, e.g., letter from James A. Brigagliano, Acting Associate Director, Division of Market Regulation, to Alan J. Reed, Jr., First Vice President and Director of Compliance, Instinet Group, LLC. (June 15, 2006) (granting Instinet modified exemptive relief from Rule 10a-1 for certain transactions executed through Instinet's Intraday Crossing System). These systems have requested relief from Rule 10a-1 because matches could potentially occur at a price below the last reported sale price. Due to the passive nature of pricing and the lack of price discovery, trades executed through the passive systems generally do not appear to involve the types of abuses that Rule 10a-1 was designed to prevent.

broker-dealer receives a sell order from a customer who is net "long" the securities being sold, and the broker-dealer then seeks to execute that order, either in whole or in part, by selling the security as riskless principal, even if the broker-dealer has an overall net "short" position in such security; or (b) a broker-dealer receives a buy order from a customer, and the broker-dealer then seeks to execute that order, either in whole or in part, by purchasing the security as riskless principal, and then selling the security to the customer, even if the broker-dealer has an overall net "short" position in such security.[47] We have granted these exemptions because we believe that the types of trading activities described in each of the exemptive request letters do not appear to involve the types of abuses that Rule 10a-1 was designed to address.[48] We believe, however, that by granting these exemptions we limit the reach of the price test restrictions contained in Rule 10a-1 and potentially create an unlevel playing field among market participants. Moreover, the fact that an increasing number of market participants have requested these exemptions indicates to us that the current rule may no longer be suited to the wide variety of trading strategies and systems currently used in the marketplace.

D. Pilot Results

The Pilot commenced on May 2, 2005 and is scheduled to terminate no later than August 6, 2007.[49] The purpose of the Pilot was to allow the Commission to study the effectiveness of current price test restrictions and, in particular, to assist the Commission

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[47] See Letter from James A. Brigagliano, Assistant Director, Division of Market Regulation to Ira Hammerman, Senior Vice President and General Counsel, Securities Industry Association (July 18, 2005).

[48] We note, however, that each exemption from Rule 10a-1 was granted subject to conditions for relief designed to ensure that the trading activities contemplated by the requests for relief do not implicate the types of trading activity that Rule 10a-1 was designed to prevent.

[49] See supra n.6 and supporting text.

in determining whether current price test restrictions should be removed or modified, in part or whole, for some or all securities.[50] Consistent with this purpose, the Commission has been able to collect empirical evidence on the effects of relatively unrestricted short selling on market volatility, price efficiency (including manipulation), and liquidity from the OEA Staff's Draft Summary Pilot Report and the Academic Studies. The Commission has also collected information on whether unrestricted short selling affects actively-traded securities differently than thinly-traded securities (according to turnover) or affects large securities differently than small securities (according to market capitalization). In addition, the Commission has collected empirical evidence on the effect of price test restrictions on the level of short selling and options trading, the balance of trade, and the effect of disparate price test restrictions on different market centers trading the same securities. Finally, the Commission has collected information on whether the impact of Rule 10a-1 is different than the impact of former NASD Rule 3350 on short selling activity.

i. OEA Staff's Draft Summary Pilot Report

OEA analyzed the effects of the Pilot on the securities included in the Pilot by comparing short selling activity, volatility, price efficiency, and liquidity in those securities to a control group of securities.[51] In particular, OEA estimated how these

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[50] See Regulation SHO Adopting Release at 48012–48013.

[51] OEA selected the securities to be included in the Pilot by sorting the 2004 Russell 3000, first by listing market and then by average daily dollar volume from June 2003 through May 2004, and then within each listing market, selecting every third company starting with the second. Because the selection process relied on average daily dollar volume, companies that had their Initial Public Offering ("IPO") in May or June 2004, just prior to the Russell reconstitution, were not included. The securities in the control group came from the remainder of the 2004 Russell 3000 not included in the Pilot (excluding the IPOs in May or June 2004 and any securities added to the Russell 3000 after June 2004). See OEA Staff's Draft Summary Pilot Report at 22 (discussing the selection of securities included in the Pilot and the control group).

securities changed from the four months prior to the Pilot to the first six months of the Pilot and compared the Pilot securities' changes to the control group securities' changes.[52] OEA's analysis was conducted separately for listed securities and Nasdaq Global Market securities. OEA's main empirical results are discussed below.

Because price test restrictions are meant to keep short sales from creating excessive downward price pressure,[53] OEA studied whether price test restrictions dampen volatility. In particular, OEA studied whether price test restrictions dampen short-term intraday volatility associated with temporary order imbalances or daily volatility associated with price changes. OEA found that price test restrictions did not have a significant impact on daily volatility for either listed or Nasdaq Global Market securities, while price test restrictions appear to dampen intraday volatility, particularly in listed securities.[54]

OEA analyzed the Pilot data to determine what impact, if any, price test restrictions have on price efficiency. OEA found that the Pilot data provided limited evidence that price test restrictions distort a security's price.[55] In addition, the Pilot data did not provide any indication that there is an association between manipulative short selling, such as "bear raids," and price test restrictions on short selling.[56]

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[52] Table 2 of the OEA Staff's Draft Summary Pilot Report shows that the Pilot stocks were statistically similar to the control group securities during the four months prior to the Pilot. See id. at 61.

[53] See, e.g., supra n.3 and supporting text (providing that a primary reason that the Commission adopted Rule 10a-1 in 1938 was to restrict short selling in a declining market).

[54] See infra n.61-63 and supporting text.

[55] On the day the Pilot went into effect, listed Pilot securities underperformed listed control group securities by approximately 24 basis points. The Pilot and control group securities, however, had similar returns over the first six months of the Pilot. See OEA Staff's Draft Summary Pilot Report at 8.

[56] See id. at 48, 56.

Price test restrictions could inhibit the free movement of a security's price, and thereby, make markets less liquid. Price test restrictions could also induce more liquidity by forcing short sellers to engage in more passive trading strategies. To test these potential effects, OEA analyzed whether price test restrictions have an impact on liquidity by comparing quoted and effective spreads and quoted bid and ask depth for those securities contained in the Pilot and the control group. OEA found that price test restrictions resulted in an increase in quote depths. Liquidity levels, however, were unaffected by the removal of price test restrictions.[57]

An important element of the Pilot was to determine whether price test restrictions affect securities of varying size and trading volume differently. For the most part, OEA found that current price test restrictions affect securities to the same extent regardless of size or trading volume.[58] For example, OEA found that regardless of a security's size or trading volume, price test restrictions discouraged short selling.[59] In addition, OEA found that price test restrictions did not distort a security's price or affect its liquidity in a way that was related to the size of, or trading volume in, the security.[60] OEA did find, however, that a security's size or volume mattered with respect to routing decisions and volatility. For example, OEA found that for Nasdaq Global Market securities, in the

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[57] This conclusion is based on the result that changes in effective spreads were not economically significant (less than a basis point) and that the changes in the bid and ask depth appear not to affect the transaction costs paid by investors. Arguably, the changes in bid and ask depth appeared to affect the intraday volatility. However, OEA concludes that overall, the Pilot data does not suggest a deleterious impact on market quality or liquidity. See id. at 42, 56.

[58] See id. at Section IV.E.

[59] See id. at 52.

[60] See id. at 52-53. The report finds that former NASD Rule 3350 seems to generate statistically lower effective spreads for large or more active Nasdaq Global Market securities. However, the difference does not appear to be economically meaningful.

absence of a price test, there was a more significant increase in Nasdaq's market share of short sales than in smaller Nasdaq Global Market securities.[61] Similarly, OEA found that price test restrictions dampen both transitory and permanent price volatility in smaller securities while amplifying it in larger securities.[62] With respect to intraday volatility, OEA found that there was an increase in volatility in smaller securities and a decline in volatility in larger securities in the absence of price tests. This evidence was much weaker for Nasdaq Global Market securities than listed securities.[63]

When reviewing the results of the Pilot, OEA analyzed whether price test restrictions represent an economically meaningful constraint on short selling and, thereby, may induce some traders to avoid short selling or reduce the size of their short positions. OEA found that for both listed and Nasdaq Global Market securities, price test restrictions reduce the volume of executed short sales relative to total volume, indicating that price test restrictions act as a constraint on short selling.[64] In neither market, however, did OEA find a significant difference in short interest positions.[65]

Because not all market centers that trade Nasdaq Global Market securities apply price test restrictions, OEA analyzed whether removing price test restrictions affects where short sales in Nasdaq Global Market securities are executed. OEA found that

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[61] See id. at 52.

[62] See id. at 53.

[63] See id. at 43, 53.

[64] See id. at 35.

[65] See id.

Nasdaq's share of short selling volume is negatively impacted by price test restrictions, suggesting that some short sellers route orders to avoid the application of a price test.[66]

In addition, OEA tested whether broker-dealers use the options markets to avoid application of a price test. OEA found no evidence, however, that price test restrictions on equity securities have any impact on options trading.[67]

OEA found that price test restrictions affect the ability of short sellers to demand liquidity by getting prompt execution of market orders. For listed Pilot securities, OEA found that the application of the tick test of Rule 10a-1 resulted in significantly fewer than 50% of transactions occurring on minus ticks or zero-minus ticks. In the absence of a tick test, OEA found that tick-to-tick changes in price were more balanced.[68] For Nasdaq Global Market securities, OEA found that the percentage of time the market was in a down bid state declined when the bid test was removed, suggesting that down bids occur more regularly when the bid test applies.[69] This result suggests that short selling under former NASD Rule 3350 might shorten the duration of upbids, reflecting the restriction that short sales can only hit upbids. Removing former NASD Rule 3350 resulted in longer lasting upbids.

In summary, OEA found little empirical justification for maintaining price test restrictions, especially for large securities. Despite changes in the displayed liquidity, all securities in the study had about the same realized liquidity and pricing efficiency whether or not price test restrictions apply. When OEA examined the differences

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[66] See id. at 36.

[67] See id. at 37.

[68] See id. at 39.

[69] See id.

between large and small securities, the most interesting pattern showed that price test restrictions actually amplify volatility in large securities while dampening it in small securities. While the majority of results do not suggest that removing price test restrictions would harm small securities, this volatility result is a potential concern.[70]

ii. Academic Studies and Regulation SHO Roundtable

To better inform the Commission regarding the effects of the Pilot and, in turn, of price test restrictions, we encouraged researchers to provide the Commission with their own empirical analyses of the Pilot. In response to this request, the Commission received the Academic Studies.[71] In addition, the Commission held the Regulation SHO Roundtable that focused on the empirical evidence learned from the Pilot.[72] The Academic Studies and Regulation SHO Roundtable contained a variety of observations, which we considered in determining whether or not to propose removal of price test restrictions.

Generally, the Academic Studies and Regulation SHO Roundtable panelists, who were all economists, urged removal of short sale price test restrictions; although they also noted some market quality benefits of these restrictions. The results of the Academic Studies on volatility and price efficiency were largely consistent with the results in the OEA Staff's Draft Summary Pilot Report. However, the conclusions regarding liquidity

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[70] But, c.f., n.80 and supporting text (noting that one Academic Study did not document that volatility was affected by the size of the security).

[71] See supra n.12. The Commission notes that although these Academic Studies examined the Pilot data, the Academic Studies vary with respect to the time periods and the composition of the sample securities examined and the methodologies used. Thus, the Commission realizes that differences in findings among the Academic Studies may be due, in part, to the different approaches used for each of the Academic Studies.

[72] See supra n.13 (providing a url link to the transcript of the Regulation SHO Roundtable).

differed. For example, some of the Academic Studies found that price test restrictions result in narrower spreads than if these restrictions did not apply.[73] Similarly, some Academic Studies found that bid and ask depths are greater when short sale price test restrictions apply.[74] Thus, according to some of the Academic Studies the Commission received, the Pilot results indicate that removal of price test restrictions may result in a decrease in liquidity.[75] Several panelists at the Regulation SHO Roundtable questioned whether this result, that is, the decrease in liquidity after the removal of price test restrictions, is economically meaningful.[76]

In addition, we note that only one Academic Study examined whether Rule 10a-1 has a different impact on small securities than on large securities and found that the significance of the impact of the removal of Rule 10a-1 at times depended on the size

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[73] See, e.g., Wu at 5, 18. As an explanation for this finding, Wu notes that price test restrictions require short sellers to act as liquidity suppliers because price test restrictions might require short sellers to place more limit orders on the ask side. Wu notes that in the absence of price test restrictions, short sellers demand liquidity by being able to place market orders without restrictions. See id.; see also, Alexander and Peterson at 19; Diether, Lee and Werner at 19-23. Although Diether, Lee and Werner find that spreads widen when price test restrictions do not apply for NYSE-listed securities, this study also states that they do not interpret wider spreads as evidence that price tests are effective. See id. at 6, 31.

[74] See, e.g., Alexander and Peterson at 19-20 (finding smaller bid and ask depths for NYSE-listed securities included in the Pilot). Alexander and Peterson suggest that bid depth declines because short sale market orders can execute immediately, and when they do, depth at the bid is reduced. As an explanation for the decline in ask depth, Alexander and Peterson suggest that in the absence of short sale price test restrictions, market orders no longer turn into limit orders and, therefore, contribute to the ask depth. See id.; see also Diether, Lee and Werner at 20. Diether, Lee and Werner note that the suspension of price tests result in wider spreads because price tests ". . . distort how people trade. Specifically, NYSE short sale orders are treated as liquidity supplying orders so as to comply with the Uptick Rule. As a result, short sellers forgo the option-value of their order flow. Moreover, their opportunities to trade in a timely manner are curtailed. The fact that short-sellers are unable to use marketable orders increases the costs of trading for buyers relying on passive pricing strategies (limit orders). In addition, short-sellers effectively "penny" long-sellers using limit orders. Thus, the regulation causes redistribution of welfare away from short-sellers and passive buyers and (long) sellers in favor of active buyers." Id. at 31.

[75] See, e.g., Alexander and Peterson at 2, 20 (providing that the studies' results appear to indicate a decrease in liquidity associated with the removal of price tests). Alexander and Peterson note, however, that "while it is tempting to conclude that price tests improve liquidity, it is more appropriate to view them as distorting liquidity." Id. at 27.

[76] See Roundtable Transcript at 50, 93, 99, 114, 151.

(that is, market capitalization) of the securities examined.[77] While the results of this Academic Study suggest that Rule 10a-1 can have a larger impact on small securities, the specific results are not consistent with the results described in the OEA Staff's Draft Summary Pilot Report described above. For example, although OEA found the effect of Rule 10a-1 on short selling volume did not depend on size, this Academic Study found that removal of Rule 10a-1 resulted in a significant increase in short selling volume only in smaller securities.[78] Similarly, with respect to the widening of spreads following the removal of Rule 10a-1, this Academic Study found that the widening of spreads was more pronounced for smaller rather than larger securities, while OEA documents no relationship between size and spreads in the OEA Staff's Draft Summary Pilot Report.[79] Finally, unlike the OEA Staff's Draft Summary Pilot Report, this Academic Study did not document that volatility was affected by the size of the security.[80] Overall, when considering the results in this Academic Study and the OEA Staff's Draft Summary Pilot Report, the evidence regarding the application of price test restrictions to small securities is inconsistent. While there is some evidence supporting the application of price test restrictions to smaller securities, the evidence is not strong enough to warrant its continuation in any subset of securities or the expansion of price test restrictions to securities currently not covered by any price test restrictions.

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[77] See Wu.

[78] See id. at 4, 14 (finding that the increase in short selling volume occurred only in smaller NYSE-listed securities. Wu found that larger NYSE-listed securities did not experience a significant change in short selling volume).

[79] See id. at 5, 19 (finding that smaller NYSE-listed securities experience the most pronounced widening of spreads, while larger NYSE-listed securities saw no changes in spreads. Wu noted that an explanation for this result might be that small securities are harder to sell short and are more sensitive to liquidity shocks).

[80] See id. at 16, 20.

Consistent with the results in the OEA Staff's Draft Summary Pilot Report, we note that some Academic Studies found that the significance of the impact of the removal of price test restrictions at times depended on which price test restrictions applied.[81] In particular, the magnitude of the changes from removing Rule 10a-1 are larger than the changes from removing former NASD Rule 3350, suggesting that Rule 10a-1 is more restrictive.

Two of the Academic Studies commented on whether the original rationale for adopting Rule 10a-1 in 1938 still applies in today's market. For example, one Academic Study noted that it found "little evidence to support the argument that price tests are needed to prevent short sellers from driving prices down from either shorting 'successively lower prices' or 'exhausting all remaining bids at one price level, causing successively lower prices.'"[82] Another Academic Study noted that there is no empirical support for the rationale underlying the adoption of the tick test that unfettered short selling would produce significant volatility.[83] In addition, nine of the twelve panelists in the Regulation SHO Roundtable explicitly supported removing price test restrictions,[84] though a few of the nine noted a lack of evidence for removing price test restrictions from

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[81] See e.g., Alexander and Peterson at 3 (stating that Nasdaq's bid test seems to be relatively inconsequential); see also, Diether, Lee and Werner at 30 (stating that this Academic Study's results show that the "NYSE Uptick Rule has a very different effect on the trading strategies of short-sellers compared to the Nasdaq bid-price rule").

[82] See Alexander and Peterson at 18.

[83] See Diether, Lee and Werner at 23.

[84] Prof. Werner, Prof. Irvine, Prof. Alexander, Prof. Harris, Prof. Kyle, Prof. Lamont, Prof. Lehmann, Dr. Lindsey and Dr. Sofianos. See Roundtable Transcript at ,48, 49, 72, 97, 100, 104, 111, 113, 119. The remaining panelists did not explicitly state an opinion regarding removing price test restrictions.

small securities.[85] The Commission considered these opinions in deciding whether to propose removing price test restrictions for all securities.

III. Discussion of Proposed Amendments

A. Removal of Price Test Restrictions

We are proposing to remove the tick test of Rule 10a-1[86] and add Rule 201 of Regulation SHO[87] to provide that no price test, including any price test of any SRO, shall apply to short sales in any security. In addition, we are proposing to prohibit any SRO from having a price test.

Price test restrictions have applied to short sales for almost 70 years. Current short sale regulation is disparate, however, with different price tests applying depending on the type of security being sold and where the short sale order is executed. Rule 10a-1's tick test applies only to short sale transactions in securities listed on a national securities exchange, other than Nasdaq securities, whether the transaction is effected on an exchange or otherwise. The NASD's bid test applies only to short sale transactions in Nasdaq Global Market securities reported to a NASD facility. Nasdaq's bid test applies only to trades in Nasdaq Global Market securities on Nasdaq. In addition, no price test applies to short sales of Nasdaq securities executed on other exchanges trading Nasdaq securities. This disparate regulation has the potential for confusion and compliance difficulties. In addition, we are concerned that this current market structure could competitively disadvantage investors because short sale orders obtain different treatment depending on where the orders are executed.

[85] Dr. Sofianos and Dr. Lindsey. See Roundtable Transcript at 117, 119, 123.

[86] 17 CFR 240.10a-1.

[87] Id. at 242.201.

We also note that small or more thinly-traded securities, such as Nasdaq Capital Market securities and those quoted on the OTCBB and pink sheets continue to be unrestricted by any price test, while large or more actively-traded securities remain subject to a price test. Continuing to impose a price test on only larger securities or those that are more actively-traded would be anomalous, given the greater difficulty of manipulating the price of a security as market capitalization and trading volume increase.[88]

Moreover, we believe that the increasing number of requests for relief from the provisions of Rule 10a-1 that the Commission has granted in recent years for a wide range of short selling activities have limited the applicability of the rule's price restrictions, potentially created an unlevel playing field among market participants and has indicated to us that current price test restrictions have not kept pace with the wide variety of trading strategies and systems currently used in the marketplace. Rule 10a-1 was adopted in 1938 and its restrictions on short selling have remained essentially unchanged since that time. Thus, we believe that this is an appropriate time to propose amendments that would provide for a more consistent and simpler approach to short sale regulation.[89]

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[88] See Exchange Act Release No. 42037 (October 20, 1999), 64 FR 57996 (October 28, 1999) (noting that some of the Commission's anti-manipulation rules assume that highly liquid securities are less susceptible to manipulation and abuse than other securities).

[89] We note that in 2003, in the Regulation SHO proposing release, we proposed a price test that, if adopted, would have required that all short sales in covered securities be effected at a price at least one cent above the consolidated best bid at the time of execution. Additionally, the Commission sought comment on an alternative price test that would allow short selling at a price equal to or above the consolidated best bid if the current best bid was above the previous bid (i.e. an upbid). Under this alternative, short selling would be restricted to a price at least one cent above the consolidated best bid if the current best bid was below the previous bid (i.e. a downbid). See Exchange Act Release No. 48709 (October 28, 2003), 68 FR 62972 (November 6, 2003) (the "Regulation SHO Proposing Release"). Based on the comments received to that proposal, however, the Commission determined to defer consideration of the proposed uniform bid test until after completion of the Pilot. See Regulation SHO Adopting Release at 48010. Although a uniform

In addition, based on the Pilot Results, we believe that removal of current price test restrictions would not have a significant impact on market quality. The Pilot Results found little evidence suggesting that the removal of the price test restrictions would harm market volatility, price efficiency, or liquidity. In fact, the empirical results indicate that the observed effect of a price test may have a larger negative than positive impact on markets. For example, the OEA Staff's Draft Summary Pilot Report suggests that price test restrictions result in decreased short selling volume.[90] Short selling provides the marketplace with important benefits such as liquidity and price efficiency. The OEA Staff's Draft Summary Pilot Report indicates that price test restrictions may limit these benefits. In addition, the OEA Staff's Draft Summary Pilot Report suggests that price test restrictions result in market participants routing orders to avoid application of price test restrictions,[91] resulting in a loss of trading volume for market centers that have a price test. Other market centers may use the absence of a price test to their advantage to attract order flow away from market centers that have a price test. Thus, current price test regulation may competitively disadvantage certain investors because their short sale orders may or may not be subject to price test restrictions depending on which market center the order is executed.

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bid test similar to that proposed in the Regulation SHO Proposing Release would also result in consistent price test regulation, based on our review of the applicability of current price test restrictions, in particular, the need for such price test restrictions in light of today's market structure and the Pilot Results, we do not believe that any price test restrictions are currently necessary.

[90] See OEA Staff's Draft Summary Pilot Report at 35.

[91] See id. at 36.

As noted above, a primary reason that the Commission adopted Rule 10a-1 in 1938 was to restrict short selling in a declining market.[92] Although there is concern regarding the possibility of manipulation using short sales, we note that the OEA Staff's Draft Summary Pilot Report did not evidence an increase in manipulative short selling during the time period studied.[93] In addition, we believe that the high levels of transparency and sophisticated surveillance for securities traded on exchanges and other regulated markets would allow manipulative or abusive short selling activity to be detected and pursued in the absence of price test restrictions. Moreover, the general anti-fraud and anti-manipulation provisions of the federal securities laws would continue to prohibit trading activity designed to improperly influence the price of a security.[94]

In addition, after a review of the Pilot Results, we believe that the empirical analyses not only provide support for removing price test restrictions for either large or actively-traded securities, but also do not provide strong support for extending a price test to either small or thinly-traded securities. For example, the OEA Staff's Draft Summary Pilot Report discusses whether the removal of price test restrictions affects thinly- and actively-traded securities (according to turnover) differently.[95] Generally, the results indicate that neither Rule 10a-1 nor former NASD Rule 3350 affects thinly-traded stocks differently than actively-traded stocks.

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[92] See supra n.3.

[93] See OEA Staff's Draft Summary Pilot Report at 47-51 (discussing the Pilot data in connection with "bear raids"). We note that the OEA Staff's Draft Summary Pilot Report did not evaluate the impact of short selling activity in connection with extraordinary events, such as initial or secondary public offerings, mergers and acquisitions or private placements.

[94] See supra n.16.

[95] See OEA Staff's Draft Summary Pilot Report Section VI.E. at 51-54 and Wu at 4-5,19-20.

The OEA Staff's Draft Summary Pilot Report and one Academic Study also discuss whether the removal of price test restrictions affect small and large stocks differently (according to market capitalization). These studies provide inconsistent results regarding whether Rule 10a-1 has a larger impact on the liquidity and volatility of smaller rather than larger securities. In addition, several Regulation SHO Roundtable panelists asserted that price test restrictions are unnecessary in smaller stocks because these stocks are harder to borrow and, therefore, are less likely to be sold short.[96]

Overall, because the results suggest that price test restrictions affect thinly-traded securities no differently than actively-traded securities and the results are inconsistent regarding the effects of price test restrictions on large and small stocks, we believe the current evidence is not strong enough to warrant a proposal to continue imposing price test restrictions on only a subset of either small or thinly-traded securities, or to extend price test restrictions to securities currently not subject to any price test restrictions. We request comment, however, regarding whether or not price test restrictions should apply to securities not currently covered by any price test restrictions.

We also note that current price test restrictions impose costs on market participants in terms of time and technology. For example, to comply with the tick test of Rule 10a-1, short sellers may incur additional transactional costs as they await a proper tick for execution. Moreover, in some cases, the tick test of Rule 10a-1 can create potential conflicts with best execution responsibilities (although the Commission has provided relief to minimize these instances).[97]

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[96] See Roundtable Transcript at 122-130.

[97] For example, as previously described by the Commission, "in order to resolve a potential conflict between the tick test and the quote rule, the Commission adopted (e)(5)(ii) to permit market makers to

In addition, we are aware that in a decimals environment, with penny or even sub-penny price points and narrow spreads, a short seller can await or create an uptick with minimal burden. On the other hand, in a decimals environment, the tick test of Rule 10a-1 may be triggered by a change in price that reflects an extremely small decrease in the price of the security. We do not believe that a price change as small as one penny per share results in the type of market impact that Rule 10a-1 was designed to prevent. Rather, we believe that current price test restrictions may have become unduly burdensome and are possibly ill-suited to present and future markets.

Thus, for all these reasons, we believe that this is an appropriate time to modernize and simplify price test regulation by proposing to remove Rule 10a-1's tick test and add Rule 201(a) of Regulation SHO to provide that no price test, including any price test of any SRO, shall apply to short sales in any securities.

In addition, we are proposing to add Rule 201(b) of Regulation SHO that would provide that no SRO shall have a price test. A primary goal of the proposed amendments is to achieve greater regulatory consistency and simplification. To date, we have permitted SROs to adopt their own price tests. As noted above, this has resulted in a regulatory environment that applies different tests to securities trading in different markets, and even to the same security trading in different markets. We believe that by

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execute transactions at their offer following a trade-through, and (e)(11) to permit non-market makers to effect a short sale at a price equal to the price associated with their most recently communicated offer up to the size of that offer so long as the offer was at a price, when communicated, that was permissible under Rule 10a-1. The (e)(11) exception was added in response to several comments that, in addition to orders for their own account, specialists and other floor members also often represent as part of their displayed quotations orders of other market participants (*e.g.*, public agency orders or proprietary orders of non-market makers) that also might be ineligible for execution under Rule 10a-1 following a trade-through in another market." Exchange Act Release No. 48709 (October 28, 2003), 68 FR 62972, 62986 (November 6, 2003).

proposing to require that no SRO shall have its own price test, the goals of regulatory simplification and consistency would be better met.

We are aware, however, that some SROs may want to maintain or adopt a new price test. For example, we are aware that previously, SROs have adopted price tests to attract issuers concerned about the potential effects of short selling on the issuer's stock price. Thus, we solicit comment regarding whether we should allow SROs to have their own price tests.

Regardless of whether or not we adopt the proposed amendments, however, the Commission and the SROs will continue to monitor for, and pursue, abusive trading activities. In addition, as already noted, the general anti-fraud and anti-manipulation provisions of the federal securities laws will continue to prohibit trading activity that improperly influences the price of a security.[98]

Request for Comment

The Commission seeks comment generally on all aspects of the proposed amendments to Rule 10a-1 and Regulation SHO. In addition, we seek comment on the following:

- The proposed amendments state that no "short sale price test" shall apply to short sales in any security. Should we define the term "short sale price test" for purposes of these amendments?
- Some SROs have adopted price tests to attract issuers concerned about the potential effects of short selling on the issuer's stock price. The proposed amendments would prohibit any SRO from having its own price test. If the

[98] In addition, as noted previously, this proposal would not amend any short selling regulations other than those related to price tests. See supra n.15.

Commission removes Rule 10a-1, should the Commission continue to allow the SROs to adopt their own price tests? Should the Commission require uniformity with respect to any SRO price tests? Should any such SRO price tests be limited to certain securities? What would be the costs and benefits of allowing the SROs to adopt their own price tests?

- We request comment from issuers regarding their views of the impact of the proposed amendments on their securities. Are issuers concerned that unrestricted short selling could result in undue downward price pressure on their company's stock? Are issuers concerned that the proposed amendments could result in manipulative short selling of their company's stock? Alternatively, would these concerns be mitigated because the general anti-fraud and anti-manipulation provisions of the federal securities laws would continue to prohibit trading activity designed to improperly influence the price of a security? Please submit any available empirical evidence of manipulation of pilot stocks.
- To what extent does the tick test of Rule 10a-1 impose market costs on traders desiring to sell short? For example, if the removal of price test restrictions were to result in wider spreads, could this result in higher transaction costs for all traders? What would be the impact on investors? Would the removal of the price test restrictions result in shifting higher trading costs from short sellers to other traders? To what extent would such costs justify any benefits of removing price test restrictions?
- Would the removal of price tests benefit the markets by allowing investors to more freely short sell potentially over-valued securities so that the security's price

more accurately reflects its fundamental value? Would the removal of price tests lead to benefits such as a reduction in costs associated with systems and surveillance costs? What would be the costs to the markets of removing price tests? Please provide any quantified evidence available.

- To what extent does the tick test of Rule 10a-1 affect the ability to sell short in a decimals environment? Please explain any difficulties of complying with the tick test or any other price test in a decimals environment. In light of all the exemptions from, and exceptions to, Rule 10a-1, how significant a test is it? On what types of trading activities does Rule 10a-1 have a significant or meaningful impact? Similarly, in light of the exceptions to NASD Rule 5100 and Nasdaq Rule 3350, how significant are these tests? On what types of trading activities do NASD Rule 5100 and Nasdaq Rule 3350 have a significant or meaningful impact? Please explain.
- To what extent, if any, is retention of price test restrictions valuable for investor confidence to commit capital to the markets?
- Is the tick test in Rule 10a-1 appropriate for some securities but not all securities? If the Commission were to maintain a price test for some securities, which types of securities should be subject to a price test?
- We note that in 2003, in the Regulation SHO Proposing Release, we proposed adopting a price test using the consolidated best bid as a reference point for permissible short sales.[99] Should the Commission adopt a new price test, such as a uniform bid test, that would replace all current price tests, including those of any

[99] See supra n.89.

exchange or national securities association? If so, should the new price test apply to all securities, including those not currently subject to a price test? What should be the requirements of any new price test?

- If the Commission were to maintain the tick test contained in Rule 10a-1, should the Commission amend the tick test to apply to all markets or securities equally?
- If the Commission were to maintain the tick test contained in Rule 10a-1, which, if any, of the exceptions contained in paragraph (e) of Rule 10a-1 should the Commission retain? Please explain. Should the Commission include exceptions not currently in Rule 10a-1? What should those exceptions address?
- If the Commission were to retain the tick test contained in Rule 10a-1, should the Commission codify all the exemptions the Commission has previously granted from this rule? If not all the exemptions, which exemptions should the Commission codify?
- NASD Rule 5100 and Nasdaq Rule 3350 contain exceptions for bona-fide market making. If the Commission were to retain the tick test contained in Rule 10a-1 or adopt a new price test, should such price test include an exception for bona-fide market making? If the Commission were to continue to allow for a market maker exception in NASD Rule 5100 or Nasdaq Rule 3350 or adopt a price test that contains a market maker exception, should the Commission limit the applicability of the exception? How should it be limited? What would be the purpose of such limitations?

- We request specific comment regarding the importance of retaining a market maker exception, for example, with respect to liquidity, price efficiency, market depth, speed of execution and flexibility for capital commitment.
- Should the Commission retain a price test for times during which there are unusual market declines? If so, please discuss what type of price test should be retained and under what types of circumstances such a price test should be applied?
- To what extent, if at all, would removal of price test restrictions impact the ability of short sellers to be liquidity providers versus liquidity demanders?
- If the Commission were to maintain the current tick test of Rule 10a-1 or adopt a new price test, should the price test apply only during regular market hours or should the price test apply regardless of when trades occur? What are the benefits and costs of applying price tests in the after-hours market?
- To what extent does real-time access to information regarding issuers, their respective industries and other influences on a security's price reduce the ability to manipulate prices in declining markets through short selling?
- To what extent is a price test an impediment to trading in a down market? Is it preferable to allow unimpeded short selling in a down market? Are there circumstances where such trading should not be permitted?
- Would removal of all price test restrictions result in the markets being truly representative of what is a fair price for an individual security?
- Are there any technical or operational challenges that would arise in complying with the proposal if the Commission were to adopt the proposal?

- How much would the proposed amendments affect specific compliance costs or other costs for small, medium and large entities (brokers, dealers, and SROs)?
- Would the proposed amendments create additional costs for, or otherwise impact, short sellers, issuers, investors, or others?
- Should we provide a compliance date, separate from an effective date, if the Commission were to adopt the proposed amendments? If yes, please explain why a compliance date would be appropriate and give suggestions as to how long a compliance period would be needed.
- Nine reporting markets have been making public information on short selling transactions.[100] This information was vital to the study of the Pilot. Would it be in the public interest to request that the markets continue to release this information? In particular, would it improve transparency of short selling? Would it help the Commission and the markets monitor for potential abuses if the Commission were to approve the removal of price tests? How costly would continuing to produce the data be? Are there any less costly alternatives to the current information being released by the markets?
- If the Commission were to adopt the proposed amendments, the Commission and the SROs would continue to monitor for manipulative activity. Should the Commission ask the SROs to submit periodic reports regarding the effects of the removal of price tests at regular intervals, for example, on a semi-annual or annual basis? What would be the costs associated with such reporting?

[100] See supra n.11.

- Is the data from the Pilot sufficient for the purposes for which the Commission is using it? Is the data reliable? Are there any limitations in the Pilot Results that call the results and conclusions into question?
- The Pilot created a temporary rule amendment that affected a subset of securities trading in the market. To what extent would a permanent rule amendment applied to all stocks affect the market differently than the Pilot?

B. Removal of "Short Exempt" Marking Requirement

We are proposing to amend Rule 200(g) of Regulation SHO[101] to remove the requirement that a broker-dealer mark a sell order of an equity security as "short exempt" if the seller is relying on an exception from the tick test of Rule 10a-1, or any price test of any exchange or national securities association.

Rule 200(g) of Regulation SHO provides that a broker-dealer must mark all sell orders of any security as "long," "short," or "short exempt."[102] Further, Rule 200(g)(2) of Regulation SHO provides that a short sale order must be marked "short exempt" if the seller is "relying on an exception from the tick test of 17 CFR 240.10a-1, or any short sale price test of any exchange or national securities association."[103] The "short exempt" marking requirement provides a record that short sellers are availing themselves of the various exceptions to, or exemptions from, the application of the restrictions of Rule 10a-1 or of any price test of any exchange or national securities association. However, if the Commission were to adopt the proposals to remove all price test restrictions, as well as

[101] 17 CFR 242.200(g).

[102] See id.

[103] See id. at 242.200(g)(2).

prohibit any price test by any SRO, the "short exempt" marking requirement would no longer be applicable. Thus, we are proposing to remove this marking requirement. Broker-dealers would, however, continue to be required to mark sell orders as either "long" or "short" in compliance with Rule 200(g).[104]

Request for Comment

- If the Commission were to adopt the proposal to remove the "short exempt" marking requirement of Rule 200(g) of Regulation SHO, would it be sufficient to require broker-dealers to mark all sell orders of any equity security as either "long" or "short"? Under what circumstances, if any, would broker-dealers need to mark sell orders other than as "short" or "long"?
- To facilitate the application of Rule 10a-1, NASD Rule 5100, and Nasdaq Rule 3350, market makers and specialists receive information allowing them to distinguish short sales from other sales. In other words, the information on whether an order is marked "long," "short," or "short exempt" is made transparent to market makers and specialists but not to other market participants or the public. In the absence of price test restrictions, would the marking of sell orders need to be transparent to market makers and specialists? Would there be any systems or market quality costs/benefits associated with not revealing this information to specialists and market makers?
- Would there be any costs or burdens associated with removing the "short exempt" marking requirement of Rule 200(g) of Regulation SHO? If so, please explain.

[104] See id. at 242.200(g).

IV. General Request for Comment

The Commission seeks comment generally on all aspects of the proposed amendments to Rule 10a-1 and Regulation SHO. Commenters are requested to provide empirical data to support their views and arguments related to the proposals herein. In addition to the questions posed above, commenters are welcome to offer their views on any other matter raised by the proposed amendments to Rule 10a-1 and Regulation SHO. With respect to any comments, we note that they are of the greatest assistance to our rulemaking initiative if accompanied by supporting data and analysis of the issues addressed in those comments and by alternatives to our proposals where appropriate.

V. Paperwork Reduction Act

The proposed amendments to Regulation SHO would impose a "collection of information" within the meaning of the Paperwork Reduction Act of 1995;[105] however, the collection of information is covered by the approved collection for Exchange Act Rule 19b-4.[106] Proposed Rule 201(a) of Regulation SHO provides that no price test, including any price test of any SRO, shall apply to short sales in any security. In addition, proposed Rule 201(b) of Regulation SHO would prohibit any SRO from having a price test. Thus, to the extent that any SRO currently has a price test, that SRO would be required to amend its rules to comply with these proposed amendments to Regulation SHO. Any such amendments would need to be filed with the Commission as proposed rule changes, pursuant to Section 19(b) of the Exchange Act[107] and Rule 19b-4 thereunder. This collection of information, however, would be collected pursuant to

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[105] 44 U.S.C. 3501 et seq.

[106] 17 CFR 240.19b-4.

[107] 15 U.S.C. 78s(b).

Exchange Act Rule 19b-4 and, therefore, would not be a new collection of information for purposes of the proposed amendments.

VI. Consideration of Costs and Benefits of Proposed Amendments to Rule 10a-1 and Regulation SHO

The Commission is considering the costs and benefits of the proposed amendments to Rule 10a-1 and Regulation SHO. The Commission is sensitive to these costs and benefits, and encourages commenters to discuss any additional costs or benefits beyond those discussed here. In particular, the Commission requests comment from all market participants regarding the costs and benefits of unrestricted short selling activity. The Commission also requests comment regarding the costs associated with complying with the proposed amendments, if the Commission were to adopt the proposed amendments. Specifically, we seek comment regarding any costs relating to the removal of price test restrictions adopted by the SROs. In addition, the Commission requests comment on the potential costs for any modification to both computer systems and surveillance mechanisms and for information gathering, management, and recordkeeping systems or procedures, as well as any potential benefits resulting from the proposals for registrants, issuers, investors, brokers or dealers, other securities industry professionals, regulators, and other market participants. Commenters should provide analysis and data to support their views on the costs and benefits associated with the proposed amendments to Rule 10a-1 and Regulation SHO.

A. Removal of Price Test Restrictions

1. Benefits

The proposed amendments would remove the tick test of Rule 10a-1 and provide that no SRO shall have a price test. We believe that this is an appropriate time to propose removing existing price test restrictions because the current regulation is disparate, potentially creates an unlevel playing, allows for regulatory arbitrage and has not kept pace with the types of trading systems and strategies currently used in the marketplace. In addition, today's markets are characterized by high levels of transparency and regulatory surveillance. These characteristics greatly reduce the risk of undetected manipulation and permit regulators to monitor for the types of activities that Rule 10a-1 and other price tests are designed to prevent.

The Commission believes that removal of all price test restrictions would benefit market participants by providing market participants with the ability to execute short sales in all securities in all market centers without regard to price test restrictions. In addition, market centers would be competing for executions on a level playing field because they would not be affected by the existence or non-existence of price test restrictions.

The Commission believes that removing price test restrictions would be preferable to applying different tests in different markets, which can require market participants to apply different rules to different securities depending on which market the trade is executed. Thus, the proposed amendments would reduce confusion and compliance difficulties for market participants.

We also believe that the proposed amendments would benefit exchanges and other market centers because market participants would no longer be able to select a market on which to execute a short sale based on the applicability of price test restrictions. The proposed amendments would remove a competitive disadvantage purportedly experienced by some market centers because market participants would no longer route orders to avoid application of a market center's price test. Nor would market centers that do not have a price test be able to use that factor to attract order flow away from market centers that have a price test.

In addition, the proposed amendments would result in benefits associated with systems and surveillance mechanisms because these systems and mechanisms would no longer need to be programmed to account for price test restrictions based on last sale and last bid information. We also note that in the absence of price test restrictions, new staff (compliance personnel, broker-dealers, etc.) would no longer need to be trained regarding rules relating to price tests. Over the long run, we believe this would likely lead to decreased training and compliance costs for market participants.

We are aware that the degree of restrictiveness of a price test may affect how well a security's price represents a company's true financial value. We seek comment regarding whether the absence of price test restrictions would result in prices that are a better reflection of a company's true financial value.

In addition, we seek estimates and views regarding the benefits to particular types of market participants as well as any other benefits that may result from the adoption of the proposed amendments. Please provide any specific data.

We also believe that the proposed amendments would lead to a reduction in costs because market participants and their lawyers, both in-house and outside counsel, would no longer need to make either informal (phone calls) or formal (letters) requests for exemptions from Rule 10a-1. We request empirical data to quantify this benefit.

We anticipate that broker-dealers, including specialists and market makers in listed securities, could provide greater liquidity in the marketplace because the absence of price test restrictions would make it easier for market participants to fill orders. In addition, an increase in trading volume resulting from the removal of price test restrictions could result in increased price efficiency because prices may more fully reflect both buy and sell interest.

We solicit comment on any additional benefits that could be realized if the Commission were to adopt the proposed amendments, including both short-term and long-term benefits. We solicit comment regarding other benefits to market efficiency, pricing efficiency, market stability, market integrity, and investor protection.

2. Costs

In order to comply with the Pilot when it became effective on May 2, 2005, market participants needed to modify their systems and surveillance mechanisms to exempt those securities included in the Pilot from all price test restrictions. The Pilot exempts a select group of securities from price test restrictions during regular trading hours. Between the close of the consolidated tape and the open of the consolidated tape on the following day, however, all equity securities are exempted from price test restrictions. Thus, we believe that the infrastructure necessary to comply with the proposed amendments should, for the most part, already be in place. Any additional

changes to the infrastructure should be minimal. In addition, because the proposed amendments would remove all price test restrictions, rather than for example, imposing a modified price test, we believe that further changes to systems and surveillance mechanisms or procedures should be relatively minor. Nor do we believe that market participants would need to incur costs to purchase new systems, or increase staffing based solely on the implementation of the proposed amendments.

In addition, the proposed amendments would remove a restriction on trading activity with which market participants must currently monitor for compliance. Thus, we do not believe that the proposed amendments would impose additional compliance costs. Moreover, we believe that any costs incurred to modify, establish or implement existing or new supervisory and compliance procedures due to the proposed amendments would be minimal because market participants should currently have in place supervisory or compliance procedures to monitor for trading activity that current price test restrictions are designed to prevent.

We seek comment as to how the proposed amendments would affect costs for market participants. We believe that market participants, including broker-dealers and SROs, would incur costs related to systems changes to computer hardware and software, reprogramming costs, or surveillance costs that could be necessary to comply with this proposed rule. We believe that these costs would be on a one-time basis. We solicit comment on these costs as well as whether these costs would be incurred on a one-time or ongoing basis.

We also note that if the Commission were to adopt the proposed amendments, all SROs that have adopted price test restrictions would have to remove such price tests. As

discussed above, the NASD and Nasdaq have their own bid tests that, under the proposed amendments, would no longer be applicable. In addition, some exchanges have adopted short sale rules in conformity with the provisions of the tick test of Rule 10a-1, which also would no longer be applicable if the Commission were to adopt the proposed amendments. We believe the SROs could incur costs associated with the processes to remove such rules, including filing rule changes with the Commission, as well as reprogramming systems designed to enforce these rules. We request comment regarding these costs, including costs relating to preparing and filing any necessary rule changes with the Commission.

Based on the Pilot Results, we believe that removing the tick test of Rule 10a-1 and providing that no price test, including any price test of any SRO, shall apply to short sales in any security, has the potential to increase transaction costs, decrease quoted depth and increase intraday price volatility, particularly in small stocks. The Pilot Results suggest, however, that these changes are small in magnitude and would not significantly increase costs or reduce liquidity.

We seek comment regarding the following specific costs:

- What are the economic costs of removing the tick test of Rule 10a-1 and any price test of any SRO for all securities? How would this affect the liquidity and transaction costs of equity securities? How would this affect the quoted depth and the price volatility of equity securities? Would the effects be more severe for liquid or illiquid securities? Would the effects be more severe for small or large securities?
- Are there any other costs associated with the proposal?

- How much would the removal of price test restrictions affect the compliance costs for small, medium, and large market participants (e.g., personnel or system changes)? We seek comment on the costs of compliance that could arise as a result of these proposed amendments. For instance, to comply with the proposed amendments, would market participants be required to:
    - Purchase new systems or implement changes to existing systems? Would changes to existing systems be significant? What would be the costs associated with acquiring new systems or making changes to existing systems? How much time would be required to fully implement any new or changed systems?
    - Increase staffing and associated overhead costs? Would market participants have to hire more staff? How many, and at what experience and salary level? Could existing staff be retrained? What would be the costs associated with hiring new staff or retraining existing staff? If retraining were required, what other costs could be incurred, e.g., would retrained staff be unable to perform existing duties in order to comply with the proposed amendments? Would other resources need to be re-dedicated to comply with the proposed amendments?
    - Implement, enhance or modify surveillance systems and procedures? Please describe what would be needed, and what costs would be incurred.

- Establish and implement new supervisory or compliance procedures, or modify existing procedures? What would be the costs associated with such changes? Would new compliance or supervisory personnel be needed? What would be the costs of obtaining such staff?

- Are there any other costs that may be incurred to comply with the proposed amendments?

B. Removal of "Short Exempt" Marking Requirement

1. Benefits

The proposed amendment would remove the "short exempt" marking requirement of Rule 200(g) of Regulation SHO.[108] Rule 200(g)(2) of Regulation SHO provides that a short sale order must be marked "short exempt" if the seller is "relying on an exception from the tick test of 17 CFR 240.10a-1, or any short sale price test of any exchange or national securities association."[109] Thus, if the Commission were to adopt the proposed amendments that would remove all price test restrictions, as well as prohibit any SRO from having a price test, the "short exempt" marking requirement would no longer be applicable.

2. Costs

Some market participants, including broker-dealers and SROs, may have to reprogram systems and update supervisory procedures due to the removal of the "short exempt" marking requirement. Sales of securities previously marked "short exempt," however, would continue to be marked either "long" or "short." Thus, we believe that

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[108] 17 CFR 242.200(g).

[109] See id. at 242.200(g)(2).

such costs would be minor. We seek comment, however, on these and any additional costs that could be incurred, as well as specific data to support such costs.

VII. Consideration of Burden on Competition and Promotion of Efficiency, Competition, and Capital Formation

Section 3(f) of the Exchange Act requires the Commission, whenever it engages in rulemaking and whenever it is required to consider or determine if an action is necessary or appropriate in the public interest, to consider whether the action would promote efficiency, competition, and capital formation.[110] In addition, Section 23(a)(2) of the Exchange Act requires the Commission, when making rules under the Exchange Act, to consider the impact such rules would have on competition.[111] Exchange Act Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

The proposed amendments would remove the price test restrictions of Rule 10a-1[112] and provide that no price test, including any price test of any SRO, shall apply to short sales in any security. The proposed amendments would also prohibit any SRO from having a price test. In addition, the proposed amendments would remove the "short exempt" marking requirement of Rule 200(g) of Regulation SHO because this marking requirement applies only if the seller is relying on an exception from the tick test of Rule 10a-1 or any short sale price test of any exchange or national securities association.

[110] 15 U.S.C. 78c(f).

[111] 15 U.S.C. 78w(a)(2).

[112] 17 CFR 242.10a-1.

Current short sale regulation is disparate. For example, Rule 10a-1 applies only to short sale transactions in listed securities. The NASD's and Nasdaq's bid tests apply only to Nasdaq Global Market securities. No price tests apply to short sales in Nasdaq Capital Market securities or securities quoted on the OTCBB or pink sheets. In addition, no price test applies to short sales of Nasdaq Global Market securities executed on exchanges trading Nasdaq securities on a UTP basis, unless the market on which the securities are being traded has adopted its own price test. Moreover, the current exceptions to, and exemptions from, the price tests for a wide range of short selling activities, have limited the applicability of the restrictions contained in these rules. The end result is inconsistent short sale regulation of securities, depending on the market where the securities are trading, and the type of short selling activity. Thus, the proposed amendments are intended to promote regulatory simplification and uniformity by no longer applying any price test restrictions on short selling.

We believe that the proposed amendments would not harm efficiency because the empirical evidence from the Pilot Results shows that the Pilot did not adversely impact price efficiency. Further, market participants would no longer have to apply different price tests to securities trading in different markets. We seek comment on whether the proposed amendments promote price efficiency, including whether the proposals might impact the potential for manipulative short selling.

In addition, we believe that the proposed amendments would not have an adverse impact on capital formation because the empirical evidence from the Pilot Results shows that the price tests have very little impact on overall market quality and, particularly in large securities, may be harmful to overall market quality. We solicit comment on

whether the proposed amendments would promote capital formation, including to what extent the proposed removal of price test restrictions would affect investors' decisions to sell short certain equity securities.

We believe that the proposed amendments would promote competition among exchanges and other market centers because market participants would no longer be able to select a market on which to execute a short sale based on the applicability of price test restrictions. The proposed amendments would remove a purported competitive disadvantage experienced by some market centers because market participants would no longer route orders to avoid application of a market center's price test. Nor would market centers that do not have a price test be able to use that factor to attract order flow away from market centers that have a price test. Moreover, the proposed amendments would level the playing field for all market participants by requiring that no price test shall apply to any short sale in any security in any market.

We solicit comment on whether the proposed amendments would promote competition, including whether market participants' decisions regarding on which market to execute a short sale would be affected by the removal of all price test restrictions.

We request comment on whether the proposed amendments would be expected to promote efficiency, competition, and capital formation.

VIII. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"[113] we must advise the Office of Management and Budget as to

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

whether the proposed regulation constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in:

- An annual effect on the economy of $100 million or more (either in the form of an increase or a decrease);
- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effect on competition, investment or innovation.

If a rule is "major," its effectiveness will generally be delayed for 60 days pending Congressional review. We request comment on the potential impact of the proposed amendments on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

IX. Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis (IRFA), in accordance with the provisions of the Regulatory Flexibility Act (RFA),[114] regarding the proposed amendments to Rule 10a-1 and Regulation SHO, Rules 200 and 201, under the Exchange Act.

A. Reasons for the Proposed Action

Based on the Pilot Results as well as our review of the status of short sale regulation in the context of the current application of Rule 10a-1 and other price tests, including the exceptions to the current rules and grants of relief from Rule 10a-1 by the Commission for a wide range of short selling activities, we are proposing to remove the tick test of Rule 10a-1 and to amend Regulation SHO to provide that no price test, as well as any price test by any SRO, shall apply to short selling in any security. In addition, the

[114] 5 U.S.C. 603.

proposed amendments would prohibit any SRO from having a price test. These amendments are designed to modernize and simplify short sale regulation in light of current short selling systems and strategies used in the marketplace, while providing greater regulatory consistency to short selling. We are also proposing to remove the "short exempt" marking requirement of Regulation SHO because this requirement only applies if a seller is relying on an exception to a price test.

B. Objectives

The proposed amendments are designed to provide consistent regulation for short selling in all securities regardless of when or where such trades occur by removing all price test restrictions. In addition, the proposed amendments are intended to provide greater flexibility in effecting short sales because market participants would no longer be constrained by price test restrictions. Moreover, in light of the number of exemptions the Commission has granted under Rule 10a-1 for a wide range of short selling activities, the proposed amendments are designed to accommodate trading strategies and systems currently utilized in the marketplace that conflict with current price test restrictions. The proposed amendment to the "short exempt" marking requirement of Rule 200(g) of Regulation SHO[115] is necessary because this requirement only applies if a seller is relying on an exception to a price test.

C. Legal Basis

Pursuant to the Exchange Act and, particularly, Sections 2, 3(b), 6, 9(h), 10, 11A, 15, 15A, 17, 19, 23(a) thereof, 15 U.S.C. 78b, 78c, 78f, 78i, 78j, 78k-1, 78o, 78o-3, 78q,

[115] 17 CFR 242.200(g).

78s, 78w(a), the Commission is proposing to remove Rule 10a-1, § 240.10a-1 and to amend Regulation SHO, §§ 242.200 and 242.201.

D. Small Entities Subject to the Rule

The entities covered by the proposed rule would include small broker-dealers, small businesses, and any investor who effects a short sale that qualifies as a small entity. Although it is impossible to quantify every type of small entity that may be able to effect a short sale in a security, Paragraph (c)(1) of Rule 0-10 under the Exchange Act[116] states that the term "small business" or "small organization," when referring to a broker-dealer, means a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to §240.17a-5(d); and is not affiliated with any person (other than a natural person) that is not a small business or small organization. As of 2005, the Commission estimates that there were approximately 910 broker-dealers that qualified as small entities as defined above.[117]

Paragraph (e) of Rule 0-10 under the Exchange Act[118] states that the term "small business" or "small organization," when referring to an exchange, means any exchange that: (1) has been exempted from the reporting requirements of Rule 11Aa3-1 under the Exchange Act; and (2) is not affiliated with any person (other than a natural person) that is not a small business or small organization, as defined by Rule 0-10. No national securities exchanges are small entities because none meets these criteria. There is one

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[116] 17 CFR 240.0-10(c)(1).

[117] These numbers are based on OEA's review of 2005 FOCUS Report filings reflecting registered broker-dealers. This number does not include broker-dealers that are delinquent on FOCUS Report filings.

[118] 17 CFR 240.0-10(e).

national securities association (NASD) that would be subject to these proposed amendments. NASD is not a small entity as defined by 13 CFR 121.201.

Any business, however, regardless of industry, could be subject to the proposed amendments if it effects a short sale. The Commission believes that, except for the broker-dealers discussed above, an estimate of the number of small entities that fall under the proposed rule is not feasible.

E. Reporting, Recordkeeping, and other Compliance Requirements

The proposed amendments may impose some new or additional reporting, recordkeeping, or compliance costs on any affected party, including broker-dealers, that are small entities.

In order to comply with the Pilot when it became effective on May 2, 2005, small entities needed to modify their systems and surveillance mechanisms to exempt those securities included in the Pilot from current price test restrictions. Thus, the systems and surveillance mechanisms required to comply with the proposed amendments should already be in place. We believe that any necessary additional systems and surveillance changes would be small because, due to the Pilot, systems are currently programmed to exempt many securities from price test restrictions prior to the close of the consolidated tape and exempt all securities from price test restrictions between the close of the consolidated tape and the open of the consolidated tape on the following day.

We believe that any reprogramming costs or updating of surveillance mechanisms associated with the removal of the "short exempt" marking requirement should be minimal because sales of securities would continue to be required to be marked either

"long" or "short." The proposed amendments, if adopted, would merely remove an alternative marking requirement.

We solicit comment on what new recordkeeping, reporting or compliance requirements may arise as a result of these proposed amendments.

F. Duplicative, Overlapping or Conflicting Federal Rules

The Commission believes that there are no federal rules that duplicate, overlap or conflict with the proposed amendments.

G. Significant Alternatives

The RFA directs the Commission to consider significant alternatives that will accomplish the stated objective, while minimizing any significant adverse impact on small entities. Pursuant to Section 3(a) of the RFA,[119] the Commission must consider the following types of alternatives: (a) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (b) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities; (c) the use of performance rather than design standards; and (d) an exemption from coverage of the rule, or any part thereof, for small entities.

The proposed amendments are intended to modernize and simplify price test regulation by removing restrictions on the execution prices of short sales contained in current price tests, such as Rule 10a-1. As such, we believe that imposing different compliance requirements, and possibly a different timetable for implementing compliance requirements, for small entities would undermine the goal of this proposal.

[119] 5 U.S.C. 603(c).

In addition, we have concluded similarly that it would be inconsistent with this goal of the proposed amendments to further clarify, consolidate or simplify the proposed amendments for small entities. Finally, the proposed amendments would impose performance standards rather than design standards.

H. Request for Comments

The Commission encourages the submission of written comments with respect to any aspect of the IRFA. In particular, the Commission seeks comment on (i) the number of small entities that will be affected by the proposed amendments; and (ii) the existence or nature of the potential impact of the proposed amendments on small entities. Those comments should specify costs of compliance with the proposed amendments, and suggest alternatives that would accomplish the objective of the proposed amendments.

X. Statutory Authority

Pursuant to the Exchange Act and, particularly, Sections 2, 3(b), 6, 9(h), 10, 11A, 15, 15A, 17, 17A, 23(a) thereof, 15 U.S.C. 78b, 78c, 78f, 78i, 78j, 78k-1, 78o, 78o-3, 78q, 78q-1, 78w(a), the Commission is proposing to remove Rule 10a-1, § 240.10a-1 and to amend Regulation SHO, §§ 242.200 and 201.

Text of the Proposed Amendments to Rule 10a-1 and Regulation SHO

List of Subjects in 17 CFR Parts 240 and 242

Brokers, Fraud, Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, Title 17, Chapter II, of the Code of Federal Regulations is proposed to be amended as follows.

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

1. The general authority citation for part 240 is revised to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et. seq.; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

2. Section 240.10a-1 is removed and reserved.

PART 242 — REGULATIONS M, SHO, ATS, AC AND NMS, AND CUSTOMER MARGIN REQUIREMENTS FOR SECURITY FUTURES

3. The authority citation for part 242 continues to read as follows:

Authority: 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78g(c)(2), 78i(a), 78j, 78k-1(c), 78l, 78m, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd-1, 78mm, 80a-23, 80a-29, and 80a-37.

* * * * *

4. Section 242.200 is amended by revising the introductory text of paragraph (g) to read as follows:

§ 242.200 Definition of "short sale" and marking requirements.

(g) A broker or dealer must mark all sell orders of any equity security as "long" or "short."

5. Section 242.200(g)(2) is removed and reserved.

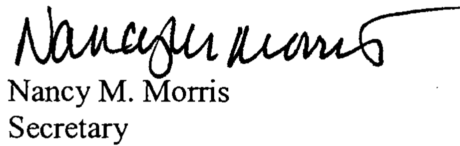
6. Section 242.201 is added to read as follows:

§ 242.201 Price test.

(a) No short sale price test, including any short sale price test of any self-regulatory organization, shall apply to short sales in any security.

(b) No self-regulatory organization shall have any rule that is not in conformity with, or conflicts with, paragraph (a) of this section.

By the Commission.



Nancy M. Morris
Secretary

Dated: December 7, 2006

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES AND EXCHANGE ACT OF 1934
Rel. No. 54913 / December 11, 2006

Admin. Proc. File No. 3-12229

In the Matter of the Application of

DENNIS A. PEARSON, JR.
13722 Trento Place
San Diego, CA 92130

For Review of Action Taken by

NASD

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION - - REVIEW OF NASD ACTION

Former registered representative of former member firm of registered securities association who failed to respond to requests for information appealed association's sanction. Held, the application for review is dismissed.

APPEARANCES:

Dennis A. Pearson, Jr., pro se.

Marc Menchel, Alan Lawhead, James S. Wrona, and Leavy Matthews III, for NASD.

Appeal filed: March 3, 2006
Last brief received: June 30, 2006

I.

Dennis A. Pearson, Jr., formerly a registered representative associated with Intra Network Securities, Inc. ("INSI" or the "Firm"), a former NASD member firm, seeks review of NASD action. 1/ NASD found that Pearson failed to provide information that it requested pursuant to

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1/ Pearson was registered with INSI from May 1996 until December 2004, where he was an owner and served as its Chief Executive Officer. Richard W. Simpson, INSI's other (continued...)

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NASD Procedural Rule 8210. 2/ As a result of his failure to respond, NASD barred Pearson from association with any member firm in any capacity. We base our findings on an independent review of the record.

II.

NASD's Information Requests. On August 25, 2004, NASD staff sent Pearson a written request to appear for an on-the-record interview ("OTR") on, and provide various documents and related information by, September 8, 2004, in connection with an NASD investigation of a private placement offering of the securities of Deltacom Network, Inc. ("Deltacom"), for which INSI was a selling agent. 3/ The letter, which was sent by mail to Pearson's residential address in San Diego, California, contained in NASD's Central Registration Depository ("CRD"), with a

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1/ (...continued)
principal owner, served as its President and Chief Operating Officer. In December 2004, INSI was expelled from NASD membership.

Pearson is currently associated with XO Financial Group, Inc., a registered investment adviser. XO is owned by Pearson and Simpson and shares the same business address as INSI. Pearson serves as XO's CEO and Simpson serves as its president.

2/ NASD Procedural Rule 8210 requires members and associated persons to provide information if requested by NASD as part of an investigation, complaint, examination, or proceeding.

3/ NASD's inquiry arose following a routine examination of INSI by NASD staff in February 2004. Pursuant to its investigation, the staff sought information about the possibility that sales practice abuses occurred in connection with the Deltacom offering. The staff's letter to Pearson requested that he provide NASD with information concerning his and INSI's involvement in the sale of the Deltacom securities, including, among other items, (1) a list of investors who purchased Deltacom's securities through INSI, along with a copy of "all incoming and outgoing correspondence (electronic and hard copy)" with those investors; (2) copies of the offering memorandum and other sales materials sent to the purchasers or used to sell the Deltacom securities; (3) a copy of INSI's due diligence file for the Deltacom offering; (4) a statement "as to what made Deltacom a suitable investment for his clients, including a description as to whom it would not be suitable;" (5) a detailed list of the fees earned by Pearson, Simpson, and INSI through the sale of the Deltacom securities; and (6) information about the nature of the relationship between INSI, Deltacom, and their respective owners and executive officers.

copy to INSI's offices in Rancho Santa Fe, California, 4/ stated that Pearson was "obligated to appear on" the date specified in the letter but that, if that date was not acceptable, Pearson should contact the staff so that a mutually acceptable date for the OTR could be scheduled. Pearson did not appear for the OTR, provide the requested information, or otherwise respond to NASD's August 25 letter.

On September 8, 2004, NASD staff mailed a second letter to Pearson's residential address directing him to appear for an OTR interview on September 29, 2004, and provide the requested information by September 23, 2004. Pearson did not respond to this letter. A third request letter was mailed to Pearson's residence on September 27, 2004. This letter notified Pearson that he had not provided any of the requested information and directed that he do so by the date of his previously scheduled September 29 OTR. The letter notified Pearson that this was NASD's "final request" and that "[f]ailure to comply with this request may subject [him] and [INSI] to disciplinary action, including the imposition of sanctions that may provide for a bar in all capacities."

On September 29, 2004, NASD staff mailed a fourth letter to Pearson's residential address notifying him that, because he did not appear at the September 29 OTR, he was requested to appear at an OTR on October 13, 2004, and to provide the requested information by October 6, 2004. Again, NASD advised Pearson that this was its "final request," and warned him that failure to comply could subject him to disciplinary action, which could result in a bar. 5/ Pearson did not respond to the letter.

On October 7, 2004, NASD staff mailed a fifth letter to Pearson's residence notifying him that it had not received any of the requested information and directing that Pearson submit it by October 12, the day before his rescheduled OTR. 6/ As before, Pearson failed to respond to the letter. Pearson does not deny receiving any of these five NASD requests and expressly acknowledges in his brief that he received the August 25, September 8, September 29 and October 7, 2004 requests.

4/ NASD sent one copy of the letter to INSI's post office address in Rancho Santa Fe, California, and another copy to INSI's street address, also in Rancho Santa Fe. The record indicates that this was the only one of NASD's request letters to Pearson where a copy was also sent to INSI's address.

5/ This letter was sent by certified mail, return receipt requested to Pearson's residential address. The return receipt was signed by "D. Pearson" on October 1, 2004.

6/ The letter was sent by certified mail, return receipt requested. The return receipt was signed by "Dennis Pearson" on October 8, 2004.

It appears that, at some point during October 2004, Pearson's attorney, Dudley Muth, contacted NASD staff to try to reschedule the OTR for a time in early 2005. 7/ It is unclear from the record whether any agreement was reached between Muth and NASD regarding the rescheduling of the OTR, but the record does show that Pearson never appeared for an OTR and that he did not respond to NASD's information requests. 8/

NASD Issues Suspension Notice. In a July 29, 2005 letter, NASD notified Pearson of its intent to suspend him (the "Initial Notice") because he had "failed to provide information to NASD, which had been requested of [him] in accordance with and pursuant to Procedural Rule 8210." The Initial Notice specifically noted that Pearson had failed to respond to four separate NASD request letters and informed him that, pursuant to NASD Procedural Rule 9552, 9/ if he did not provide the information NASD had requested by August 23, 2005 (the "Suspension Date"), NASD would suspend him from association in all capacities with any member. 10/ The Initial Notice was delivered by Federal Express to Pearson's home address in San Diego as reported in the CRD. 11/ The Federal Express tracking notice for the Initial Notice stated that the letter was signed for by "D. Pearson." Pearson did not respond to the Initial Notice.

7/ The evidence of this contact consists of a copy of an e-mail Muth sent to Pearson and Simpson in October 2004 stating that Muth "had discussed a time for the OTR in mid-January 2005 and [an NASD staff person] will get back to me after talking to her superiors."

8/ The record does not show whether proceedings were ever instituted against INSI or any other party as a result of NASD's investigation.

9/ NASD Procedural Rule 9552(a) provides that, if an associated person fails to furnish information requested by NASD, NASD may provide written notice specifying the nature of that associated person's failure and stating that the failure to take corrective action within twenty-one days after service of such written notice will result in the suspension of that person's association.

10/ The Initial Notice did not cite Pearson's failures to appear at the OTR as a reason for the sending of the notice and NASD states in its brief that "[t]he bar imposed on Pearson . . . is not based on his failure to appear for this interview."

11/ The Initial Notice further stated that Pearson could request a hearing pursuant to NASD Procedural Rule 9552(e), which would operate as a stay. NASD Procedural Rule 9552(e) provides that a person requesting a hearing must do so in writing before the effective date of the suspension.

The Federal Express tracking system showed that the Initial Notice was sent on July 29, 2005 and was delivered on August 1, 2005.

On August 24, 2005, NASD staff sent Pearson a letter (the "Suspension Notice") to Pearson's home address stating that, because he failed to provide the requested information by the Suspension Date, he was suspended from association with any NASD member in any capacity. The Suspension Notice advised Pearson that he could file a request for termination of the suspension, pursuant to NASD Procedural Rule 9552(f). 12/ The Suspension Notice further stated that, pursuant to NASD Procedural Rule 9552(h), if Pearson failed to file a request for termination of the suspension within six months of the Initial Notice, he would automatically be barred. The Suspension Notice was sent to Pearson's home address by an overnight delivery service and by first class mail. 13/ Pearson did not file a request for termination of the suspension or otherwise respond.

On February 3, 2006, NASD advised Pearson by letter, sent to Pearson's residential address, that, effective immediately, he was barred from associating with any NASD member firm in any capacity (the "Bar Notice"). Pearson admits that he received the Bar Notice. One month later, on March 3, 2006, Pearson filed this appeal.

III.

Section 19(f) of the Securities Exchange Act of 1934 provides the standards for our review. 14/ If we find that "the specific grounds" on which NASD based its action "exist in fact," that NASD's determination not to permit Pearson's association is in accordance with its rules, that such rules were applied in a manner consistent with the purposes of the Exchange Act,

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12/ NASD Procedural Rule 9552(f) provides that a person subject to a suspension may file a written request for termination of the suspension on the ground of full compliance with the notice or decision. Procedural Rule 9552(h) provides that a person who is suspended and fails to request termination of the suspension within six months of issuance of the original notice of suspension will automatically be expelled or barred.

13/ The DHL Waybill indicates that the Suspension Notice was sent to Pearson's home at the address reported on the CRD on August 24, 2005. The DHL tracking system shows that the Suspension Notice was delivered on August 25, 2005 and left at the front door at 10:59 a.m. It appears that no one signed for this delivery.

Pearson states, in the application for review he filed with us, that "NASD properly sent two letters entitled Notice of Intent to Suspend and Notice of Suspension dated July 29, 2005, and August 24, 2005" to his home and business addresses as listed in CRD. Pearson further states that the copy sent to his business address was "signed for by Cassandra King, a secretary who is now suing Pearson for sexual harassment" and who, according to Pearson, "never forwarded the July 29, 2005 and August 24 2005 letters to Pearson."

14/ 15 U.S.C. § 78s(f).

and that NASD's action does not impose an undue burden on competition, we must dismiss Pearson's appeal. We turn first to whether the grounds on which NASD acted existed in fact and whether NASD's barring of Pearson accorded with its rules.

A.

Pearson admittedly was aware, as discussed above, of NASD's Deltacom investigation and that NASD had made several requests to him for information related to that investigation. Pearson also admittedly failed personally to respond to any of those requests or to appear before NASD to give testimony in the matter. As a result, NASD, acting pursuant to its Procedural Rule 9552, notified Person that, because he had repeatedly failed to provide information requested pursuant to NASD Procedural Rule 8210, he would be suspended. Six months later, by automatic operation of NASD Procedural Rule 9552(h), Pearson was barred based on his failure to request, during that six-month period, termination of the suspension.

1. Pearson argues that the specific grounds for NASD's action do not "exist in fact" because, in his view, he did respond to NASD's information requests. Although Pearson seems to concede that he did not personally respond to any of those requests, he contends that he nevertheless took reasonable steps to ensure that NASD obtained the documents it was seeking. 15/ Pearson claims that, when he and INSI's president Richard Simpson received the first NASD request letter in August 2004, they "immediately took steps to retain legal counsel." Pearson asserts that he and Simpson provided their attorney "with a box of documents that included documents already provided to the NASD, as well as additional documents that the NASD might want for the Deltacom investigation." 16/ According to Pearson, the attorney also

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15/ In support of this and other contentions, Pearson seeks to adduce nine exhibits that are not a part of the record. Our Rule of Practice 452 provides that a motion to introduce new evidence must "show with particularity that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence previously." 17 C.F.R. § 201.452. NASD objects to the admission of most of these exhibits, arguing that they are not material, because they mainly consist of correspondence, declarations and phone records that evidence what Simpson and Simpson's and Pearson's joint attorney did, or claimed they did, to comply with NASD's requests to Simpson and Pearson. We find that there is probative value to Pearson's exhibits since they arguably have some bearing on the question of whether Pearson attempted to comply with NASD's requests. Moreover, since NASD's sanction was imposed automatically and without a hearing being held, there were reasonable grounds for Pearson's failure to adduce this evidence previously. Accordingly, we will treat Pearson's inclusion of these exhibits in his brief as a motion to adduce additional evidence and will grant Pearson's motion.

16/ Pearson does not give details about the contents of the "box of documents" that he purportedly gave to his attorney so it is unclear what "additional documents" were

(continued...)

had a number of conversations with NASD staff regarding the scheduling of Pearson's and Simpson's OTRs. Pearson contends that neither he nor Simpson heard anything further from their attorney about the OTRs or NASD's information requests. 17/ Pearson claims that, under these circumstances, he "reasonably believed that NASD's investigatory needs had been addressed by Muth and, as the months passed, believed that NASD had abandoned its investigation." 18/

We have held that the person to whom an information request is directed "ha[s] a duty to respond himself or to supervise others diligently with adequate follow-up to ensure a prompt response to the NASD." 19/ We have further held that the person to whom such a request is made "is responsible for responding directly to the NASD's requests for information and cannot shift responsibility to [another] for his own failure to provide requested information in a timely fashion." 20/ Thus, a member or an associated person cannot satisfy his obligation to respond to

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16/ (...continued)
included. It is also not clear from the record or Pearson's brief whether NASD ever received any of these documents, although he appears to concede that his attorney failed to deliver them to NASD.

17/ Muth advised Pearson that he had discussed the possibility of rescheduling his OTR with an NASD staff person who had agreed to discuss with her superiors the rescheduling of the OTR for sometime in mid-January 2005. However, there is no evidence in the record showing whether or not NASD agreed to this rescheduling. See supra note 7 and accompanying text.

18/ Pearson claims that the remaining documents NASD had not originally received were eventually provided after Pearson discovered that his lawyer had failed to transmit them. However, there is no evidence in the record that Pearson sent any such documents to NASD or otherwise communicated with NASD staff regarding its information request. Moreover, regardless of whether Pearson sent these additional documents, it is undisputed that they were not sent within the time period specified by NASD.

19/ Richard J. Rouse, 51 S.E.C. 581, 585 (1993).

20/ Ashton Noshir Gowadia, 53 S.E.C. 786, 792 (1998); see also Mark Allen Elliott, 51 S.E.C. 1148, 1151 (1994) (noting that broker's asserted reliance on his wife's responses was no defense to his failure to furnish the information requested of him); Michael David Borth, 51 S.E.C. 178, 181 (1992) (rejecting registered representative's attempt to shift his responsibility to provide NASD with requested information to his firm's legal counsel).

an information request by simply referring the matter to a lawyer, 21/ particularly where, as here, the member or person fails to act to ensure that the lawyer had provided the requested information. 22/

Pearson also contends that the information requests that NASD made to him were duplicative and unnecessary because the same information had already been obtained from INSI. Pearson claims that the information requested in the letters NASD sent to him and Simpson between August and October 2004 was "the same information that the NASD had already received just weeks, or in some cases, days earlier." He argues that it is "irrelevant . . . [w]hether Pearson himself physically handed the [requested] documents to NASD or his agent did so . . . [because] [t]he relevant inquiry is whether NASD received the documents, which they did." He contends that, "[a]s nearly all, if not all, of the same documents called for by the NASD Request Letters had already been produced by INSI, there was no regulatory need for the document and information requests." 23/

21/ Michael Markowski, 51 S.E.C. 553, 557-58 (1993), aff'd, 34 F.3d 99 (2d Cir. 1994) (holding that respondent "knew or should have known that he could not delegate to counsel the ultimate responsibility for complying with the NASD's request"); Robert Fitzpatrick, 55 S.E.C. 419, 425 (2001) (holding that respondent's "only apparent response to the NASD's requests was to refer them to [his firm's] outside counsel . . . [and that was] not an adequate response"); Borth, 51 S.E.C. at 181 n.10 (holding that respondent's responsibility to comply with NASD information request was not excused by his decision to follow his firm's policy of referring such requests to the firm's counsel).

22/ Cf. Paz Sec., Inc., Securities Exchange Act Rel. No. 52693 (Oct. 28, 2005), 86 SEC Docket 1880, 1887 (rejecting respondents' contention that their counsel's negligence in failing to file an answer on their behalf provided "good cause" for setting aside default in proceeding based on violation of NASD Procedural Rule 8210, and noting that, among other things, there was no evidence that respondents took any actions to consult with counsel about the status of the answer or of the disciplinary matter).

23/ Pearson argues that NASD should not have sent its letters to him because, he claims, "the documents and information request were for Firm records and related business records, and not the personal records of Pearson. . . [but were rather] the property of the the corporation (i.e., the Firm), not Pearson personally" (emphasis in original). However, Pearson was INSI's chief executive officer and he and Simpson were its only principals. It is undisputed that the requested documents were within Pearson's control. Indeed, Pearson's claim that he and Simpson had provided their attorney with some of the documents that were responsive to NASD's requests indicates his control over the documents. Moreover, even if there were certain documents that Pearson was unable to furnish to NASD because they were not within his control, he should have so informed NASD, rather than simply ignore the request.

It is well established, however, that a member or an associated person may not "second guess[]" an NASD information request and that a belief that NASD no longer needs the requested information "provides no excuse for a failure to provide it." 24/ As we have held, a member or an associated person has "an obligation to respond to an NASD request even if his response [is] a statement that he believed he had already provided the NASD with the information it had requested." 25/

Moreover, and contrary to Pearson's assertion, the record indicates that NASD's requests to him were not entirely duplicative of the one made to INSI. For example, NASD asked Pearson to explain the basis for his own determination that Deltacom securities were "suitable investments for his clients" and a description of the type of client for whom the securities would not be suitable. 26/ NASD also requested that Pearson provide all "incoming and outgoing correspondence (electronic and hard copy)" related to the Deltacom offering. Certainly some of this correspondence could have been held by Pearson alone and not by the Firm. Moreover, NASD may have been interested in determining whether there were discrepancies in the responses given by the various targets of the investigation. Thus, while there was undoubtedly some overlap in what had been requested of INSI and Pearson, there was a legitimate investigatory basis for the inquiry being directed to Pearson, as well as to Simpson and INSI. In addition, Pearson asserts that, at some point after his receipt of the information requests, he provided his attorney with "additional documents" for delivery to NASD -- which, as discussed above, the attorney failed to deliver -- thus conceding that there was additional information that NASD had not received through its initial requests to INSI that was nevertheless potentially responsive to the requests. Finally, Pearson's failure to respond impeded the Deltacom investigation by, at a minimum, delaying it, even if much of the requested information ultimately was provided by others. 27/

24/ Borth, 51 S.E.C. at 181.

25/ Gowadia, 53 S.E.C. at 790.

26/ See supra note 3.

We note that NASD separately asked Simpson, on behalf of INSI, to provide a statement from Pearson as to what made Deltacom a suitable investment for his clients, although it is unclear from the record whether Simpson provided NASD with the requested suitability statement from Pearson.

27/ As we recently noted, "[w]hen members and associated persons delay their responses to requests for information, they impede the ability of NASD to conduct its investigations fully and expeditiously." Elliot M. Hershberg, Exchange Act Rel. No. 53145 (Jan. 19, 2006), 87 SEC Docket 494, 498.

2. Pearson also challenges NASD's action based on what he claims was the inadequacy of NASD efforts to notify him of its suspension, which he claims conflicted with NASD rules. While Pearson acknowledges that he received at least four of NASD's requests for information, he denies ever receiving either the Initial Notice or the Suspension Notice. 28/ Pearson concedes that they were sent to his home, his residential CRD address, but claims that, at such time, he was temporarily living elsewhere due to marital problems. 29/ Pearson states, without any evidentiary support, that it is "likely that [his then-] estranged wife or another person received the correspondence and discarded it."

These notices were issued pursuant to NASD Procedural Rule 9552, which refers to NASD Rule 9134 with respect to how service of such notices is to be effected. NASD Procedural Rule 9134 provides that service may be accomplished through personal service, service by mail, or by courier. It further provides that "[s]ervice by courier may be accomplished by sending the papers through a courier service that generates a written confirmation of receipt or of attempts at delivery." The record establishes that NASD complied with the requirements of NASD Procedural Rule 9134 by sending the notices through courier services that generated the requisite confirmation. 30/

Pearson contends however that, because of his special personal circumstances, NASD's service of the notices was insufficient. He claims that "[b]ecause NASD staff apparently had

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28/ Pearson also claims that the Initial Notice failed to comply with NASD Procedural Rule 9552 because it did not state "the specific grounds and include a factual basis for the suspension and subsequent bar." The Initial Notice stated that Pearson would be suspended because he had "failed to respond to request letters issued by NASD staff on August 25, 2004, September 8, 2004, September 29, 2004 and October 7, 2004" pursuant to NASD Procedural Rule 8210. The Initial Notice, which included copies of the referenced request letters, also stated that Pearson would be barred in six months if he failed to request termination of the suspension. This fully satisfied NASD Procedural Rule 9552's requirement to provide the basis for NASD's action.

29/ Pearson explains that "from at least July 2005 through August 2005, [he] was temporarily staying elsewhere due to marital problems that were subsequently resolved," and that he had moved back to his home by the time NASD notified him in February 2006 that he had been barred. We note that, other than this assertion, Pearson has failed to substantiate this claim.

30/ Although, as mentioned, the FedEx tracking slip shows that Initial Notice was signed for by a "D. Pearson," Pearson denies that the signature was his. We need not determine whether the signature was his, however, because NASD rules do not require that receipt be acknowledged by the addressee. See, e.g., Jeffrey King, Exchange Act Rel. No. 52571 (Oct. 7, 2005), 86 SEC Docket 1439, 1441 n.8 (noting that suspension notice based on failure to respond to information requests "was left at [respondent's] door").

actual knowledge that Pearson had not received the suspension notices at his CRD residential address, fairness and NASD rules dictate that NASD staff obtain a current address for Pearson by simply asking [other INSI personnel] for this information, or by sending the suspension notices to the CRD business address for Pearson." He supports his claim that NASD had actual knowledge that Pearson had not received the correspondence by noting that, after NASD had sent similar request letters to his business partner Simpson, Simpson challenged the action. According to Pearson, NASD "must have known" that Pearson would also have challenged NASD's action if he had received these notices "because he had, in fact, fully complied with the NASD Request Letters." Pearson also contends that NASD should have tried to reach him at his home and, if they had done so, would have learned that he was not then residing there. 31/

NASD Procedural Rule 9134(b)(1) provides that "[p]apers served on a natural person may be served at the natural person's residential address, as reflected in the [CRD]." It further provides that:

> When a Party or other person responsible for serving such person has actual knowledge that the natural person's [CRD] address is out of date, duplicate copies shall be served . . . at the . . . last known residential address and the business address in the [CRD] of the entity with which the natural person is employed or affiliated.

Contrary to Pearson's claim, we do not find that NASD had actual knowledge that Pearson's CRD address was out of date. 32/ First, Pearson argues only that NASD must have known. That is not proof of actual knowledge. In fact, Pearson provided no evidence on this subject at all. Second, although Pearson argues that NASD must have known that he had not received the notices because he did not respond, that is exactly what he did in response to the previous requests for information, most of which he admittedly received. Thus, Pearson's response to the notices was fully consistent, from the perspective of NASD, with his earlier response to the information requests, and there is nothing about his failure to respond that would have indicated he had not received them, such as the notices being returned as undeliverable. Third, for similar reasons, no strong logical inference that Pearson had not received the notices arises because Simpson was challenging the suspension. Pearson did not provide evidence that NASD knew he would not act independently of Simpson.

31/ Pearson also contends that, because of its "actual knowledge that Pearson had not received the suspension notices," NASD should have sent them to Pearson's business address. However, he expressly admitted that the notices were sent to his business address. See supra note 13.

32/ We note that we have previously remanded to NASD proceedings brought under similar NASD provisions where, among other things, the record raised questions about whether NASD was aware that its information requests and notices were not reaching the respondent. See Robert J. Langley, Exchange Act Rel. No. 50917 (Dec. 22, 2004), 84 SEC Docket 1959, 1964. As discussed, that is not the situation presented here.

It is the responsibility of NASD members and their associated persons to keep NASD apprised of any changes in their addresses, and a failure to respond to NASD in connection with an investigation, as is the case here, is not excused by that person's having temporarily moved from the address listed in the CRD. 33/ As we have previously held, associated persons have "a continuing duty to notify the Association . . . of [their] current address, and to receive and read mail sent to [them] at that address." 34/ Pearson "cannot shift the burden of keeping [address] information current to the NASD" because "NASD must be able to rely on its records." 35/ Nor are we persuaded by Pearson's claim that NASD must have known he would challenge the suspension because he had fully complied with NASD's information request. To the contrary, as discussed, the evidence establishes that Pearson had not complied.

B.

We now turn to the question of whether NASD applied its rules in a manner that is consistent with the purposes of the Exchange Act. Pearson claims that NASD's action is inconsistent with those purposes. In doing so, Pearson focuses on the sanction imposed, arguing that it was "fundamentally unfair" for NASD to bar him because, among other things, Pearson never had the opportunity to defend himself before the automatic bar was imposed. While Pearson questions the fairness of the Rule 9552 procedures, which resulted in his having been barred without a hearing, we do not believe that those procedures operated unfairly here, for the reasons already explained. Pearson has presented no mitigating evidence that would raise questions about the appropriateness of the sanction and, in our view, the circumstances amply

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33/ See, e.g., Paz Sec., Inc., 86 SEC Docket at 1885 (finding that associated person who was temporarily out of the country was still obligated to respond to NASD requests for information and to provide CRD with address at which he could receive documents).

We also note that the record contains a declaration from Simpson in which Simpson averred that he was in close contact with Pearson throughout the period and that they had discussed the fact that Simpson had received a pre-suspension notice, while Pearson presumed that he had not. In light of Pearson's knowledge of the NASD's action against Simpson and their apparently similar situations, a reasonably diligent person would have sought to ascertain whether similar action was being taken against him, particularly when, as Pearson's assertions indicate, he had some uncertainty about his spouse's willingness to forward mail to him.

34/ Warren B. Minton, Jr., Exchange Act Rel. No. 46709 (Oct. 23, 2002), 78 SEC Docket 2369, 2375 n.15 (quoting William T. Banning, 50 S.E.C. 415, 416 (1990)).

35/ Nazmi C. Hassanieh, 52 S.E.C. 87, 90-91 n.13. (1994).

justify a bar. 36/ As discussed, NASD sent Pearson a series of requests for information and for him to appear at an OTR, most of which he admittedly received. He responded to none of them. Moreover, to the extent that Pearson did not learn about NASD's action against him, the fault is not NASD's but his own because he neither apprised NASD of his change of address nor inquired of NASD after his partner Simpson told him about his own notice of suspension stemming from the same investigation. Thus, this is not a case where a respondent unintentionally failed to respond or where other mitigating circumstances might support a lesser sanction. 37/

In sum, we find that NASD applied its rules in a manner consistent with the purposes of the Exchange Act. As we have repeatedly emphasized, it is critically important to the self-regulatory system that members and their associated persons cooperate with NASD investigations by complying with information requests. 38/ In this connection, we have observed that, because NASD lacks subpoena power, it "must rely upon Procedural Rule 8210 in

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36/ We note that NASD's Sanction Guidelines direct that if an individual fails to respond in any manner to an NASD request for information under NASD Procedural Rule 8210, "a bar should be standard." NASD Sanction Guidelines (2001 ed.) at 39 ("Failure to Respond or Failure to Respond Truthfully, Completely, Timely to Requests Made Pursuant to NASD Procedural Rule 8210").

We further note that Pearson has been subject to other NASD disciplinary proceedings. In December 2002, Pearson and INSI executed a Letter of Acceptance, Waiver and Consent ("AWC") with NASD, without admitting or denying the allegations, for engaging in what the NASD alleged was fraudulent securities solicitation and sales practices. In the AWC, Pearson and INSI were suspended from all broker-dealer activities for seven months, ordered to make offers of rescission to investors, and fined $30,000. On December 13, 2004, the NASD revoked Pearson's registration and expelled INSI from NASD membership for "for Failing to Pay Fines and/or Costs." NASD Case #C02030001 (available at http://www.nasd.com/web/groups/enforcement/documents/monthly_disciplinary_actions/nasdw_007450.pdf, and http://www.nasd.com/web/groups/enforcement/documents/monthly_disciplinary_actions/nasdw_013015.pdf).

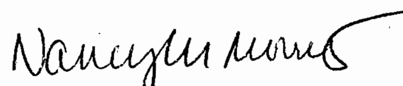
37/ See Ryan R. Henry, Exchange Act. Rel. No. 53957 (June 8, 2006), 88 SEC Docket 587, 592 (remanding to NASD, among other reasons, to determine whether bar was appropriate given questions about whether respondent had received NASD's requests and notices and whether his failure to respond was intentional).

38/ See, e.g., Hershberg, 87 SEC Docket at 498; Paz Sec., Inc., 86 SEC Docket at 1889; Fitzpatrick, 55 S.E.C. at 423-24; Borth, 51 S.E.C. at 180.

connection with its obligation to police the activities of its members and associated persons." 39/ Vigorous enforcement of Rule 8210, therefore, helps to ensure the continued strength of the self-regulatory system by making it more likely that members and their associated persons will provide prompt and full cooperation with NASD investigations. NASD's barring of Pearson is "consistent with the Exchange Act's basic purpose of protecting public investors." 40/ Based, therefore, on our consideration of the elements identified in Section 19(f), we shall dismiss this appeal.

An appropriate order will issue. 41/

By the Commission (Chairman COX and Commissioners ATKINS, CAMPOS, NAZARETH and CASEY).



Nancy M. Morris
Secretary

39/ Joseph Patrick Hannan, 53 S.E.C. 854, 858-59 (1998); see also Rouse, 51 S.E.C. at 584 (finding rule requiring NASD members and associates to comply with its information requests to be "a key element in the NASD's effort to police its members").

40/ Gershon Tannenbaum, 50 S.E.C. 1138, 1141 (1992).

Pearson also contends that NASD's requests imposed unnecessary costs on the Firm and constituted an undue burden on competition. This contention is without merit. There is no evidence in the record quantifying the cost to the Firm of complying with NASD's requests or its impact on the Firm's finances. Even if such evidence were produced, however, we do not believe that such cost, being necessary to ensure regulatory compliance, constitutes an undue burden on competition. Cf. Joseph Dillon & Co., Inc., 54 S.E.C. 960, 965 (2000) (acknowledging that, while the cost of complying with special supervisory procedures was "high," such costs were "necessary for the protection of investors"). Pearson also did not demonstrate how the compliance costs harmed the Firm's ability to compete with other firms.

41/ 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. 54913 / December 11, 2006

Admin. Proc. File No. 3-12229

In the Matter of the Application of

DENNIS A. PEARSON, JR.
13722 Trento Place
San Diego, CA 92130

For Review of Action Taken by

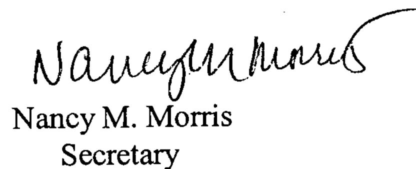
NASD

ORDER DISMISSING APPLICATION FOR REVIEW OF NASD ACTION

On the basis of the Commission's opinion issued this day, it is

ORDERED that Dennis A. Pearson, Jr.'s application for review be, and it hereby is, dismissed.

By the Commission.



Nancy M. Morris
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 8759 / December 11, 2006

SECURITIES EXCHANGE ACT OF 1934
Release No. 54907 / December 11, 2006

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2523 / December 11, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12502

In the Matter of

MICHAEL S. JOSEPH, CPA

Respondent.

ORDER INSTITUTING PUBLIC ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, AND 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 Michael S. Joseph ("Joseph" or "Respondent") pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 102(e)(1)(ii) of the Commission's Rules of Practice.[1]

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[1] 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.

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II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement of Michael S. Joseph (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 Joseph and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Public Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Section 21C of the Securities Exchange Act of 1934, and Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

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

A. SUMMARY

This action concerns violations by Respondent Michael S. Joseph of certain of the antifraud, reporting, and recordkeeping provisions of the federal securities laws, as well as auditor independence standards. During 2001, Joseph was a partner in the national office of Ernst & Young LLP ("E&Y"). That year, Joseph helped develop and market an accounting product for one client, American International Group, Inc. ("AIG"), and then worked with an E&Y audit team to advise an E&Y audit client, The PNC Financial Services Group, Inc. ("PNC"), on the accounting treatment for a version of that product.[3]

AIG's product purported to enable a public company to transfer volatile financial assets to a special purpose entity ("SPE") and thereby to remove those assets from the public company's financial statements. AIG sold three of these accounting products to PNC in 2001. As a result, PNC improperly excluded certain assets from its consolidated financial statements. Joseph advised PNC that the accounting for each of these transactions conformed to GAAP, even though Joseph should have known that this advice was inaccurate. Subsequently, PNC filed with the Commission several Forms 10-Q and the registration statements for PNC securities, yet these filings were materially misleading in that they incorporated improper accounting of the SPE transactions. In January 2002, PNC announced that it would restate its financial statements for the second and third

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[2] 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.

[3] The Commission previously brought settled proceedings against both PNC and AIG related to their roles in these matters. PNC Financial Services Group, Inc., Securities Act Release No. 8112, Exchange Act Release No. 46225, Accounting and Auditing Enforcement Release No. 1597 (July 18, 2002); SEC v. American International Group, Inc., No. 1:04CV02070 (GK) (D.D.C. judgment entered Dec. 7, 2004).

quarters of 2001, and revise its previously announced financial results for the fourth quarter and year-end of 2001.

Joseph advised PNC, in connection with E&Y's work as PNC's auditor, on the appropriateness of the accounting treatment of the SPE product that he had helped AIG develop and market. Accordingly, Joseph compromised his and his firm's auditor independence required by generally accepted auditing standards ("GAAS") and Regulation S-X of the Commission's rules and regulations. Additionally, because Joseph should have known that the accounting treatment for the product that AIG sold to PNC did not conform with GAAP and would result in materially misleading filings by PNC, he was a cause of PNC's violation of certain antifraud, reporting and recordkeeping provisions of the federal securities laws.

B. RESPONDENT

Michael S. Joseph, age 55, was employed by E&Y from June 1972 until June 1981 and again from June 1983 until 2005. At all relevant times, he was a partner in E&Y's National Office. In 2001, he was a nationally recognized expert on the accounting for structured financial vehicles and SPEs. At that time, his duties in the National Office consisted of advising E&Y accountants on local engagement teams regarding complex accounting issues, and advising audit and non-audit clients on the accounting ramifications of financial products that they developed and planned to market. Joseph, at all relevant times was licensed to practice as a certified public accountant in both New York and Illinois.

C. RELEVANT ENTITIES

Ernst & Young LLP, is a national accounting firm with its headquarters in New York, New York. At all relevant times, E&Y provided auditing services to PNC. Specifically, E&Y was responsible for, among other things, the audit of PNC's consolidated financial statements, interim reviews of quarterly financial statements, reviews and consultations pertaining to filings with the SEC, and internal control reviews. While serving as auditor and consultant for PNC, E&Y also was employed as a consultant for AIG with responsibility for addressing GAAP compliance issues during the product design stage of an SPE accounting product ultimately used in transactions between AIG and PNC.

American International Group, Inc. is a Delaware Corporation with its principal place of business in New York, New York. Through its subsidiaries, AIG is engaged in a broad range of insurance-related and asset management activities in the United States and abroad.

The PNC Financial Services Group, Inc. is a Pennsylvania corporation with its principal place of business in Pittsburgh, Pennsylvania. PNC is a bank holding company that is regulated by the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of Cleveland (together the "Federal Reserve") and has a national bank subsidiary that is regulated by the Comptroller of the Currency.

D. FACTS

1. Development and Marketing of the C-GAITS Product

In early 2001, AIG engaged Joseph to help develop a financial product, known as a Contributed Guaranteed Alternative Investment Trust Security ("C-GAITS"). The C-GAITS product purported to enable a public company to reduce the earnings impact of potentially volatile assets by transferring those assets from the public company's balance sheet to an SPE established by AIG. Under the C-GAITS structure, the SPE was to be consolidated onto AIG's balance sheet, but the public company still would hold a substantial interest in the SPE. Under GAAP, this transfer of assets and consolidation onto AIG's balance sheet required that AIG make a substantive capital investment into the SPE[4] constituting at least 3% of the total assets in the SPE.[5] GAAP further provided that a fee for structuring the transaction (*i.e.*, a "structuring" fee), would be treated as a return of AIG's initial capital investment and correspondingly reduce that investment.[6] Thus, if AIG invested only 3% in the SPE, any structuring fee that AIG received would be counted against AIG's investment, reducing it below the required 3% minimum required by GAAP to achieve the desired nonconsolidation accounting.

To assist AIG in its marketing of the C-GAITS product, Joseph caused E&Y to issue reports pursuant to Statement on Auditing Standards No. 50, *Reports on the Application of Accounting Principles* ("SAS 50 letters").[7] The SAS 50 letters represented that the favorable nonconsolidation accounting treatment for the assets transferred to the SPE established in a proposed C-GAITS transaction was an appropriate application of GAAP. As intended, AIG used the E&Y SAS 50 letters to promote the C-GAITS product. AIG also relied extensively on Joseph's advice as it attempted to sell the product. For example, AIG referred to E&Y's advice in its marketing materials and referred potential buyers directly to Joseph to answer accounting-related questions. Joseph reviewed and edited term sheets for at least two proposed C-GAITS deals. On several occasions, Joseph also participated in conference calls with AIG when it was marketing the C-GAITS product.

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[4] Emerging Issues Task Force, Topic D-14, *Transactions Involving Special Purpose Entities.*

[5] Emerging Issues Task Force, Issue No. 90-15, *Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions*, Response to Question No. 3.

[6] Emerging Issues Task Force Issue No. 96-21, Response to Question No. 6.

[7] A "SAS 50" letter is a report issued by an accounting firm that provides accounting guidance to a non-audit client. A SAS 50 letter could provide accounting guidance on the audit opinion on a specific entity's financial statements, new transactions, or hypothetical transactions. These letters frequently were used for marketing purposes by non-audit clients. SAS No. 50 was amended in June 2002 by Statement on Auditing Standards No. 97, *Amendment to Statement on Auditing Standards No. 50, Reports on the Application of Accounting Principles.* Accountants are now prohibited from providing a report on accounting principles concerning hypothetical transactions.

From March 2001 through January 2002, AIG marketed the C-GAITS product, with the assistance of Joseph, to several public companies. Despite its marketing effort, though, AIG sold the product only to PNC. AIG ultimately closed three C-GAITS deals with PNC.[8]

2. PNC's Second Quarter 2001

Around the beginning of June 2001, AIG marketed a C-GAITS product to PNC, known as PAGIC I, using a SAS 50 letter written by Joseph. Throughout its negotiations with AIG that month, PNC management consulted with the E&Y audit engagement team, which, in turn, consulted with Joseph to determine the proper accounting treatment for PAGIC I. In fact, when PNC began considering PAGIC I, PNC senior management contacted the E&Y engagement team and requested formal written guidance on the accounting treatment for the transaction. The engagement team then contacted Joseph.

Joseph provided the engagement team with the SAS 50 letter he previously had written for AIG, for use as a template for the PNC accounting guidance letter. Joseph also discussed accounting issues with the team. Joseph billed his time for this work to PNC's audit account. Without performing any meaningful separate analysis, the E&Y engagement team incorporated virtually verbatim into the guidance letter the accounting analysis and conclusions that Joseph had included in his earlier SAS 50 letter.[9] Joseph reviewed drafts of the guidance letter and approved issuance of the final letter. The guidance letter provided PNC with a written opinion memorializing E&Y's view that PNC's nonconsolidation of the SPE conformed with GAAP.

While E&Y was analyzing the contemplated accounting for the transaction, questions about the nature of the fee paid to AIG were raised. Joseph knew that the desired nonconsolidation of the assets transferred to the SPE would not conform with GAAP unless the fees paid to AIG in the deal were for actual services that AIG provided to the SPE, rather than merely for setting up the deal – also known as a "structuring" fee. In fact, the fees paid to AIG in the PAGIC transactions were intended by AIG to compensate AIG for structuring the transactions and not for providing management services.

Joseph should have known that AIG's fee – characterized as a "Fee to the Managing Member" – was not for management services. At a minimum, there were numerous red flags highlighting the true nature of the fee. Among other things, the deal documents showed that

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[8] The transactions were referred to respectively as PAGIC I, PAGIC II, and PAGIC III. The C-GAITS transactions initially contemplated the transfer of equity assets to the SPE, while PAGIC I and PAGIC II transferred troubled loan assets. The applicable accounting principles relevant to this action are the same for the PAGIC and C-GAITS transactions.

[9] Each guidance letter for each of the three PAGIC transactions included a factual description of the particular transaction for which the guidance letter was written and a discussion of accounting issues. The factual descriptions in the letters differed, but the discussion of the accounting issues was virtually identical to the corresponding discussion in the SAS 50 letter.

even though AIG was nominally responsible for managing the affairs of the SPE, it did not have many duties to perform as managing member. The major responsibility in managing the SPE was processing the loans that PNC had sold to the SPE. However, PNC had a side agreement with the SPE providing that PNC would service the loans, subject to AIG's review and approval. For this service, PNC was paid 50 basis points (i.e., .005) of the value of the assets in the SPE. Moreover, PNC's fee for servicing the loans was paid directly by the SPE, not out of AIG's 75-basis-point fee. In addition, the transaction documents stated that AIG's fee, subject to some minor conditions, would be paid for five years, even in the event of early termination. Thus, if PNC decided to terminate the SPE after two years, AIG would still receive the present value of the remaining three years of fees. The funding mechanism for paying this fee also provided that the fee would always be paid out first before virtually all other expenses of the SPE. Finally, AIG's five-year fee added up to a little more than its 3% initial capital investment in the SPE, suggesting a round-trip of AIG's initial 3% investment in the SPE.

The written guidance letter provided to PNC did not discuss AIG's fee and on June 28, 2001, PNC closed PAGIC I with AIG.

On August 14, 2001, PNC filed a Form 10-Q for the second quarter of 2001 with the Commission.[10] The Form 10-Q included the second quarter financial statements that E&Y had reviewed. In those financial statements, PNC excluded from its balance sheet the assets it had transferred to the SPE in the PAGIC I transaction. The financial statements reflected that PNC had $374 million in nonperforming loan assets and $16 million in other nonperforming assets. These figures did not include $84 million in nonperforming assets among the $257 million of loan assets that PNC had transferred to the SPE. PNC's second quarter Form 10-Q did not provide any disclosure concerning the PAGIC I transaction.

3. PNC's Third Quarter 2001

During the third quarter of 2001, Joseph continued to assist AIG in marketing the C-GAITS product to other public companies. In September 2001, Joseph and another partner from E&Y's National Office accompanied an AIG marketing team to pitch the C-GAITS product to another public company that was not an E&Y audit client. Also in September 2001, E&Y's engagement team and Joseph advised PNC on a second PAGIC transaction with AIG, which closed on September 27, 2001. PNC again relied on E&Y's and Joseph's advice. Once again, E&Y agreed to provide PNC with a written guidance letter memorializing E&Y's opinion that nonconsolidation was the appropriate accounting treatment for PAGIC II. As before, E&Y

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[10] E&Y performed a review of PNC's financial statements for the second quarter of 2001 and subsequently for the third quarter of 2001. The E&Y engagement team did not perform a separate analysis of PNC's accounting for the PAGIC transactions. In evaluating the accounting for the transactions, the E&Y team instead incorporated and relied on Joseph's analysis, including the written guidance letter issued to PNC, which mirrored the SAS 50 letters he provided to AIG. As a result, E&Y's conclusion on the appropriateness of PNC's accounting essentially was based on work performed by Joseph for AIG during the design of the product.

incorporated virtually verbatim into the guidance letter the accounting analysis and conclusions that Joseph had included in his earlier SAS 50 letter. Joseph once again reviewed and approved the issuance of the guidance letter.

On September 18, 2001, PNC filed with the Commission a registration statement on Form S-3 (the "September 18, 2001 registration statement") that would allow it to offer and sell approximately $4 billion of common stock, preferred stock, warrants, guarantees, depositary shares and debt securities. This filing was for a shelf registration of these securities, such that PNC could offer and sell the registered securities from time to time pursuant to applicable rules of the Commission. The September 18, 2001 registration statement incorporated by reference, among other things, the Form 10-Q filed with the Commission by PNC for the second quarter of 2001.

On October 1, 2001, a few days after PAGIC II closed, Joseph sent to AIG a revised term sheet with his edits for a C-GAITS deal that AIG was pitching to another public company. The term sheet featured an AIG initial capital investment of approximately 5%, and described AIG's fee as a "structuring" fee. The provisions surrounding the "structuring" fee virtually mirrored the terms surrounding what had previously been named the "fee" in previous drafts of the term sheet. This similarity should have been another significant red flag to Joseph that the "Fee to the Managing Member" in all of the PAGIC deals was in fact a structuring fee. Only days earlier, however, PAGIC II, which relied on the advice of Joseph, closed with deal documents that provided for only a 3% investment by AIG, and labeled AIG's fee a "Fee to the Managing Member."

In an October 18, 2001 press release, PNC announced that its earnings per share for the third quarter of 2001 were $1.02. The press release noted, "Loans declined $8.5 billion from December 31, 2000 to $42.1 billion at September 30, 2001 as a result of ongoing efforts to reduce lending leverage." The press release later noted, "Total assets were $71.9 billion at September 30, 2001 compared with $69.9 billion at September 30, 2000. Average interest-earning assets were $57.9 billion for the third quarter of 2001 compared with $59.7 billion for the third quarter of 2000. The decrease was primarily due to a $2.5 billion decrease in commercial loans related to initiatives to downsize certain higher-risk, non-strategic portfolios."

The October 18, 2001 press release further stated that PNC had $361 million in nonperforming loans and $13 million in other nonperforming assets. These figures did not include a total of $207 million in nonperforming assets among the assets that PNC had transferred to the SPEs in the two PAGIC transactions. Significantly, this release made no mention of the two PAGIC transactions into which PNC had entered by October 18, 2001.

Certain financial results set forth in the October 18, 2001 press release were also set forth in a prospectus relating to an offering made pursuant to the September 18, 2001 registration statement, which prospectus was filed with the Commission on October 25, 2001 and utilized in the offer and sale of approximately $1 billion of debt securities on or about October 29, 2001. In particular, the prospectus announced that PNC's earnings per share for the third quarter of 2001 were $1.02.

On November 14, 2001, PNC filed a Form 10-Q for the third quarter of 2001 with the Commission. The Form 10-Q included the third quarter financial statements that E&Y had reviewed. In those financial statements, PNC excluded from its balance sheet the assets it transferred in the two PAGIC transactions, and reported that PNC's earnings per share for that quarter were $1.02 per share. The financial statements reflected that PNC had $361 million in nonperforming loan assets and $13 million in other nonperforming assets. These figures did not include a total of $207 million in nonperforming assets among the $592 million of loan assets that PNC had transferred to the SPEs in the PAGIC transactions. PNC's third quarter Form 10-Q did not provide any disclosure concerning the completed PAGIC transactions.

4. PNC's Fourth Quarter 2001

Throughout October and November 2001, Joseph continued his marketing efforts on behalf of AIG, and on November 29, 2001, Joseph caused E&Y to issue another SAS 50 letter for AIG's negotiations with yet another public company. Joseph's new SAS 50 letter identified the fee to AIG as a "structuring" fee and mentioned that a structuring fee could reduce the amount of AIG's initial capital investment in the SPE. The structuring fee issue was included in the SAS 50 letter at the insistence of the counterparty public company. Also at about the same time, Joseph conferred with another E&Y audit client regarding a potential C-GAITS transaction with AIG.

On October 23, 2001, the Federal Reserve sent a letter to PNC expressing concern about PNC's accounting for the assets transferred in the first PAGIC transaction. Joseph worked at PNC's behest to address the Federal Reserve's concerns and to defend the accounting. During the same October-to-November period, Joseph, through E&Y's engagement team advised PNC on the accounting treatment for a third PAGIC transaction with AIG, which closed on November 29, 2001.[11] Again, Joseph reviewed and approved the issuance of a formal guidance letter to PNC memorializing E&Y's opinion concerning the accounting treatment for PAGIC III. As before, the guidance letter incorporated virtually verbatim the accounting analysis and conclusions that Joseph had included in the SAS 50 letter.

Also in November 2001, another of E&Y's banking audit clients discussed with the Federal Reserve the accounting for a C-GAITS transaction that the audit client was contemplating. On or about December 4, 2001, the Federal Reserve informed E&Y's client of its view that the proposed accounting was not in conformity with GAAP. Joseph worked at AIG's request to defend the proposed accounting for the transaction.

On December 6, 2001, PNC filed with the Commission a registration statement on Form S-8, in order to register the offer and sale of certain shares of common stock. This registration statement incorporated by reference the Forms 10-Q filed by PNC with the Commission for the second and third quarters of 2001.

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[11] The assets to be transferred to the PAGIC III SPE were equity assets, including venture capital investments. The accounting principles at issue in this matter were the same for all three PAGIC transactions.

On January 11, 2002, the Federal Reserve directed PNC to consolidate the assets of the three PAGIC SPEs in its bank holding company regulatory reports for 2001. Thereafter, on January 29, 2002, PNC announced it would reverse the accounting for all three PAGIC transactions, restate its financial statements for the second and third quarters of 2001, and revise its previously announced fourth quarter and full-year 2001 financial results. After the consolidation, PNC reflected a $155 million charge to PNC's earnings, a $0.53 per share drop (equivalent to 38%) in PNC's previously reported earnings per share for 2001, and an $0.18 per share drop (approximately 18%) in PNC's earnings per share as reported in the company's original Form 10-Q for the third quarter of 2001.

E. LEGAL ANALYSIS

1. Joseph Caused PNC to Violate Reporting and Recording-Keeping Provisions

Section 13(a) of the Exchange Act requires issuers of registered securities to file periodic reports with the Commission containing information prescribed by Commission rules and regulations. Exchange Act Rule 13a-13 requires the filing of quarterly reports on Form 10-Q, and Exchange Act Rule 12b-20 requires that, in addition to the information required by Commission rules to be included in periodic reports, such further material information as may be necessary to make the required statements not misleading also must be included. Periodic reports must be complete and accurate.

Section 13(b)(2)(A) of the Exchange Act requires issuers to "make and keep books, records, and accounts, which in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer." "A company's 'books and records' include not only general ledgers and accounting entries, but also memoranda and internal corporate reports." In the Matter of Gibson Greetings, Inc., Ward A. Cavanaugh, and James H. Johnsen, Admin. Proc. File No. 3-8866, Release No. 34-36357, 60 SEC Docket 1401 (Oct. 11, 1995).

PNC's accounting for the three PAGIC transactions did not conform with GAAP because, in each, AIG received a structuring fee which consequently reduced AIG's initial capital investment in the SPE below the 3% minimum required for nonconsolidation. Because the PAGIC transactions did not satisfy the criteria for nonconsolidation of SPEs, PNC should have consolidated the PAGIC entities in PNC's financial statements. PNC improperly excluded the PAGIC entities' assets from PNC's balance sheet included in its Forms 10-Q for the quarters ended June 30 and September 30, 2001, and materially overstated its earnings for the third quarter of 2001. In addition, the amounts of nonperforming assets were also materially understated in these filings. Accordingly, PNC violated Section 13(a) of the Exchange Act and Exchange Act Rules 13a-13 and 12b-20. Similarly, because PNC improperly accounted for the PAGIC transactions, PNC failed to maintain accurate books and records and consequently violated Section 13(b)(2)(A). Because Joseph should have known that PNC's accounting for the PAGIC transactions was not in conformity with GAAP, and by his conduct described above, Joseph was a cause of PNC's violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Exchange Act Rules 13a-13 and 12b-20.

2. Joseph Caused PNC to Violate Antifraud Provisions

Sections 17(a)(2) and 17(a)(3) of the Securities Act make it unlawful, in the offer or sale of securities, by the use of any means or instruments of transportation or communication in interstate commerce, or the mails, to obtain money or property by means of an untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

In its Forms S-3 and S-8 filed in September and December 2001, respectively, PNC offered its securities for sale. Those filings incorporated by reference PNC's Form 10-Q for the second quarter of 2001. The December filing also incorporated PNC's Form 10-Q for the third quarter of 2001. Because both Forms 10-Q materially misstated PNC's financial results through omitting the first two PAGIC transactions, PNC's offers of securities were materially misleading, and it engaged in a practice that would operate as a fraud upon purchasers of PNC securities.

Consequently, PNC violated Sections 17(a)(2) and 17(a)(3) of the Securities Act. As described above, Joseph should have known that the PAGIC transactions did not conform to GAAP. By his conduct described above, Joseph was a cause of PNC's violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act.

3. Applicable Professional Standards

Standards relating to the independence of public accounting firms are contained in GAAS and Rule 2-01(b) of Regulation S-X. Throughout the relevant time, GAAS required that "[i]n all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors."[12] This requirement is necessary because of the importance in having the public maintain confidence in the independence of auditors.[13] Auditors, accordingly, are required not only to be independent in fact, but also to avoid the appearance of a lack of independence.[14]

Rule 2-01(b) of Regulation S-X, in pertinent part, states:

> The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising

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[12] Codification of Statements on Auditing Standards, Statement on Auditing Standards No. 1, § 150.02 (Am. Inst. of Certified Pub. Accountants 1972).

[13] See id. § 220.03.

[14] Id.

objective and impartial judgment on all issues encompassed within the accountant's engagement. In determining whether an accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission.

4. Joseph Violated Independence Standards

As discussed above, Joseph was involved in the development and marketing of AIG's C-GAITS accounting product. He advised AIG on the structure, he prepared several SAS 50 letters used in marketing the product, he participated in conference calls with potential purchasers of the product and, on at least one occasion, accompanied AIG salespersons on a trip to market the product to a potential customer. Consequently, Joseph was invested both financially and reputationally in the success of the C-GAITS product and therefore had a conflict of interest when he later evaluated the accounting for the product by E&Y's audit client, PNC.

While working on the development and marketing of the C-GAITS product, Joseph also evaluated the accounting for transactions involving the PAGIC transaction pursued by E&Y's audit client, PNC. Joseph's advice and analysis of the accounting for the PAGIC transactions were relied upon during the drafting and issuance of the guidance letters to PNC, and during the E&Y engagement team's interim reviews of PNC's Form 10-Qs. At those times, the E&Y engagement team performed no separate, meaningful analysis of the accounting, but relied instead on that of Joseph. Because of the role that Joseph had played in the development and marketing of the C-GAITS product, and because of the role Joseph also had played in evaluating and advising PNC on PAGIC I, II and III in connection with E&Y's audit assignment for PNC, a reasonable investor with knowledge of all relevant facts and circumstances would conclude that Joseph was on both sides of the PNC transactions and that Joseph was not impartial and lacked the requisite independence with respect to his work in connection with E&Y's engagement for PNC.

The departures from GAAS and failure to comply with Rule 2-01 of Regulation S-X described above constitute improper professional conduct within the meaning of Rule 102(e)(1)(ii). Regarding accountants, the term "improper professional conduct" is defined by Rule 102(e)(1)(iv)(A) to include a "single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted."[15] Inasmuch as a reasonable investor would have concluded that Joseph was operating on both sides of several transactions which led to auditor independence violations, Joseph engaged in highly unreasonable conduct under circumstances which he should have known warranted heightened scrutiny. As the Commission has stated, "Because of the importance of an accountant's independence to the integrity of the financial reporting system, the Commission has concluded that circumstances that raise questions about an accountant's independence *always* merit heightened scrutiny."[16]

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[15] 17 CFR § 201.102(e)(1)(iv).

[16] Amendment to Rule 102(e) of the Commission's Rules of Practice, Release No. 33-7593 (October 19, 1998) (emphasis added).

F. **FINDINGS**

A. Based on the foregoing, the Commission finds that Joseph engaged in improper professional conduct pursuant to Rule 102(e)(1)(ii) of the Commission's Rules of Practice.

B. Based on the foregoing, the Commission finds that Joseph was a cause of PNC's violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act, Exchange Act Rules 13a-13 and 12b-20, and Sections 17(a)(2) and 17(a)(3) of the Securities Act.

IV.

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

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

A. Joseph shall cease and desist from (i) causing any violations and any future violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act, Exchange Act Rules 13a-13 and 12b-20, and (ii) committing or causing any violations and any future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act.

B. Joseph is denied the privilege of appearing or practicing before the Commission as an accountant.

C. After three (3) years from the date of this order, Respondent may request that the Commission consider his reinstatement by submitting an application (attention: Office of the Chief Accountant) to resume appearing or practicing before the Commission as:

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

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

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

(b) Respondent, or the registered public accounting firm with which he is associated, has been inspected by the Board and that inspection did not identify any criticisms

of or potential defects in the Respondent's or the firm's quality control system that would indicate that the Respondent will not receive appropriate supervision;

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

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

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.

Nancy M. Morris
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 54906 / December 11, 2006

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2522 / December 11, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12501

In the Matter of **THOMAS F. GARBE,** **Respondent.**	**ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted against Thomas F. Garbe ("Garbe" or "Respondent") pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act").

II.

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

III.

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

A. SUMMARY

In 2001, the PNC Financial Services Group, Inc. ("PNC") endeavored to remove certain loans and venture capital investments from its financial statements by transferring them to certain entities that were specially created to receive these assets. PNC made these transfers in order to reduce its exposure to loan losses and venture capital investment losses. PNC intended that the entities receiving these assets be regarded as "special purpose entities" ("SPEs") under generally accepted accounting principles ("GAAP") that would not have to be consolidated with PNC. For the second and third quarters of 2001, PNC filed financial statements with the Commission that did not consolidate these entities.

PNC's accounting with respect to these entities was improper under GAAP, and PNC made materially inaccurate statements in its filings with the Commission about its financial condition and performance, including, among other things, a material overstatement of its 2001 earnings. PNC's failure to account properly for these transactions, and its inaccurate disclosures, created a materially inaccurate picture that it was reducing its exposure to commercial lending and venture capital activities. Further, PNC's books and records were inaccurately maintained in connection with these transactions. Accordingly, PNC violated, among other provisions, reporting and recordkeeping provisions of the federal securities laws.[2]

Respondent Garbe failed to inquire adequately about facts and circumstances and was a cause of PNC's violations of the reporting and recordkeeping provisions of the federal securities laws. During 2001, Garbe was the head of PNC's Accounting Policy department, and, as such, had responsibility for ensuring that PNC's accounting for each of the three transactions described below was in conformity with GAAP. Garbe participated in discussions for the three transactions into which PNC entered with American International Group, Inc. ("AIG") during 2001, reviewed transaction-related documents, and researched and analyzed the proposed accounting treatment for those transactions. Garbe should have inquired further to determine if certain features of the transactions made nonconsolidation of the entities by PNC improper under GAAP. Most significantly, Garbe failed to adequately inquire whether the fees paid to AIG reduced AIG's investments in the SPEs below the point at which nonconsolidation would be appropriate under GAAP. Garbe, however, as head of PNC's Accounting Policy department, approved PNC's

[1] 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.

[2] The Commission previously brought settled proceedings against both PNC and AIG related to their roles in these matters. PNC Financial Services Group, Inc., Securities Act Release No. 8112, Exchange Act Release No. 46225, Accounting and Auditing Enforcement Release No. 1597 (July 18, 2002); SEC v. American International Group, Inc., No. 1:04CV02070 (GK) (D.D.C. judgment entered Dec. 7, 2004).

accounting for the three transactions and thereby was a cause of PNC's violation of Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Exchange Act Rules 12b-20 and 13a-13.

B. RESPONDENT

Thomas F. Garbe, age 54, was the director of PNC's Accounting Policy department from December 2000 to December 2001. The Accounting Policy department followed and reported on relevant accounting literature and examined the accounting for all significant transactions at PNC to determine the proper accounting for them. In January 2002, Garbe became director of Financial Accounting at PNC. Garbe resides in Pittsburgh, Pennsylvania and is a certified public accountant licensed in North Carolina and Pennsylvania.

C. RELEVANT ENTITIES

1. **The PNC Financial Services Group, Inc.** is a Pennsylvania corporation with its principal place of business in Pittsburgh, Pennsylvania. PNC is a bank holding company that is regulated by the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of Cleveland (together the "Federal Reserve") and has a national bank subsidiary that is regulated by the Comptroller of the Currency.

2. **American International Group, Inc.** is a Delaware Corporation with its principal place of business in New York, New York. Through its subsidiaries, AIG is engaged in a broad range of insurance-related and asset management activities in the United States and abroad.

D. FACTS

1. Structure and Accounting Treatment of Special Purpose Entity Transactions

During 2001, PNC entered into three transactions with AIG, "PAGIC I," "PAGIC II", and "PAGIC III," respectively. Each PAGIC transaction was intended to transfer certain loan or venture capital assets from PNC's balance sheet to a SPE. Each transaction involved the creation of two limited liability companies, one of which sold a substantial ownership interest to PNC and a minority ownership interest to AIG. With funds received in exchange for its shares, each PAGIC entity purchased loan or venture capital assets from PNC; some assets were acquired directly in exchange for shares. Many of the loan and other assets transferred by PNC were volatile, troubled or nonperforming.

In each of the second, third and fourth quarters of 2001, PNC entered into a PAGIC transaction. In its original financial reports filed with the Commission for the second and third quarters of 2001, PNC treated the loan and other assets transferred to the SPEs as if they were no longer assets of PNC. PNC intended that, as a result of the PAGIC transactions, PNC's balance sheet would reflect a reduction in exposure to troubled loans and volatile assets. PNC also intended, as a result of the PAGIC transactions, not to charge losses on the loans and other assets transferred to the SPEs against its income.

In sum, PNC transferred a total of approximately $762 million in loan and venture capital assets to the PAGIC SPEs, and PNC received preferred stock in exchange. PNC continued to service the loans and other assets transferred to the SPEs.

PNC's ability to treat the assets transferred to the PAGIC SPEs as no longer owned by PNC depended upon whether the transactions complied with the GAAP requirements for nonconsolidation of SPEs. As is discussed in greater detail below, at the time PNC entered into each of the PAGIC transactions, GAAP required, among other things, that an independent third party be the majority owner of each PAGIC SPE and that the independent third party provide a substantive capital investment in the SPE. Three percent was the minimally acceptable amount under GAAP to indicate a substantive capital investment sufficient for nonconsolidation. GAAP further provided that fees paid to the owner of the SPE for structuring the transaction were treated as a return of the owner's initial capital investment.

In fact, none of the PAGIC transactions complied with the GAAP requirements for nonconsolidation, in part because, in each transaction, AIG was to receive a fee that was in substance a structuring fee that eroded its minimum capital investment in the SPE. Therefore, PNC's second and third quarter 2001 financial statements included in the company's Forms 10-Q were not presented in conformity with GAAP. In short, PNC improperly treated the transfers of assets to the PAGIC SPEs as sales, when it should have consolidated the assets of the PAGIC entities in its financial statements. This failure to consolidate resulted in, among other things, (a) a material overstatement of PNC's earnings per share for the third quarter of 2001 by 21.4%, (b) material understatements of the amounts of PNC's nonperforming loans and nonperforming assets, and (c) material overstatements of the amounts of reductions in loans held for sale and overstatements in the amounts of securities available for sale.

2. The PAGIC Transactions

PAGIC I closed on June 28, 2001 (two days before the end of PNC's second quarter), PAGIC II closed on September 27, 2001 (three days before the end of PNC's third quarter), and PAGIC III closed on November 30, 2001 (during PNC's fourth quarter). In the PAGIC I and PAGIC II transactions, PNC transferred to the PAGIC entities loans and participations in loans ("loan assets") held by PNC's principal bank subsidiary, PNC Bank, N.A., and in the PAGIC III transaction, PNC transferred venture capital investments held by a non-bank subsidiary. In the PAGIC I transaction, PNC transferred $257.3 million in loan assets plus cash to a PAGIC entity, and in the PAGIC II transaction, PNC transferred $334.8 million in loan assets plus cash to a PAGIC entity. In the PAGIC III transaction, PNC transferred $169.6 million of venture capital assets plus cash to a PAGIC entity.

Each of the PAGIC transactions provided for AIG to receive, in the first five years, total fees exceeding the amount that AIG contributed to the transaction. For PAGIC I, AIG was to receive fees exceeding the $11.6 million that it contributed; for PAGIC II, AIG was to receive fees exceeding the $16.9 million that it contributed; and for PAGIC III, AIG was to receive fees exceeding the $8 million that it contributed. In each transaction, a portion of the fees was paid

by the PAGIC entity to AIG at the closing of the transaction, and the remainder was to be paid over the following four years. The agreements further provided that, if PNC liquidated its interest in the PAGIC entities, AIG would receive the present value of the remainder of the fees for the remainder of the five-year period.

3. PNC's Form 10-Q for the Quarter Ended June 30, 2001

In its Form 10-Q for the quarter ended June 30, 2001, filed with the Commission on August 14, 2001, PNC disclosed its financial performance and financial condition for the second quarter of 2001. PNC did not include on its balance sheet, as set forth in this Form 10-Q, the assets it transferred to the PAGIC I SPE but did include its holdings of the PAGIC I preferred stock on its balance sheet, in the line item entry for securities available for sale. Among other things, PNC stated in the Form 10-Q that (1) management was evaluating opportunities to reduce lending exposure, (2) loans at the end of the quarter were $44.2 billion, a $6.4 billion decrease from year-end 2000, and (3) PNC had $374 million in nonperforming loan assets and $390 million in total nonperforming assets. The figures on nonperforming loan assets and nonperforming assets did not include $84 million in nonperforming assets among the $257 million in loan assets that PNC had transferred to the PAGIC I SPE. PNC's Form 10-Q did not include any reference to the PAGIC I transaction.

4. PNC's Form 10-Q for the Quarter Ended September 30, 2001

In its Form 10-Q for the quarter ended September 30, 2001, filed on November 14, 2001, PNC reported that earnings per share for that quarter were $1.02 per share. PNC did not include on its balance sheet, as set forth in this Form 10-Q, the assets it transferred to the PAGIC I and PAGIC II SPEs but did include its holdings of the PAGIC I and PAGIC II preferred stock on its balance sheet, in the line item entry for securities available for sale. Among other things, PNC stated in the Form 10-Q that (1) loans at the end of the quarter were $42.1 billion, an $8.5 billion decrease from year-end 2000 and (2) PNC had $361 million in nonperforming loan assets and $374 million in total nonperforming assets. The figures on nonperforming loan assets and nonperforming assets did not include a total of $207 million in nonperforming assets among the $592 million of loan assets that PNC had transferred to the SPEs established for PAGIC I and PAGIC II. PNC's Form 10-Q also did not include any reference to the PAGIC I or PAGIC II transactions.

5. PNC's January 17, 2002 Press Release

On January 11, 2002, the Federal Reserve directed PNC to consolidate the entities created in the three PAGIC transactions in PNC's bank holding company regulatory reports for 2001.

On January 17, 2002, PNC issued a press release announcing its fourth quarter and full-year 2001 financial results. In this release, PNC stated that its earnings per share were $1.91, and that its fourth quarter loss would be ($1.15) per share. PNC also stated that it had reduced its institutional loan portfolio through, among other things, "sale of institutional loans to

subsidiaries of a third party financial institution." The release reported PNC's results as though PNC did not consolidate the assets of the three PAGIC SPEs for financial reporting purposes.

6. PNC Announces a Restatement with Respect to PAGIC Entities and Files Restated Financial Results

On January 29, 2002, PNC announced that it would reverse the accounting for all three PAGIC transactions, restate its financial statements for the second and third quarters of 2001, and revise its previously announced fourth quarter and full-year 2001 financial results. The change in accounting and restatement resulted in, among other things, a $155 million charge to PNC's earnings and a $0.53 per share drop (equivalent to 38%) in PNC's previously reported earnings per share for 2001.

On March 29, 2002, PNC filed amended Forms 10-Q for the quarters ended June 30, 2001, and September 30, 2001, that included restated financial results. The amended Form 10-Q for the quarter ended September 30, 2001 set forth PNC's restated financial results for the third quarter of 2001, including, among other things, PNC's earnings per share for this quarter, which were $0.84 per share (approximately 18% less than the $1.02 per share reported in PNC's original Form 10-Q for this quarter).

7. Garbe's Role in the PAGIC Transactions

In late May or early June 2001, Garbe learned from others that PNC was contemplating entering into the first of the PAGIC transactions. PNC senior management asked Garbe, as head of PNC's Accounting Policy department, to review PNC's accounting for the proposed transaction. Garbe participated in internal meetings with other PNC personnel in which the terms of the transactions were discussed. He discussed the transaction with personnel from Ernst & Young, LLP, PNC's auditor. Garbe was also present for certain conversations between PNC and AIG personnel during which certain transaction terms were discussed, and he reviewed transaction documents. Prior to the closing of PAGIC I, Ernst & Young provided to PNC and Garbe a draft "Guidance Letter," which opined that nonconsolidation of the PAGIC SPE conformed with GAAP. This letter, however, made no mention of the fee paid to AIG. A similar Guidance Letter was provided by Ernst &Young to PNC for PAGIC II and PAGIC III. Garbe subsequently reviewed and approved a memorandum prepared by PNC's Accounting Policy department for each PAGIC transaction that analyzed the accounting for the transaction and mentioned the fee paid to AIG, but without analyzing the accounting implications of such a fee. These memos concluded that PNC's nonconsolidation of the PAGIC entities was the appropriate accounting treatment under GAAP.

Throughout the relevant period, Garbe received information that should have prompted him to inquire further to determine whether PNC's nonconsolidation of the PAGIC entities was proper under GAAP. Most significantly, he should have known that, although the final transaction documents referred to AIG's fee as "fee to the managing member" and "management fee," the fee was in fact a structuring fee that would cause AIG's investment to be reduced below the 3% minimally acceptable amount required for nonconsolidation under GAAP. In connection with the PAGIC I transaction, Garbe knew that AIG initially proposed that PNC directly pay

AIG a fee at the closing of the transaction. Garbe rejected that proposal because such a fee would be viewed as a structuring fee. The manner in which the fee would be paid to AIG was thereafter renegotiated. As subsequently renegotiated, a PAGIC entity would pay AIG's fee. For the first five years, AIG would receive a fixed annual fee that, in total, exceeded the amount that AIG invested in the transaction. AIG would receive the present value of this fee even if PNC liquidated its interest in the PAGIC entities during the five-year period, and AIG would receive the same amount regardless of what took place with respect to the value or disposition of the loan assets that PNC contributed in the transaction.[3] The facts relating to the funding and payment of the fee were understood by Garbe.

Garbe further knew that PNC would be the servicer of the loan assets that it transferred to the PAGIC entities. PNC would retain the relevant loan records and establish bank accounts for loan collections. As the loan servicer, PNC would receive payments, would be responsible for valuing the loans annually and for developing action plans for managing the workout of the loans, which would be reviewed by AIG periodically. AIG's actual management of the PAGIC entities was limited, at best. For its role as servicer of the loan assets, PNC was to receive a servicing fee paid by a PAGIC entity separately from the fee that the PAGIC entity paid to AIG. The servicing fee paid to PNC, however, was significantly less than the fee paid to AIG, and, unlike the fee paid to AIG for the first five years, varied based on the value of the loan assets that PNC transferred in the transaction.[4] This and other information that arose during the course of the negotiations with AIG presented Garbe with reasons to evaluate whether AIG's fee for management services was actually a structuring fee that would reduce AIG's investment below the required 3% minimum and accordingly would cause the accounting for the transaction not to be in conformity with GAAP. Consequently, Garbe should have made further inquiry into the nature of AIG's fee. Nevertheless, Garbe, as head of PNC's Accounting Policy department, approved PNC's nonconsolidation of the SPE established for the PAGIC I transaction without making such an inquiry.

For accounting purposes, the PAGIC II and PAGIC III transactions were substantially similar to the PAGIC I transaction. In each case, Garbe should have made further inquiry to determine if the fees paid to AIG in the PAGIC II and PAGIC III transactions also were structuring fees that reduced AIG's investments in those transactions below the 3% level. Nevertheless, Garbe approved PNC's nonconsolidation accounting for the PAGIC II and PAGIC III transactions without making such inquiry.

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[3] During the first five years, AIG could not liquidate the PAGIC entities without PNC's consent. To help ensure that AIG would receive its fee, the agreements further provided that, with one minor exception, the first monies received in connection with the loan assets would be deposited into a "Management Fee Account" until that account had a sufficient amount to pay AIG the fee when it became due.

[4] After the first five years, AIG's fee would vary based on the value of both the loan assets and the value of a zero-coupon Treasury security purchased with some of the cash that PNC had contributed in the transaction.

E. DISCUSSION

Section 13(a) of the Exchange Act requires issuers of registered securities to file periodic reports with the Commission containing information prescribed by specific Commission rules. Rule 13a-1 requires the filing of annual reports on Form 10-K. Rule 13a-13 requires the quarterly filing of a Form 10-Q. Rule 12b-20 requires, in addition to information required by Commission rules to be included in periodic reports, such further material information as may be necessary to make the required statements not misleading. These reports are required to be complete and accurate.[5] Under the federal securities laws,[6] PNC is, and was at all relevant times, required to comply with GAAP in its filings with the Commission.

Section 13(b)(2)(A) of the Exchange Act requires issuers to "make and keep books, records, and accounts, which in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer." "A company's 'books and records' include not only general ledgers and accounting entries, but also memoranda and internal corporate reports."[7]

1. PNC Violated Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Exchange Act Rules 12b-20 and 13a-13

PNC's accounting for the PAGIC transactions was not in conformity with GAAP. Among other things, the transactions did not satisfy the requirement that the majority owner (in this case AIG) make a substantive capital investment. Because AIG's fees were structuring fees, they should have been treated under GAAP as a return of AIG's investment in the transaction, which reduced that investment below the 3% threshold. Because the PAGIC transactions did not satisfy the criteria for nonconsolidation, PNC should have consolidated the PAGIC entities in its financial statements.

The failure to account properly for the PAGIC transactions resulted in a material overstatement of PNC's earnings for the third quarter of 2001, among other things, and in inaccurate disclosures in the company's Forms 10-Q for the second and third quarters of 2001. Those disclosures, described above, created a materially inaccurate picture of the extent to which PNC was reducing its exposure to commercial lending activities and the risks attendant thereto. Thus, for example, the amounts of nonperforming loans, nonperforming assets, and reductions in loans held for sale, were all materially inaccurate, in that they were improperly recorded on the assumption that the assets transferred to PAGIC I and PAGIC II had been removed from PNC's financial statements. In fact, PNC's nonperforming assets and loans were materially greater than disclosed, because they should have included certain assets transferred to PAGIC I and PAGIC II, and its reductions in loans were materially overstated. As a result of PNC's improper accounting

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5 See SEC v. Savoy Indus., Inc., 587 F.2d 1149, 1165 (D.C. Cir. 1978), cert. denied, 440 U.S. 913 (1979).

6 17 CFR § 210.4-01(a)(1).

7 Gibson Greetings, Inc., Exchange Act Release No. 36357, 60 SEC Docket 1401 (Oct. 11, 1995).

for the PAGIC transactions for the second and third quarters of 2001 and the resulting misleading disclosures in the company's Forms 10-Q for those periods, PNC violated Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Exchange Act Rules 12b-20 and 13a-13.

2. Garbe Was a Cause of PNC's Violations

For the reasons discussed above, Garbe should have known that the fee paid to AIG in each PAGIC transaction was a structuring fee and that PNC's nonconsolidation of the PAGIC entities did not comply with GAAP. Garbe, as head of PNC's Accounting Policy department, had responsibility for ensuring that the accounting for each of the PAGIC transactions was in conformity with GAAP. By his actions described above, Garbe was a cause of PNC's violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Exchange Act Rules 12b-20 and 13a-13.

IV.

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

Accordingly, it is hereby ORDERED that:

Respondent Garbe cease and desist from causing any violations and any future violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act, and Exchange Act Rules 12b-20 and 13a-13.

By the Commission.

Nancy M. Morris
Secretary

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

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-54920]

December 12, 2006

Extension of Order Regarding Broker-Dealer Financial Statement Requirements under Section 17 of the Exchange Act

The Securities and Exchange Commission ("Commission") is extending its Order, originally issued on August 4, 2003,[1] and extended on July 14, 2004[2] and on December 7, 2005 (the "2005 Order")[3] under Section 17(e) of the Securities Exchange Act of 1934 ("Exchange Act"), regarding audits of financial statements of broker-dealers that are not issuers ("non-public broker-dealers"). The 2005 Order provided that non-public broker-dealers may file with the Commission and may send to their customers documents and information required by Section 17(e) certified by an independent public accountant, instead of by a registered public accounting firm, for fiscal years ending before January 1, 2007.

Section 17(e)(1)(A) of the Exchange Act requires that every registered broker-dealer annually file with the Commission a certified balance sheet and income statement, and Section 17(e)(1)(B) requires that the broker-dealer annually send to its customers its "certified balance sheet."[4] The Sarbanes-Oxley Act of 2002 ("Act")[5] established the Public Company Accounting Oversight Board ("Board")[6] and amended Section 17(e) to

[1] Exchange Act Release No. 48281, 68 FR 47375 (August 8, 2003).
[2] Exchange Act Release No. 50020, 69 FR 43482 (July 20, 2004).
[3] Exchange Act Release No. 52909, 70 FR 73809 (December 13, 2005).
[4] Exchange Act Rule 17a-5 requires registered broker-dealers to provide to the Commission and to customers of the broker-dealer other specified financial information.
[5] Public Law 107-204.
[6] Section 101 of the Act.

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replace the words "an independent public accountant" with "a registered public accounting firm."[7]

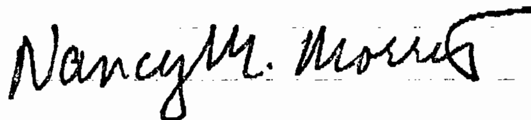
The Act establishes a deadline for registration with the Board of auditors of financial statements of "issuers," as that term is defined in the Act.[8] The Act does not provide a deadline for registration of auditors of non-public broker-dealers.

The 2005 Order expires January 1, 2007. Application of registration requirements and procedures to auditors of non-public broker-dealers is still being considered. The Commission has therefore determined that extending the Order for two years is consistent with the public interest and the protection of investors.

Accordingly,

IT IS ORDERED, pursuant to Section 17(e) of the Exchange Act, that non-public broker-dealers may file with the Commission a balance sheet and income statement and may send to their customers a balance sheet certified by an independent public accountant, instead of by a registered public accounting firm, for fiscal years ending before January 1, 2009.

By the Commission.



Nancy M. Morris
Secretary

[7] Section 205(c)(2) of the Act.

[8] Section 2 of the Act defines "issuer." Section 102 of the Act establishes a specific deadline by which auditors of issuers must register with the Board. Based on the statutory deadline of 180 days after the Commission determined the Board was ready to carry out the requirements of the Act, that date was October 22, 2003. See Exchange Act Release No. 48180 (July 16, 2003).

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-54919; File No. SR-CBOE-2006-14)

December 12, 2006

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing of Amendment Nos. 1 and 2 to the Proposed Rule Change Relating to Customer Portfolio Margining; Order Granting Accelerated Approval to the Proposed Rule Change, as Amended

I. Introduction

On February 2, 2006, the Chicago Board Options Exchange, Incorporated ("CBOE" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act" or "Exchange Act")[1] and Rule 19b-4[2] thereunder, a proposed rule change seeking to amend CBOE Rule 12.4 to expand the scope of products that are eligible for treatment as part of CBOE's approved portfolio margin pilot program and to eliminate the requirement for a separate cross-margin account.[3] The proposed rule change would

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

2 17 CFR 240.19b-4.

3 See Exchange Act Release No. 52032 (July 14, 2005), 70 FR 42118 (July 21, 2005) (SR-CBOE-2002-03). On July 14, 2005, the Commission approved on a pilot basis expiring July 31, 2007, amendments to CBOE's margin rules that permit broker-dealers to determine customer margin requirements for portfolios of listed broad-based securities index options, warrants, futures, futures options and related exchange-traded funds using a specified portfolio margin methodology. The Commission also approved rule amendments to require disclosure to, and written acknowledgment from, customers using a portfolio margin account.

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expand the scope of eligible products in the pilot to include margin equity securities,[4] unlisted derivatives, listed options and securities futures.[5] The proposed rule change was published in the Federal Register on April 6, 2006.[6] The Commission subsequently extended the comment period for the original proposed rule filing until May 11, 2006.[7] The Commission received 7 comment letters in response to the Federal Register notice.[8]

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[4] For purposes of the pilot, a margin equity security is a security that meets the definition of a "margin equity security" under Regulation T of the Federal Reserve Board ("FRB"). See 12 CFR 220.2. An unlisted derivative means "any equity-based (or equity index-based) unlisted option, forward contract or swap that can be valued by a theoretical pricing model approved by the Securities and Exchange Commission." See proposed Rule 12.4(a)(4).

[5] In addition to CBOE Rule 12.4, the proposed rule change also approves changes to CBOE Rules 9.15, 13.5 and 15.8A.

[6] See Exchange Act Release No. 53576 (March 30, 2006), 71 FR 17519 (April 6, 2006) (SR-CBOE-2006-14). The New York Stock Exchange LLC ("NYSE") also filed a similar proposed rule filing seeking to expand the scope of eligible products under its portfolio margin pilot program. See Exchange Act Release No. 53577 (March 30, 2006), 71 FR 17539 (April 6, 2006) (SR-NYSE-2006-13).

[7] See Exchange Act Release No. 53728 (April 26, 2006), 71 FR 25878 (May 2, 2006).

[8] See letter from Timothy H. Thompson, Senior Vice President, Chief Regulatory Officer, Regulatory Services Division, CBOE, to Nancy Morris, Secretary, Commission, dated June 5, 2006 ("CBOE Letter"); letter from William H. Navin, Executive Vice President, General Counsel and Secretary, The Options Clearing Corporation ("OCC"), to Nancy M. Morris, Secretary, Commission, dated May 19, 2006 ("OCC Letter"); letter from James Barry, on behalf of the Ad Hoc Portfolio Margin Committee, John Vitha, Chair, Derivatives Product Committee and Christopher Nagy, Chair, Options Committee, Securities Industry Association, to Nancy M. Morris, Secretary, dated May 16, 2006 ("SIA Letter"); letter from Gary Alan DeWaal, Group General Counsel and Director of Legal and Compliance, Fimat USA, LLC, to Nancy M. Morris, Secretary, Commission, dated May 11, 2006 ("Fimat Letter"); letter from Stuart J. Kaswell, Partner, Dechert LLP, Counsel for Federated Investors, Inc., to Nancy M. Morris, Secretary, Commission, dated May 10, 2006 ("Federated Letter"); letter from Craig S. Donohue, Chief Executive Officer, Chicago Mercantile Exchange Inc., to

On July 26, 2006, CBOE filed a response to these comments.[9] The comment letters and CBOE's response to the comments are summarized below. On August 9, 2006, CBOE filed Amendment No. 1 to the proposed rule change.[10] On September 27, 2006, CBOE filed Amendment No. 2 to the proposed rule change.[11]

This order provides notice of filing of Amendment Nos. 1 and 2 and solicits comments from interested persons on Amendment Nos. 1 and 2. This order also grants accelerated approval of the proposed rule change, as amended by Amendment Nos. 1 and 2.[12]

Jonathan G. Katz, Secretary, Commission, dated May 9, 2006 ("CME Letter"); and letter from Gerard J. Quinn, Vice President and Associate General Counsel, SIA, to Nancy M. Morris, Secretary, Commission, dated April 21, 2006 ("SIA Extension Letter").

9 See letter from Timothy H. Thompson, Senior Vice President, Chief Regulatory Officer, Regulatory Services Division, CBOE, to Nancy M. Morris, Secretary, Commission, dated July 26, 2006 ("CBOE Response").

10 CBOE filed Amendment No. 1 in response to comments received and to make other clarifying changes to the proposed rule filing. Amendment No. 1 replaced and superceded the original filing in its entirety.

11 CBOE filed partial Amendment No. 2 to conform its day trading language to the NYSE rule language and to request accelerated approval. A clean copy of the proposed rule, as amended by Amendment Nos. 1 and 2, is attached to this order as Exhibit A.

12 By separate order, the Commission also is approving a parallel rule filing by the NYSE (SR-NYSE-2006-13). Exchange Act Release No. 54918; see also supra note 6.

II. Description

a. Portfolio Margining

The proposed rule change consists of amendments to Rule 12.4 to include margin equity securities (as defined in Regulation T), unlisted derivatives, listed options and securities futures as eligible products for the portfolio margining pilot.[13] The proposed rule change also includes amendments to eliminate the requirement of a separate cross-margin account. CBOE Rule 12.3 prescribes specific margin requirements for customers based on the type of securities held in their accounts.[14] Outside the existing pilot program, CBOE's margin rules require that margin be calculated using fixed percentages, on a position-by-position basis. In contrast, the current portfolio margin pilot program permits a broker-dealer to calculate customer margin requirements by grouping all products in an account that are based on the same index or issuer into a single portfolio. For example, futures, options and exchange traded funds based on the S&P 500 would each be grouped in a portfolio and products based on IBM would be grouped into a separate portfolio.

The broker-dealer then calculates a customer's margin requirement by "shocking" each portfolio at different equidistant points along a range representing a potential

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[13] The list of eligible products under the pilot currently includes listed broad-based securities index options, warrants, futures, futures options and related exchange-traded funds.

[14] The margin rules specify the amount of equity a customer must maintain in his or her margin account with respect to securities positions financed by the broker-dealer. The equity protects the broker-dealer in the event the customer defaults on the obligation to re-pay the financing and the broker-dealer is forced to liquidate the position at a loss.

percentage increase and decrease in the value of the instrument or underlying instrument in the case of a derivative product. Currently, under the pilot, products of portfolios based on high capitalization, broad-based securities indexes are shocked along a range spanning an increase of 6% and a decrease of 8%. Portfolios of products based on non-high capitalization, broad-based securities indexes are shocked along a range spanning an increase of 10% and a decrease of 10%. The proposed rule change would continue to apply these shock ranges. Under the proposed amendments, portfolios of products based on an equity security or a narrow-based index would be shocked along a range spanning an increase of 15% and a decrease of 15%.[15] In addition, as with the current pilot, a theoretical options pricing model would continue to be used to derive position values at each valuation point for the purpose of determining the gain or loss.[16]

The portfolio shocks described above result in a gain or loss for each instrument in a portfolio at each calculation point along the range. These gains and losses are netted to derive a potential portfolio-wide gain or loss for the point. The margin requirement for a portfolio is the amount of the greatest portfolio-wide loss among the calculation points. The margin requirements for each portfolio are added together to calculate the total

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[15] For example, under the pilot, a portfolio of single stock futures and listed equity options would be shocked at 10 equidistant points along a range bounded on one end by a 15% increase in the market value of the instrument and at the other end by a 15% decrease (i.e., at +/-3%, +/-6%, +/-9%, +/-12% and +/-15%).

[16] Currently, the only model that qualifies is the OCC's Theoretical Intermarket Margining System (TIMS).

margin requirement for the portfolio margin account. This approach, in most cases, will generally lower customer margin requirements.[17]

The amount of margin (initial and maintenance) required with respect to a given portfolio would be the larger of: (1) the greatest portfolio-wide loss amount among the valuation point calculations; or (2) the sum of $.375 for each option and future in the portfolio multiplied by the contract's or instrument's multiplier.[18] The second computation establishes a minimum margin requirement to ensure that a certain level of margin is required from the customer in the event the greatest portfolio-wide loss among the valuation points is de minimis.

b. Expansion of Eligible Products

Under CBOE's proposed rule, products eligible for portfolio margining would be expanded to include margin equity securities (as defined under Regulation T),[19] unlisted derivatives, listed options and securities futures. The unlisted derivatives would be included in a portfolio based on the underlying reference index or security. Individual

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17 For example, the current required initial and maintenance margin requirements for an equity security are 50% and 25%, respectively. The market movement range to calculate the potential gains and losses under the proposed portfolio margin rule for equity securities is +/-15%.

18 The multiplier for a standard listed option is fixed by the options market on which the options series is traded. For example, a cash settled equity option generally has a multiplier of 100. Therefore, the minimum margin for one options contract would be $37.50. The multipliers for different securities and futures products may vary.

19 Margin equity securities include certain foreign equity securities and options on foreign equity securities. See 12 CFR 220.2

equities and narrow-based index futures would be included in a portfolio shocked at a range spanning an increase of 15% and a decrease of 15%.

c. Margin Deficiency

The proposed rule change would require a customer to satisfy a margin deficiency in a portfolio margin account within three business days by depositing additional margin or effecting an offsetting hedge. The current pilot requires that a customer deposit addition margin by T+1. The proposed rule also would require a broker-dealer to deduct from its net capital the amount of any portfolio margin call not met by the close of business on T+1 and until the call is satisfied. Additionally, the proposal would further require a broker-dealer to have in place procedures to identify accounts that periodically liquidate positions to eliminate margin deficiencies, and to take appropriate action when warranted.[20]

d. $5 Million Equity Requirement

The current pilot requires customers that are not broker-dealers or futures firms to maintain minimum account equity of $5 million dollars. The proposed rule change would eliminate the $5 million account equity requirement for all portfolio margin accounts, except those holding unlisted derivatives.[21]

e. Risk Management Methodology

The pilot requires member broker-dealers to monitor the risk of portfolio margin accounts and maintain a written risk analysis methodology for assessing potential risk to

[20] See proposed rule 12.4(i)(1).

[21] See proposed rule 12.4(b)(3).

the firm's capital. This risk analysis methodology must be filed and maintained with CBOE. The proposed rule change strengthens these requirements by providing that, member organizations must file the risk analysis methodology with its firm's DEA and submit it to the Commission prior to implementation.[22] The proposed rule change also requires the inclusion of additional procedures and guidelines as part of the methodology.[23]

f. Cross-Margin Account

The proposed rule change would eliminate the requirement that portfolios with futures positions be held in a separate cross-margin account. Under the proposal, a customer would be permitted to use a single securities margin account for all eligible products. The Exchange and commenters have indicated that maintaining and monitoring two separate margin accounts would be operationally difficult and that it would be more efficient to hold all positions in one securities account.

g. Excess Equity and Collateral

CBOE also proposes to amend Rule 12.4 to add language allowing a customer to use excess equity in a regular margin account to meet a margin deficiency in a portfolio margin account without having to transfer any funds or securities where the portfolio margin account is a sub-account of the regular margin account. In addition, the proposed

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[22] See proposed Rule 12.4(b), under which the broker-dealer must receive prior approval from its DEA prior to offering portfolio margining to its customers. As part of the approval process, CBOE will require a firm to demonstrate compliance with the risk management analysis rules.

[23] See proposed Rule 15.8A.

rule change adds language allowing positions (including nonequity securities and money market mutual funds) not eligible for portfolio margin treatment to be carried in the portfolio margin account for their collateral value, subject to the margin requirements of a regular margin account.

h. Day Trading

The proposed rule change amends the day trading provisions of Rule 12.4 to provide that CBOE's day trading rules do not apply to portfolio margin accounts that have at least $5 million equity, provided the member firm has the ability to monitor the intra-day risk associated with day trading. In addition, the proposed rule change would provide that day trading will not be deemed to have occurred whenever the position or positions day traded were part of a hedge strategy[24] that reduced the risk of the portfolio.

i. Risk Disclosure Statement

The proposed rule change eliminates the sample risk disclosure statement and acknowledgement in the rule text.[25]

j. Hedged Positions

Under the pilot, an underlying security in a portfolio margin account must be removed from the account if it is no longer offset by an option position. The amendments propose to eliminate the requirement to remove instruments that are no longer offset by

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24 A "hedge strategy" for purposes of the day trading restrictions on portfolio margining means a transaction or series of transactions that reduces or offsets a material portion of the risk in a portfolio.

25 Instead the Exchange will send out a regulatory circular with the sample disclosure language. The Exchange made this change to avoid having to file a proposed rule change each time in the risk disclosure document is changed.

options positions. CBOE made this change in response to comments that all positions eligible for a portfolio margin account, including underlying securities, should receive equal treatment. Moreover, CBOE noted that it would be operationally difficult to move positions in and out of the portfolio margin account based on whether they are currently being offset.

III. Summary of Comments Received and CBOE Response

The Commission received a total of 7 comment letters to the proposed rule change.[26] The comments, in general, were supportive. One commenter stated that it strongly supports "the significant step forward represented by the currently proposed changes."[27] Another commenter stated that the portfolio margining of securities products will "help US brokers and exchanges compete more effectively with their overseas counterparts. . .and thereby increase the strength and liquidity of US markets."[28] Each commenter, however, recommended changes to specific provisions of the proposed rule change.

Several commenters[29] submitted comments regarding the ability to use portfolio margin methodologies other than the method prescribed in the rule to calculate customer margin requirements. One commenter stated that the Commission has experience in approving proprietary market risk models for consolidated supervised entities (CSEs) and

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[26] See supra note 8. One of the comment letters related to the extension of the comment period for the proposed rule change. See SIA Extension Letter.

[27] See SIA Letter.

[28] See Fimat Letter.

[29] See SIA Letter and OCC Letter; see also CME Letter (discussing SPAN).

OTC derivatives dealers.[30] The Exchange stated, however, that initially, the most prudent course is for all broker-dealers to utilize the rule's specified methodology and that in the longer term, proprietary risk models could be considered as alternatives.[31]

One commenter suggested that CBOE eliminate the requirement for a separate cross margin account and provide for one portfolio margin account for both futures and options; eliminate the requirement that stock must be hedged in order to be carried in a portfolio margin account; and eliminate the two-tiered per contract minimum margin requirement in favor of one overall minimum.[32] The CBOE stated that it agrees with the proposed changes and believes they are operationally feasible. In response, CBOE made these changes in Amendment No. 1 to the proposed rule filing.[33]

One commenter stated that portfolio margining should be expanded to include nonequity securities, interest rate derivatives, collateralized debt obligations and other similar non-equity related products, and foreign currency derivatives.[34] This commenter also requested that nonequity securities be permitted to be held in the portfolio margin account for collateral purposes only, subject to the other applicable margin

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30 See SIA Letter.

31 See CBOE Response, supra note 9.

32 See SIA Letter.

33 CBOE also made these changes to maintain consistency with the NYSE filing.

34 See SIA Letter.

requirements.[35] The Exchange noted that it agrees with the commenter to the extent that nonequity securities may serve as collateral in the portfolio margin account.[36]

One commenter requested that CBOE and NYSE eliminate differences between the CBOE and NYSE risk disclosure documents. In response, CBOE (and the NYSE) amended the rule text to eliminate the risk disclosure language.[37]

IV. Discussion and Commission Findings

The Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.[38] In particular, the Commission believes that the proposed rule change, as amended, is consistent with Section 6(b)(5) of the Act[39] in that it is designed to perfect the mechanism of a free and open market and to protect investors and the public interest. The Commission notes that the proposed portfolio margin rule change is intended to promote greater reasonableness, accuracy and efficiency with respect to Exchange margin requirements and will better align margin requirements with actual risk.

Under a portfolio margin system, offsets are fully realized, whereas under the Exchange's current margin rules, positions are margined independent of each other and

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35 See SIA Letter.

36 See Amendment No. 1; see also CBOE Response, supra note 9.

37 Id.; see supra note 25.

38 In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

39 15 U.S.C. 78f(b)(5).

offsets between them do not figure into the total margin requirement. A portfolio margin system recognizes the offsetting gains from positions that react favorably in market declines, while market rises are tempered by offsetting losses from positions that react negatively. Consequently, a portfolio margin approach can have a neutralizing effect on the volatility of margin requirements. Thus, a portfolio margin system may better align a customer's total margin requirement with the actual risk associated with the customer's positions taken as a whole. The Commission further notes portfolio margining may alleviate excessive margin calls, improve cash flows and liquidity, and reduce volatility.

Moreover, the Commission notes that approving the proposed rule change would enhance portfolio margining by permitting more products to be margined under this methodology. This is consistent with the amendments to Regulation T made by the FRB in 1998, which sought to advance the use of portfolio margining.[40] The Commission also believes that this expanded program for portfolio margining will serve to advance the development of even more risk-sensitive approaches to margining customer positions, including the use of internal models as advocated by commenters. The Commission intends to work with CBOE and the NYSE towards this objective after it gains experience with the portfolio margining system of this proposal.

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40 Federal Reserve System, "Securities Credit Transactions; Borrowing by Brokers and Dealers," 63 FR 2806 (January 16, 1998); see also 12 CFR 220.1(b)(3)(i); see also letter from the FRB to James E. Newsome, Acting Chairman, Commodity Futures Trading Commission, and Laura S. Unger, Acting Chairman, Commission, dated March 6, 2001. The FRB concluded the letter by writing "the Board anticipates that the creation of securities futures products will provide another opportunity to develop more risk-sensitive, portfolio-based approaches for all securities, including securities options and securities futures products." Id.

The Commission believes that while the portfolio margining system in the proposed rule will have the effect of reducing customer margin (in most cases), the methodology is relatively conservative in that it requires positions to be shocked at specified market move ranges (e.g., +/-15% for individual equities) that represent potential future stress events. Essentially the same portfolio methodology has been used by broker-dealers to calculate haircuts on options positions for net capital purposes.[41] Furthermore, the proposed requirement that a firm receive pre-approval from the Exchange prior to offering portfolio margining to its customers, coupled with the requirement for enhanced risk management procedures, is designed to ensure that only those firms with adequate controls would be eligible to implement a customer portfolio margining program.[42]

CBOE also has requested that the Commission approve Amendment Nos. 1 and 2 to the proposed rule change prior to the thirtieth day after publication of notice of the filing in the Federal Register. The Commission believes that the changes in Amendment Nos. 1 and 2 to the proposed rule change do not raise significant new or unique issues from those previously raised in the earlier portfolio margin rule filings.[43] The changes proposed by the Exchange in Amendment Nos. 1 and 2 are designed to ensure

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[41] See Exchange Act Release No. 38248 (February 6, 1997), 62 FR 6474 (February 12, 1997).

[42] The proposed rules also would continue to require a minimum per contract charge of $.375. The Commission also notes that the proposed rules contain a leverage test under which a broker-dealer cannot permit the amount of portfolio margin required of its customers to exceed 10 times the firm's net capital.

[43] See supra note 3.

consistency with the companion NYSE proposed rule filing and to respond to comments received as a result of the Federal Register notice.[44] The Commission believes that these proposed changes strengthen the proposed rule change.

Accordingly, the Commission finds good cause for approving Amendment Nos. 1 and 2 to the proposed rule change prior to the thirtieth day after the date of publication of notice thereof in the Federal Register. Specifically, the Commission believes that it is consistent with Section 19(b)(2) of the Act[45] to approve Amendment Nos. 1 and 2 to CBOE's proposed rule change prior to the thirtieth day after publication of the notice of filing thereof in the Federal Register.

Uniform Effective Date

The Commission believes that approving the amendments on an accelerated basis will permit CBOE to begin the process of approving broker-dealers to implement portfolio margining and would allow firms to begin to make the necessary changes and upgrades to their systems, as well as their policies and procedures, in order to accommodate customer portfolio. The Commission, however, believes that if some firms receive CBOE approval to begin offering customer portfolio margining to customers before other firms, these other firms would be at a competitive disadvantage. Therefore, the Commission has determined to set a uniform effective date of April 2, 2007 for the proposed rule change, as amended. As stated above, the Commission believes that setting

[44] See supra notes 6 and 7.

[45] 15 U.S.C. 78s(b)(2).

a uniform effective date will avoid placing some firms at a competitive disadvantage and reduce confusion in the marketplace.

V. Solicitation of Comments of Amendment Nos. 1 and 2

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as amended, is consistent with the Exchange Act. 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 e-mail to rule-comments@sec.gov. Please include File Number SR-CBOE-2006-14 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-CBOE-2006-14. 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 Web site (http://www.sec.gov/rules/sro/shtml). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld

from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing also will be available for inspection and copying at the principal office of the Exchange. 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 submission should refer to File Number SR-CBOE-2006-14 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

VI. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[46] that the proposed rule change (File No. SR-CBOE-2006-14), as amended, be and it hereby is, approved on an accelerated basis, on a pilot basis to expire on July 31, 2007. The effective date will be April 2, 2007.

By the Commission.

Florence E. Harmon
Deputy Secretary

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46 15 U.S.C. 78s(b)(2).

Exhibit A

Chicago Board Options Exchange, Inc.

Chapter XII

Margins

Rule 12.4. Portfolio Margin

As an alternative to the transaction / position specific margin requirements set forth in Rule 12.3 of this Chapter 12, a member organization may require margin for all margin equity securities (as defined in Section 220.2 of Regulation T), listed options, unlisted derivatives, security futures products, and index warrants in accordance with the portfolio margin requirements contained in this Rule 12.4.

In addition, a member organization, provided it is a Futures Commission Merchant ("FCM") and is either a clearing member of a futures clearing organization or has an affiliate that is a clearing member of a futures clearing organization, is permitted under this Rule 12.4 to combine a customer's related instruments (as defined below), listed index options, unlisted derivatives, options on exchange traded funds, index warrants, and underlying instruments and compute a margin requirement for such combined products on a portfolio margin basis. Application of the portfolio margin provisions of this Rule 12.4 to IRA accounts is prohibited.

(a) Definitions.

(1) The term "listed option" shall mean any equity (or equity index-based) option traded on a registered national securities exchange or automated facility of a registered national securities association.

(2) The term "security future" means a contract of sale for future delivery of a single security or of a narrow-based security index, including any interest therein or based on the value thereof, to the extent that that term is defined in Section 3(a)(55) of the Securities Exchange Act of 1934.

(3) The term "security futures product" means a security future, or an option on any security future.

(4) The term "unlisted derivative" means any equity-based (or equity index-based) unlisted option, forward contract or swap that can be valued by a theoretical pricing model approved by the Securities and Exchange Commission.

(5) The term "option series" means all option contracts of the same type (either a call or a put) and exercise style, covering the same underlying instrument with the same exercise price, expiration date, and number of underlying units.

(6) The term "class" refers to all listed options, unlisted derivatives, security futures products, and related instruments that are based on the same underlying instrument, and the underlying instrument itself.

(7) The term "portfolio" means products of the same class grouped together.

(8) The term "related instrument" within a class or product group means index futures contracts and options on index futures contracts covering the same underlying instrument, but does not include security futures products.

(9) The term "underlying instrument" means a security or security index upon which any listed option, unlisted derivative, security futures product or related instrument is

based. The term underlying instrument shall not be deemed to include futures contracts, options on futures contracts or underlying stock baskets.

(10) The term "product group" means two or more portfolios of the same type for which it has been determined by Rule 15c3-1a(b)(ii) under the Securities Exchange Act of 1934 that a percentage of offsetting profits may be applied to losses at the same valuation point.

(11) The terms "theoretical gains and losses" means the gain and loss in the value of each eligible position at 10 equidistant intervals (valuation points) ranging from an assumed movement (both up and down) in the current market value of the underlying instrument.

The magnitude of the valuation point range shall be as follows:

Portfolio Type	Up / down market move (high & low valuation points)
High Capitalization, Broad-based Market Index [1]	+6%/-8%
Non-High Capitalization, Broad-based Market Index [1]	+/-10%
Narrow-based Index[1]	+/-15%
Individual Equity[1]	+/-15%

1 In accordance with sub-paragraph (b)(1)(i)(B) of Rule 15c3-1a under the Securities Exchange Act of 1934.

(b) Eligible Participants.

Any member organization intending to apply the portfolio margin provisions of this Rule 12.4 to its accounts must receive prior approval from its DEA. The member organization will be required to, among other things, demonstrate compliance with Rule 15.8A – Risk

Analysis of Portfolio Margin Accounts, and with the net capital requirements of Rule 13.5 – Customer Portfolio Margin Accounts.

The application of the portfolio margin provisions of this Rule 12.4 is limited to the following customers:

(1) any broker or dealer registered pursuant to Section 15 of the Securities Exchange Act of 1934;

(2) any member of a national futures exchange to the extent that listed index options, unlisted derivatives, options on exchange traded funds, index warrants or underlying instruments hedge the member's related instruments, and

(3) any person or entity not included in (b)(1) or (b)(2) above that is approved for writing uncovered options. However, such persons or entities may not establish or maintain positions in unlisted derivatives unless minimum equity of at least five million dollars is established and maintained with the member organization. For purposes of the five million dollar minimum equity requirement, all securities and futures accounts carried by the member organization for the same customer may be combined provided ownership across the accounts is identical. A guarantee by any other account for purposes of the minimum equity requirement is not permitted.

(c) Opening of Accounts.

(1) Only customers that, pursuant to Rule 9.7, have been approved for writing uncovered options are permitted to utilize a portfolio margin account.

(2) On or before the date of the initial transaction in a portfolio margin account, a member shall:

(A) furnish the customer with a special written disclosure statement describing the nature and risks of portfolio margining and which includes an acknowledgement for all portfolio margin account owners to sign, attesting that they have read and understood the disclosure statement, and agree to the terms under which a portfolio margin account is provided, and

(B) obtain a signed acknowledgement from the customer and record the date of receipt.

(d) Establishing Account and Eligible Positions.

(1) For purposes of applying the portfolio margin requirements provided in this Rule 12.4, member organizations are to establish and utilize a dedicated securities margin account, or sub-account of a margin account, clearly identified as a portfolio margin account that is separate from any other securities account carried for a customer.

A margin deficit in the portfolio margin account of a customer may not be considered as satisfied by excess equity in another account. Funds and/or securities must be transferred to the deficient account and a written record created and maintained. In the case of a portfolio margin account carried as a sub-account of a margin account, excess equity in the margin account may be used to satisfy a margin deficiency in the portfolio margin sub-account without transferring funds and/or securities to the portfolio margin sub-account.

(3) Eligible Positions

(A)

(i) a margin equity security (including a foreign equity security and option on a foreign equity security, provided the foreign equity security is deemed to have a "ready market" under SEC Rule 15c3-1 or a no-action position issued thereunder; and a control or restricted security, provided the security has met the requirements in a manner consistent with SEC Rule 144 or an SEC no-action position issued thereunder, sufficient to permit the sale of the security, upon exercise of any listed option or unlisted derivative written against it, without restriction).

(ii) a listed option on an equity security or index of equity securities,

(iii) a security futures product,

(iv) an unlisted derivative on an equity security or index of equity securities,

(v) a warrant on an equity security or index of equity securities, and

(vi) a related instrument.

(4) Positions other than those listed in (3)(A) above are not eligible for portfolio margin treatment. However, positions not eligible for portfolio margin treatment (except for ineligible related instruments) may be carried in a portfolio margin account subject to the margin required pursuant Rule 12.3 of this Chapter 12. Shares of a money market mutual fund may be carried in a portfolio margin account subject to the margin required pursuant to Exchange Rule 12.3 of this Chapter 12 provided that:

(i) the customer waives any right to redeem the shares without the member organization's consent,

(ii) the member organization (or, if the shares are deposited with a clearing organization, the clearing organization) obtains the right to redeem the shares in cash upon request,

(iii) the fund agrees to satisfy any conditions necessary or appropriate to ensure that the shares may be redeemed in cash, promptly upon request, and

(iv) the member organization complies with the requirements of Section 11(d)(1) of the Securities Exchange Act of 1934 and Rule 11d1-2 thereunder.

(e) Initial and Maintenance Margin Required. The amount of margin required under this Rule 12.4 for each portfolio shall be the greater of:

(1) the amount for any of the ten equidistant valuation points representing the largest theoretical loss as calculated pursuant to paragraph (f) below or

(2)$.375 for each listed option, unlisted derivative, security futures product, and related instrument multiplied by the contract or instrument's multiplier, not to exceed the market value in the case of long positions.

(f) Method of Calculation.

(1) Long and short positions in eligible positions are to be grouped by class; each class group being a "portfolio". Each portfolio is categorized as one of the portfolio types specified in paragraph (a)(11) above.

(2) For each portfolio, theoretical gains and losses are calculated for each position as specified in paragraph (a)(11) above. For purposes of determining the theoretical gains and losses at each valuation point, member organizations shall obtain and utilize the theoretical value of a listed option, unlisted derivative, security futures product, underlying instrument, and related instrument rendered by a theoretical pricing model that has been approved by the Securities and Exchange Commission.[1]

(3) Offsets. Within each portfolio, theoretical gains and losses may be netted fully at each valuation point.

Offsets between portfolios within the High Capitalization, Broad-Based Index Option, Non-High Capitalization, Broad-Based Index Option and Narrow-Based Index Option product groups may then be applied as permitted by Rule 15c3-1a under the Securities Exchange Act of 1934.

(4) After applying paragraph (3) above, the sum of the greatest loss from each portfolio is computed to arrive at the total margin required for the account (subject to the per contract minimum).

(5) In addition, if a security that is convertible, exchangeable, or exercisable into a security that is an underlying instrument requires the payment of money or would result in a loss if converted, exchanged, or exercised at the time when the security is deemed an underlying instrument, the full amount of the conversion loss is required.

(g) Minimum Equity Deficiency. If, as of the close of business, the equity in the portfolio margin account declines below the five million dollar minimum equity required under

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1 Currently, the theoretical model utilized by the Options Clearing Corporation is the only model qualified.

Paragraph (b) of this Rule 12.4 and is not restored to the required level within three (3) business days by a deposit of funds or securities, or through favorable market action; member organizations are prohibited from accepting new orders beginning on the fourth business day, except that new orders entered for the purpose of reducing market risk may be accepted if the result would be to lower margin requirements. This prohibition shall remain in effect until such time as:

(1) the required minimum account equity is re-established or

(2) all unlisted derivatives are liquidated or transferred from the portfolio margin account to the appropriate account.

In computing net capital, a deduction in the amount of a customer's equity deficiency may not serve in lieu of complying with the above requirements.

(h) Determination of Value for Margin Purposes. For the purposes of this Rule 12.4, all eligible positions shall be valued at current market prices. Account equity for the purposes of this Rule 12.4 shall be calculated separately for each portfolio margin account by adding the current market value of all long positions, subtracting the current market value of all short positions, and adding the credit (or subtracting the debit) balance in the account.

(i) Additional Margin.

(1) If, as of the close of business, the equity in any portfolio margin account is less than the margin required, the customer may deposit additional margin or establish a hedge to meet the margin requirement within three business days. After the three business day period, member organizations are prohibited from accepting new

orders, except that new orders entered for the purpose of reducing market risk may be accepted if the result would be to lower margin requirements. In the event a customer fails to deposit additional margin in an amount sufficient to eliminate any margin deficiency or hedge existing positions after three business days, the member organization must liquidate positions in an amount sufficient to, at a minimum, lower the total margin required to an amount less than or equal to account equity. Member organizations should not permit a customer to make a practice of meeting a portfolio margin deficiency by liquidation. Member organizations must have procedures in place to identify accounts that periodically liquidate positions to eliminate margin deficiencies, and a member organization is expected to take appropriate action when warranted. Liquidations to eliminate margin deficiencies that are caused solely by adverse price movements may be disregarded.- Guarantees by any other account for purposes of margin requirements is not permitted.

(2) Pursuant to Rule 13.5 - Customer Portfolio Margin Accounts, if additional margin required is not obtained by the close of business on T+1, member organizations must deduct in computing net capital any amount of the additional margin that is still outstanding until such time as the additional margin is obtained or positions are liquidated pursuant to (i)(1) above.

(3) A deduction in computing net capital in the amount of a customer's margin deficiency may not serve in lieu of complying with the requirements of (i)(1) above.

(4) A member organization may request from its DEA an extension of time for a customer to deposit additional margin. Such request must be in writing and will be granted only in extraordinary circumstances.

(5) The day trading restrictions promulgated under Rule 12.3(j) shall not apply to portfolio margin accounts that establish and maintain at least five million dollars in equity, provided a member organization has the ability to monitor the intra-day risk associated with day trading. Portfolio margin accounts that do not establish and maintain at least five million dollars in equity will be subject to the day trading restrictions under Rule 12.3(j), provided the member organization has the ability to apply the applicable day trading restrictions under that Rule. However, if the position or positions day traded were part of a hedge strategy, the day trading restrictions will not apply. A "hedge strategy" for the purpose of this rule means a transaction or a series of transactions that reduces or offsets a material portion of the risk in a portfolio. Member organizations are also expected to monitor these portfolio margin accounts to detect and prevent circumvention of the day trading requirements.

(j) Portfolio Margin Accounts - Requirement to Liquidate.

(1) A member organization is required immediately either to liquidate, or transfer to another broker-dealer eligible to carry related instruments within portfolio margin accounts, all customer portfolio margin accounts with positions in related instruments if the member is:

(i) insolvent as defined in section 101 of title 11 of the United States Code, or is unable to meet its obligations as they mature;

(ii) the subject of a proceeding pending in any court or before any agency of the United States or any State in which a receiver, trustee, or liquidator for such debtor has been appointed;

(iii) not in compliance with applicable requirements under the Securities Exchange Act of 1934 or rules of the Securities and Exchange Commission or any self-regulatory organization with respect to financial responsibility or hypothecation of customers' securities; or

(iv) unable to make such computations as may be necessary to establish compliance with such financial responsibility or hypothecation rules.

(2) Nothing in this paragraph (j) shall be construed as limiting or restricting in any way the exercise of any right of a registered clearing agency to liquidate or cause the liquidation of positions in accordance with its by-laws and rules.

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(Note: the sample risk description document is deleted in its entirety)

Chapter 9

Doing Business with the Public

Rule 9.15. Delivery of Current Options Disclosure Documents and Prospectus

(a) no change

(b) no change

(c) The special written disclosure statement describing the nature and risks of portfolio margining and acknowledgement for customer signature, required by Rule 12.4(c)(2) shall be in a format prescribed by the Exchange or in a format developed by the

member organization, provided it contains substantially similar information as the prescribed Exchange format and has received prior written approval of the Exchange.

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Chapter XIII

Net Capital

Rule 13.5. Customer Portfolio Margin Accounts

(a) No member organization that requires margin in any customer accounts pursuant to Rule 12.4 - Portfolio Margin shall permit gross customer portfolio margin requirements to exceed 1,000 percent of its net capital for any period exceeding three business days. The member organization shall, beginning on the fourth business day of any non-compliance, cease opening new portfolio margin accounts until compliance is achieved.

(b) If, at any time, a member organization's gross customer portfolio margin requirements exceed 1,000 percent of its net capital, the member organization shall immediately transmit telegraphic or facsimile notice of such deficiency to the Office of Market Supervision, Division of Market Regulation, Securities and Exchange Commission, 100 F Street, NE, Washington, DC, 20549; to the district or regional office of the Securities and Exchange Commission for the district or region in which the member organization maintains its principal place of business; and to its Designated Examining Authority.

(c) If any customer portfolio margin account becomes subject to a call for additional margin, and all of the additional margin is not obtained by the close of business on T+1, member organizations must deduct in computing net capital any amount of the additional

margin that is still outstanding until such time as it is obtained or positions are liquidated pursuant to Rule 12.4(i)(1).

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Chapter XV

Records, Reports and Audits

Rule 15.8A. Risk Analysis of Portfolio Margin Accounts

(a) Each member organization that maintains any portfolio margin accounts for customers shall establish and maintain a comprehensive written risk analysis methodology for assessing and monitoring the potential risk to the member organization's capital over a specified range of possible market movements of positions maintained in such accounts. The risk analysis methodology shall specify the computations to be made, the frequency of computations, the records to be reviewed and maintained, and the person(s) within the organization responsible for the risk function. This risk analysis methodology must be filed with the member organization's Designated Examining Authority and submitted to the SEC prior to the implementation of portfolio margining.

(b) Upon direction by the Department of Member Firm Regulation, each affected member organization shall provide to the Department such information as the Department may reasonably require with respect to the member organization's risk analysis for any or all of the portfolio margin accounts it maintains for customers.

(c) In conducting the risk analysis of portfolio margin accounts required by this Rule 15.8A, each member organization shall include in the written risk analysis methodology required pursuant to paragraph (a) above procedures and guidelines for:

(1) obtaining and reviewing the appropriate customer account documentation and financial information necessary for assessing the amount of credit extended to customers,

(2) the determination, review and approval of credit limits to each customer, and across all customers, utilizing a portfolio margin account,

(3) monitoring credit risk exposure to the member organization from portfolio margin accounts, on both an intra-day and end of day basis, including the type, scope and frequency of reporting to senior management,

(4) the use of stress testing of portfolio margin accounts in order to monitor market risk exposure from individual accounts and in the aggregate,

(5) the regular review and testing of these risk analysis procedures by an independent unit such as internal audit or other comparable group,

(6) managing the impact of credit extension on the member organization's overall risk exposure,

(7) the appropriate response by management when limits on credit extensions have been exceeded, and

(8) determining the need to collect additional margin from a particular eligible participant, including whether that determination was based upon the creditworthiness of the participant and/or the risk of the eligible position(s).

Moreover, management must periodically review, in accordance with written procedures, the member organization's credit extension activities for consistency with these guidelines. Management must periodically determine if the data necessary to

apply this Rule 15.8A is accessible on a timely basis and information systems are available to capture, monitor, analyze and report relevant data.

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-54918; File No. SR-NYSE-2006-13)

December 12, 2006

Self-Regulatory Organizations; New York Stock Exchange LLC; Order Approving a Proposed Rule Change to Rule 431 ("Margin Requirements") and Rule 726 ("Delivery of Options Disclosure Document and Prospectus"), and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 1 to the Proposed Rule Change Relating to Customer Portfolio Margining

I. Introduction

On March 2, 2006, the New York Stock Exchange LLC ("NYSE" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act" or "Exchange Act")[1] and Rule 19b-4[2] thereunder, a proposed rule change seeking to amend NYSE Rules 431 and 726 to expand the scope of products that are eligible for treatment as part of the NYSE's approved portfolio margin pilot program and to eliminate the requirement for a separate cross-margin account.[3] The proposed rule change would expand the scope of eligible

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

2 17 CFR 240.19b-4.

3 See Exchange Act Release No. 52031 (July 14, 2005), 70 FR 42130 (July 21, 2005) (SR-NYSE-2002-19). On July 14, 2005, the Commission approved on a pilot basis expiring July 31, 2007, amendments to Rule 431 that permit broker-dealers to determine customer margin requirements for portfolios of listed broad-based securities index options, warrants, futures, futures options and related exchange-traded funds using a specified portfolio margin methodology. The Commission also approved amendments to Rule 726 to require disclosure to, and written acknowledgment from, customers using a portfolio margin account. See also NYSE Information Memo 05-56, dated August 18, 2005 (for additional information); and Exchange Act Release No. 54125 (July 11, 2006), 71 FR 40766 (July 18, 2006) (SR-NYSE-2005-93) (approving securities futures products and listed single stock options as eligible products for portfolio margining).

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products in the pilot to include margin equity securities and unlisted derivatives.[4] The proposed rule change was published in the Federal Register on April 6, 2006.[5] The Commission subsequently extended the comment period for the original proposed rule filing until May 11, 2006.[6] The Commission received 8 comment letters in response to the Federal Register notice.[7] On July 20, 2006, the Exchange filed a response to these

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[4] For purposes of the pilot, a margin equity security is a security that meets the definition of a "margin equity security" under Regulation T of the Federal Reserve Board ("FRB"). See 12 CFR 220.2. An unlisted derivative means "any equity-based or equity index-based unlisted option, forward contract, or security-based swap that can be valued by a theoretical pricing model approved by the SEC." See proposed Rule 431(g)(2)(I).

[5] See Exchange Act Release No. 53577 (March 30, 2006), 71 FR 17539 (April 6, 2006) (SR-NYSE-2006-13). The Chicago Board Options Exchange, Incorporated ("CBOE") also filed a similar proposed rule filing seeking to expand the scope of eligible products under its portfolio margin pilot program. See Exchange Act Release No. 53576 (March 30, 2006), 71 FR 17519 (April 6, 2006) (SR-CBOE-2006-14).

[6] See Exchange Act Release No. 53728 (April 26, 2006), 71 FR 25878 (May 2, 2006).

[7] See letter from Timothy H. Thompson, Senior Vice President, Chief Regulatory Officer, Regulatory Services Division, CBOE, to Nancy Morris, Secretary, Commission, dated June 5, 2006 ("CBOE Letter"); letter from William H. Navin, Executive Vice President, General Counsel and Secretary, The Options Clearing Corporation ("OCC"), to Nancy M. Morris, Secretary, Commission, dated May 19, 2006 ("OCC Letter"); letter from James Barry, on behalf of the Ad Hoc Portfolio Margin Committee, John Vitha, Chair, Derivatives Product Committee and Christopher Nagy, Chair, Options Committee, Securities Industry Association, to Nancy M. Morris, Secretary, dated May 16, 2006 ("SIA Letter"); letter from Gary Alan DeWaal, Group General Counsel and Director of Legal and Compliance, Fimat USA, LLC, to Nancy M. Morris, Secretary, Commission, dated May 11, 2006 ("Fimat Letter"); letter from Stuart J. Kaswell, Partner, Dechert LLP, Counsel for Federated Investors, Inc., to Nancy M. Morris, Secretary, Commission, dated May 10, 2006 ("Federated Letter"); letter from Craig S. Donohue, Chief Executive Officer, Chicago Mercantile Exchange Inc., to Jonathan G. Katz, Secretary, Commission, dated May 9, 2006 ("CME Letter"); letter from Gerard J. Quinn, Vice President and Associate General Counsel, SIA,

comments.[8] The comment letters and the Exchange's responses to the comments are summarized below. On September 13, 2006, the Exchange filed Amendment No. 1 to the proposed rule change.[9]

This order approves the proposed rule change. Simultaneously, the Commission provides notice of filing of Amendment No. 1, grants accelerated approval of Amendment No. 1 and solicits comments from interested persons on Amendment No. 1.[10]

II. Description

a. Portfolio Margining

The proposed rule change consists of amendments to Rule 431 to include margin equity securities (as defined in Regulation T) and unlisted derivatives as eligible products for the portfolio margining pilot.[11] The proposed rule change also includes amendments

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to Nancy M. Morris, Secretary, Commission, dated April 21, 2006 ("SIA Extension Letter"); and e-mail from Stephen A. Kasprzak, Principal Counsel, Rule and Interpretive Standards, NYSE, dated April 21, 2006 ("Kasprzak e-mail").

8 See letter from Mary Yeager, Assistant Secretary, NYSE, to Michael A. Macchiaroli, Associate Director, Division of Market Regulation, Commission, dated July 20, 2006 ("NYSE Response").

9 The NYSE filed Amendment No. 1 in response to comments received and to make other clarifying changes to the proposed rule filing. See Section II. for a discussion of the changes in Amendment No. 1. A clean copy of the proposed rule, as amended by Amendment No. 1, is attached to this order as Appendix A.

10 By separate order, the Commission also is approving a parallel rule filing by CBOE (SR-CBOE-2006-14). Exchange Act Release No. 54919; see also supra note 5.

11 The list of eligible products under the pilot currently includes listed broad-based securities index options, warrants, futures, futures options and related exchange-traded funds, as well as single stock options and securities futures products.

to eliminate the requirement of a separate cross-margin account. Rule 431 prescribes specific margin requirements for customers based on the type of securities held in their accounts.[12] Outside the existing pilot program, Rule 431 requires that margin be calculated using fixed percentages, on a position-by-position basis. In contrast, the current portfolio margin pilot program permits a broker-dealer to calculate customer margin requirements by grouping all products in an account that are based on the same index or issuer into a single portfolio. For example, futures, options and exchange traded funds based on the S&P 500 would each be grouped in a portfolio and products based on IBM would be grouped into a separate portfolio.

The broker-dealer then calculates a customer's margin requirement by "shocking" each portfolio at different equidistant points along a range representing a potential percentage increase and decrease in the value of the instrument or underlying instrument in the case of a derivative product. Currently, under the pilot, products of portfolios based on high capitalization, broad-based securities indexes are shocked along a range spanning an increase of 6% and a decrease of 8%. Portfolios of products based on non-high capitalization, broad-based securities indexes are shocked along a range spanning an increase of 10% and a decrease of 10%. Portfolios of products based on an equity

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[12] The margin rules specify the amount of equity a customer must maintain in his or her margin account with respect to securities positions financed by the broker-dealer. The equity protects the broker-dealer in the event the customer defaults on the obligation to re-pay the financing and the broker-dealer is forced to liquidate the position at a loss.

security are shocked along a range spanning an increase of 15% and a decrease of 15%.[13] The proposed rule change would continue to apply these shock ranges. In addition, as with the current pilot, a theoretical options pricing model would continue to be used to derive position values at each valuation point for the purpose of determining the gain or loss.[14]

The portfolio shocks described above result in a gain or loss for each instrument in a portfolio at each calculation point along the range. These gains and losses are netted to derive a potential portfolio-wide gain or loss for the point. The margin requirement for a portfolio is the amount of the greatest portfolio-wide loss among the calculation points. The margin requirements for each portfolio are added together to calculate the total margin requirement for the portfolio margin account. This approach, in most cases, will generally lower customer margin requirements.[15]

The amount of margin (initial and maintenance) required with respect to a given portfolio would be the larger of: (1) the greatest portfolio-wide loss amount among the valuation point calculations; or (2) the sum of $.375 for each option and future in the

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13 For example, under the pilot, a portfolio of single stock futures and listed equity options would be shocked at 10 equidistant points along a range bounded on one end by a 15% increase in the market value of the instrument and at the other end by a 15% decrease (i.e., at +/-3%, +/-6%, +/-9%, +/-12% and +/-15%).

14 Currently, the only model that qualifies is the OCC's Theoretical Intermarket Margining System (TIMS).

15 For example, the current required initial and maintenance margin requirements for an equity security are 50% and 25%, respectively. The market movement range to calculate the potential gains and losses under the proposed portfolio margin rule for equity securities is +/-15%.

portfolio multiplied by the contract's or instrument's multiplier.[16] The second computation establishes a minimum margin requirement to ensure that a certain level of margin is required from the customer in the event the greatest portfolio-wide loss among the valuation points is de minimis.

b. Expansion of Eligible Products

Under the Exchange's proposed rule, products eligible for portfolio margining would be expanded to include margin equity securities (as defined under Regulation T),[17] unlisted derivatives and futures contracts on narrow-based security indexes.[18] The unlisted derivatives would be included in a portfolio based on the underlying reference index or security. Individual equities and narrow-based index futures would be included in a portfolio shocked at a range spanning an increase of 15% and a decrease of 15% (as is the case with listed single stock options and securities futures).

c. Margin Deficiency

The current rule requires a customer to satisfy a margin deficiency in a portfolio margin account within three business days by depositing additional securities or cash or

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16 The multiplier for a standard listed option is fixed by the options market on which the options series is traded. For example, a cash settled equity option generally has a multiplier of 100. Therefore, the minimum margin for one options contract would be $37.50. The multipliers for different securities and futures products may vary.

17 Margin equity securities include certain foreign equity securities and options on foreign equity securities. See 12 CFR 220.2

18 The Commission approved listed single stock options and securities futures products (excluding narrow-based indexes) as eligible products on July 11, 2006. See supra note 3.

effecting an offsetting hedge.[19] The current pilot also requires a broker-dealer to deduct from its net capital the amount of any portfolio margin call not met by the close of business on T+1 and until the call is satisfied. The proposal would now further require the broker-dealer to have in place procedures to identify accounts that periodically liquidate positions to eliminate margin deficiencies, and to take appropriate action when warranted.[20]

d. $5 Million Equity Requirement

The current pilot requires customers that are not broker-dealers or futures firms to maintain minimum account equity of $5 million if they opt to include portfolios of broad-based securities index products in their accounts.[21] The proposed rule change would eliminate the $5 million account equity requirement for all portfolio margin accounts, except those holding unlisted derivatives.[22]

e. Risk Management Methodology

The pilot requires member broker-dealers to monitor the risk of portfolio margin accounts and maintain a written risk analysis methodology for assessing potential risk to

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19 The original pilot required margin calls to be met by T+1. The current requirement of meeting margin calls within three business days was approved in SR-NYSE-2005-93. See Exchange Act Release No. 54125 (July 11, 2006), 71 FR 40766 (July 18, 2006).

20 The current pilot requires that member firms not permit a customer to make a practice of meeting a portfolio margin deficiency through liquidation.

21 The $5 million account equity requirement for such customers was eliminated to the extent they limited their accounts to portfolios of listed options and securities futures. See SR-NYSE-2005-93, supra note 3.

22 See proposed Rule 431(g)(4)(C).

the firm's capital. This risk analysis methodology must be made available to the Exchange upon request. The proposed rule change strengthens these requirements by providing that, the member broker-dealer must file the risk analysis methodology with the Exchange (or the firm's Designated Examining Authority, if not the Exchange)[23] and submit it to the Commission prior to implementation. The proposed rule change also requires the inclusion of additional procedures and guidelines as part of the methodology.[24]

f. Cross-Margin Account

The proposed rule change would eliminate the requirement that portfolios with futures positions be held in a separate cross-margin account. Under the proposal, a customer would be permitted to use a single securities margin account for all eligible products. The Exchange and commenters have indicated that maintaining and monitoring two separate margin accounts would be operationally difficult and that it would be more efficient to hold all positions in one securities account.

g. Hedged Positions

Under the pilot, an underlying security in a portfolio margin account must be removed from the account if it is no longer offset by an option position. The amendments propose to eliminate the requirement to remove instruments that are no longer offset by

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23 Amendment No. 1 to the proposed rule amended the rule language to state that the written risk methodology must be filed with the Exchange, rather than approved by the Exchange, as proposed, in the March 2, 2006 rule filing.

24 The current pilot also requires member firms to notify, and receive approval from the Exchange, prior to opening portfolio margin accounts for customers. The proposed rule modifies this requirement by requiring approval from a member firm's DEA, if it is not the Exchange.

options positions. The Exchange made this change in response to comments that all positions eligible for a portfolio margin account, including underlying securities, should receive equal treatment. Moreover, the Exchange noted that it would be operationally difficult to move positions in and out of the portfolio margin account based on whether they are currently being offset.

h. Discussion of Changes to the Proposed Rule Change in Amendment No. 1

The Exchange filed Amendment No. 1 to the proposed rule change in response to comments received, to make conforming changes to the CBOE rule filing[25] and to otherwise clarify certain terms and definitions. The following summarizes the changes made in Amendment No. 1 to the proposed rule change. In Amendment No. 1, the Exchange:

- clarifies certain definitions and conforms others to the CBOE filing;
- adds language allowing a customer to use excess equity in a regular margin account to meet a margin deficiency in a portfolio margin account without having to transfer any funds or securities where the portfolio margin account is a sub-account of the regular margin account;
- adds language allowing positions not eligible for portfolio margin treatment to be carried in the portfolio margin account for their collateral value, subject to the margin requirements of a regular margin account;

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[25] See supra note 5.

- adds language permitting shares of a money market mutual fund to be held in a portfolio margin account (subject to applicable margin requirements), provided certain requirements are met;
- clarifies the restrictions with respect to day trading[26] in a portfolio margin account; and
- eliminates the sample risk disclosure statement and acknowledgement in the rule text.[27]

III. Summary of Comments Received and NYSE Response

The Commission received a total of 8 comment letters to the proposed rule change.[28] The comments, in general, were supportive. One commenter stated that it strongly supports "the significant step forward represented by the currently proposed changes."[29] Another commenter stated that the portfolio margining of securities products will "help US brokers and exchanges compete more effectively with their overseas

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[26] NYSE proposed to amend the rule text to allow a customer that establishes and maintains at least $5 million in equity to engage in day trading without the restrictions of NYSE's day trading rules, if the member firm has the ability to monitor the intra-day risk associated with day trading. Further, if a participant has less than $5 million equity, the day trading restrictions will apply, unless the position or positions day traded were part of a hedge strategy.

[27] Instead the Exchange will send out an Information Memo with the sample disclosure language. The Exchange made this change to avoid having to file a proposed rule change each time in the risk disclosure document is changed.

[28] See supra note 7. Two of these comment letters related to the extension of the comment period for the proposed rule change. See SIA Extension Letter and Kasprzak e-mail.

[29] See SIA Letter.

counterparts. . .and thereby increase the strength and liquidity of US markets."[30] Each commenter, however, recommended changes to specific provisions of the proposed rule change.

Several commenters[31] submitted comments regarding the ability to use portfolio margin methodologies other than the method prescribed in the rule to calculate customer margin requirements. One commenter stated that the Commission has experience in approving proprietary market risk models for consolidated supervised entities (CSEs) and OTC derivatives dealers.[32] In its response, the Exchange acknowledged that proprietary models may prove to be effective and efficient in managing risk.[33] The Exchange stated, however, that initially, regulators should gain experience with portfolio margining through the rule's specified methodology and that in the longer term, proprietary risk models could be considered as alternatives.

One commenter suggested that futures positions in a portfolio margin account be held in a separate futures account, while securities positions be held in a securities account.[34] The commenter referred to this approach as the "two pot" model.[35] The commenter stated that it favors this "two pot" approach because it believes that it more

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[30] See Fimat Letter.

[31] See SIA Letter and OCC Letter; see also CME Letter (discussing SPAN).

[32] See SIA Letter.

[33] See NYSE Response, supra note 8.

[34] See CME Letter.

[35] Id.

easily accommodates differences in customer protection and capital requirements of the Commission and the Commodity Futures Trading Commission ("CFTC").[36] Commenters, in general, favored a single portfolio margin securities account (referred to as the "one pot" approach).[37] One commenter stated that the "disadvantages of a two pot model outweigh its advantages."[38] The Exchange stated that it believes that a one pot approach will provide for more efficient margining, reduce broker-dealer/FCM liquidity risk and reduce operational inefficiencies.

Three commenters expressed the need for the Commission and the CFTC to continue working towards eliminating the legal and regulatory impediments to cross-margining futures and securities products.[39] In response, the Exchange stated that it will continue to work with the Commission and the CFTC on the regulatory issues related to holding securities and futures in a portfolio.

One commenter stated that portfolio margining should be expanded to include nonequity securities, interest rate derivatives, collateralized debt obligations and other similar non-equity related products, and foreign currency derivatives.[40] This commenter also requested that nonequity securities be permitted to be held in the portfolio margin account for collateral purposes only, subject to the other margin requirements of NYSE

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[36] See CME Letter.

[37] See OCC and CBOE Letters.

[38] See CBOE Letter.

[39] See SIA, Fimat and OCC Letters.

[40] See SIA Letter.

Rule 431.[41] The Exchange noted that it agrees with the commenter to the extent that nonequity securities may serve as collateral in the portfolio margin account.[42] The Exchange also stated that once the SROs and broker-dealers gain more experience with portfolio margining, the Exchange may consider whether nonequity products should be eligible for portfolio margining.

One commenter sought clarification as to whether broker-dealers and their customers could use shares of money market funds as collateral for portfolio margining.[43] The Exchange noted that it believes the rule currently permits the use of money market funds in a portfolio margin account, and clarified this issue through changes to the rule text in Amendment No. 1 to the proposed rule change.[44]

One commenter objected to the $0.375 per contract minimum margin requirement, and offered alternative lower minimums.[45] In response to this comment, the Exchange noted that the $.375 per contract minimum provides a cushion against significant market movements. The Exchange also noted that it is concerned about potential illiquidity in the market and the creation of gap risk in the event both sides of a hedge cannot be closed out simultaneously.

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41 See SIA Letter.

42 See Amendment No. 1.

43 See Federated Letter.

44 See NYSE Response; see also Amendment No. 1 (adding language regarding use of money market mutual funds in a portfolio margin account).

45 See SIA Letter.

Several commenters objected to the proposed prohibition on day trading in a portfolio margin account.[46] The Exchange noted that the day trading prohibition is not intended to prohibit intraday trading in an account that contains a large portfolio of hedged instruments and, in response to the comments, amended the day trading rule language.[47]

Finally, the Exchange encouraged the Commission to move forward in approving the amendments.[48]

IV. Discussion and Commission Findings and Accelerated Approval of Amendment No. 1

The Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.[49] In particular, the Commission believes that the proposed rule change, as amended, is consistent with Section 6(b)(5) of the Act[50] in that it is designed to perfect the mechanism of a free and open market and to protect investors and the public interest. The Commission notes that the proposed portfolio margin rule change is intended to promote greater reasonableness, accuracy and efficiency with respect to Exchange margin requirements and will better align margin requirements with actual risk.

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46 See SIA and Fimat Letters.

47 See Amendment No. 1.

48 See NYSE Response.

49 In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

50 15 U.S.C. 78f(b)(5).

Under a portfolio margin system, offsets are fully realized, whereas under the Exchange's current margin rules, positions are margined independent of each other and offsets between them do not figure into the total margin requirement. A portfolio margin system recognizes the offsetting gains from positions that react favorably in market declines, while market rises are tempered by offsetting losses from positions that react negatively. Consequently, a portfolio margin approach can have a neutralizing effect on the volatility of margin requirements. Thus, a portfolio margin system may better align a customer's total margin requirement with the actual risk associated with the customer's positions taken as a whole. The Commission further notes portfolio margining may alleviate excessive margin calls, improve cash flows and liquidity, and reduce volatility.

Moreover, the Commission notes that approving the proposed rule change would enhance portfolio margining by permitting more products to be margined under this methodology. This is consistent with the amendments to Regulation T made by the FRB in 1998, which sought to advance the use of portfolio margining.[51] The Commission also believes that this expanded program for portfolio margining will serve to advance the development of even more risk-sensitive approaches to margining customer positions, including the use of internal models as advocated by commenters. The Commission

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[51] Federal Reserve System, "Securities Credit Transactions; Borrowing by Brokers and Dealers," 63 FR 2806 (January 16, 1998); see also 12 CFR 220.1(b)(3)(i); see also letter from the FRB to James E. Newsome, Acting Chairman, Commodity Futures Trading Commission, and Laura S. Unger, Acting Chairman, Commission, dated March 6, 2001. The FRB concluded the letter by writing "the Board anticipates that the creation of securities futures products will provide another opportunity to develop more risk-sensitive, portfolio-based approaches for all securities, including securities options and securities futures products." Id.

intends to work with the NYSE and CBOE towards this objective after it gains experience with the portfolio margining system of this proposal.

The Commission believes that while the portfolio margining system in the proposed rule will have the effect of reducing customer margin (in most cases), the methodology is relatively conservative in that it requires positions to be shocked at specified market move ranges (e.g., +/-15% for individual equities) that represent potential future stress events. Essentially the same portfolio methodology has been used by broker-dealers to calculate haircuts on options positions for net capital purposes.[52] Furthermore, the proposed requirement that a firm receive pre-approval from the Exchange prior to offering portfolio margining to its customers, coupled with the requirement for enhanced risk management procedures, is designed to ensure that only those firms with adequate controls would be eligible to implement a customer portfolio margining program.[53]

Accelerated Approval of Amendment No. 1

The Exchange also has requested that the Commission approve Amendment No. 1 to the proposed rule change prior to the thirtieth day after publication of notice of the filing in the Federal Register. The Commission believes that the changes in Amendment No. 1 to the proposed rule change do not raise significant new or unique issues from

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[52] See Exchange Act Release No. 38248 (February 6, 1997), 62 FR 6474 (February 12, 1997).

[53] The proposed rules also would continue to require a minimum per contract charge of $.375. The Commission also notes that the proposed rules contain a leverage test under which a broker-dealer cannot permit the amount of portfolio margin required of its customers to exceed 10 times the firm's net capital.

those previously raised in the earlier portfolio margin rule filings.[54] The changes proposed by the Exchange in Amendment No. 1 are designed to ensure consistency with the companion CBOE proposed rule filing and to respond to comments received as a result of the Federal Register notice.[55] The Commission believes that these proposed changes strengthen the proposed rule change.

Accordingly, the Commission finds good cause for approving Amendment No. 1 to the proposed rule change prior to the thirtieth day after the date of publication of notice thereof in the Federal Register. Specifically, the Commission believes that it is consistent with Section 19(b)(2) of the Act[56] to approve Amendment No. 1 to the Exchange's proposed rule change prior to the thirtieth day after publication of the notice of filing thereof in the Federal Register.

Uniform Effective Date

The Commission believes that approving the amendment on an accelerated basis will permit the NYSE to begin the process of approving broker-dealers to implement portfolio margining and would allow firms to begin to make the necessary changes and upgrades to their systems, as well as their policies and procedures, in order to accommodate customer portfolio. The Commission, however, believes that if some firms receive NYSE approval to begin offering customer portfolio margining to customers

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54 See supra note 3.

55 See supra notes 5 and 7.

56 15 U.S.C. 78s(b)(2).

before other member firms, these other firms would be at a competitive disadvantage. Therefore, the Commission has determined to set a uniform effective date of April 2, 2007 for the proposed rule change, as amended. As stated above, the Commission believes that setting a uniform effective date will avoid placing some members firms at a competitive disadvantage and reduce confusion in the marketplace.

V. Solicitation of Comments of Amendment No. 1

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as amended, is consistent with the Exchange Act. 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 e-mail to rule-comments@sec.gov. Please include File Number SR-NYSE-2006-13 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-NYSE-2006-13. 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 Web site (http://www.sec.gov/rules/sro/shtml). Copies of the submission, all subsequent

amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing also will be available for inspection and copying at the principal office of the Exchange. 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 submission should refer to File Number SR-NYSE-2006-13 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

VI. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[57] that the proposed rule change (File No. SR-NYSE-2006-13), is hereby approved, and that Amendment No. 1 to the proposed rule change be, and hereby is, approved on an accelerated basis, both on a pilot basis to expire on July 31, 2007. The effective date will be April 2, 2007.

By the Commission.

Florence E. Harmon
Deputy Secretary

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57 15 U.S.C. 78s(b)(2).

Exhibit A

Margin Requirements

Rule 431. (a) through (f) unchanged.

Portfolio Margin

(g) As an alternative to the "strategy-based" margin requirements set forth in sections (a) through (f) of this Rule, member organizations may elect to apply the portfolio margin requirements set forth in this section (g) to all margin equity securities[1], listed options, unlisted derivatives, and security futures products (as defined in Section 3(a)(56) of the Securities Exchange Act of 1934 (the "Exchange Act")), provided that the requirements of section (g)(6)(B)(1) of this Rule are met.

In addition, a member organization, provided that it is a Futures Commission Merchant ("FCM") and is either a clearing member of a futures clearing organization or has an affiliate that is a clearing member of a futures clearing organization, is permitted under this section (g) to combine an eligible participant's related instruments as defined in section (g)(2)(E), with listed index options, options on exchange traded funds ("ETF"), index warrants and underlying instruments and compute a margin requirement for such combined products on a portfolio margin basis.

The portfolio margin provisions of this Rule shall not apply to Individual Retirement Accounts ("IRAs").

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[1] For purposes of this section (g) of the Rule, the term "margin equity security" utilizes the definition at section 220.2 of Regulation T of the Board of Governors of the Federal Reserve System, excluding a nonequity security.

(1) Member organizations must monitor the risk of portfolio margin accounts and maintain a comprehensive written risk analysis methodology for assessing the potential risk to the member organization's capital over a specified range of possible market movements of positions maintained in such accounts. The risk analysis methodology shall specify the computations to be made, the frequency of computations, the records to be reviewed and maintained, and the person(s) within the organization responsible for the risk function. This risk analysis methodology must be filed with the New York Stock Exchange ("Exchange"), or the member organization's designated examining authority ("DEA"), if other than the Exchange, and submitted to the Securities and Exchange Commission ("SEC") prior to the implementation of portfolio margining. In performing the risk analysis of portfolio margin accounts required by this Rule, each member organization shall include in the written risk analysis methodology procedures and guidelines for:

(A) obtaining and reviewing the appropriate account documentation and financial information necessary for assessing the amount of credit to be extended to eligible participants.

(B) the determination, review and approval of credit limits to each eligible participant, and across all eligible participants, utilizing a portfolio margin account,

(C) monitoring credit risk exposure to the member organization from portfolio margin accounts, on both an intra-day and end of day basis, including the type, scope and frequency of reporting to senior management,

(D) the use of stress testing of portfolio margin accounts in order to monitor market risk exposure from individual accounts and in the aggregate,

(E) the regular review and testing of these risk analysis procedures by an independent unit such as internal audit or other comparable group,

(F) managing the impact of credit extended related to portfolio margin accounts on the member organization's overall risk exposure,

(G) the appropriate response by management when limits on credit extensions related to portfolio margin accounts have been exceeded, and

(H) determining the need to collect additional margin from a particular eligible participant, including whether that determination was based upon the creditworthiness of the participant and/or the risk of the eligible product.

Moreover, management must periodically review, in accordance with written procedures, the member organization's credit extension activities for consistency with these guidelines. Management must periodically determine if the data necessary to apply this section (g) is accessible on a timely basis and information systems are available to adequately capture, monitor, analyze and report relevant data.

(2) Definitions.-- For purposes of this section (g), the following terms shall have the meanings specified below:

(A) For purposes of portfolio margin requirements the term "equity", as defined in section (a)(4) of this Rule, includes the market value of any long or short positions held in an eligible participant's account.

(B) The term "listed option" means any equity-based or equity index-based option traded on a registered national securities exchange or automated facility of a registered national securities association.

(C) The term "portfolio" means any eligible product, as defined in section (g)(6)(B)(1), grouped with its underlying instruments and related instruments.

(D) The term "product group" means two or more portfolios of the same type (see table in section (g)(2)(G) below) for which it has been determined by Rule 15c3-1a under the Exchange Act that a percentage of offsetting profits may be applied to losses at the same valuation point.

(E) The term "related instrument" within a security class or product group means broad-based index futures and options on broad-based index futures covering the same underlying instrument. The term "related instrument" does not include security futures products.

(F) The term "security class" refers to all listed options, security futures products, unlisted derivatives, and related instruments covering the same underlying instrument and the underlying instrument itself.

(G) The term "theoretical gains and losses" means the gain and loss in the value of individual eligible products and related instruments at ten equidistant intervals (valuation points) ranging from an assumed movement (both up and down) in the current market value of the underlying instrument. The magnitude of the valuation point range shall be as follows:

Portfolio Type	Up / Down Market Move (High & Low Valuation Points)
High Capitalization, Broad-based Market Index[2]	+6% / -8%
Non-High Capitalization, Broad-based Market Index[3]	+/- 10%
Any other eligible product that is, or is based on, an equity security or a narrow-based index	+/- 15%

(H) The term “underlying instrument” means a security or security index upon which any listed option, unlisted derivative, security future, or broad-based index future is based.

(I) The term “unlisted derivative” means any equity-based or equity index-based unlisted option, forward contract, or security-based swap that can be valued by a theoretical pricing model approved by the SEC.

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2 In accordance with section (b)(1)(i)(B) of Rule 15c3-1a (Appendix A to Rule 15c3-1) under the Securities Exchange Act of 1934, 17 CFR 240.15c3-1a(b)(1)(i)(B).

3 See footnote above.

(3) Approved Theoretical Pricing Models.-- Theoretical pricing models must be approved by the SEC.

(4) Eligible Participants.-- The application of the portfolio margin provisions of this section (g) is limited to the following:

(A) any broker or dealer registered pursuant to Section 15 of the Exchange Act;

(B) any member of a national futures exchange to the extent that listed index options hedge the member's index futures; and

(C) any person or entity not included in sections (g)(4)(A) and (g)(4)(B) above approved for uncovered options and, if transactions in security futures are to be included in the account, approval for such transactions is also required. However, an eligible participant under this section (g)(4)(C) may not establish or maintain positions in unlisted derivatives unless minimum equity of at least five million dollars is established and maintained with the member organization. For purposes of this minimum equity requirement, all securities and futures accounts carried by the member organization for the same eligible participant may be combined provided ownership across the accounts is identical. A guarantee pursuant to section (f)(4) of this Rule is not permitted for purposes of the minimum equity requirement.

(5) Opening of Accounts.

(A) Member organizations must notify and receive approval from the Exchange or the member organization's DEA, if other than the Exchange, prior to establishing a portfolio margin methodology for eligible participants.

(B) Only eligible participants that have been approved to engage in uncovered short option contracts pursuant to Exchange Rule 721, or the rules of the member organization's DEA, if other than the Exchange, are permitted to utilize a portfolio margin account.

(C) On or before the date of the initial transaction in a portfolio margin account, a member organization shall:

(1) furnish the eligible participant with a special written disclosure statement describing the nature and risks of portfolio margining which includes an acknowledgement for all portfolio margin account owners to sign, attesting that they have read and understood the disclosure statement, and agree to the terms under which a portfolio margin account is provided (see Exchange Rule 726(d)), and

(2) obtain the signed acknowledgement noted above from the eligible participant and record the date of receipt.

(6) Establishing Account and Eligible Positions

(A) For purposes of applying the portfolio margin requirements prescribed in this section (g), member organizations are to establish and utilize a specific securities margin account, or sub-account of a margin account, clearly identified as a portfolio margin account that is separate from any other securities account carried for an eligible participant.

A margin deficit in the portfolio margin account of an eligible participant may not be considered as satisfied by excess equity in another account. Funds and/or securities must be transferred to the deficient account and a written record created and maintained. However, if a portfolio margin account is carried as a sub-account of a margin account, excess equity in the margin account (determined in accordance with the rules applicable to a margin account other than a portfolio margin account) may be used to satisfy a margin deficit in the portfolio margin sub-account without having to transfer any funds and/or securities.

(B) Eligible Products

(1) For eligible participants as described in sections (g)(4)(A) through (g)(4)(C), a transaction in, or transfer of, an eligible product may be effected in the portfolio margin account. Eligible products under this section (g) consist of:

(i) a margin equity security (including a foreign equity security and option on a foreign equity security, provided the security is deemed to have a "ready market" under SEC Rule 15c3-1 or a "no-action" position issued thereunder, and a control or restricted security, provided the security has met the requirements in a manner consistent with SEC Rule 144 or an SEC "no-action" position issued thereunder, sufficient to permit the sale of the security, upon exercise or assignment of any listed option or unlisted derivative written or held against it, without restriction).

(ii) a listed option on an equity security or index of equity securities,

(iii) a security futures product,

(iv) an unlisted derivative on an equity security or index of equity securities,

(v) a warrant on an equity security or index of equity securities,

(vi) a related instrument as defined in section (g)(2)(E).

(7) Margin Required.-- The amount of margin required under this section (g) for each portfolio shall be the greater of:

(A) the amount for any of the ten equidistant valuation points representing the largest theoretical loss as calculated pursuant to section (g)(8) below, or

(B) for eligible participants as described in section (g)(4)(A) through (g)(4)(C), $.375 for each listed option, unlisted derivative, security future product, and related instrument, multiplied by the contract's or instrument's multiplier, not to exceed the market value in the case of long contracts in eligible products.

(C) Account guarantees pursuant to section (f)(4) of this Rule are not permitted for purposes of meeting margin requirements.

(D) Positions other than those listed in section (g)(6)(B)(1) above are not eligible for portfolio margin treatment. However, positions not eligible for portfolio margin treatment (except for ineligible related instruments) may be carried in a portfolio margin account, provided the member organization has the ability to apply the applicable strategy based margin requirements promulgated

under this Rule. Shares of a money market mutual fund may be carried in a portfolio margin account, also subject to the applicable strategy based margin requirements under this Rule provided that:

(1) the customer waives any right to redeem shares without the member organization's consent,

(2) the member organization (or, if the shares are deposited with a clearing organization, the clearing organization) obtains the right to redeem shares in cash upon request,

(3) the fund agrees to satisfy any conditions necessary or appropriate to ensure that the shares may be redeemed in cash, promptly upon request, and

(4) the member organization complies with the requirements of Section 11(d)(1) of the Exchange Act and Rule 11d1-2 thereunder.

(8) Method of Calculation.

(A) Long and short positions in eligible products including underlying instruments and related instruments, are to be grouped by security class; each security class group being a "portfolio". Each portfolio is categorized as one of the portfolio types specified in section (g)(2)(G) above as applicable.

(B) For each portfolio, theoretical gains and losses are calculated for each position as specified in section (g)(2)(G) above. For purposes of determining the theoretical gains and losses at each valuation point, member organizations shall obtain and utilize the theoretical values of eligible products as described in this section (g) rendered by an approved theoretical pricing model.

(C) Offsets. Within each portfolio, theoretical gains and losses may be netted fully at each valuation point. Offsets between portfolios within the eligible product groups, as described in section (g)(2)(G), may then be applied as permitted by Rule 15c3-1a under the Exchange Act.

(D) After applying the offsets above, the sum of the greatest loss from each portfolio is computed to arrive at the total margin required for the account (subject to the per contract minimum).

(9) Portfolio Margin Minimum Equity Deficiency

(A) If, as of the close of business, the equity in the portfolio margin account of an eligible participant as described in section (g)(4)(C), declines below the five million dollar minimum equity required, if applicable, and is not restored to at least five million dollars within three business days by a deposit of funds and/or securities, member organizations are prohibited from accepting new opening orders beginning on the fourth business day, except that new opening orders entered for the purpose of reducing market risk may be accepted if the result would be to lower margin requirements. This prohibition shall remain in effect until,

(1) equity of five million dollars is established or,

(2) all unlisted derivatives are liquidated or transferred from the portfolio margin account to the appropriate securities account.

(B) Member organizations will not be permitted to deduct any portfolio margin minimum equity deficiency amount from Net Capital in lieu of collecting the minimum equity required.

(10) Portfolio Margin Deficiency

(A) If, as of the close of business, the equity in the portfolio margin account of an eligible participant, as described in section (g)(4)(A) through (g)(4)(C), is less than the margin required, the eligible participant may deposit additional funds and/or securities or establish a hedge to meet the margin requirement within three business days. After the three business day period, member organizations are prohibited from accepting new opening orders, except that new opening orders entered for the purpose of reducing market risk may be accepted if the result would be to lower margin requirements. In the event an eligible participant fails to hedge existing positions or deposit additional funds and/or securities in an amount sufficient to eliminate any margin deficiency after three business days, the member organization must liquidate positions in an amount sufficient to, at a minimum, lower the total margin required to an amount less than or equal to the account equity.

(B) If the portfolio margin deficiency is not met by the close of business on the next business day after the business day on which such deficiency arises, member organizations will be required to deduct the amount of the deficiency from Net Capital until such time as the deficiency is satisfied.

(C) Member organizations will not be permitted to deduct any portfolio margin deficiency amount from Net Capital in lieu of collecting the margin required.

(D) The Exchange, or the member organization's DEA, if other than the Exchange, may grant additional time for an eligible participant to meet a portfolio

margin deficiency upon written request, which is expected to be granted in extraordinary circumstances only.

(E) Member organizations should not permit an eligible participant to make a practice of meeting a portfolio margin deficiency by liquidation. Member organizations must have procedures in place to identify accounts that periodically liquidate positions to eliminate margin deficiencies, and the member organization is expected to take appropriate action when warranted. Liquidations to eliminate margin deficiencies that are caused solely by adverse price movements may be disregarded.

(11) Determination of Value for Margin Purposes.-- For the purposes of this section (g), all eligible products shall be valued at current market prices. Account equity for the purposes of sections (g)(9)(A) and (g)(10)(A) shall be calculated separately for each portfolio margin account.

(12) Net Capital Treatment of Portfolio Margin Accounts.

(A) No member organization that requires margin in any portfolio margin account pursuant to section (g) of this Rule shall permit the aggregate portfolio margin requirements to exceed ten times its Net Capital for any period exceeding three business days. The member organization shall, beginning on the fourth business day, cease opening new portfolio margin accounts until compliance is achieved.

(B) If, at any time, a member organization's aggregate portfolio margin requirements exceed ten times its Net Capital the member organization shall immediately transmit telegraphic or facsimile notice of such deficiency to the

principal office of the Securities and Exchange Commission in Washington, D.C., the district or regional office of the Securities and Exchange Commission for the district or region in which the member organization maintains its principal place of business; and to the Exchange, or the member organization's DEA, if other than the Exchange.

(13) Day Trading Requirements.— The day trading restrictions promulgated under section (f)(8)(B) of this Rule shall not apply to portfolio margin accounts that establish and maintain at least five million dollars in equity, provided a member organization has the ability to monitor the intra-day risk associated with day trading. Portfolio margin accounts that do not establish and maintain at least five million dollars in equity will be subject to the day trading restrictions under section (f)(8)(B), provided the member organization has the ability to apply the applicable day trading requirements under this Rule. However, if the position or positions day traded were part of a hedge strategy, the day trading restrictions will not apply. A "hedge strategy" for the purpose of this rule means a transaction or a series of transactions that reduces or offsets a material portion of the risk in a portfolio. Member organizations are expected to monitor these portfolio margin accounts to detect and prevent circumvention of the day trading requirements.

(14) Requirements to Liquidate

(A) A member organization is required immediately either to liquidate, or transfer to another broker-dealer eligible to carry portfolio margin accounts, all portfolio margin accounts with positions in related instruments, if the member organization is:

(1) insolvent as defined in section 101 of title 11 of the United States Code, or is unable to meet its obligations as they mature;

(2) the subject of a proceeding pending in any court or before any agency of the United States or any State in which a receiver, trustee, or liquidator for such debtor has been appointed;

(3) not in compliance with applicable requirements under the Exchange Act or rules of the Securities and Exchange Commission or any self-regulatory organization with respect to financial responsibility or hypothecation of eligible participant's securities; or

(4) unable to make such computations as may be necessary to establish compliance with such financial responsibility or hypothecation rules.

(B) Nothing in this section (14) shall be construed as limiting or restricting in any way the exercise of any right of a registered clearing agency to liquidate or cause the liquidation of positions in accordance with its by-laws and rules.

(15) Member organizations must ensure that portfolio margin accounts are in compliance with all other applicable Exchange rules promulgated in Rules 700 through 795.

* * * * *

Delivery of Options Disclosure Document and Prospectus

Rule 726 (a) through (c) unchanged.

Portfolio Margining Disclosure Statement and Acknowledgement

(d) The special written disclosure statement describing the nature and risks of portfolio margining, and acknowledgement for an eligible participant signature, required by Rule 431(g)(5)(C) shall be in a format prescribed by the Exchange or in a format developed by the member organization, provided it contains substantially similar information as in the prescribed Exchange format and has received the prior written approval of the Exchange.

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 54940 / December 14, 2006

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2524 / December 14, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12506

In the Matter of Mark B. Leffers, 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 Mark B. Leffers ("Respondent" or "Leffers").

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

The Commission, with due regard to the public interest and without preliminary hearing, may, by order, . . . temporarily suspend from appearing or practicing before it any . . . 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.

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II.

The Commission finds that:

A. RESPONDENT

1. Leffers, age 44, is and has been a certified public accountant ("CPA") licensed to practice in the State of Maryland. From early 1999 through Fall 2000, Leffers served as the chief financial officer ("CFO") to Busybox.com, Inc. ("Busybox"). Acting in his capacity as Busybox CFO, Leffers signed and caused to be filed with the Commission the registration statement for the initial public offering ("IPO") of the securities of Busybox that took place in June 2000 (File Number 333-80315). Leffers also assisted with the preparation of the Busybox IPO registration statement and participated in the preparation of Busybox's periodic filings with the Commission. Leffers has therefore practiced before the Commission within the meaning of Rule 102(f) of the Commission's Rules of Practice [17 CFR § 201.102(f)].

B. CIVIL INJUNCTION

1. On October 24, 2006, the U.S. District Court for the Southern District of New York entered a final judgment against Leffers, permanently enjoining him from future violations, direct or indirect, of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. Securities and Exchange Commission v. Patrick A. Grotto, et al., Civil Action Number 05 Civ. 5880 (GEL).

2. The Commission's complaint filed in SEC v. Grotto alleges, among other things, the following facts. Leffers and others engaged in fraud in connection with the June 2000 IPO of Busybox securities. Barron Chase Securities Inc. ("Barron Chase"), the lead underwriter for the Busybox IPO, agreed to underwrite a firm commitment offering that would raise approximately $12.8 million for Busybox. After he learned that Barron Chase was having difficulty selling the IPO securities to bona fide investors, Leffers agreed to participate in a fraudulent scheme to complete the offering. Specifically, Leffers and several other Busybox officers and directors ("insiders") agreed secretly to "purchase" IPO securities using undisclosed payments styled as "bonuses," and Busybox's outside securities counsel received an inflated and undisclosed legal fee paid in IPO securities. Barron Chase secretly financed these transactions and, during the IPO closing, Leffers and others caused Busybox to repay Barron Chase out of the proceeds of the offering. As a result of these purchases, Leffers and other insiders at Busybox along with its outside securities counsel acquired almost 20% of the securities being offered in the IPO and reduced the proceeds available to Busybox by over $2.1 million. Leffers knew that the IPO registration statement and prospectus did not disclose the insiders' stock purchases, the inflated legal fee paid to outside counsel, Barron Chase's financing of these transactions or the repayment to Barron Chase using IPO proceeds.

III.

Based upon the foregoing, the Commission finds that a court of competent jurisdiction has permanently enjoined Leffers, 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 Leffers be temporarily suspended from appearing or practicing before the Commission.

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

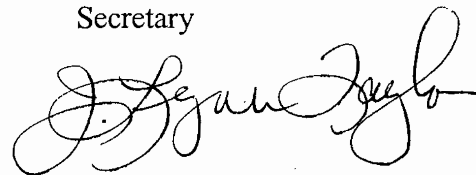
IT IS FURTHER ORDERED that Leffers may within thirty days after service of this Order file a petition with the Commission to lift the temporary suspension. If the Commission within thirty days after service of the Order receives no petition, the suspension shall become permanent pursuant to Rule 102(e)(3)(ii).

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 Leffers personally or by certified mail at his last known address.

By the Commission.

Nancy M. Morris
Secretary



By: J. Lynn Taylor
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 54937 / December 14, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12505

In the Matter of

JOHN M. REPINE and
ARCHER ALEXANDER
SECURITIES CORP.,

Respondents.

ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS PURSUANT TO SECTIONS 15(b) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against John M. Repine ("Repine") and Archer Alexander Securities Corp. ("Archer Alexander") (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, Making Findings, and Imposing Remedial Sanctions Pursuant to Sections 15(b) and 21C of the Exchange Act ("Order"), as set forth below.

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III.

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

A. SUMMARY

Archer Alexander and John M. Repine, its chief executive officer, failed reasonably to supervise a registered representative associated with the firm during 2003 (the "Registered Representative") with a view to preventing and detecting his violations of the federal securities laws arising from a fraudulent trading scheme involving inverse floating rate collateralized mortgage obligations ("inverse floaters"). Archer Alexander also violated various net capital, books and records, and reporting provisions of the federal securities laws as a result of the Registered Representative's conduct.

During 2003, the Registered Representative exclusively traded inverse floaters, a complex and thinly-traded type of collateralized mortgage obligation. Archer Alexander restricted the Registered Representative to trading these securities on a riskless principal basis and instituted a special supervisory procedure requiring that he obtain prior approval from Repine before entering into any inverse floater transaction.[2] Contrary to these restrictions, the Registered Representative entered into non-riskless principal transactions in which he secretly bought new issues of inverse floaters worth millions of dollars from other dealers for forward settlement without getting prior authorization from or informing Repine and Archer Alexander. The Registered Representative held these proprietary positions for weeks before selling them to other dealers or to his retail customers. He then falsified trade tickets to make it appear as though the transactions had been done on a riskless principal basis. The Registered Representative also made material misrepresentations and omissions when he sold inverse floaters to retail investors for whom these complex and risky securities were unsuitable. By engaging in this conduct, the Registered Representative violated the antifraud provisions of the federal securities.

Archer Alexander generated approximately half of its 2003 revenues from the Registered Representative's inverse floater trading and paid him millions of dollars in compensation for these trades. Repine did not respond reasonably to numerous red flags regarding the Registered Representative's trading and the suitability of inverse floaters for the Registered Representative's retail customers. Repine and Archer Alexander also did not develop and implement reasonable supervisory policies and procedures relating to the Registered Representative's trading in inverse floaters and did not reasonably implement the firm's special supervisory procedure requiring the Registered Representative to get Repine's prior approval for his inverse floater trades. Accordingly, Repine and Archer Alexander failed reasonably to supervise the Registered Representative with a view to detecting and preventing his violations of the antifraud provisions. In addition, the Registered Representative's conduct caused Archer Alexander to violate various net capital, books and records, and reporting provisions.

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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] "A riskless principal transaction occurs when a dealer receives from its customer an order to purchase (or sell) a security and purchases (or sells) that security to another person in a transaction that is proximate in time and designed to offset the customer's order." *In the Matter of David E. Lynch*, Exchange Act Rel. No. 46439, at n.13 (Aug. 30, 2002).

B. RESPONDENTS

John M. Repine, age 51, is a registered representative with his principal residence in Spring Hill, Kansas. He holds Series 7, 24, and 27 licenses. Repine is the chief executive officer and managing principal of Archer Alexander. During 2003, he had primary responsibility for overseeing the firm's operations and supervising brokers in branch offices, including the Registered Representative.

Archer Alexander Securities Corp. ("Archer Alexander") is a broker-dealer registered with the Commission since December 1996. Archer Alexander is incorporated in Kansas and has its principal offices in Overland Park, Kansas. It is a wholly-owned subsidiary of Great Plains Capital Corp., a holding company owned by Repine and John S. Raydo, his brother-in-law and Archer Alexander's president and chief financial officer. From January to mid-December 2003, Archer Alexander was an introducing broker-dealer with a fully disclosed clearing agreement with Clearing Firm, pursuant to which Clearing Firm cleared all of Archer Alexander's securities transactions and maintained customer accounts. As of the date of this Order, Archer Alexander is in the process of winding up its operations, and has consented to having its broker-dealer registration revoked by the Commission, effective December 15, 2006.

C. FACTS

1. The Registered Representative's Trading

The Registered Representative was an independent contractor associated with Archer Alexander from August 2002 to December 2003. During this time, he was the head of an Archer Alexander branch office located in Boca Raton, Florida and responsible for supervising the brokers and other employees working in that office. Repine, who worked in Archer Alexander's main office in Kansas, supervised the Registered Representative. The Registered Representative's business focused entirely on trading inverse floaters,[3] and he had between 200 and 250 retail customer accounts for whom he purchased and sold these securities. Archer Alexander paid the

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[3] Inverse floaters are a type of collateralized mortgage obligation ("CMO") issued by the Federal National Mortgage Association ("Fannie Mae"), the Federal Home Loan Mortgage Corp. ("Freddie Mac"), or the Government National Mortgage Association ("Ginnie Mae"), which guarantee principal and interest payments on the securities. Inverse floaters are structured so that interest payments move in the opposite direction of a floating rate index, such as the London Interbank Offered Rate ("LIBOR"). The coupon formulas typically contain multipliers that magnify the effect of changes in the specified index, making them highly leveraged and giving them a high degree of price volatility as interest rates move. Some of the main risks associated with inverse floaters include market, liquidity, and extension risk. Inverse floaters trade in the over-the-counter market, and are among the most thinly traded and volatile types of CMOs. CMOs issued and guaranteed by Fannie Mae, Freddie Mac, and Ginnie Mae are exempt from registration under Section 3(a)(2) of the Securities Act of 1933 ("Securities Act") and are "exempted securities" under Section 3(a)(12) of the Exchange Act. The antifraud provisions still apply to the offer, purchase, and sale of CMOs, however, even if the securities are not registered. *See In the Matter of Kenneth R. Ward*, Exchange Act Release No. 34-47535 (March 19, 2003) (Commission opinion finding that broker violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 in connection with sale of inverse floaters); *see also Staff Report on Enhancing Disclosure in the Mortgage-Backed Securities Markets, A Staff Report of the Task Force on Mortgage-Backed Securities Disclosure*, at n. 52-59 and accompanying text (Jan. 2003) (available at http://www.sec.gov/news/studies/mortgagebacked.htm) ("MBS Task Force Staff Report").

Registered Representative ninety percent of the net markups[4] – *i.e.*, after ticket charges and other such expenses were deducted – on his retail customers' trades.

In late 2002 or early 2003, the Registered Representative requested and obtained Repine's approval to do dealer-to-dealer trading of inverse floaters. In other words, the Registered Representative bought inverse floaters into an Archer Alexander proprietary account from a dealer, and then sold the securities from the Archer Alexander proprietary account to a dealer rather than to his retail customers. Archer Alexander paid the Registered Representative ninety-five percent of the net markups on such trades. The Registered Representative was Archer Alexander's leading producer, and markups from his inverse floater trading accounted for approximately half of the firm's revenues during 2003.

2. Archer Alexander's Policies and Procedures Governing the Registered Representative's Trading

Archer Alexander's policies and procedures governing the Registered Representative's trading were consistent throughout 2003. The firm only allowed the Registered Representative to trade on a riskless principal basis. The firm imposed this restriction, which applied both to the Registered Representative's retail customer and dealer-to-dealer trades, because it did not want to violate its net capital requirements and did not want to assume the trading risk associated with holding proprietary positions.

Repine also imposed a special supervisory procedure that required the Registered Representative to get his prior authorization before entering into any trade. Repine imposed this requirement because he believed the Registered Representative's trading required extra scrutiny due to his history of purchasing more inverse floaters than his retail customers could purchase with the money available in their accounts. After getting the required approval for a trade, the Registered Representative was supposed to fax trade tickets to Archer Alexander and Clearing Firm. Repine informed his assistant of the terms of these trades, and at his direction she reviewed the tickets submitted by the Registered Representative to verify that they matched the terms of the trades that Repine had approved.

3. The Registered Representative's Fraudulent Trading Scheme

In fact, however, the Registered Representative consistently did not trade on a riskless principal basis during 2003. Rather, on almost every trade, the Registered Representative bought new issues of inverse floaters worth millions of dollars on Archer Alexander's behalf from other dealers for forward settlement one to two months after the trade date.[5] He did not have buyers for the securities at the time he purchased them and, in many instances, did not obtain authorization from Repine before committing to buy the securities. He also did not prepare or submit tickets at the time he entered into these purchase transactions. As a result, the Registered Representative

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[4] "A markup is the difference between the price charged to a customer for a security and the prevailing market price for the security, when the seller of the security is acting as a principal, holding ownership of the security and selling it to the customer." *Press v. Chemical Investment Servs. Corp.*, 166 F.3d 529, 533 n.3 (2d Cir. 1999) *(citing S.E.C. v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1469 (2d Cir. 1996)).

[5] "The CMO market convention is corporate settlement (3 business days after the trade date) unless the CMO is a new issue. In the case of a new issue, the settlement date for all CMO classes is usually 1 to 3 months after the CMO is initially offered for sale. This period allows dealers to accumulate the collateral that will back the CMO." FRANK J. FABOZZI, THE HANDBOOK OF MORTGAGE-BACKED SECURITIES 195 (5th ed. 2001).

committed Archer Alexander to multi-million dollar proprietary positions without Repine's or Archer Alexander's knowledge or authorization. The value of these proprietary positions well exceeded Archer Alexander's available net capital, thereby exposing the firm to substantial risk.

The Registered Representative then waited weeks, or sometimes even months, before selling the positions in the hope that the market would turn in his favor. In some cases, he sold the securities to his retail customers at a markup, but in many instances he sold them to other dealers. As the settlement dates approached, and after the Registered Representative had found buyers for the securities, he instructed his assistant to prepare two trade tickets: one trade ticket for the purchase that reflected a false trade date, and one trade ticket for the sale with a matching trade date, to make it appear as though he had bought and sold the securities on the same day (*i.e.*, on a riskless principal basis). At the Registered Representative's direction, his assistant then sent these falsified trade tickets to Archer Alexander's main office and Clearing Firm.

For example, on June 23, 2003, the Registered Representative submitted trade tickets stating that on that day he had purchased a block of the FNR 03-40 MS inverse floater with a face value of over $10.1 million from Dealer A at $89.75 for settlement on June 30, and that same day had sold the entire block of securities back to Dealer A at $97, also for settlement on June 30. In reality, however, the Registered Representative bought the position from Dealer A on March 26 for settlement on June 30, and then sold the position back to Dealer A on May 12, also for settlement on June 30. Archer Alexander paid the Registered Representative over $698,000 for this trade.

To facilitate his trading scheme, the Registered Representative also entered into "roll trades" or "dollar rolls" with other dealers, in which he sold blocks of inverse floaters to other dealers while simultaneously agreeing to repurchase the securities for settlement on a future date. The Registered Representative submitted falsified trade tickets that made it appear as though a roll trade had been two, separate riskless principal transactions.[6] For example, on May 22, 2003, the Registered Representative submitted trade tickets stating that he had bought a block of the FNR 03-23 SN inverse floater with a face value of $3.7 million from Dealer A at $97 for settlement on May 30 and sold the entire block back to Dealer A on the same day at the same price, also for settlement on May 30. On July 1, the Registered Representative submitted tickets stating that he had bought the block from Dealer A at $96.1875 and sold it back to Dealer A at $101.25, both for settlement on July 7. In reality, however, the Registered Representative first bought the securities from Dealer A on March 10 for settlement on May 30, and then on April 16 did a roll trade with Dealer A to extend the settlement date to July 7. On June 3, after the market had moved in his favor, the Registered Representative sold the block back to Dealer A at $101.25. Archer Alexander paid the Registered Representative almost $180,000 for this trade.

During 2003, Archer Alexander paid the Registered Representative almost $5 million for his inverse floater trades. In most cases, the Registered Representative only was able to generate markups resulting in these payments because he took unauthorized proprietary positions and did not trade on a riskless principal basis. Eventually, in early December 2003, Archer Alexander incurred a loss of approximately $1.9 million on one of the Registered Representative's unauthorized trades. The loss caused a net capital deficiency that forced the firm to halt operations

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[6] Although roll trades are a common financing technique in the mortgage-backed securities market, *see* MBS Task Force Staff Report, at n. 49-51 and accompanying text, the Registered Representative did not inform Repine or Archer Alexander that he was doing such trades, nor did the tickets he submitted reflect his agreement to repurchase the securities for settlement at a later date.

for several weeks. On December 9, 2003, Archer Alexander terminated the Registered Representative for violating "firm policy and procedures" by engaging in unauthorized trading in connection with this particular transaction.

4. Repine's and Archer Alexander's Supervision of the Registered Representative

During 2003, Repine ignored or failed to conduct a reasonable inquiry into numerous red flags regarding the Registered Representative's trading and the suitability of inverse floaters for some of his retail customers. In addition, Repine and Archer Alexander failed to develop and implement reasonable supervisory policies and procedures to prevent and detect the Registered Representative's violations of the federal securities laws.

Throughout the course of 2003, the Registered Representative sought approval or submitted tickets for numerous dealer-to-dealer trades that constituted red flags. On multiple occasions, including the FNR 03-40 MS transaction described above, the Registered Representative purportedly bought and sold the same large block of inverse floaters on the same day, often with the same counterparty and/or at unusually large spreads. Despite the highly irregular circumstances of these trades, Repine only questioned the Registered Representative about such a trade once, when the Registered Representative sought approval for a trade in which he purportedly bought and sold the same block of inverse floaters with the same counterparty on the same day at approximately a ten point spread. The Registered Representative falsely told Repine that after he bought the securities from a dealer, he received a call from the trader at that dealer, who said he had another customer willing to pay much more for the securities and asked the Registered Representative to sell them back. Repine accepted this explanation and did not conduct any additional inquiry, such as contacting the counterparty to verify that the trade dates submitted by the Registered Representative were accurate.

Repine also ignored red flags regarding the Registered Representative's roll trades. During 2003, the Registered Representative submitted tickets for at least four trades similar to the FNR 03-23 SN transaction described above, in which he purportedly bought and sold the same large block of inverse floaters on the same day with the same counterparty at the same price. Repine did not question the Registered Representative or conduct any additional inquiry regarding these trades.

Repine also failed to respond reasonably to red flags regarding the suitability of inverse floaters for some of the Registered Representative's retail customers. Under Archer Alexander's policies and procedures, Repine was supposed to review and approve every new account "to determine customer suitability for investments in CMOs." Repine knew that the Registered Representative's business focused exclusively on inverse floaters, and that any customer of the Registered Representative would be investing in inverse floaters. In their new account forms, however, many of the Registered Representative's customers expressed conservative objectives incompatible with a potentially volatile investment such as inverse floaters. Repine never identified investments in inverse floaters as unsuitable for any of the Registered Representative's customers.

Repine and Archer Alexander also failed to develop and implement reasonable supervisory policies and procedures to prevent and detect the Registered Representative's violations of the federal securities laws. The firm did not have reasonable policies and procedures to monitor whether the Registered Representative traded inverse floaters on a riskless principal basis. In addition, Repine and the firm failed to develop a reasonable system to implement the special supervisory procedure requiring the Registered Representative to get prior approval for his trades.

When Repine learned that the Registered Representative had entered into trades without obtaining the required prior approval, he took no action to enforce the requirement other than reprimanding the Registered Representative. Repine and the firm also failed to develop a reasonable system to implement Archer Alexander's procedure requiring Repine to conduct an annual inspection of the Registered Representative's office. The firm failed to produce a written report showing that this inspection was conducted during 2003.

5. Archer Alexander's False Books and Records

By engaging in his fraudulent trading scheme, the Registered Representative caused Archer Alexander to create false and inaccurate books and records throughout 2003. Archer Alexander's purchase and sales blotter did not reflect the Registered Representative's numerous purchase transactions for forward settlement and its general ledger did not reflect the resulting proprietary positions. In addition, the Registered Representative created trade tickets for purchases reflecting falsified trade dates that matched the dates of subsequent sell transactions to make it appear as though he had effected purchase and sale transactions on a riskless principal basis.

6. Archer Alexander's Insufficient Net Capital During 2003

Because he committed Archer Alexander to tens of millions of dollars worth of proprietary positions that he had bought for forward settlement, the Registered Representative caused the firm to miscalculate its net capital throughout 2003. During that period, Archer Alexander calculated its net capital in accordance with Exchange Act Rule 15c3-1(a)(2)(vi), which required that the firm maintain minimum net capital of only $5,000. However, a broker-dealer that engages in more than ten non-riskless principal transactions for its own account in a calendar year is required to calculate its net capital in accordance with Rule 15c3-1(a)(2)(iii), which requires a broker-dealer to maintain net capital of not less than $100,000. Furthermore, because Archer Alexander's purchase and sales blotter did not reflect the Registered Representative's purchase transactions and its general ledger did not reflect the resulting proprietary positions, Archer Alexander's calculation of net worth was incorrect and the firm did not take "haircuts" on these positions when performing its net capital computations.[7] As a result of not using the appropriate minimum when calculating net capital and failing to take haircuts on these positions, Archer Alexander's net capital computations were incorrect throughout 2003, and it continued to do business while undercapitalized.

For example, during March 2003 the Registered Representative bought positions in eight different inverse floaters – with a combined value of $67,077,410 – for forward settlement at the end of May and end of June. As of the end of March 2003, he had not yet sold any of these inverse floaters, meaning that Archer Alexander had proprietary positions in these securities. Consequently, the firm should have included the securities in its inventory as an asset, and its obligation to pay for these securities as a liability on its balance sheet. The firm computed its excess net capital for the first three months of 2003 as $158,395. However, in doing so, Archer Alexander did not take the required haircuts on any of the open proprietary positions in inverse floaters that the Registered Representative had purchased on Archer Alexander's behalf. In fact, Archer Alexander should have taken millions of dollars in combined haircuts on those proprietary

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[7] "In computing 'net capital,' the [net capital] rule requires deductions from 'net worth' of certain specified percentages of the market values of marketable securities and future commodity contracts, long and short, in the capital and proprietary accounts of the broker or dealer, and in the 'accounts of partners.' These deductions are generally referred to in the industry as 'haircuts.'" *Net Capital Requirements for Brokers and Dealers – Interpretation and Guide*, Exchange Act Rel. No. 8024 (Jan. 18, 1967).

positions, resulting in a significant net capital deficit. Because Archer Alexander never included haircuts for the Registered Representative's proprietary positions during 2003, its net capital computations throughout this period were materially incorrect.

7. Archer Alexander's Inaccurate FOCUS Reports

In addition, the firm's Financial and Operational Combined Uniform Single ("FOCUS") reports for the first three quarters of 2003 were inaccurate. As stated previously, Archer Alexander failed to include the Registered Representative's proprietary positions in inverse floaters on its general ledger. Consequently, these balances were not included on its FOCUS report balance sheets. In addition, Archer Alexander stated in its FOCUS reports that its net capital requirement was $5,000, rather than $100,000. Finally, the haircut charges Archer Alexander reported on its FOCUS reports were inaccurate because they did not include any haircut charges for its inverse floater positions.

D. LEGAL ANALYSIS

1. Respondents Failed Reasonably to Supervise the Registered Representative

Sections 15(b)(4)(E) and 15(b)(6) of the Exchange Act authorize the Commission to sanction a broker, dealer, or person associated with a broker or dealer if it finds that the sanction is in the public interest and the broker, dealer, or associated person "has failed reasonably to supervise, with a view to preventing violations of the provisions of [the federal securities laws], another person who commits such a violation, if such person is subject to his supervision." "The supervisory obligations imposed by the federal securities laws require a vigorous response even to indications of wrongdoing." *In the Matter of John H. Gutfreund, et al.*, 51 S.E.C. 93, 108, Exchange Act Release No. 31554 (Dec. 3, 1992). "Red flags and suggestions of irregularities demand inquiry as well as adequate follow-up and review. When indications of impropriety reach the attention of those in authority, they must act decisively to detect and prevent violations of the federal securities laws." *In the Matter of Edwin Kantor*, 51 S.E.C. 440, 447, Exchange Act Release No. 32341 (May 20, 1993) (internal quotations omitted). Furthermore, supervisors may not rely upon the unverified representations of a person subject to their supervision when investigating red flags. *In the Matter of Prospera Financial Services, Inc., et al.*, Exchange Act Release No. 34-43352 (Sept. 26, 2000).

By engaging in the conduct described above, the Registered Representative violated the antifraud provisions of the federal securities laws and aided and abetted Archer Alexander's violations of certain net capital, books and records, and reporting provisions. Repine did not respond reasonably to red flags regarding the Registered Representative's trading. His failure to respond to these red flags trading was particularly unreasonable in light of: (a) the size of the Registered Representative's trades; (b) Archer Alexander's minimal net capital and the resulting need to ensure that all of the firm's trades were done on a riskless principal basis; and (c) Repine's recognition that the Registered Representative's trading required additional scrutiny. Repine also did not respond reasonably to red flags regarding the suitability of inverse floaters for certain of the Registered Representative's retail customers with conservative investment objectives. Moreover, as described above, Repine and Archer Alexander did not develop reasonable supervisory policies and procedures, and systems to implement these policies and procedures, to detect and prevent the Registered Representative's unlawful conduct. Repine and Archer Alexander also did not develop a reasonable system to implement the special supervisory procedure governing the Registered

Representative's trading. Repine and Archer Alexander also failed to implement the firm's procedure requiring Repine to conduct an annual inspection of the Registered Representative's office. As the firm's chief executive officer and designated supervisory principal, Repine was responsible for these failures. If Repine had responded to these red flags, or if he and the firm had developed and implemented reasonable supervisory policies and procedures, it is likely that the Registered Representative's fraudulent conduct would have been detected and prevented. Accordingly, Repine and Archer Alexander failed reasonably to supervise the Registered Representative with a view to preventing his violations of the federal securities laws.

2. Archer Alexander Violated Books and Records Provisions

Section 17(a)(1) of the Exchange Act provides that brokers and dealers "shall make and keep for prescribed periods such records, furnish such copies thereof, and make and disseminate such reports as the Commission, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this title." Rule 17a-3(a)(1) requires brokers and dealers to make and keep current "[b]lotters (or other records of original entry) containing an itemized daily record of all purchases and sales of securities." Rule 17a-3(a)(2) requires brokers and dealers to make and keep current "[l]edgers (or other records) reflecting all assets and liabilities, income and expense and capital accounts." Rule 17a-3(a)(7) requires brokers and dealers to make and keep current "[a] memorandum of each purchase and sale for the account of the member, broker, or dealer showing the price and, to the extent feasible, the time of execution." Implicit in the Commission's recordkeeping rules is the requirement that information contained in a required book or record be accurate. *See, e.g., Armstrong Jones & Co.*, Exchange Act Release No. 8420 (Oct. 3, 1968), *aff'd, Armstrong Jones & Co. v. SEC,* 421 F.2d 359 (6th Cir. 1970). This requirement applies regardless of whether the information entered itself is mandated. *See Sinclair v. SEC;* 444 F.2d 399, 401 (2d Cir. 1971); *James F. Novack,* Exchange Act Release No. 19660, 47 S.E.C. 892 (Apr. 8, 1983). Scienter is not required to violate Section 17(a)(1) of the Exchange Act and the rules thereunder. *See In the Matter of Orlando Joseph Jett,* Exchange Act Release No. 49366 at n.45 (March 5, 2004).

Archer Alexander willfully violated Section 17(a)(1) of the Exchange Act and Rules 17a-3(a)(1), 17a-3(a)(2), and 17a-3(a)(7) as a result of the Registered Representative's conduct.[8] Because the Registered Representative did not submit tickets or otherwise inform Archer Alexander when he bought inverse floaters for forward settlement, the firm's purchase and sales blotter did not reflect these transactions and its general ledger did not reflect the resulting positions. Consequently, they were inaccurate, in violation of Rules 17a-3(a)(1) and 17a-3(a)(2), respectively. Because the Registered Representative later wrote, or caused to be written, trade tickets that contained false trade dates, Archer Alexander did not have accurate memoranda of these trades, and thereby violated Rule 17a-3(a)(7).

3. Archer Alexander Violated Net Capital Provisions

Section 15(c)(3) of the Exchange Act makes it unlawful for a broker or dealer to "effect any transaction in, or to induce or attempt to induce the purchase or sale of any security . . . in contravention of such rules and regulations as the Commission shall proscribe as necessary or appropriate in the public interest or for the protection of investors to provide safeguards with

[8] "Willfully" as used in this Order means intentionally committing the act which constitutes the violation. *Cf. Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000); *Tager v. SEC*, 344 F.2d 5, 8 (2d Cir. 1965). There is no requirement that the actor also be aware that he is violating one of the Rules or Acts.

respect to financial responsibility and related practices of brokers and dealers." Pursuant to this section, the Commission promulgated Rule 15c3-1, commonly referred to as the "net capital rule." "The principal purposes of Exchange Act Rule 15c3–1 . . . are to protect customers and other market participants from broker-dealer failures and to enable those firms that fall below the minimum net capital requirements to liquidate in an orderly fashion without the need for a formal proceeding or financial assistance from the Securities Investor Protection Corporation." Exchange Act Release No. 49830 (June 8, 2004).

Archer Alexander willfully violated Section 15(c)(3) of the Exchange Act and Rule 15c3-1 because, as a result of the Registered Representative's conduct, it continued to do business while undercapitalized. Because the firm's purchase and sales blotter did not reflect the Registered Representative's purchases for forward settlement and its general ledger did not reflect the resulting proprietary positions, Archer Alexander failed to take these transactions and positions into account when determining its net capital requirements and calculating its net capital. During 2003, Archer Alexander was maintaining net capital in accordance with Rule 15c3-1(a)(2)(vi), which requires that a broker or dealer maintain net capital of not less than $5,000. Because it did more than ten transactions for its own investment account during 2003, however, Archer Alexander should have been maintaining net capital in accordance with Rule 15c3-1(a)(2)(iii), which requires a dealer to maintain net capital of not less than $100,000. Moreover, because Archer Alexander was unaware that the Registered Representative had engaged in forward settlement purchases on behalf of the firm, it failed to include the value of those positions and the corresponding liability to pay for those positions on its balance sheet and to properly reduce its tentative net capital by the amount of the haircuts the firm was required to take on the resulting positions from trade date in accordance with Rule 15c3-1(c)(2)(vi). As a result, Archer Alexander had significant net capital deficits throughout 2003, but continued to engage in a securities business.

4. <u>Archer Alexander Violated Reporting Provisions</u>

Rule 17a-5(a) requires brokers and dealers to file FOCUS reports. Implicit in the FOCUS report requirements is the requirement that the information contained in those reports be accurate. *In the Matter of Nikko Securities Co. International, Inc.*, Exchange Act Release No. 32331 (May 19, 1993). Archer Alexander willfully violated Rule 17a-5(a) by filing inaccurate FOCUS reports for the first three quarters of 2003 that did not reflect its proprietary inverse floater positions, the haircuts it should have taken on these positions, or the resulting effect of those positions on the firm's net capital.

E. <u>COOPERATION</u>

In determining to accept Respondents' Offer, the Commission has considered Respondents' undertakings to cooperate fully with the Commission in any and all investigations, litigations, or other proceedings relating to or arising from the matters described in this Order. Respondents undertake to:

1. Produce, without service of a notice or subpoena, any and all non-privileged documents and other information reasonably requested by the Commission's staff;

2. In the case of Repine, to be available to be interviewed by the Commission's staff at such times and places as the staff may reasonably request, and to appear and testify truthfully

and completely without service of a notice or subpoena in such investigations, depositions, hearings, or trials as the Commission's staff may reasonably request; and

3. In the case of Archer Alexander, make its best efforts to encourage its employees, officers, directors, and agents to be interviewed at such times and places as the staff may reasonably request and make its best efforts to cause its employees to appear and testify truthfully and completely without service of a notice or subpoena in such investigations, depositions, hearings, or trials as the Commission's staff may reasonably request.

F. UNDERTAKING

1. Repine shall provide to the Commission, within thirty days after the end of the six month supervisory suspension period described below, an affidavit that he has complied fully with the sanctions described in Section IV., below.

IV.

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

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

A. Respondents be, and hereby are, censured;

B. Archer Alexander cease and desist from committing any violations and any future violations of Section 17(a)(1) of the Exchange Act, Rules 17a-3(a)(1), 17a-3(a)(2), 17a-3(a)(7), and Rule 17a-5(a)(2)(iii) thereunder, and Section 15(c)(3) of the Exchange Act and Rule 15c3-1 thereunder;

C. The registration of Archer Alexander as a broker and dealer with the Commission be, and hereby is, revoked, effective December 15, 2006;

D. Repine be, and hereby is, suspended from association with any broker or dealer in a supervisory capacity for a period of six months, effective on the second Monday following the entry of this Order;

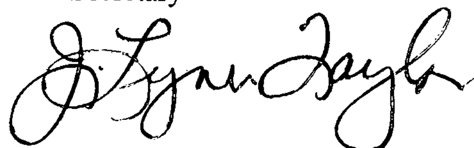
E. It is further ordered that Repine shall, within thirty days of the entry of this Order, pay a civil money penalty in the amount of $15,000 to the United States Treasury. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies John M. Repine as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent

to Antonia Chion, Associate Director, Division of Enforcement, Securities and Exchange Commission, 100 F Street N.E., Washington, D.C. 20549; and

F. Repine shall comply with the undertaking enumerated in Section III.F., Undertaking, above.

By the Commission.

Nancy M. Morris
Secretary



By: J. Lynn Taylor
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-54938; File No. PCAOB-2006-02)

[December 14, 2006]

Public Company Accounting Oversight Board; Notice of Filing and Immediate Effectiveness of Proposed Rule Change Adjusting Implementation Schedule of Rule 3523, Tax Services for Persons in Financial Reporting Oversight Roles

Pursuant to Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Act"), notice is hereby given that on October 31, 2006, the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") filed with the Securities and Exchange Commission (the "SEC" or "Commission") the proposed rule change described in Items I and II below, which items have been prepared by the Board. The PCAOB has designated the proposed rule change as "constituting a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule" under Section 19(b)(3)(A)(i) of the Securities Exchange Act of 1934 ("Exchange Act")(as incorporated, by reference, into Section 107(b)(4) of the Act), which renders the proposal effective upon receipt of this filing by the Commission. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Board's Statement of the Terms of Substance of the Proposed Rule Change

The PCAOB is filing with the SEC an adjustment of the implementation schedule for Rule 3523, Tax Services for Persons in Financial Reporting Oversight Roles. Specifically the Board will not apply Rule 3523 to tax services provided on or before April 30, 2007, when those services are provided during the audit period and are completed before the professional engagement period begins. The PCAOB is not proposing any textual changes to the Rules of the PCAOB.

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II. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Board included statements concerning the purpose of, and basis for, the proposed rule and discussed any comments it received on the proposed rule. The text of these statements may be examined at the places specified in Item IV below. The Board has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

On July 26, 2005, the Board adopted certain rules related to registered public accounting firms' provision of tax services to public company audit clients. The rules were designed to address certain concerns related to auditor independence when auditors become involved in marketing or otherwise opining in favor of aggressive tax shelter schemes or in selling personal tax services to individuals who play a direct role in preparing the financial statements of public company audit clients. As part of this rulemaking, the Board adopted Rule 3523 to prohibit registered public accounting firms from providing any tax services to persons in a financial reporting oversight role at an audit client. Rule 3523 was approved by the Securities and Exchange Commission on April 19, 2006. Under the current implementation schedule set by the Board, Rule 3523 will not apply to tax services being provided pursuant to an engagement in process on April 19, 2006, provided that such services are completed on or before October 31, 2006.[1/]

[1/] PCAOB Release No. 2006-001(March 28, 2006), at 2-3.

Rule 3523 applies to all tax services performed for persons in a financial reporting oversight role during the "audit and professional engagement period." The Board intends to revisit the application of Rule 3523 to tax services provided during the period before a registered public accounting firm becomes auditor of record for an audit client – that is, during only the "audit period."[2/] Accordingly, the Board has decided to adjust the implementation schedule for Rule 3523, as it applies to tax services provided during the "audit period," while it revisits this aspect of the rule. Specifically the Board will not apply Rule 3523 to tax services provided on or before April 30, 2007, when those services are provided during the audit period and are completed before the professional engagement period begins.[3/]

The implementation schedule for Rule 3523 as it applies to tax services provided during the professional engagement period remains unchanged.[4/] Accordingly, as of November 1, 2006, registered public accounting firms must comply with Rule 3523 as it relates to tax services provided during the professional engagement period.

(b) Statutory Basis

The statutory basis for the proposed rule change is Title I of the Act.

[2/] Consistent with the SEC's independence rules, 17 CFR 210.2-01(f)(5), the phrase "audit and professional engagement period" is defined to include two discrete periods of time. The "audit period" is the period covered by any financial statements being audited or reviewed. Rule 3501(a)(iii)(1). The "professional engagement period" is the period beginning when the accounting firm either signs the initial engagement letter or begins audit procedures and ends when the audit client or the accounting firm notifies the SEC that the client is no longer that firm's audit client. Rule 3501(a)(iii)(2).

[3/] This will apply whether there is an engagement in process on April 19, 2006 or not.

[4/] PCAOB Release No. 2006-001 (March 28, 2006), at 3.

B. Board's Statement on Burden on Competition

The Board does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Board's Statement on Comments on the Proposed Rule Change Received from Members, Participants or Others

The Board did not solicit or receive written comments on the proposed rule change.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

The foregoing rule change has become effective pursuant to Section 19(b)(3)(A) of the Exchange Act (as incorporated, by reference, into Section 107(b)(4) of the Act), in that the proposed rule change constitutes a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule of the PCAOB. At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule is consistent with the requirements of Title I of the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/pcaob.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number PCAOB-2006-02 on the subject line.

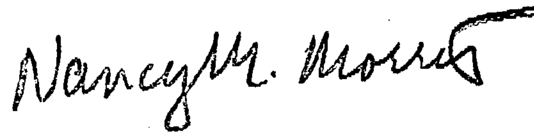
Paper comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washingtion, DC 20549-1090.

All submissions should refer to File Number PCAOB-2006-02. 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 Web site (http://www.sec.gov/rules/pcaob.shtml). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such

filing also will be available for inspection and copying at the principal office of the PCAOB. 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. All submissions should refer to File Number PCAOB-2006-02 and should be submitted on or before **[insert date 21 days from publication in the Federal Register]**.

By the Commission.



Nancy M. Morris
Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 270

[Release No. IC-27600; File No. S7-03-04]

RIN 3235-AJ05

Investment Company Governance

AGENCY: Securities and Exchange Commission.

ACTION: Request for additional comment.

SUMMARY: The Commission is reopening the comment period on its June 2006 request for comment regarding amendments to investment company ("fund") governance provisions. The purpose of the additional comment period is to permit public comment on two papers prepared by the Office of Economic Analysis on this topic that will be made public by including them in the comment file. The comments the Commission receives will be used to inform our further consideration of the matter.

DATES: Comments must be received on or before 60 days after publication of the second of the two staff economic papers in the public comment file. When the second of the two staff economic papers in the public comment file is published, the Commission will publish a document announcing the comment deadline.

ADDRESSES: To help us process and review your comments more efficiently, comments should be sent by one method only.

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-03-04 on the subject line; or

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- Use the Federal eRulemaking Portal (http://www.regulations.gov). Follow the instructions for submitting comments.

Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

All submissions should refer to File Number S7-03-04. The Commission will post all comments on the Commission's Internet Web site (http://www.sec.gov/rules/proposed.shtml). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549. All comments received will be posted without change; 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: Jonathan Sokobin, Deputy Chief Economist, Office of Economic Analysis, (202) 551-6600 or Vincent Meehan, Staff Attorney, or Penelope Saltzman, Branch Chief, Office of Regulatory Policy, (202) 551-6792, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION:

In June 2006, the Commission requested additional comment[1] regarding amendments to fund governance provisions of rules under the Investment Company Act.[2] We received many comments in response to our request, some of which provided information on the costs of the provisions. Few, however, directly addressed in a meaningful way the economic implications of the provisions. Before considering further rulemaking on this matter, the Commission wishes to

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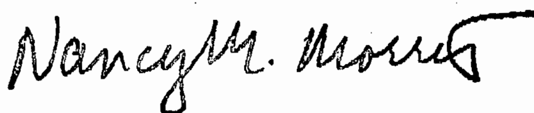
[1] Investment Company Governance, Investment Company Act Release No. 27395 (June 13, 2006) [71 FR 35366 (June 19, 2006)].

[2] 15 U.S.C. 80a.

develop a more comprehensive record and a more thorough understanding of the economic consequences of the provisions.

To that end, the Commission invites comment on any aspect of the two staff economic papers that will be published shortly after the issuance of this release. Specifically, our staff economists have reviewed existing relevant economic literature related to conflicts of interest that advisers have with regard to mutual funds they advise, as well as literature related to mutual fund governance, independent chairmen, and board independence. Our staff economists also have performed an analysis of the statistical properties of mutual fund returns and potential limitations inherent in any empirical analysis designed to identify a relationship between those returns and fund governance. We will include their papers in the public comment file, and we request comment on them. In addition, in order to facilitate our assessment of the economic implications of the fund governance provisions and any alternative approaches available to us, we also seek comment on any other extant analyses, and we request that commenters provide us their best assessment of these.

By the Commission.



Nancy M. Morris
Secretary

Dated: December 15, 2006

SECURITIES AND EXCHANGE COMMISSION

17 CFR PARTS 210, 228, 229, 240 and 249

[RELEASE NOS. 33-8760; 34-54942; File No. S7-06-03]

RIN 3235-AJ64

INTERNAL CONTROL OVER FINANCIAL REPORTING IN EXCHANGE ACT PERIODIC REPORTS OF NON-ACCELERATED FILERS AND NEWLY PUBLIC COMPANIES

AGENCY: Securities and Exchange Commission.

ACTION: Final rule; extension of compliance dates; request for comment on Paperwork Reduction Act burden estimates.

SUMMARY: We are extending further for smaller public companies the dates that were published on September 29, 2005, in Release No. 33-8618 [70 FR 56825], for their compliance with the internal control reporting requirements mandated by Section 404 of the Sarbanes-Oxley Act of 2002. Under the extension, a non-accelerated filer is not required to provide management's report on internal control over financial reporting until it files an annual report for its first fiscal year ending on or after December 15, 2007. If we have not issued additional guidance for management on how to complete its assessment of internal control over financial reporting in time to be of sufficient assistance in connection with annual reports filed for fiscal years ending on or after December 15, 2007, we will consider whether we should further postpone this date. A non-accelerated filer is not required to file the auditor's attestation report on internal control over financial reporting until it files an annual report for its first fiscal year ending on or after December 15, 2008. We will consider further postponing this date after we consider the anticipated revisions to Auditing Standard No. 2. Management's report included in a non-accelerated filer's annual report during the filer's first year of compliance with the Section

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404(a) requirements will be deemed "furnished" rather than filed. Management's report for foreign private issuers filing on Form 20-F or 40-F that are accelerated filers (but not large accelerated filers) also will be deemed furnished rather than filed for the year that such issuers are only required to provide management's report. Companies that only provide management's report during their first year of compliance in accordance with our rules must state in the annual report that the report does not include the auditor's attestation report and that the company's registered public accounting firm has not attested to management's report on the company's internal control over financial reporting.

We also are adopting amendments that provide for a transition period for a newly public company before it becomes subject to the internal control over financial reporting requirements. Under the new amendments, a company will not become subject to these requirements until it either had been required to file an annual report for the prior fiscal year with the Commission or had filed an annual report with the Commission for the prior fiscal year. A newly public company is required to include a statement in its first annual report that the annual report does not include either management's assessment on the company's internal control over financial reporting or the auditor's attestation report.

DATES: Effective Date: The effective date published on June 18, 2003, in Release No. 33-8238 [68 FR 36636], remains August 14, 2003. The effective date of this document is [insert 60 days after publication in the Federal Register] except Temporary §210.2-02T(c), Temporary §228.308T, Temporary §229.308T, Temporary Item 15T of Form 20-F (§249.220f), Temporary Instruction 3T of General Instruction B(6) of Form 40-F (§249.240f), Temporary Item 4T of Form 10-Q (§249.308a), Temporary Item 3A(T) of Form 10-QSB (§249.308b), Temporary Item 9A(T) of Form 10-K (§249.310), and Temporary Item 8A(T) of Form 10-KSB (§249.310b) are

effective from [insert 60 days after publication in the Federal Register] to June 30, 2009. Temporary §210.2-02T(a) remains effective from September 14, 2006 to December 31, 2007.

Compliance Dates: The compliance dates are extended as follows: A company that does not meet the definition of either an "accelerated filer" or a "large accelerated filer," as these terms are defined in Rule 12b-2 under the Securities Exchange Act of 1934, is not required to comply with the requirement to provide management's report on internal control over financial reporting until it files an annual report for its first fiscal year ending on or after December 15, 2007. Non-accelerated filers must begin to comply with the provisions of Exchange Act Rule 13a–15(d) or 15d–15(d), whichever applies, requiring an evaluation of changes to internal control over financial reporting requirements with respect to the company's first periodic report due after the first annual report that must include management's report on internal control over financial reporting. The extended compliance also applies to the amendments of Exchange Act Rule 13a-15(a) or 15d-15(a) relating to the maintenance of internal control over financial reporting. We also are extending the compliance date to permit a non-accelerated filer to omit the portion of the introductory language in paragraph 4 as well as language in paragraph 4(b) of the certification required by Exchange Act Rules 13a-14(a) and 15d-14(a) that refers to the certifying officers' responsibility for designing, establishing and maintaining internal control over financial reporting for the company, until it files an annual report that includes a report by management on the effectiveness of the company's internal control over financial reporting.

A company that does not meet the definition of either an accelerated filer or a large accelerated filer is not required to comply with the requirement to provide the auditor's attestation report on internal control over financial reporting until it files an annual report for its first fiscal year ending on or after December 15, 2008. Furthermore, until this type of company

becomes subject to the auditor attestation report requirement, the registered public accounting firm retained by the company need not comply with the obligation in Rule 2-02(f) of Regulation S-X. Rule 2-02(f) requires every registered public accounting firm that issues or prepares an accountant's report that is included in an annual report filed by an Exchange Act reporting company (other than a registered investment company) containing an assessment by management of the effectiveness of the company's internal control over financial reporting to attest to, and report on, such assessment.

Comment Date: Comments regarding the collection of information requirements within the meaning of the Paperwork Reduction Act of 1995 should be received on or before [insert 30 days after the date of publication in the Federal Register].

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

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/final.shtml);
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-06-03 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 Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-06-03. 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/final.shtml). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549. All comments received will be posted without change; 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: Sean Harrison, Steven G. Hearne, or Katherine Hsu, Special Counsels, Office of Rulemaking, Division of Corporation Finance, at (202) 551-3430, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-3628.

SUPPLEMENTARY INFORMATION: We are amending certain internal control over financial reporting requirements in Rules 13a-14,[1] 13a-15,[2] 15d-14,[3] and 15d-15[4] under the Securities Exchange Act of 1934,[5] Item 308 of Regulations S-K[6] and S-B,[7] Item 15 of Form 20-F,[8] General Instruction B(6) of Form 40-F,[9] and Rule 2-02(f)[10] of Regulation S-X.[11] We also are adding the following temporary provisions: Rule 2-02T of Regulation S-X, Item 308T of Regulations S-K and S-B, Item 3A(T) of Form 10-QSB, Item 4T of Form 10-Q, Item 8A(T) of

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[1] 17 CFR 240.13a-14.

[2] 17 CFR 240.13a-15.

[3] 17 CFR 240.15d-14.

[4] 17 CFR 240.15d-15.

[5] 15 U.S.C. 78a et seq.

[6] 17 CFR 229.10 et seq.

[7] 17 CFR 228.10 et seq.

[8] 17 CFR 249.220f.

[9] 17 CFR 249.240f.

[10] 17 CFR 210.2-02(f).

[11] 17 CFR 210.1-01 et seq.

Form 10-KSB, Item 9A(T) of Form 10-K, Item 15T of Form 20-F, and Instruction 3T of General Instruction B(6) of Form 40-F.

I. Background

On June 5, 2003,[12] the Commission adopted several amendments to its rules and forms implementing Section 404 of the Sarbanes-Oxley Act of 2002.[13] Among other things, these amendments require companies, other than registered investment companies, to include in their annual reports filed with us a report of management, and an accompanying auditor's attestation report, on the effectiveness of the company's internal control over financial reporting, and to evaluate, as of the end of each fiscal quarter, or year in the case of a foreign private issuer filing its annual report on Form 20-F or Form 40-F, any change in the company's internal control over financial reporting that occurred during the period that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

Under the compliance dates that we originally established, companies meeting the definition of an "accelerated filer" in Exchange Act Rule 12b-2[14] would have become subject to the internal control reporting requirements with respect to the first annual report that they filed for a fiscal year ending on or after June 15, 2004. Non-accelerated filers[15] would not have become subject to the requirements until they filed an annual report for a fiscal year ending on or after April 15, 2005. The Commission provided a lengthy compliance period for these requirements in light of the substantial time and resources needed by companies to implement

[12] See Release No. 33-8238 (June 5, 2003) [68 FR 36636].

[13] 15 U.S.C. 7262.

[14] 17 CFR 240.12b-2.

[15] Although the term "non-accelerated filer" is not defined in our rules, we use it throughout this release to refer to an Exchange Act reporting company that does not meet the Exchange Act Rule 12b-2 definitions of either an "accelerated filer" or a "large accelerated filer."

the rules properly.[16] In addition, we believed that a corresponding benefit to investors would result from an extended transition period that allowed companies to implement the new requirements carefully, and noted that an extended period would provide additional time for the Public Company Accounting Oversight Board (the PCAOB) to consider relevant factors in determining and implementing new attestation standards for registered public accounting firms.[17]

In February 2004, we extended the compliance dates for accelerated filers to fiscal years ending on or after November 15, 2004, and for non-accelerated filers and for foreign private issuers to fiscal years ending on or after July 15, 2005.[18] The primary purpose of this extension was to provide additional time for companies' auditors to implement Auditing Standard No. 2, which the PCAOB had issued in final form in June 2004.[19]

In March 2005, we approved a further one-year extension of the compliance dates for non-accelerated filers and for all foreign private issuers filing annual reports on Form 20-F or 40-F in view of the efforts by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") to provide more guidance on how the COSO framework on internal control can be applied to smaller public companies.[20] We also acknowledged the significant efforts being expended by many foreign private issuers to apply the International Financial Reporting Standards.

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[16] See Release No. 33-8238.

[17] Under the Sarbanes-Oxley Act, the PCAOB was granted authority to set auditing and attestation standards for registered public accounting firms.

[18] See Release No. 33-8392 (Feb. 24, 2004) [69 FR 9722].

[19] See Release No. 34-49884 File No. PCAOB 2004-03 (June 17, 2004) [69 FR 35083]. Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Connection with an Audit of Financial Statements, provides the professional standards and related performance guidance for independent auditors to attest to, and report on, management's assessment of the effectiveness of companies' internal control over financial reporting.

[20] Release No. 33-8545 (Mar. 2, 2005) [70 FR 11528].

Most recently, in September 2005, we again extended the compliance dates for the internal control over financial reporting requirements applicable to companies that are non-accelerated filers.[21] Based on the September 2005 extension, domestic and foreign non-accelerated filers were scheduled to comply with the internal control over financial reporting requirements beginning with annual reports filed for their first fiscal year ending on or after July 15, 2007. This extension was based primarily on our desire to have the additional guidance in place that COSO had begun to develop to assist smaller companies in applying the COSO framework. In addition, the extension was consistent with a recommendation made by the SEC Advisory Committee on Smaller Public Companies.

Since we granted that extension last year, a number of events related to internal control over financial reporting assessments have occurred. Most recently, on July 11, 2006, COSO and its Advisory Task Force issued Guidance for Smaller Public Companies Reporting on Internal Control over Financial Reporting.[22] The guidance is intended to assist the management of smaller companies in understanding and applying the COSO framework. It outlines 20 fundamental principles associated with the five key components of internal control described in the COSO framework, defines each principle, describes a variety of approaches that smaller companies can use to apply the principles to financial reporting, and includes examples of how smaller companies have applied the principles.

[21] See Release No. 33-8618 (Sept. 22, 2005) [70 FR 56825].

[22] See SEC Press Release No. 2006-114 (July 11, 2006) at http://www.sec.gov/news/press/2006/2006-114.htm.

In addition, on April 23, 2006, the SEC Advisory Committee on Smaller Public Companies submitted its final report to the Commission.[23] The final report includes recommendations designed to address the potential impact of the internal control reporting requirements on smaller public companies. Specifically, the Advisory Committee recommended that certain smaller public companies be provided exemptive relief from the management report requirement and from external auditor involvement in the Section 404 process under certain conditions unless and until a framework for assessing internal control over financial reporting is developed that recognizes the characteristics and needs of these companies.

In April 2006, the U.S. Government Accountability Office (GAO) issued a report entitled Sarbanes-Oxley Act, Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies.[24] This report recommended that the Commission consider whether the currently available guidance, particularly the guidance on management's assessment, is sufficient or whether additional action is needed to help companies comply with the internal control over financial reporting requirements. The report indicates that management's implementation and assessment efforts were largely driven by Auditing Standard No. 2 because guidance at a similar level of detail was not available for management's implementation and assessment process. Furthermore, the report recommended that the Commission coordinate its efforts with the PCAOB so that the Section 404-related audit standards and guidance are

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[23] See Final Report of the Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission (Apr. 23, 2006), available at http://www.sec.gov/info/smallbus/acspc.shtml.

[24] U.S. Govt. Accountability Office, Report to the Committee on Small Business and Entrepreneurship, U.S. Senate: Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies (April 2006).

consistent with any additional guidance applicable to management's assessment of internal control over financial reporting.[25]

Finally, on May 10, 2006, the Commission and the PCAOB sponsored a roundtable to elicit feedback from companies, their auditors, board members, investors, and others regarding their experiences during the accelerated filers' second year of compliance with the internal control over financial reporting requirements.[26] Several of the comments provided at, and in connection with, the roundtable suggested that additional management guidance would be useful, particularly for smaller public companies, and also expressed support for revisions to the PCAOB's Auditing Standard No. 2.[27]

II. Extension of Internal Control Reporting Compliance Dates for Non-Accelerated Filers

On May 17, 2006, the Commission and the PCAOB each announced a series of actions that they intended to take to improve the implementation of the Section 404 internal control over financial reporting requirements.[28] These actions included:

- Issuance of a concept release[29] soliciting comment on a variety of issues that might be included in future Commission guidance for management to assist in its performance of a top-down, risk-based assessment of internal control over financial reporting;
- Consideration of additional guidance from COSO;

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[25] See GAO Report at 52-53, 58.

[26] Materials related to the roundtable, including an archived broadcast and a transcript of the roundtable, are available on-line at http://www.sec.gov/spotlight/soxcomp.htm.

[27] See, for example, letters from the Biotech Industry Association, American Electronics Association, Emerson Electric Institute, U.S. Chamber of Commerce and Joseph A. Grundfest. These letters are available in File No. 4-511, at http://www.sec.gov/news/press/4-511.shtml.

[28] See SEC Press Release 2006-75 (May 17, 2006), "SEC Announces Next Steps for Sarbanes-Oxley Implementation" and PCAOB Press Release (May 17, 2006), "Board Announces Four-Point Plan to Improve Implementation of Internal Control Reporting Requirements."

[29] Release No. 34-54122 (July 11, 2006) [71 FR 40866].

- Revisions to Auditing Standard No. 2;
- Reinforcement of auditor efficiency through PCAOB inspections and Commission oversight of the PCAOB's audit firm inspection program;
- Development, or facilitation of development, of implementation guidance for auditors of smaller public companies;
- Continuation of PCAOB forums on auditing in the small business environment; and
- Provision of an additional extension of the compliance dates of the internal control reporting requirements for non-accelerated filers.

Consistent with this announcement, on August 9, 2006, we proposed to extend further the date for complying with the internal control over financial reporting requirements for domestic and foreign non-accelerated filers.[30] Approximately 44% of domestic companies filing periodic reports are non-accelerated filers, and an estimated 38% of the foreign private issuers subject to Exchange Act reporting are non-accelerated filers.[31] Prior to today's actions, non-accelerated filers were scheduled to begin complying with the management report requirement in Item 308(a) of Regulations S-K and S-B and the auditor attestation requirement in Item 308(b) of Regulations S-K and S-B for their fiscal years ending on or after July 15, 2007. We proposed to postpone for five months (from fiscal years ending on or after July 15, 2007 to fiscal years ending on or after December 15, 2007) the date by which non-accelerated filers must begin to include management's report. We also proposed to extend the compliance date for a non-

[30] Release No. 33-8731 (Aug. 9, 2006) [71 FR 47060].

[31] The percentage of domestic filing companies, excluding Investment Company Act of 1940 filers, that is categorized as non-accelerated filers is based on public float where available (or market capitalization, otherwise) from Datastream as of December 31, 2005. The estimated percentage of foreign private issuers that are non-accelerated filers is based on market capitalization data from Datastream as of December 31, 2005.

accelerated filer regarding the auditor attestation report requirement for 17 months -- until it files an annual report for a fiscal year ending on or after December 15, 2008.[32]

Furthermore, in a separate release also issued on August 9, 2006, we adopted an extension of the date for complying with the auditor attestation requirement for foreign private issuers that meet the Exchange Act definition of an accelerated filer, but not a large accelerated filer, and that file their annual reports on Form 20-F or 40-F, so that such issuers would not be subject to the auditor attestation requirement until a year after they first begin complying with the management report requirement.[33]

We received letters from a total of 36 commenters on the proposed extension of the internal control over financial reporting compliance dates for non-accelerated filers.[34] Thirty-five of these commenters generally supported the proposed extension.[35] Many of these commenters believed that the extension would reduce compliance costs for smaller companies

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[32] We also proposed and are extending the compliance dates for the auditor attestation report requirement appearing in Item 15(c) of Form 20-F and General Instruction B(6) of Form 40-F with respect to foreign private issuers that are non-accelerated filers.

[33] Release No. 33-8730A (Aug. 9, 2006) [71 FR 47056].

[34] The public comments we received are available for inspection in the Commission's Public Reference Room at 100 F Street, NE, Washington DC 20549 in File No. S7-06-03. They are also available on-line at http://www.sec.gov/rules/proposed/s70603.shtml.

[35] See letters from American Bar Association (ABA), American Bankers Association, America's Community Bankers (ACB), American Institute of Certified Public Accountants (AICPA), BDO Seidman, LLP (BDO), Biotechnology Industry Organization and eight other commenters (BIO), Callidus Software Inc. (Callidus), Calix Networks, Inc. (Calix), Core-Mark International, Inc. (Core-Mark), Cravath, Swaine & Moore LLP (Cravath), Davis Polk & Wardwell (Davis Polk), Deloitte Touche LLP (Deloitte), Ernst & Young (E&Y), Financial Executives International (FEI), James Finn (J. Finn), Grant Thornton LLP (Grant Thorton), Graybar Electric (Graybar), Hermes Equity Ownership Services Ltd. (Hermes), Independent Community Bankers of America (ICBA), Idaho Independent Bank (IIB), IncrediMail Ltd., Institute of Public Auditors of Germany (IDW), Key Technology (Key), KPMG LLP (KPMG), LaCrosse Footwear, Inc. (LaCrosse), Congressman Stephen F. Lynch (Congressman Lynch), George Merkl (G. Merkl), MOCON, Inc. (MOCON), National Venture Capital Association (NVCA), PricewaterhouseCoopers LLP (PwC), Priority Fulfillment Services, Inc. (PFS), The Office of Advocacy of the Small Business Administration (SBA), Telecommunications Industry Association (TIA), Village Super Market, Inc. (Village) and Washington Legal Foundation.

and provide them with additional time to develop best practices for compliance and greater efficiencies in preparing management reports.[36] Some commenters suggested that the Commission extend the compliance date associated with the management report requirement for an even longer period of time than proposed.[37] The commenter that did not express support for the proposed extension opposed, in particular, the 17-month extension of the auditor attestation compliance date.[38]

We are adopting the extension of the compliance dates substantially as proposed. In response to public comment, we are adding a requirement that a non-accelerated filer clearly disclose in management's report that management's assessment of internal control has not been attested to by the auditor, if it is providing only management's report during its first year of compliance with the Section 404 requirements.[39]

Some commenters suggested that the Commission broaden the scope of relief so that the extended compliance dates would still cover companies that currently are non-accelerated filers even if they become accelerated filers or large accelerated filers before December 15, 2008.[40] We are not adopting this relief as proposed. Consistent with the Exchange Act Rule 12b-2 definition of an accelerated filer and of a large accelerated filer, companies should determine their accelerated filing status at the end of the fiscal year in order to determine whether the extension is applicable to them.

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[36] See, for example, letters from Core-Mark, FEI, J. Finn, Graybar, and Village.

[37] See, for example, letters from ABA, ACB, Davis Polk, ICBA, and MOCON.

[38] See letter from Council of Institutional Investors (CII). This commenter indicated that it would not oppose one additional modest extension of the compliance date for the internal control over financial reporting requirements for non-accelerated filers.

[39] See paragraph 4 of Item 308T of Regulations S-K and S-B, paragraph 4 of Item 15T of Form 20-F, and Instruction 3T of General Instruction B(6) of Form 40-F.

[40] See letters from Callidus, Core-Mark, IIB, PFS, and Village.

Pursuant to the extension, a non-accelerated filer must begin to provide management's report on internal control over financial reporting in an annual report it files for its first fiscal year ending on or after December 15, 2007.[41] Non-accelerated filers must begin to comply with the provisions of Exchange Act Rule 13a–15(d) or 15d–15(d),[42] whichever applies, requiring an evaluation of changes to internal control over financial reporting requirements with respect to the company's first periodic report due after the first annual report that must include management's report on internal control over financial reporting. The extended compliance date also applies to the amendments of Exchange Act Rule 13a-15(a) or 15d-15(a)[43] relating to the maintenance of internal control over financial reporting. Under the extension, a non-accelerated filer must begin to provide the auditor attestation report in the annual report it files for its first fiscal year ending on or after December 15, 2008. We believe that these changes will make the internal control reporting process more efficient and effective, while preserving the intended benefits of the internal control over financial reporting provisions to investors.

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[41] While the definition of an accelerated filer in Exchange Act Rule 12b–2 previously has had applicability only for a foreign private issuer that files its Exchange Act periodic reports on Forms 10–K and 10–Q, the definition by its terms does not exclude foreign private issuers. A foreign private issuer that is a large accelerated filer under the Exchange Act Rule 12b–2 definition, and that files its annual reports on Form 20–F or Form 40–F, must begin to comply with the internal control over financial reporting and related requirements in the annual report for its first fiscal year ending on or after July 15, 2006. A foreign private issuer that is an accelerated filer, but not a large accelerated filer, under the definition in Rule 12b-2 of the Exchange Act, and that files its annual report on Form 20-F or Form 40-F, must begin to comply with the requirement to provide the auditor's attestation report on internal control over financial reporting in the annual report filed for its first fiscal year ending on or after July 15, 2007. A foreign private issuer that is not an accelerated filer under the Exchange Act Rule 12b–2 definition is required, under this extension, to begin to comply with the management report requirement in its annual report for its first fiscal year ending on or after December 15, 2007.

[42] 17 CFR 240.13a-15(d) and 17 CFR 240.15d-15(d).

[43] 17 CFR 240.13a-15(a) and 17 CFR 240.15d-15(a).

We estimate that fewer than 15% of all non-accelerated filers will have a fiscal year ending between July 15, 2007 and December 15, 2007.[44] Therefore, the extension of the compliance date of the management report requirement to December 15, 2007 will not impact the majority of non-accelerated filers in 2007, including those with a calendar year-end. Our intention is to provide all non-accelerated filers, none of which is yet required to comply with the Section 404 requirements, with the benefit of the management guidance that the Commission plans to issue and the recently issued COSO guidance on understanding and applying the COSO framework, before planning and conducting their internal control assessments. We expect that extending the implementation of the management report requirement for another five months will provide sufficient time for the Commission to issue final guidance to assist in management's performance of a top-down, risk-based and scalable assessment of controls over financial reporting.[45] If such guidance is not finalized in time to be of assistance to management of non-accelerated filers in connection with their assessments as of the end of the fiscal year for the annual reports filed for fiscal years ending on or after December 15, 2007, we will consider further postponing this compliance date.

The extension of the date for complying with the management report requirement permits non-accelerated filers to complete only management's report on internal control over financial reporting in the first year of compliance. As noted in the Proposing Release, we have several reasons for deferring the implementation of the auditor attestation report requirement for an additional year after the implementation of the management report requirement. First, we

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[44] The percent of all non-accelerated filers is categorized using float where available (or market capitalization, otherwise) using Datastream as of December 31, 2005 and excludes 1940 Act filers. Fiscal year ends are also from Datastream.

[45] We anticipate issuing the proposed guidance for management by mid-December 2006. See SEC Press Release No. 2006-172 (Oct. 11, 2006) at http://www.sec.gov/news/press/2006/2006-172.htm.

believe that the deferred implementation affords non-accelerated filers and their auditors the benefit of anticipated changes by the PCAOB to Auditing Standard No. 2, subject to Commission approval, as well as any implementation guidance that the PCAOB plans to issue for auditors of smaller public companies. We will consider further postponing this date after we consider the anticipated revisions to Auditing Standard No. 2.

Second, we believe that the deferred implementation of the auditor attestation requirement should save non-accelerated filers the full potential costs associated with the initial auditor's attestation to, and report on, management's assessment of internal control over financial reporting during the period that changes to Auditing Standard No. 2 are being considered and implemented, and the PCAOB is formulating guidance that will be specifically directed to auditors of smaller companies. Public commenters previously have asserted that the internal control reporting compliance costs are likely to be disproportionately higher for smaller public companies than larger ones, and that the auditor's fee represents a large percentage of those costs. Furthermore, we have learned from public comments, including our roundtables on implementation of the internal control reporting provisions,[46] that while companies incur increased internal costs in the first year of compliance as well due to "deferred maintenance" items (e.g., documentation, remediation, etc.), these costs may decrease in the second year. Therefore, postponing the costs that result from the auditor's attestation report until the second year may help non-accelerated filers to smooth the significant cost spike that many accelerated filers experienced in their first year of compliance with the Section 404 requirements.

[46] Materials related to the Commission's 2005 Roundtable Discussion on Implementation of Internal Control Reporting Provisions and 2006 Roundtable on Second-year Experiences with Internal Control Reporting and Auditing Provisions, including the archived roundtable broadcasts, are available at http://www.sec.gov/spotlight/soxcomp.htm.

One commenter that opposed the 17-month extension of the compliance date for the auditor attestation requirement noted that there is anecdotal evidence that smaller companies have not taken advantage of the previous extensions for non-accelerated filers.[47] Unlike the previous extensions, however, which provided for an extension for both the management report requirement and the auditor attestation requirement, the extension that we are adopting now requires management of non-accelerated filers to examine their companies' internal control over financial report reporting (and to permit investors to see and evaluate the results of management's first compliance efforts) while enabling management to more gradually prepare for full compliance with the Section 404 requirements and to gain some efficiencies in the process of reviewing and evaluating the effectiveness of internal control over financial reporting before becoming subject to the auditor attestation requirement. Finally, deferred implementation should provide the Commission and the PCAOB with additional time to consider the public comments we received in response to the questions we raised in the Concept Release[48] on management guidance related to the appropriate role of the auditor in evaluating management's internal control assessment process.[49]

Several commenters supported the sequential implementation of the management assessment and auditor attestation requirements, which we are adopting.[50] Some agreed that the deferred implementation of the auditor report requirement would help smaller companies reduce

[47] See letter from CII.

[48] Release No. 34-54122. The comment period for the Concept Release closed on September 18, 2006, and the letters that we received on the Concept Release are available in File No. S7-11-06, at http://www.sec.gov/comments/s7-11-06/s71106.shtml.

[49] Six commenters agreed that an extension will provide the Commission with additional time to consider the comments to the questions raised in the Concept Release. See letters from FEI, Hermes, ICBA, G. Merkl, NVCA, and ICBA.

[50] See letters from ACB, Cravath, FEI, J. Finn, Hermes, ICBA, LaCrosse, G. Merkl, MOCON, and SBA.

the overall cost of compliance with the internal control over financial reporting requirements.[51] Some commenters opposed the deferred implementation of the auditor attestation requirement,[52] while some other commenters expressed concerns over the proposal without expressly opposing it.[53] For example, commenters questioned whether during the year in which management's report is not attested to by the auditor, there will be a greater risk that management will fail to report material weaknesses,[54] or whether there will be a lack of meaningful disclosure provided by management's assessment of internal control over financial reporting.[55] We acknowledge that investors will not receive the full assurance that a management assessment that has been attested to by an auditor would provide. Nevertheless, we believe that the graduated introduction of the 404 requirements will provide more meaningful benefit to investors more quickly than either the immediate introduction of both requirements or further delays in implementing the management report requirement.[56] This graduated approach will allow management to gain efficiencies in reporting without the full cost of an attestation and allow investors to review important information that would be otherwise unavailable.

We received some comments noting that the different schedules for implementing the two requirements on internal control over financial reporting might cause confusion to investors and the capital markets.[57] Also, several commenters, in response to a specific request for

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[51] See, for example, letters from FEI, Hermes, and SBA.

[52] See, for example, letters from ABA, CII, IDW, and PwC.

[53] See, for example, letters from AICPA, BDO, Davis Polk, Deloitte, and E&Y.

[54] See, for example, letters from AICPA, Grant Thorton, IDW, PwC, and Deloitte. The letter from CII, which also opposed the deferred implementation of the auditor attestation requirement, stated, in general, that smaller companies are prone to more misstatements and restatements of financial information, and make up the bulk of accounting fraud cases.

[55] See, for example, letters from IDW.

[56] See also letter from KPMG.

[57] See, for example, letters from CII and PwC.

comment, expressed support for a requirement that non-accelerated filers disclose in its annual report that management's assessment has not been attested to by the auditor during the year that the auditor's attestation is not required.[58] In response to these comments that we received, we are adopting an additional disclosure requirement to Item 308 of Regulations S-K and S-B, Item 15 of Form 20-F, and General Instruction B(6) of Form 40-F.[59] Non-accelerated filers will be now required to include a statement in management's report on internal control over financial reporting in substantially the following form:

> This annual report does not include an attestation report of the company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the company's registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the company to provide only management's report in this annual report.

In the Proposing Release, we indicated that we had issued a separate release to extend the date by which a foreign private issuer that is an accelerated filer (but not a large accelerated filer) and that files its annual report on Form 20-F or 40-F must begin to comply with the auditor attestation report portion of the Section 404 requirements. We requested comment on whether we should consider taking additional actions specifically with respect to foreign private issuers. Like non-accelerated filers, these foreign private issuers will provide only management's report

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[58] See letters from AICPA, BDO, Deloitte, E&Y, Grant Thorton, and KPMG.

[59] See paragraph 4 of Item 308T of Regulations S-K and S-B, paragraph 4 of Item 15T of Form 20-F, and Instruction 3T of General Instruction B(6) of Form 40-F.

during their first year of compliance with the internal control over financial reporting requirements.[60] Some commenters expressed support for the delayed audit report compliance date for these issuers and thought it was appropriate for us to take similar action with respect to both non-accelerated filers and the foreign private issuers.[61] To maintain consistency among the revised requirements, we are adopting the same type of disclosure requirement for foreign private issuers that are accelerated filers that we are adopting for the non-accelerated filers.

One commenter noted that disagreements over whether management failed to report a material weakness could create conflict between management and the auditor,[62] and two other commenters noted that disagreements could also arise if the auditor does not agree with management's approach or methodology for testing internal control over financial reporting.[63] As noted in the Proposing Release, during the year that non-accelerated filers are only required to provide management's report, we encourage frequent and frank dialogue among management, auditors and audit committees to improve internal controls and the financial reports upon which investors rely. We believe that management should not fear that a discussion of internal controls with, or a request for assistance or clarification from, the company's auditor will itself be deemed a deficiency in internal control or constitute a violation of our independence rules as long as management determines the accounting to be used and does not rely on the auditor to design or implement its controls.[64] We believe that open dialogue between management and auditors may help to ameliorate some of the concerns of commenters regarding disagreements

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[60] Release No. 33-8730A.

[61] See, for example, letters from E&Y and FEI.

[62] See letter from IDW.

[63] See, for example, letters from Davis Polk and G. Merkl.

[64] See Commission Statement on Implementation of Internal Control Requirements, Press Release No. 2005-74 (May 16, 2005), available at http://www.sec.gov/news/press/2005-74.htm.

between these parties in the second year of compliance with the internal control reporting provisions.

Nevertheless, as noted in the Proposing Release, we acknowledge that a company that files only a management report during its first year of compliance with the Section 404 requirements may become subject to more second-guessing as a result of separating the management and auditor reports than under the current requirements. For example, management may conclude that the company's internal control over financial reporting is effective when only management's report is filed in the first year of compliance, but the auditor may come to a contrary conclusion in its report filed in the subsequent year, and as a result, the company's previous assessment may be called into question. To further address this, we proposed a temporary amendment whereby the management report included in the non-accelerated filer's annual report during the first year of compliance would be deemed "furnished" rather than "filed."[65]

Almost all of the commenters remarking on this aspect of the proposal supported it.[66] We are adopting this provision as proposed. Commenters also supported our corresponding proposal[67] to afford similar relief to foreign private issuers that are accelerated filers (but not large accelerated filers), that like non-accelerated filers, will only provide management's report

[65] Management's report is not be deemed to be filed for purposes of Section 18 of the Exchange Act [15 U.S.C. 78r] or otherwise subject to the liabilities of that section, unless the issuer specifically states that the report is to be considered "filed" under the Exchange Act or incorporates it by reference into a filing under the Securities Act or the Exchange Act.

[66] Eight commenters supported the proposed revision to deem the management's report on internal control over financial reporting to be "furnished" rather than "filed" during the first year that non-accelerated filers are required to complete only management's report on internal control over financial reporting. See letters from ACB, Cravath, Deloitte, E&Y, FEI, Hermes, LaCrosse, and G. Merkl. But see letter from IDW.

[67] See, for example, letters from E&Y, FEI, Hermes, and G. Merkl.

during their first year of compliance with the internal control over financial reporting requirements. We are adopting that provision as well.[68]

We also are extending the compliance date to permit a non-accelerated filer to omit the portion of the introductory language in paragraph 4 as well as language in paragraph 4(b) of the certification required by Exchange Act Rules 13a-14(a) and 15d-14(a)[69] that refers to the certifying officers' responsibility for designing, establishing and maintaining internal control over financial reporting for the company, until it files an annual report that includes a report by management on the effectiveness of the company's internal control over financial reporting. This language is required to be provided in the first annual report required to contain management's internal control report and in all periodic reports filed thereafter.

Finally, we are clarifying that, until a non-accelerated filer becomes subject to the auditor attestation report requirement, the registered public accounting firm retained by the non-accelerated filer need not comply with the obligation in Rule 2-02(f) of Regulation S-X. Rule 2-02(f) requires every registered public accounting firm that issues or prepares an accountant's report that is included in an annual report filed by an Exchange Act reporting company (other than a registered investment company) containing an assessment by management of the effectiveness of the company's internal control over financial reporting to attest to, and report on, such assessment.

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[68] See paragraph (b) of Item 15T of Form 20-F and Instruction 3T to General Instruction B(6) of Form 40-F.

[69] 17 CFR 240.13a-14(a) and 240.15d-14(a).

The extended compliance periods do not, in any way, alter requirements regarding internal control that already are in effect with respect to non-accelerated filers, including, without limitation, Section 13(b)(2) of the Exchange Act[70] and the rules thereunder.

III. Transition Period for Compliance with the Internal Control Over Financial Reporting Requirements by Newly Public Companies

A. Proposed Amendment and Public Comments

In the Proposing Release, we also proposed to add a transition period for newly public companies before they become subject to compliance with the internal control over financial reporting requirements. Under the rules existing prior to the amendments, after all Exchange Act reporting companies have been phased-in and are required to comply fully with the internal control reporting provisions, any company undertaking an initial public offering or registering a class of securities under the Exchange Act for the first time would have been required to comply with those provisions as of the end of the fiscal year in which it became a public company.

For many companies, preparation of the first annual report on Form 10-K, 10-KSB, 20-F or 40-F is a comprehensive process involving the audit of financial statements, compilation of information that is responsive to many new public disclosure requirements and review of the report by the company's executive officers, board of directors and legal counsel. Requiring a newly public company and its auditor to complete the management report and auditor attestation report on the effectiveness of the company's internal control over financial reporting within the same timeframe imposes an additional burden on newly public companies.

The Proposing Release also specifically recognized the burden that preparing the reports imposed on companies, including foreign companies, that become subject to Section 15(d) after

[70] 15 U.S.C. 78m(b)(2).

filing a registration statement under the Securities Act of 1933[71] but may be eligible to terminate their periodic filing obligations after filing just one annual report.[72] In light of the compliance burden of these requirements, we proposed to provide a transition period for newly public companies.

Specifically, we proposed that a newly public company would not need to comply with our internal control over financial reporting requirements in the first annual report that it files with the Commission.[73] Rather, the company would begin to comply with these requirements in the second annual report that it is required to file with the Commission. We stated our belief in the Proposing Release that providing additional time for a newly public company to conduct its first assessment of internal control over financial reporting would benefit investors by making implementation of the internal control reporting requirements more effective and efficient and reducing the costs that a company faces in its first year as a public company. We also expressed a belief that the proposed transition period would limit any interference by our rules with a company's business decision regarding the timing and use of resources relating to its initial U.S. listing or public offering.

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[71] 15 U.S.C. 77a et seq.

[72] A transition period also would provide relief for foreign companies that become subject to the Exchange Act reporting requirements by virtue of Exchange Act Rule 12g-3 [17 CFR 240.12g-3] in connection with a transaction which is not registered under the Securities Act that constitutes an exchange offer for the securities of, or business combination with, a company that has reporting obligations under the Exchange Act. The relief, as adopted, would thus apply to an unregistered foreign company that succeeds to the reporting obligations of a registered foreign company under Rule 12g-3 in connection with an acquisition transaction effected under, for example, Securities Act Section 3(a)(10) [15 U.S.C. 77c(a)(10)] or Securities Act Rule 802 [17 CFR 230.802].

[73] See Release No. 33-8731 (Aug. 9, 2006) [71 FR 47060].

We received 22 comment letters addressing our proposal on newly public companies.[74] Most of these commenters supported our efforts to reduce the burden of compliance with our internal control over financial reporting requirements by providing a transition period for those companies.[75]

B. Discussion of Final Amendment

After consideration of the public comments that were received, we are adopting the newly public company amendments substantially as proposed. We are therefore amending the rules to provide that a newly public company does not need to comply with our internal control over financial reporting requirements in the first annual report that it files with the Commission.[76] As noted, there was broad support from commenters for a transition period postponing compliance with these requirements until the second annual report filed with the Commission.[77] One commenter suggested that the transition period was of "critical importance" for effective and meaningful compliance with Section 404 requirements by newly public companies.[78]

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[74] See letters from ABA, ACB, AICPA, BDO, BIO, Calix, CII, Core Mark, Cleary, Cravath, Davis Polk, Deloitte, E&Y, Grant Thornton, Graybar, Hermes, G. Merkl, NVCA, PFS, PwC, SBA and TIA.

[75] See, for example, letters from ABA, ACB, AICPA, BDO, BIO, Calix, Cravath, Cleary, Davis Polk, Grant Thornton, Graybar, Hermes, NVCA, PFS, SBA, and TIA.

[76] Instruction 1 to Item 308 of Regulations S-B and S-K, Item 15 of Form 20-F, and General Instruction B(6) of Form 40-F, and Exchange Act Rules 13a-15(a), (c) and (d) and 15d-15(a), (c) and (d). The definition of an accelerated filer was based, in part, on the requirements for registration of primary offerings for cash on Form S-3. See Section II.B.3 in Release No. 33-8128 (Sept. 5, 2002)[67 FR 58480] and Section I in Release No. 33-8644 (Dec. 21, 2005)[70 FR 76626]. In some situations, a newly formed public company may seek to use another entity's reporting history for purposes of using Form S-3. For example, a spun-off entity may attempt to use its parent's reporting history or a newly formed holding company may seek to use its predecessor's reporting history. Because of the inter-relationship between Form S-3 eligibility and accelerated filer status, we believe that, to the extent a newly formed public company seeks to use and is deemed eligible to use Form S-3 on the basis of another entity's reporting history, that company would also be an accelerated filer and therefore required to comply with Items 308(a) and 308(b) of Regulation S-K in the first annual report that it files.

[77] See n.75 above.

[78] See letter from Cleary.

Two commenters objected to the proposed relief, noting the importance of the internal control over financial reporting requirements to the Sarbanes-Oxley Act reforms.[79] We believe that the one-year transition period strikes an appropriate balance by requiring newly public companies to develop and implement effective internal controls and procedures, while allowing management some time to more cost-effectively conduct their entry into the public markets and gain efficiencies in preparation for compliance with our internal control over financial reporting requirements. As noted below, we are also requiring clear disclosure by newly public companies that they are not required to include either a report by management or an auditor's attestation report on internal control over financial reporting in their first annual report so that investors can consider that information when making their investing decisions.

One commenter sought clarification on the transition period,[80] and others suggested expanding the transition period for newly public companies to allow them more time to comply with the requirements.[81] We are adopting amendments to provide that a registrant need not comply with the internal control over financial reporting requirements "until it either had been required to file an annual report pursuant to section 13(a) or 15(d) of the Act for the prior fiscal year or had filed an annual report with the Commission for the prior fiscal year."[82] The

[79] See, for example, letters from CII and Deloitte.

[80] See letter from BDO. BDO sought clarification in the commentary regarding the application of the transition rules to a company that becomes an Exchange Act registrant after its year-end but before it is required to file financial statements for the year that just ended.

[81] See, for example, letters from ACB, Core-Mark and Davis Polk. Davis Polk suggested slightly expanding the deferral to require compliance after the filing of an annual report other than for a fiscal year ending before the company went public. ACB more broadly suggested extending the transition period to correspond to the timeframe for non-accelerated filers, not requiring compliance until the second annual report beginning with fiscal years ending on or after December 31, 2008. Core-Mark suggested expanding the deferral to apply to the first two annual reports filed.

[82] See n.76 above. This transition period applies to companies conducting an initial public offering (equity or debt) or a registered exchange offer or that otherwise become subject to the Exchange Act reporting requirements. For these purposes, a newly public company that has filed a special financial

amendments require a newly public company to fully comply with the internal control over financial reporting requirements when filing its second annual report with the Commission, allowing a company at least one annual reporting period from the time it becomes a public company to prepare for compliance. A newly public company also need not comply with the provisions of Exchange Act Rule 13a–15(d) or 15d–15(d), requiring an evaluation of changes to internal control over financial reporting requirements, or comply with the provisions of Exchange Act Rule 13a-15(a) or 15d-15(a) relating to the maintenance of internal control over financial reporting until the first periodic report due after the first annual report that must include management's report on internal control over financial reporting.[83]

The amendments also permit a newly public company, during the transition period, to omit the portion of the introductory language in paragraph 4 as well as language in paragraph 4(b) of the certification required by Exchange Act Rules 13a-14(a) and 15d-14(a) that refers to the certifying officers' responsibility for designing, establishing and maintaining internal control over financial reporting for the company, until it files an annual report that includes a report by management on the effectiveness of the company's internal control over financial reporting. This language is required to be provided in the first annual report required to contain management's internal control report and in all periodic reports filed thereafter.

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report under Exchange Act Rule 15d-2 [17 CFR 240.15d-2] or that has filed a transition report on Form 10-K, 10-KSB, 20-F, or 40-F under Exchange Act Rule 13a-10 [17 CFR 240.13a-10] or Rule 15d-10 [17 CFR 240.15d-10] will have filed an annual report. As a result, a newly public company that files a special financial report or a transition report will be required to fully comply with the internal control over financial reporting requirements when filing an annual report for its next fiscal year.

[83] SEC staff provided its views on the disclosure of changes or improvements to controls made as a result of preparing for the registrant's first management report on internal control over financial reporting. See Question 9 in Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports Frequently Asked Questions (revised October 6, 2004), at http://www.sec.gov/info/accountants/controlfaq1004.htm.

One commenter suggested that if the Commission decides to provide for a transition period, prominent disclosure by the company and the auditor should be required indicating that the company is not yet required to comply with and there has been no management assessment or audit of the company's internal control over financial reporting.[84] We agree that newly public companies should include a statement in their annual report alerting investors about the company's obligations with respect to the internal control over financial reporting provisions. Therefore, we are adding a requirement that newly public companies that are relying on the transition rules must include a statement in the first annual report that they file that the report does not include management's assessment report or the auditor's attestation report.[85] This disclosure is consistent with the disclosure that non-accelerated filers and foreign private issuers will have to include in their annual reports during the year that they are not required to comply with the auditor attestation requirement.

IV. Paperwork Reduction Act

As discussed in the Proposing Release, we submitted a request for approval of the "collection of information" requirements contained in the amendments to the Office of Management and Budget ("OMB") in accordance with the Paperwork Reduction Act of 1995 ("PRA")[86] in connection with our original proposal and adoption of the rule and form amendments implementing the Section 404 requirements.[87] OMB approved these requirements. The new disclosure amendments that we are adopting today contain collection of information requirements within the meaning of PRA.

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[84] See letter from Deloitte.

[85] See Instruction 1 to Item 308 of Regulations S-B and S-K, Item 15 of Form 20-F, and General Instruction B(6) of Form 40-F.

[86] 44 U.S.C. 3501 et seq. and 5 CFR 1320.11.

[87] See Section IV. of Release No. 33-8238.

The titles for the collections of information are:[88]

(1) "Regulation S-B" (OMB Control No. 3235-0417);

(2) "Regulation S-K" (OMB Control No. 3235-0071);

(3) "Form 10-K" (OMB Control No. 3235-0063);

(4) "Form 10-KSB" (OMB Control No. 3235-0420);

(5) "Form 20-F" (OMB Control No. 3235-0288); and

(6) "Form 40-F" (OMB Control No. 3235-0381).

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information such as Form 10-K or Form 20-F unless it displays a currently valid OMB control number.

The amendments to Regulation S-B, Regulation S-K, Form 10-K, Form 10-KSB, Form 20-F and Form 40-F adopted in this release require non-accelerated filers and foreign private issuers that are accelerated filers (but not large accelerated filers) to include a statement in management's report on the company's internal control over financial reporting in the annual report in which the company is not required to include the auditor attestation requirement. The statement should disclose that the annual report does not contain a report by the company's registered public accounting firm on management's report of the company's internal control over financial reporting, and management's report was not subject to attestation by the accounting firm pursuant to temporary rules of the Commission that permit the company to provide only management's report in the annual report. The amendments we are adopting also require newly public companies to provide a similar statement in their first annual report to reflect the

[88] The paperwork burden from Regulations S-K and S-B is imposed through the forms that are subject to the requirements in those Regulations and is reflected in the analysis of those forms. To avoid a Paperwork Reduction Act inventory reflecting duplicative burdens, for administrative convenience we estimate the burdens imposed by each of Regulations S-K and S-B to be a total of one hour.

transition schedule we are adopting for those companies. We are requesting comment in this release with regard to the collections of information requirements for these amendments.

The requirements are designed to avoid investor confusion regarding application of the internal control over financial reporting requirements to non-accelerated filers for their fiscal years ending on or after December 15, 2007 but before December 15, 2008; to foreign private issuers that are accelerated filers (but not large accelerated filers) for their fiscal years ending on or after July 15, 2006 but before July 15, 2007; and to newly public companies for the first annual report that they are required to file. The requirements are mandatory. The respondents to the collection of information requests here will be: (1) non-accelerated filers that do not file an auditor's attestation report for a fiscal year ending on or after December 15, 2007 but before December 15, 2008; (2) foreign private issuers filing on Form 20-F or Form 40-F that are accelerated filers (but not large accelerated filers) that do not file an auditor's attestation report for a fiscal year ending on or after July 15, 2006 but before July 15, 2007; and (3) newly public companies that do not comply with the internal control over financial reporting requirements in the first annual report filed with the Commission in accordance with the new rules.

Form 10-K prescribes information that registrants must disclose annually to the market about its business. Form 10-KSB prescribes information that registrants that are "small business issuers" as defined under our rules must disclose annually to the market about its business. Form 20-F is used by foreign private issuers to either register a class of securities under the Exchange Act or provide an annual report required under the Exchange Act. Form 40-F is used by foreign private issuers to file reports under the Exchange Act after having registered securities under the Securities Act and by certain Canadian registrants.

For the purposes of the Paperwork Reduction Act, we estimate that, over a three year period, the annual incremental burden imposed by the disclosure amendments will average 15 minutes per form. We have based our estimates of the effects that these additional disclosure requirements would have on the Forms 10-K, 10-KSB, 20-F and 40-F primarily based on our review of the most recently completed PRA submissions for those collections of information, and those requirements in those Regulations and Forms.

Form 10-K

For purposes of the PRA, we estimate that the amendments affecting the Form 10-K collection of information requirements will increase the annual paperwork burden by approximately 1,289 hours of company personnel time and a cost of approximately $171,294 for the services of outside professionals.[89] Based on our research into the number of non-accelerated filers in 2004 and 2005, we estimate that approximately 6,025 annual reports filed on Form 10-K would be filed by non-accelerated filers that could be subject to the additional disclosure requirement that we are adopting for non-accelerated filers. This estimate is based on the assumption that the number of annual responses on Form 10-K is 10,041.[90] Based on our review of the number of newly public companies in 2005, we estimate that approximately 853 companies filing on Form 10-K would be subject to the additional disclosure requirement that we are adopting for newly public companies. We estimate that the incremental burden for the newly public company amendments for Form 10-K is 213 hours.

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[89] This estimate is based on the assumed 75% and 25% split of the burden hours between internal staff and external professionals, and an hourly rate of $400 for external professionals. The hourly cost estimate is based on consultations with several registrants and law firms and other persons who regularly assist registrants in preparing and filing periodic reports with the Commission.

[90] This number is based on the number of responses made in the period from October 1, 2005 through September 30, 2006.

Form 10-KSB

For purposes of the PRA, we estimate that the amendments affecting the Form 10-KSB collection of information requirements will increase the annual paperwork burden by approximately 980 hours of company personnel time and a cost of approximately $130,709 for the services of outside professionals. Based on our research into the number of non-accelerated filers in 2004 and 2005, we estimate that all (4,819) of the annual reports filed on Form 10-KSB would be filed by non-accelerated filers that could be subject to the additional disclosure requirement that we are adopting for non-accelerated filers. This estimate is based on the assumption that the number of annual responses on Form 10-KSB is 4,819.[91] Based on our review into the number of newly public companies in 2005, we estimate that approximately 409 companies filing on Form 10-KSB would be subject to the additional disclosure requirement that we are adopting for newly public companies. We estimate that the incremental burden for the newly public company amendments for Form 10-KSB is 102 hours.

Form 20-F

For purposes of the PRA, we estimate that the amendments affecting the Form 20-F collection of information requirements will increase the annual paperwork burden by approximately 36 hours of company personnel time and a cost of approximately $42,809 for the services of outside professionals.[92] Based on our review into the percentage of total foreign private issuers that were non-accelerated filers in 2005, we estimate that 40% (or 471) of the annual reports filed on Form 20-F would be filed by non-accelerated filers that could be subject

[91] This number is based on the number of responses made in the period from October 1, 2005 through September 30, 2006.

[92] The burden allocation for Forms 20-F and 40-F, however, use a 25% internal to 75% outside professional allocation to reflect the fact that foreign private issuers rely more heavily on outside professionals for the preparation of these forms.

to the additional disclosure requirement that we are adopting for non-accelerated filers. Based on our review into the percentages of foreign private issuers that were accelerated filers (but not large accelerated filers) in 2005, we estimate that 21% (or 247) of the annual reports filed on 20-F would be accelerated filers and not large accelerated filers. These estimates are based on the assumption that the number of annual responses on Form 20-F is 1177.[93] Based on our review of the number of newly public companies in 2005, we estimate that approximately 100 companies filing on Form 20-F would be subject to the additional disclosure requirement that we are adopting for newly public companies. We estimate that the incremental burden for the newly public company amendments for Form 20-F is 25 hours.

Form 40-F

For purposes of the PRA, we estimate that the amendments affecting the Form 40-F collection of information requirements will increase the annual paperwork burden by approximately 27 hours of company personnel time and a cost of approximately $8,002 for the services of outside professionals. Based on recent research into the percentage of total foreign private issuers that are non-accelerated filers, we estimate that 40% (or 88) of the annual reports filed on Form 40-F would be filed by non-accelerated filers that could be subject to the additional disclosure requirement that we are adopting for non-accelerated filers. Based on our review into the percentages of foreign private issuers that were accelerated filers (but not large accelerated filers) in 2005, we estimate that 21% (or 46) of the annual reports filed on 40-F would be accelerated filers and not large accelerated filers. These estimates are based on the

[93] This number is based on the number of responses made in the period from October 1, 2005 through September 30, 2006.

assumption that the number of annual responses on Form 40-F is 220.[94] Based on our review of the number of newly public companies in 2005, we estimate that approximately 19 companies filing on Form 40-F would be subject to the additional disclosure requirement that we are adopting for newly public companies. We estimate that the incremental burden for the newly public company amendments for Form 40-F is 5 hours.

Request for Comment

We solicit comment on the expected effects of the amendments on Regulations S-B and S-K, Form 20-F and Form 40-F under the PRA. In particular, we solicit comment on:

- How accurate are our burden and cost estimates for Forms 10-K, 10-KSB, 20-F and 40-F;
- Whether the amendments are necessary to avoid investor confusion regarding the internal control over financial reporting requirements for non-accelerated filers and newly public companies;
- Whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and
- Whether there are ways to minimize the burden of the additional disclosure requirements on non-accelerated filers and newly public companies.

Any member of the public may direct to us any comments concerning these burden and cost estimates and any suggestions for reducing the burdens and costs. Persons who desire to submit comments on the collections of information requirements should direct their comments to the OMB, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, or send an e-mail to David_Rostker@omb.eop.gov, and send a copy of the comments to Nancy M. Morris, Secretary,

[94] This number is based on the number of responses made in the period from October 1, 2005 through September 30, 2006.

Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090, with reference to File No. S7-06-03. Requests for materials submitted to the OMB by us with regard to these collections of information should be in writing, refer to File No. S7-06-03, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 100 F Street, NE, Washington, DC 20549. Because the OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, your comments are best assured of having their full effect if the OMB receives them within 30 days of publication.

V. Cost-Benefit Analysis

A. Benefits

The extension of the compliance dates is intended to make implementation of the internal control reporting requirements more efficient and cost-effective for non-accelerated filers. First, the extension postpones for five months (from fiscal years ending on or after July 15, 2007 until fiscal years ending on or after December 15, 2007) the date by which non-accelerated filers must begin to include a report by management assessing the effectiveness of the company's internal control over financial reporting. Based on our estimates, we believe that fewer than 15% of all non-accelerated filers have a fiscal year ending between July 15, 2007 and December 15, 2007.[95] In addition, under the extension, a non-accelerated filer is not required to include an auditor attestation report on management's assessment of internal control over financial reporting until it files an annual report for its first fiscal year ending on or after December 15, 2008. As a result, all non-accelerated filers are required to complete only management's assessment in their first year of compliance with the Section 404 requirements.

[95] See n.44 above.

We believe that the following benefits will flow from an additional postponement of the dates by which non-accelerated filers must comply with the internal control reporting requirements:

- Auditors of non-accelerated filers will have more time to conform their initial attestation reports on management's assessment of internal control over financial reporting to the changes to the auditing attestation standard and other actions that the PCAOB determines to take;
- Non-accelerated filers will save opportunity costs associated with their initial audit of internal control over financial reporting while changes to the auditing standard are being considered and implemented and the PCAOB is developing, or facilitating the development of, additional guidance that will be specifically directed to auditors of smaller public companies;
- Management of non-accelerated filers are able to begin the process of assessing the effectiveness of internal control over financial reporting before their auditors attest to such assessment (and investors can begin to see and evaluate the results of their initial efforts); and
- Non-accelerated filers with a fiscal year ending between July 15, 2007 and December 15, 2007 have additional time to consider the management guidance to be issued by the Commission and the recently issued COSO guidance on understanding and applying the COSO framework, before planning and conducting their first internal control assessment.

Many public commenters on the Proposing Release and on previous occasions have asserted that the internal control reporting compliance costs are likely to be disproportionately higher for smaller public companies than larger ones, and that the audit fee represents a large

percentage of those costs.[96] We acknowledge that some non-accelerated filers may incur audit fee costs in the first year that they provide management's report due to the fact that management may engage in a dialogue with their auditors regarding their assessment of the company's internal control over financial reporting. Nevertheless, we believe that the potential cost savings derived from the year that the non-accelerated filers are not required to include an auditor's attestation report on management's assessment of the effectiveness of their internal control over financial reporting will likely be substantial. The cost that a non-accelerated filer will save as a result of the extension of the auditor attestation report is likely to vary significantly.[97]

Additionally, we have previously learned from public comments, including our roundtables on implementation of the internal control reporting provisions,[98] that while companies incur increased internal costs in the first year of compliance in part due to "deferred maintenance" items (e.g., documentation, remediation, etc.), these costs may decrease in the second year. Therefore, we believe that postponing many of the auditor costs until the second year will help non-accelerated filers smooth the significant cost spike that many accelerated filers have experienced in their first year of compliance. Many commenters agreed that the deferred implementation of the auditor attestation requirement would relieve smaller companies

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[96] See, for example, letters on the Proposing Release from FEI and SBA.

[97] Numerous cost surveys have been made public citing the high cost of compliance with the Section 404 requirements. For a sampling, see surveys from CRA International (Apr. 2006), FEI (Mar. 2006), Foley & Lardner LLP (June 2006), ICBA (Mar. 2005), NASDAQ and American Electronics Association (Oct. 2005), and the Business Roundtable (Mar. 2006). Note that many of these studies do not isolate the cost of the auditor's attestation; some studies discuss full audit costs or other fees. The Commission has not independently verified the reliability or accuracy of the survey data.

[98] Materials related to the Commission's 2005 Roundtable Discussion on Implementation of Internal Control Reporting Provisions and 2006 Roundtable on Second-year Experiences with Internal Control Reporting and Auditing Provisions, including the archived roundtable broadcasts, are available at http://www.sec.gov/spotlight/soxcomp.htm.

from regulatory costs.[99] One commenter noted that the additional time will provide time for smaller companies to not only learn from the guidance that the Commission and PCAOB plan to issue but also the experiences of larger public companies.[100]

We also are adopting amendments that provide for a transition period before a newly public company is required to comply with Section 404 requirements. We think that the benefits of the transition period for newly public companies include the following:

- Companies that are going public are able to concentrate on their initial securities offering without the additional burden of becoming subject to the Section 404 requirements soon after the offering;
- Newly public companies are able to prepare their first annual report without the additional burden of having to comply with the Section 404 requirements at the same time;
- The quality of newly public companies' first compliance efforts may improve due to the additional time that the companies have to prepare to satisfy the Section 404 requirements; and
- T he transition period reduces the incentive that the previous rules created for a company that plans to go public to time its initial public offering to defer compliance with the Section 404 requirements for as long as possible after the offering.

The comments that we received generally supported the transition period for newly public companies and our rationale for adopting the amendments. Several commenters agreed that the Section 404 requirements act as a barrier to becoming a public company and increase the

[99] See, for example, letters from Cravath, Hermes, LaCrosse, and SBA.

[100] See, for example, letter from FEI.

cost of going public.[101] Because 404 compliance costs vary by size and complexity of the company, it is difficult to quantify precisely the cost-savings that these amendments may afford to newly public companies.[102]

One commenter offered a study on companies with internal control deficiencies disclosures and their cost of capital, which we have considered in our analysis.[103] While we note that the potential costs due to a lack of assurance, we believe the counterbalancing benefits and clear disclosure to investor regarding the internal control requirements justify our actions. Another venture capital association did not anticipate a major change in the cost and effort of an initial public offering to diminish until "the overall 404 cost-benefit ratio" is brought into balance, as venture-backed companies would still begin the process of obtaining a clean opinion from the auditor long before the public offering.[104] While we recognize that newly public companies will still incur costs in preparation for the implementation of the internal control requirements, we believe that the savings from the transition period for these companies may still be substantial, as the newly public companies will not be required to include either management's report on the company's internal control over financial reporting or the auditor's attestation on management's report in their first annual report.

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[101] See letters from ABA, Calix, Core-Mark, Cravath, Davis Polk, E&Y, and SBA.

[102] In its comment letter, the SBA cites various data regarding Section 404 compliance costs.

[103] See letter from CII (citing Hollis Ashbaugh-Skaife et al., The Effect of Internal Control Deficiencies on Firm Risk and Cost of Equity Capital (April 2006)). The study found that companies with internal control deficiencies exhibit higher costs of capital and those that subsequently receive an unqualified auditor attestation report on the company's internal control over financial reporting exhibit a decrease to their market-adjusted cost of capital. Another study cited by the Hollis study found no evidence of an effect on the cost of capital for internal control disclosures. See Ogneva, Subramanyam, and Reaghunandan, Internal Control Weaknesses and Cost of Equity: Evidence from SOX Section 404 Disclosures (2006).

[104] See letter from NVCA.

We also are adopting a requirement that requires a newly public company to disclose in the first annual report that it files that it has not included either management's report on internal control or the auditor's attestation report. Our intention is that this requirement will provide clarity to investors and the capital markets regarding the Section 404 requirements of a newly public company.

B. Costs

Under the extension, investors in companies that are non-accelerated filers will have to wait longer to review an attestation report by the companies' auditor on management's assessment of internal control over financial reporting. The extension may create a risk that, without the auditor's attestation to management's assessment process, some issuers may conclude that the company's internal control over financial reporting is effective without conducting an assessment that is as thorough, careful and as appropriate to the issuers' circumstances as they would conduct if the auditor were involved.

We received many comments on these potential costs. Several commenters believed that management's assessment of internal control would provide useful disclosure to investors even without the auditor's attestation report;[105] however, other commenters expressed concern whether management's report, absent the auditor's attestation, would provide meaningful disclosure[106] or would fail to identify a material weakness in the company's internal control over financial reporting.[107] One accounting firm noted that even though there is an increased risk that a material weakness will go undetected, the benefit that furnishing management's report provides to

[105] See letters from Deloitte, E&Y, FEI, Hermes, KPMG and G. Merkl.

[106] See, for example, letter from IDW.

[107] See letters from AICPA, Deloitte, Grant Thorton, IDW, and PwC.

investors outweighs that risk.[108] One commenter also noted that if standards are revised between the first and second year of compliance with the internal control reporting requirements for non-accelerated filers, the deferred implementation of the audit attestation requirement could result in overlapping expenditures and misallocation of resources.[109] On balance, we believe that the graduated introduction of the 404 requirements will give investors more useful information at lower overall costs.

Some commenters questioned whether the sequential implementation of the management report requirement and the auditor attestation requirement would cause confusion to investors and the capital markets.[110] Several commenters, in response to the Commission's request for public comment, supported a requirement that a non-accelerated filer, during its first year of compliance with the management report requirement, should clearly disclose that management's report has not been attested to by the auditor.[111] In response to comment, we have adopted this disclosure requirement for the year that non-accelerated filers and foreign private issuers that are accelerated filers (but not large accelerated filers) are only required to provide management's report.

Another potential cost of the extension in the form of increased litigation risk may be created by the phasing-in of the auditor's attestation report on management's assessment if, in year one, management concludes that the company's internal control over financial reporting is effective, but the auditor comes to a contrary conclusion the following year, thereby calling into

[108] See letter from KPMG. This commenter noted that the formality and discipline that will be introduced after non-accelerated filers begin to comply with the requirement for management's report will lead to more effective management evaluations and more meaningful management disclosures.

[109] See letter from ABA.

[110] See, for example, letters from ABA, CII, and PwC.

[111] See letters from AICPA, BDO, Deloitte, E&Y, Grant Thorton, and KPMG.

question management's earlier conclusion. We have mitigated the risk by adopting an amendment that the management report be furnished to, rather than filed with, the Commission in the first year of compliance.

A potential cost of the transition period for newly public companies is that investors may be subject to uncertainty as to the effectiveness of a newly public company's internal control over financial reporting for a longer period of time than under previous requirements. One commenter argued that the safeguard provided by the Section 404 requirements could be of increased importance for newly public companies and their investors, because those companies are often less sophisticated and lack the market following that provide safeguards.[112] As we noted, we are also requiring clear disclosure by newly public companies that they are not required to include either a report by management or an auditor's attestation report on internal control over financial reporting in their first annual report so that investors can consider that information when making their investing decisions.

The additional disclosure requirements that we are adopting for non-accelerated filers and foreign private issuers that are accelerated filers (but not large accelerated filers) during the year that they are only required to provide management's report on internal control and for newly public companies during the transition period may increase costs for companies, but we believe the increase should be minimal.

VI. Consideration of Impact on the Economy, Burden on Competition and Promotion of Efficiency, Competition and Capital Formation

Section 23(a)(2) of the Exchange Act[113] requires us, when adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition. Section

[112] See letter from Deloitte.

[113] 15 U.S.C. 78w(a)(2).

23(a)(2) prohibits us from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. In addition, Section 2(b) of the Securities Act[114] and Section 3(f) of the Exchange Act[115] require us, when engaging in rulemaking where we are required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation.

We expect that the extension of compliance dates will increase efficiency and enhance capital formation, and thereby benefit investors, by providing more time for non-accelerated filers to prepare for compliance with the Section 404 requirements and by affording these filers the opportunity to consider implementation guidance that is specifically tailored to smaller public companies. We further expect a more gradual phase-in of the management assessment and auditor attestation report requirements over a two-year period, rather than requiring non-accelerated filers to fully comply with both requirements in their first compliance year, to make the implementation process more efficient and less costly for non-accelerated filers. Some commenters on the Proposing Release argued that the sequential implementation of the management report requirement and auditor attestation requirement could make the application of the revised Auditing Standard No. 2 less efficient.[116] We have encouraged management to confer with their auditors to minimize any inefficiencies. Other commenters, however, supported the extension and believed that it would reduce compliance costs for smaller

[114] 15 U.S.C. 77b(b).

[115] 15 U.S.C. 78c(f).

[116] See, for example, letters from ABA, IDW, G. Merkl and PwC.

companies and provide them with additional time to develop best practices for compliance and greater efficiencies in preparing management reports.[117]

It is possible that a competitive impact could result from the differing treatment of non-accelerated filers and larger companies that already have been complying with the Section 404 requirements, but we do not expect that the extension will have any measurable effect on competition. We did not receive any comments specifically addressing the effect of the extension on competition.

The transition period for newly public companies should also increase efficiency and enhance capital formation by enabling these companies to concentrate on the initial securities offering process, if they are becoming subject to the Exchange Act reporting requirements by virtue of a public securities offering, and to prepare their first annual reports without the additional burden of complying with the Section 404 requirements. The provision of additional time for newly public companies to prepare for compliance with the internal control over financial reporting requirements may lead to increased quality of the companies' initial compliance efforts.[118] One commenter noted that given that the commitment of resources and expenditures in preparation for an initial public offering is enormous, the immediate imposition of Section 404 requirements is overly burdensome and does not provide sufficient time for careful establishment of internal control over financial reporting.[119] One commenter asserted that deferral of the Section 404 requirements may diminish the U.S. market premium based on an article that noted a study demonstrating that companies listing on U.S. markets enjoyed a valuation premium but also acknowledged that the benefits of Section 404 "are difficult to

[117] See, for example, letters from Core-Mark, FEI, J. Finn, Graybar, Congressman Lynch, and Village.
[118] See also letters from ABA and Calix.
[119] See letter from ABA.

quantify."[120] We believe that with the disclosure newly public companies must include in their first annual reports explaining that the management and auditor attestation reports on internal control over financial reporting are not required in the company's annual report, investors can better incorporate this information into their investing decisions. Also, a company that wishes to comply with Section 404 in their first year of reporting is not prevented from doing so under our rules.

In addition, the previous requirements would have provided an incentive for private companies to time their public offerings so as to maximize the length of time that they would have after going public before having to comply with the Section 404 requirements. The amendments we are adopting today that allow newly public companies to defer compliance with these requirements until they file their second annual report with the Commission reduce this incentive. As a result, capital formation should be enhanced by allowing companies to time their offerings to raise capital rather than to avoid a compliance requirement. In reducing regulatory burdens for newly public companies, we may also increase the attractiveness of the U.S. markets to foreign companies.[121]

VII. Final Regulatory Flexibility Analysis

This Final Regulatory Flexibility Analysis has been prepared in accordance with the Regulatory Flexibility Act[122] for amendments to rules and forms under the Securities Act and the Exchange Act that: (1) extend the compliance dates applicable to non-accelerated filers for certain internal control over financial reporting requirements and (2) provide a transition period for newly public companies before they become subject to compliance with the internal control

[120] See letter from CII (citing article in CFO magazine).

[121] See also letters from ACB, Cravath and Davis Polk.

[122] 5 U.S.C. 603.

over financial reporting requirements. Non-accelerated filers previously were scheduled to begin to comply with the management's assessment and auditor attestation report requirements on the company's internal control over financial reporting for their annual report filed for the first fiscal year ending on or after July 15, 2007. We are extending this compliance date with respect to the management's assessment portion so that a non-accelerated filer is required to begin including management's assessment in an annual report for its first fiscal year ending on or after December 15, 2007. We are extending the compliance date with respect to the auditor attestation report so that a non-accelerated filer is required to begin including an auditor's attestation report on management's assessment in the annual report that it files for its first fiscal year ending on or after December 15, 2008. In addition, we are also adopting amendments for newly public companies so that a newly public company need not comply with our internal control over financial reporting requirements until after it either had been required to file an annual report pursuant to the requirements of Section 13(a) or 15(d) of the Exchange Act for the prior fiscal year or had filed an annual report with the Commission for the prior fiscal year.

A. Reasons for and Objectives of the Amendments

The Commission and the PCAOB plan a series of actions that will result in the issuance of new guidance to aid companies and auditors in performing their evaluations of internal control over financial reporting. These amendments are designed to provide additional time for non-accelerated filers and newly public companies to comply with the internal control over financial reporting requirements as modified. We believe that the additional time will enhance the quality of public company disclosure concerning internal control over financial reporting.

For non-accelerated filers, we expect that extending the implementation of the management report requirement for five months will provide sufficient time for the Commission

to issue final guidance to assist in management's performance of a top-down, risk-based and scalable assessment of controls over financial reporting. We are deferring the implementation of the auditor attestation report requirement for an additional year after the implementation of the management report requirement for the following reasons:

- To afford non-accelerated filers and their auditors the benefit of any changes or additional guidance regarding application of the COSO Framework;
- To both save and postpone costs associated with the auditor's attestation during the period that changes to Auditing Standard No. 2 are being considered and implemented;
- To enable management more time to prepare and gain efficiencies in the review and evaluation of the effectiveness of internal control over financial reporting; and
- To provide the Commission with additional time to consider public comment on the questions we raised on management guidance related to the appropriate role of the auditor in evaluating management's internal control assessment process.[123]

For newly public companies, we expect that the transition period which eliminates the requirement to provide management's report and the auditor's attestation report in the first annual report filed with the Commission will alleviate some of the burdens of going public. The implementation of the transition period will:

- Provide additional time and defer costs for a newly public company, allowing it to focus on its assessment of internal control over financial reporting without the additional focus of the initial public offering; and

[123] Release No. 34-54122. The comment period closed on September 18, 2006, and the letters that we received on the Concept Release are available in File No. S7-11-06, at http://www.sec.gov/comments/s7-11-06/s71106.shtml.

- Allow companies, including foreign issuers, that become subject to Section 15(d) after filing a Securities Act registration statement but who may then be eligible to terminate their periodic filing obligations after filing just one annual report, to avoid the cost of preparing internal control reports.

B. Significant Issues Raised by Public Comment

In the Proposing Release, we requested comment on the number of small entity issuers that may be affected, the existence or nature of the potential impact and how to quantify the impact of the amendments. One commenter provided some data on general costs of compliance related to the Section 404 requirements.[124] For example, this commenter noted one survey included in the GAO report issued in April 2006 that surveyed 128 companies and found that fees paid by smaller companies to "external consultants" ranged from $3,000 to $1.4 million. These external consultants provided various forms of assistance, including assistance with developing methodologies to comply with Section 404, documenting and testing internal controls, and helping management assess the effectiveness of internal controls and remediate identified internal control weaknesses. This commenter also noted that surveys of actual Section 404 costs indicate that annual small company compliance costs approach $1,000,000 and then cited a survey from Financial Executives International showing that non-accelerated filers would each spend approximately $935,000 to comply with Section 404 requirements. Some companies provided estimates for their own compliance costs for the Section 404 requirements.[125]

[124] See letter from SBA.

[125] See, for example, letters from Core-Mark and LaCrosse.

C. Small Entities Subject to the Final Amendments

Exchange Act Rule 0-10(a)[126] defines an issuer, other than an investment company, to be a "small business" or "small organization" if it had total assets of $5 million or less on the last day of its most recent fiscal year. The amendments affect most issuers that are small entities. We estimate that there are approximately 2,500 issuers, other than registered investment companies, that may be considered small entities. The extension for non-accelerated filers and the transition period for newly public companies apply to any small entity that is subject to Exchange Act reporting requirements.

D. Reporting, Recordkeeping, and other Compliance Requirements

Our amendments are designed to alleviate reporting and compliance burdens. The compliance date extension for non-accelerated filers postpones the date by which non-accelerated filers with a fiscal year end between July 15, 2007 and December 15, 2007 must begin to comply with the internal control over financial reporting requirements. In addition, for non-accelerated filers, the amendments eliminate the requirement to include an auditor's report on internal control over financial reporting in the annual report during the initial year of compliance with the internal control over financial reporting requirements. During this year, however, non-accelerated filers are required to provide a statement in their annual reports, explaining that the annual report does not include the auditor's attestation report.

The transition for newly public companies also alleviates reporting and compliance burdens by relieving a newly public company from compliance with our internal control over financial reporting requirements in the first annual report that it files with the Commission. This amendment provides all newly public companies with at least one annual reporting period before they are required to conduct the first assessment of internal control over financial reporting and

[126] 17 CFR 240.0-10(a).

allows companies that are not required to file a second annual report to exit the system without filing management or auditor reports regarding internal control over financial reporting. During the transition period, however, newly public companies are required to provide a statement in their annual reports explaining that the annual report does not include either management's report on internal control or the auditor's attestation report.

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 impact on small entities. In connection with the amendments, we considered the following alternatives:

- Establishing different compliance or reporting requirements or timetables that take into account the resources available to small entities;
- Clarifying, consolidating or simplifying compliance and reporting requirements under the rules for small entities;
- Using performance rather than design standards; and
- Exempting small entities from all or part of the requirements.

We have considered a variety of reforms to achieve our regulatory objectives and, where possible, have taken steps to minimize the effects of the rules and amendments on small entities without proposing a complete and permanent exemption for small entities from coverage of the Section 404 requirements. The amendments establish a different compliance and reporting timetable for non-accelerated filers and provide additional time for newly public companies to prepare to comply with the internal control over financial reporting requirements.

We received some comments suggesting alternatives to the amendments that we are adopting. For example, one commenter recommended that the Commission explore ways to

provide further flexibility to smaller companies.[127] This commenter recommended that the Commission, as an alternative, exempt smaller companies from outside audit requirements. Some commenters suggested that the Commission extend the compliance date associated with the management report requirement for an even longer period of time than proposed.[128] As discussed above, the amendments are designed to provide companies that are non-accelerated filers with time to consider any guidance issued by us and other entities, such as COSO, before planning and conducting their internal control assessments, and to consider the anticipated revisions to Auditing Standard No. 2 that the PCAOB and Commission are considering. The amendments, our forthcoming management guidance, and the revisions to Auditing Standard No. 2 should make implementation of the internal control reporting requirements more effective and efficient for non-accelerated filers and newly public companies. As we implement these changes, we will consider the available information to determine whether additional flexibility is warranted, consistent with investor protection.

VIII. Statutory Authority and Text of the Amendments

The amendments described in this release are being adopted under the authority set forth in Sections 12, 13, 15 and 23 of the Exchange Act.

List of Subjects

17 CFR Part 210

Accountants, Accounting, Reporting and recordkeeping requirements, Securities.

17 CFR Part 228

Reporting and recordkeeping requirements, Securities, Small businesses.

17 CFR Parts 229, 240 and 249

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[127] See, for example, letter from SBA.

[128] See, for example, letters from ABA, ACB, Davis Polk, ICBA, and MOCON.

Reporting and recordkeeping requirements, Securities.

TEXT OF AMENDMENTS

For the reasons set out in the preamble, the Commission amends title 17, chapter II, of the Code of Federal Regulations as follows:

PART 210 - FORM AND CONTENT OF AND REQUIREMENTS FOR FINANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, PUBLIC UTILITY HOLDING COMPANY ACT OF 1935, INVESTMENT COMPANY ACT OF 1940, INVESTMENT ADVISERS ACT OF 1940, AND ENERGY POLICY AND CONSERVATION ACT OF 1975

1. The authority citation for Part 210 is revised to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 78c, 78j-1, 78l, 78m, 78n, 78o(d), 78q, 78u-5, 78w(a), 78ll, 78mm, 80a-8, 80a-20, 80a-29, 80a-30, 80a-31, 80a-37(a), 80b-3, 80b-11, 7202 and 7262, unless otherwise noted.

2. Section 210.2-02T is amended by:

a. Adding the phrase "(but not a large accelerated filer)" after the phrase "that is an accelerated filer" in paragraph (a);

b. Revising paragraph (b); and

c. Adding paragraphs (c) and (d).

The additions and revision read as follows:

§210.2-02T Accountants' reports and attestation reports on management's assessment of internal control over financial reporting.

* * * * *

(b) Paragraph (a) of this temporary section will expire on December 31, 2007.

(c) The requirements of §210.2-02(f) shall not apply to a registered public accounting firm that issues or prepares an accountant's report that is included in an annual report filed by a registrant that is neither a "large accelerated filer" nor an "accelerated filer," as those terms are

defined in §240.12b-2 of this chapter, for a fiscal year ending on or after December 15, 2007 but before December 15, 2008.

(d) Paragraph (c) of this temporary section will expire on June 30, 2009.

PART 228 – INTEGRATED DISCLOSURE SYSTEM FOR SMALL BUSINESS ISSUERS

3. The authority citation for Part 228 continues to read, in part, as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77jjj, 77nnn, 77sss, 78l, 78m, 78n, 78o, 78u-5, 78w, 78ll, 78mm, 80a-8, 80a-29, 80a-30, 80a-37, 80b-11, and 7201 et seq., and 18 U.S.C. 1350.

* * * * *

4. Section 228.308 is amended by:

a. adding an "s" to the word "instruction" in the descriptive heading at the end of the section;

b. redesignating the existing instruction to Item 308 as Instruction 2; and

c. adding new Instruction 1.

The addition reads as follows:

§228.308 (Item 308) Internal control over financial reporting.

* * * * *

1. A small business issuer need not comply with paragraphs (a) and (b) of this Item until it either had been required to file an annual report pursuant to section 13(a) or 15(d) of the Exchange Act (15 U.S.C. 78m or 78o(d)) for the prior fiscal year or had filed an annual report with the Commission for the prior fiscal year. A small business issuer that does not comply shall include a statement in the first annual report that it files in substantially the following form:

"This annual report does not include a report of management's assessment regarding internal control over financial reporting or an attestation report of the company's registered public accounting firm due to a transition period established by rules of the Securities and Exchange Commission for newly public companies."

* * * * *

5. Section 228.308T is added to read as follows:

§228.308T (Item 308T) Internal control over financial reporting.

Note to Item 308T: This is a special temporary section that applies only to an annual report filed by the small business issuer for a fiscal year ending on or after December 15, 2007 but before December 15, 2008.

(a) Management's annual report on internal control over financial reporting. Provide a report of management on the small business issuer's internal control over financial reporting (as defined in §240.13a-15(f) or §240.15d-15(f) of this chapter). This report shall not be deemed to be filed for purposes of Section 18 of the Exchange Act or otherwise subject to the liabilities of that section, unless the small business issuer specifically states that the report is to be considered "filed" under the Exchange Act or incorporates it by reference into a filing under the Securities Act or the Exchange Act. The report must contain:

(1) A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the small business issuer;

(2) A statement identifying the framework used by management to evaluate the effectiveness of the small business issuer's internal control over financial reporting as required by paragraph (c) of §240.13a-15 or §240.15d-15 of this chapter; and

(3) Management's assessment of the effectiveness of the small business issuer's internal control over financial reporting as of the end of the small business issuer's most recent fiscal year, including a statement as to whether or not internal control over financial reporting is effective. This discussion must include disclosure of any material weakness in the small business issuer's internal control over financial reporting identified by management. Management is not permitted to conclude that the small business issuer's internal control over financial reporting is effective if there are one or more material weaknesses in the small business issuer's internal control over financial reporting.

(4) A statement in substantially the following form: "This annual report does not include an attestation report of the company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the company's registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the company to provide only management's report in this annual report."

(b) Changes in internal control over financial reporting. Disclose any change in the small business issuer's internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of §240.13a-15 or §240.15d-15 of this chapter that occurred during the small business issuer's last fiscal quarter (the small business issuer's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the small business issuer's internal control over financial reporting.

Instructions to paragraphs (a) and (b) of Item 308T

1. A small business issuer need not comply with paragraph (a) of this Item until it either had been required to file an annual report pursuant to section 13(a) or 15(d) of the Exchange Act

(15 U.S.C. 78m or 78o(d)) for the prior fiscal year or had filed an annual report with the Commission for the prior fiscal year. A small business issuer that does not comply shall include a statement in the first annual report that it files in substantially the following form: "This annual report does not include a report of management's assessment regarding internal control over financial reporting or an attestation report of the company's registered public accounting firm due to a transition period established by rules of the Securities and Exchange Commission for newly public companies."

2. The small business issuer must maintain evidential matter, including documentation, to provide reasonable support for management's assessment of the effectiveness of the small business issuer's internal control over financial reporting.

(c) This temporary Item 308T, and accompanying note and instructions, will expire on June 30, 2009.

PART 229 – STANDARD INSTRUCTIONS FOR FILING FORMS UNDER SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934 AND ENERGY POLICY AND CONSERVATION ACT OF 1975 – REGULATION S-K

6. The general authority citation for Part 229 is revised to read as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77iii, 77jjj, 77nnn, 77sss, 78c, 78i, 78j, 78l, 78m, 78n, 78o, 78u-5, 78w, 78ll, 78mm, 80a-8, 80a-9, 80a-20, 80a-29, 80a-30, 80a-31(c), 80a-37, 80a-38(a), 80a-39, 80b-11, and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

7. Section 229.308 is amended by:

a. adding an "s" to the word "instruction" in the descriptive heading at the end of the section;

b. redesignating the existing instruction to Item 308 as Instruction 2; and

c. adding new Instruction 1.

The addition reads as follows:

§229.308 (Item 308) Internal control over financial reporting.

* * * * *

1. A registrant need not comply with paragraphs (a) and (b) of this Item until it either had been required to file an annual report pursuant to section 13(a) or 15(d) of the Exchange Act (15 U.S.C. 78m or 78o(d)) for the prior fiscal year or had filed an annual report with the Commission for the prior fiscal year. A registrant that does not comply shall include a statement in the first annual report that it files in substantially the following form: "This annual report does not include a report of management's assessment regarding internal control over financial reporting or an attestation report of the company's registered public accounting firm due to a transition period established by rules of the Securities and Exchange Commission for newly public companies."

* * * * *

8. Section 229.308T is added to read as follows:

§229.308T (Item 308T) Internal control over financial reporting.

<u>Note to Item 308T</u>: This is a special temporary section that applies only to a registrant that is neither a "large accelerated filer" nor an "accelerated filer" as those terms are defined in §240.12b-2 of this chapter and only with respect to an annual report filed by the registrant for a fiscal year ending on or after December 15, 2007 but before December 15, 2008.

(a) <u>Management's annual report on internal control over financial reporting</u>. Provide a report of management on the registrant's internal control over financial reporting (as defined in

§240.13a-15(f) or §240.15d-15(f) of this chapter). This report shall not be deemed to be filed for purposes of Section 18 of the Exchange Act or otherwise subject to the liabilities of that section, unless the registrant specifically states that the report is to be considered "filed" under the Exchange Act or incorporates it by reference into a filing under the Securities Act or the Exchange Act. The report must contain:

(1) A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the registrant;

(2) A statement identifying the framework used by management to evaluate the effectiveness of the registrant's internal control over financial reporting as required by paragraph (c) of §240.13a-15 or §240.15d-15 of this chapter; and

(3) Management's assessment of the effectiveness of the registrant's internal control over financial reporting as of the end of the registrant's most recent fiscal year, including a statement as to whether or not internal control over financial reporting is effective. This discussion must include disclosure of any material weakness in the registrant's internal control over financial reporting identified by management. Management is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the registrant's internal control over financial reporting.

(4) A statement in substantially the following form: "This annual report does not include an attestation report of the company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the company's registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the company to provide only management's report in this annual report."

(b) Changes in internal control over financial reporting. Disclose any change in the registrant's internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of §240.13a-15 or §240.15d-15 of this chapter that occurred during the registrant's last fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.

Instructions to paragraphs (a) and (b) of Item 308T

1. A registrant need not comply with paragraph (a) of this Item until it either had been required to file an annual report pursuant to section 13(a) or 15(d) of the Exchange Act (15 U.S.C. 78m or 78o(d)) for the prior fiscal year or previously had filed an annual report with the Commission for the prior fiscal year. A registrant that does not comply shall include a statement in the first annual report that it files in substantially the following form: "This annual report does not include a report of management's assessment regarding internal control over financial reporting or an attestation report of the company's registered public accounting firm due to a transition period established by rules of the Securities and Exchange Commission for newly public companies."

2. The registrant must maintain evidential matter, including documentation, to provide reasonable support for management's assessment of the effectiveness of the registrant's internal control over financial reporting.

(c) This temporary Item 308T, and accompanying note and instructions, will expire on June 30, 2009.

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

9. The general authority citation for Part 240 is revised to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

10. Section 240.13a-14 is amended by adding a sentence at the end of paragraph (a) to read as follows:

§240.13a-14 Certification of disclosure in annual and quarterly reports.

(a) * * * The principal executive and principal financial officers of an issuer may omit the portion of the introductory language in paragraph 4 as well as language in paragraph 4(b) of the certification that refers to the certifying officers' responsibility for designing, establishing and maintaining internal control over financial reporting for the issuer until the issuer becomes subject to the internal control over financial reporting requirements in §240.13a-15 or 240.15d-15.

* * * * *

11. Section 240.13a-15 is amended by:

a. revising paragraph (a); and

b. revising the first sentences in paragraphs (c) and (d).

The revisions read as follows:

§240.13a-15 Controls and procedures.

(a) Every issuer that has a class of securities registered pursuant to section 12 of the Act (15 U.S.C. 78l), other than an Asset-Backed Issuer (as defined in §229.1101 of this chapter), a small business investment company registered on Form N-5 (§§239.24 and 274.5 of this

chapter), or a unit investment trust as defined in section 4(2) of the Investment Company Act of 1940 (15 U.S.C. 80a-4(2)), must maintain disclosure controls and procedures (as defined in paragraph (e) of this section) and, if the issuer either had been required to file an annual report pursuant to section 13(a) or 15(d) of the Act (15 U.S.C. 78m(a) or 78o(d)) for the prior fiscal year or had filed an annual report with the Commission for the prior fiscal year, internal control over financial reporting (as defined in paragraph (f) of this section).

* * * * *

(c) The management of each such issuer that either had been required to file an annual report pursuant to section 13(a) or 15(d) of the Act (15 U.S.C. 78m(a) or 78o(d)) for the prior fiscal year or previously had filed an annual report with the Commission for the prior fiscal year, other than an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8), must evaluate, with the participation of the issuer's principal executive and principal financial officers, or persons performing similar functions, the effectiveness, as of the end of each fiscal year, of the issuer's internal control over financial reporting. * * *

(d) The management of each such issuer that either had been required to file an annual report pursuant to section 13(a) or 15(d) of the Act (15 U.S.C. 78m(a) or 78o(d) for the prior fiscal year or had filed an annual report with the Commission for the prior fiscal year, other than an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8), must evaluate, with the participation of the issuer's principal executive and principal financial officers, or persons performing similar functions, any change in the issuer's internal control over financial reporting, that occurred during each of the issuer's fiscal quarters, or fiscal year in the case of a foreign private issuer, that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting. * * *

* * * * *

12. Section 240.15d-14 is amended by adding a sentence at the end of paragraph (a) to read as follows:

§240.15d-14 Certification of disclosure in annual and quarterly reports.

(a) * * * The principal executive and principal financial officers of an issuer may omit the portion of the introductory language in paragraph 4 as well as language in paragraph 4(b) of the certification that refers to the certifying officers' responsibility for designing, establishing and maintaining internal control over financial reporting for the issuer until the issuer becomes subject to the internal control over financial reporting requirements in §240.13a-15 or 240.15d-15 of this chapter.

* * * * *

13. Section 240.15d-15 is amended by:

a. revising paragraph (a); and

b. revising the first sentences of paragraphs (c) and (d).

The revisions read as follows:

§240.15d-15 Controls and procedures.

(a) Every issuer that files reports under section 15(d) of the Act (15 U.S.C. 78o(d)), other than an Asset Backed Issuer (as defined in §229.1101 of this chapter), a small business investment company registered on Form N-5 (§§ 239.24 and 274.5 of this chapter), or a unit investment trust as defined in section 4(2) of the Investment Company Act of 1940 (15 U.S.C. 80a-4(2)), must maintain disclosure controls and procedures (as defined in paragraph (e) of this section) and, if the issuer either had been required to file an annual report pursuant to section 13(a) or 15(d) of the Act (15 U.S.C. 78m(a) or 78o(d)) for the prior fiscal year or had filed an

annual report with the Commission for the prior fiscal year, internal control over financial reporting (as defined in paragraph (f) of this section).

* * * * *

(c) The management of each such issuer that either had been required to file an annual report pursuant to section 13(a) or 15(d) of the Act (15 U.S.C. 78m(a) or 78o(d)) for the prior fiscal year or had filed an annual report with the Commission for the prior fiscal year, other than an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8), must evaluate, with the participation of the issuer's principal executive and principal financial officers, or persons performing similar functions, the effectiveness, as of the end of each fiscal year, of the issuer's internal control over financial reporting. * * *

(d) The management of each such issuer that previously either had been required to file an annual report pursuant to section 13(a) or 15(d) of the Act (15 U.S.C. 78m(a) or 78o(d)) for the prior fiscal year or previously had filed an annual report with the Commission for the prior fiscal year, other than an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8), must evaluate, with the participation of the issuer's principal executive and principal financial officers, or persons performing similar functions, any change in the issuer's internal control over financial reporting, that occurred during each of the issuer's fiscal quarters, or fiscal year in the case of a foreign private issuer, that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting. * * *

* * * * *

PART 249 – FORMS, SECURITIES EXCHANGE ACT OF 1934

14. The authority citation for Part 249 continues to read, in part, as follows:

Authority: 15 U.S.C. 78a et seq. and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

15. Form 20-F (referenced in §249.220f), Part II, is amended by:

a. adding an "s" to the word "Instruction" in the descriptive heading at the end of Item 15;

b. redesignating the existing Instruction to Item 15 as Instruction 2;

c. adding new Instruction 1 to Item 15; and

d. revising Item 15T.

The additions and revision read as follows.

Note: The text of Form 20-F does not, and this amendment will not, appear in the Code of Federal Regulations.

FORM 20-F

* * * * *

PART II

* * * * *

Item 15. Controls and Procedures.

* * * * *

Instructions to Item 15

1. An issuer need not comply with paragraphs (b) and (c) of this Item until it either had been required to file an annual report pursuant to Section 13(a) or 15(d) of the Exchange Act (15 U.S.C. 78m(a) or 78o(d)) for the prior fiscal year or had filed an annual report with the Commission for the prior fiscal year. An issuer that does not comply shall include a statement in the first annual report that it files in substantially the following form: "This annual report does not include a report of management's assessment regarding internal control over financial

reporting or an attestation report of the company's registered public accounting firm due to a transition period established by rules of the Securities and Exchange Commission for newly public companies."

* * * * *

Item 15T. Controls and Procedures.

Note to Item 15T: This is a special temporary section that applies instead of Item 15 only to: (1) an issuer that is an "accelerated filer," but not a "large accelerated filer," as those terms are defined in §240.12b-2 of this chapter and only with respect to an annual report that the issuer is required to file for a fiscal year ending on or after July 15, 2006 but before July 15, 2007; or

(2) an issuer that is neither a "large accelerated filer" nor an "accelerated filer" as those terms are defined in §240.12b-2 of this chapter and only with respect to an annual report that the issuer is required to file for a fiscal year ending on or after December 15, 2007 but before December 15, 2008.

(a) Disclosure Controls and Procedures. Where the Form is being used as an annual report filed under section 13(a) or 15(d) of the Exchange Act, disclose the conclusions of the issuer's principal executive and principal financial officers, or persons performing similar functions, regarding the effectiveness of the issuer's disclosure controls and procedures (as defined in 17 CFR 240.13a-15(e) or 240.15d-15(e)) as of the end of the period covered by the report, based on the evaluation of these controls and procedures required by paragraph (b) of 17 CFR 240.13a-15 or 240.15d-15.

(b) Management's annual report on internal control over financial reporting. Where the Form is being used as an annual report filed under section 13(a) or 15(d) of the Exchange Act, provide a report of management on the issuer's internal control over financial reporting (as

defined in §240.13a-15(f) or 240.15d-15(f) of this chapter). The report shall not be deemed to be filed for purposes of section 18 of the Exchange Act or otherwise subject to the liabilities of that section, unless the issuer specifically states that the report is to be considered "filed" under the Exchange Act or incorporates it by reference into a filing under the Securities Act or the Exchange Act. The report must contain:

(1) A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the issuer;

(2) A statement identifying the framework used by management to evaluate the effectiveness of the issuer's internal control over financial reporting as required by paragraph (c) of §240.13a-15 or 240.15d-15 of this chapter;

(3) Management's assessment of the effectiveness of the issuer's internal control over financial reporting as of the end of the issuer's most recent fiscal year, including a statement as to whether or not internal control over financial reporting is effective. This discussion must include disclosure of any material weakness in the issuer's internal control over financial reporting identified by management. Management is not permitted to conclude that the issuer's internal control over financial reporting is effective if there are one or more material weaknesses in the issuer's internal control over financial reporting; and

(4) A statement in substantially the following form: "This annual report does not include an attestation report of the company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the company's registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the company to provide only management's report in this annual report."

(c) Changes in internal control over financial reporting. Disclose any change in the issuer's internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of §240.13a-15 or 240.15d-15 of this chapter that occurred during the period covered by the annual report that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting.

(d) This temporary Item 15T, and accompanying note and instructions, will expire on June 30, 2009.

Instructions to Item 15T

1. An issuer need only comply with paragraph (b) of this Item until it either had been required to file an annual report pursuant to section 13(a) or 15(d) of the Exchange Act (15 U.S.C. 78m(a) or 78o(d)) for the prior fiscal year or had filed an annual report with the Commission for the prior fiscal year. An issuer that does not comply shall include a statement in the first annual report that it files in substantially the following form: "This annual report does not include a report of management's assessment regarding internal control over financial reporting or an attestation report of the company's registered public accounting firm due to a transition period established by rules of the Securities and Exchange Commission for newly public companies."

2. The registrant must maintain evidential matter, including documentation, to provide reasonable support for management's assessment of the effectiveness of the issuer's internal control over financial reporting.

* * * * *

16. Form 40-F (referenced in §249.240f) is amended by revising the "Instructions to paragraphs (b), (c), (d) and (e) of General Instruction B.(6)." as follows:

a. redesignating existing Instruction 1 as Instruction 2;

b. adding new Instruction 1; and

c. redesignating existing Instruction 2T as Instruction 3T;

d. revising newly redesignated Instruction 3T.

The addition and revision read as follows:

Note: The text of Form 40-F does not, and this amendment will not, appear in the Code of Federal Regulations.

FORM 40-F

* * * * *

GENERAL INSTRUCTIONS

* * * * *

B. Information To Be Filed on this Form

* * * * *

(6) * * *

Instructions to paragraphs (b), (c), (d) and (e) of General Instruction B.(6).

1. An issuer need not comply with paragraphs (c) and (d) of this Instruction until it either had been required to file an annual report pursuant to the requirements of section 13(a) or 15(d) of the Exchange Act (15 U.S.C. 78m(a) or 78o(d)) for the prior fiscal year or had filed an annual report with the Commission for the prior fiscal year. An issuer that does not comply shall include a statement in the first annual report that it files in substantially the following form: "This annual report does not include a report of management's assessment regarding internal control over financial reporting or an attestation report of the company's registered public accounting firm due to a transition period established by rules of the Securities and Exchange Commission for newly public companies."

* * * * *

3T. Paragraphs (c)(4) and (d) of this General Instruction B.6 do not apply to: (1) an issuer that is an "accelerated filer," but not a "large accelerated filer," as those terms are defined in §240.12b-2 of this chapter and only with respect to an annual report that the issuer is required to file for a fiscal year ending on or after July 15, 2006 but before July 15, 2007; or (2) an issuer that is neither a "large accelerated filer" nor an "accelerated filer," as those terms are defined in §240.12b-2 of this chapter, with respect to an annual report that the issuer is required to file for a fiscal year ending on or after December 15, 2007 but before December 15, 2008. Management's report on internal control over financial reporting that is included in an annual report filed by the type of issuer and within the period set forth in (1) or (2) above in this Instruction 3T shall not be deemed to be filed for purposes of Section 18 of the Exchange Act or otherwise subject to the liabilities of that section, unless the issuer specifically states that the report is to be considered "filed" under the Exchange Act or incorporates it by reference into a filing under the Securities Act or the Exchange Act. An issuer to which this instruction applies should provide a statement in substantially the following form: "This annual report does not include an attestation report of the company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the company's registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the company to provide only management's report in this annual report."

This temporary Instruction 3T will expire on June 30, 2009.

* * * * *

17. Form 10-Q (referenced in §249.308a) is amended by adding temporary Item 4T to Part I following Item 4.

The addition reads as follows:

Note: The text of Form 10-Q does not, and this amendment will not, appear in the Code of Federal Regulations.

Form 10-Q

* * * * *

PART I – FINANCIAL INFORMATION

* * * * *

Item 4T. Controls and Procedures.

(a) If the registrant is neither a large accelerated filer nor an accelerated filer as those terms are defined in §240.12b-2 of this chapter, furnish the information required by Items 307 and 308T of Regulation S-K (17 CFR 229.307 and 229.308T) with respect to a quarterly report that the registrant is required to file for a fiscal year ending on or after December 15, 2007 but before December 15, 2008.

(b) This temporary Item 4T will expire on June 30, 2009.

* * * * *

18. Form 10-QSB (referenced in §249.308b) is amended by adding temporary Item 3A(T) to Part I after Item 3A.

The addition reads as follows:

Note: The text of Form 10-QSB does not, and this amendment will not, appear in the Code of Federal Regulations.

Form 10-QSB

* * * * *

PART I – FINANACIAL INFORMATION

* * * * *

Item 3A(T). Controls and Procedures.

(a) Furnish the information required by Items 307 and 308T of Regulation S-B (17 CFR 228.307 and 228.308T) with respect to a quarterly report that the small business issuer is required to file for a fiscal year ending on or after December 15, 2007 but before December 15, 2008.

(b) This temporary Item 3A(T) will expire on June 30, 2009.

* * * * *

19. Form 10-K (referenced in §249.310) is amended by adding temporary Item 9A(T) to Part II following Item 9A.

The addition reads as follows:

Note: The text of Form 10-K does not, and this amendment will not, appear in the Code of Federal Regulations.

Form 10-K

* * * * *

PART II

* * * * *

Item 9A(T). Controls and Procedures.

(a) If the registrant is neither a large accelerated filer nor an accelerated filer as those terms are defined in §240.12b-2 of this chapter, furnish the information required by Items 307 and 308T of Regulation S-K (17 CFR 229.307 and 229.308T) with respect to an annual report that the registrant is required to file for a fiscal year ending on or after December 15, 2007 but before December 15, 2008.

(b) This temporary Item 9A(T) will expire on June 30, 2009.

* * * * *

20. Form 10-KSB (referenced in §249.310b) is amended by adding temporary Item 8A(T) to Part II after Item 8A.

The addition reads as follows:

Note: The text of Form 10-KSB does not, and this amendment will not, appear in the Code of Federal Regulations.

Form 10-KSB

* * * * *

PART II

* * * * *

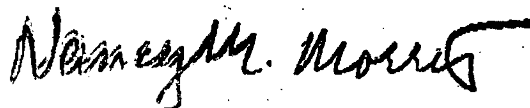
Item 8A(T). Controls and Procedures.

(a) Furnish the information required by Items 307 and 308T of Regulation S-B (17 CFR 228.307 and 228.308T) with respect to an annual report that the small business issuer is required to file for a fiscal year ending on or after December 15, 2007 but before December 15, 2008.

(b) This temporary Item 8A(T) will expire on June 30, 2009.

* * * * *

By the Commission.



Nancy M. Morris
Secretary

December 15, 2006

Commissioner Nazareth
Not Participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 54945 / December 15, 2006

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2525 / December 15, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12322

In the Matter of **JAMES T. MCCURDY, CPA,** **Respondent.**	**ORDER MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS PURSUANT TO RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE**

I.

On June 2, 2006, the Securities and Exchange Commission ("Commission") instituted public administrative proceedings pursuant to Rule 102(e)(1)(ii) of the Commission's Rules of Practice[1] against James T. McCurdy, CPA ("Respondent" or "McCurdy").

II.

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

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[1] 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 . . . improper professional conduct.

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Sanctions Pursuant to Rule 102(e) of the Commission's Rules of Practice ("Order"), as set forth below.

III.

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

A. SUMMARY

1. This matter concerns failed audits of the financial statements of two mutual funds, the Liquid Green Money Market Fund ("Liquid Green") and the Florida Street Bond Fund ("Florida Street"), as the result of improper professional conduct by James T. McCurdy, CPA.

2. McCurdy engaged in improper professional conduct during the audit of Liquid Green's financial statements for the fiscal year ended September 30, 2001 ("the 2001 Liquid Green audit"). During the 2001 Liquid Green audit, McCurdy, who was the concurring review partner, became aware that more than half of the securities in the fund's portfolio had stated maturity dates exceeding the 397-day period set forth in Rule 2a-7 under the Investment Company Act of 1940 ("Investment Company Act"), and did not assure that the engagement partner performed audit procedures to determine whether the securities were in fact eligible for a money market fund or otherwise to test the fund's compliance with Rule 2a-7.

3. Because he did not require the engagement partner to audit Liquid Green's financial statements in accordance with generally accepted auditing standards ("GAAS") and did not do so himself, McCurdy allowed his firm to issue an audit report with an unqualified opinion even though the fund's financial statements were not prepared in conformity with generally accepted accounting principles ("GAAP") because the fund was using the amortized cost method of valuing its securities and holding itself out as a money market fund when it was not eligible to do so, in violation of the Investment Company Act.

4. McCurdy also engaged in improper professional conduct during the audits of Florida Street's financial statements for the fiscal years ended October 31, 1999 (the "1999 Florida Street audit") and October 31, 2000 (the "2000 Florida Street audit"). McCurdy assigned two inexperienced auditors as engagement partners and designated himself as the concurring review partner for the 1999 and 2000 Florida Street audits.

5. Because McCurdy failed to ensure that the 1999 Florida Street audit was conducted in accordance with GAAS, he failed to detect (i) that the fund was over-accruing interest for bonds that had missed interest payments, were in default, or had previously been sold and were no longer held by the fund; (ii) that a significant portion of the fund's interest receivable balance was uncollectible; and (iii) that Florida Street's financial statements were not fairly presented in conformity with GAAP.

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

6. Florida Street's overstated interest receivable balance came to light during the 2000 Florida Street audit. As a result of the discovery, the fund was re-priced, the fund wrote off the uncollectible interest, and it was determined that the fund made a return of capital that had not been disclosed to shareholders. None of these events was disclosed in the October 31, 2000 financial statements in violation of GAAP.

7. As a result of McCurdy's reckless or at least highly unreasonable conduct, his accounting firm issued audit reports with unqualified opinions on Liquid Green's financial statements as of September 30, 2001, and Florida Street's financial statements as of October 31, 1999 and October 31, 2000, each of which falsely represented that those financial statements were fairly presented in conformity with GAAP and the audits were conducted in accordance with GAAS.

B. RESPONDENT

8. **McCurdy**, age 59, resides in Westlake, Ohio and has been a licensed certified public accountant ("CPA") in Ohio since 1979. From February 1980 until December 2003, McCurdy was the principal shareholder and managing partner of McCurdy & Associates CPAs, Inc. ("McCurdy & Associates"), an accounting firm that specialized in performing mutual fund audits. McCurdy was the concurring review partner for the 2001 Liquid Green audit and 1999 and 2000 Florida Street audits. McCurdy & Associates sold its investment industry practice, including its auditing practice, to Cohen McCurdy, Ltd. in January 2004. McCurdy & Associates continues to provide tax services to clients. The firm resigned its Public Company Accounting Oversight Board ("PCAOB") registration effective August 17, 2004. On May 19, 2005, McCurdy was temporarily denied the privilege of appearing or practicing before the Commission as an accountant for one year, as a result of his improper professional conduct in connection with the 1998 audit of the financial statements of the JWB Aggressive Growth Fund.

C. RELATED PARTIES

9. **AmeriPrime Advisors Trust ("AAT")**, an Ohio business trust, is an open-end series investment company[3] that has been registered with the Commission since 1999. On September 20, 2001, AAT organized Liquid Green as one of its series of funds. On September 28, 2001, Liquid Green acquired the assets and assumed the liabilities of the Unified Taxable Money Market Fund ("UTMM"), which was a series of the open-end series investment company Unified Funds. UTMM transferred its assets to Liquid Green and dissolved.[4] As of September 30, 2001, Liquid Green had total net assets valued at $37,695,013. In February 2002, Liquid Green dissolved after transferring all of its assets to another money market fund.

10. **AmeriPrime Funds ("AF")**, an Ohio business trust, is an open-end series investment company that has been registered with the Commission since 1995. From June 1997

[3] Although a series investment company such as AAT is organized as a single corporate entity, it may be comprised of several different series or portfolios that function as separate investment companies.

[4] For the purposes of this Order, "Liquid Green" refers collectively to both Liquid Green and its predecessor UTMM.

until November 2001, Florida Street was a high-yield bond fund under AF. As of October 31, 2001, Florida Street reported total assets of $13,184,855. AF liquidated and closed Florida Street in November 2001.

11. **Unified Fund Services, Inc. ("Unified")**, an Indiana corporation located in Indianapolis, Indiana, has provided administrative and accounting services to mutual funds since 1990. Unified's clients included AAT and AF. As fund administrator and fund accountant for Liquid Green and Florida Street, Unified was responsible for, among other things, keeping the funds' books and records and preparing their financial statements.

D. FACTS

Applicable Professional Standards

12. The "applicable professional standards" of care for accountants practicing before the Commission include, but are not limited to, GAAP and GAAS. GAAS consists of ten auditing standards, including three general standards, three standards of fieldwork and four standards of reporting.

13. The first general standard requires that an audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor. AU §210.01.

14. The third general standard provides that "due professional care is to be exercised in the performance of the audit and the preparation of the report." AU §230.01. Among other things, due professional care requires an auditor to observe the field work and reporting standards of GAAS. AU §230.02. Additionally, due professional care requires an auditor to employ professional skepticism, which is "an attitude that includes a questioning mind and a critical assessment of audit evidence." AU §230.07. Professional skepticism requires an auditor to obtain no less persuasive evidence merely because he assumes that management is honest. AU §230.09.

15. The first standard of fieldwork requires that audit work be adequately planned and supervised. AU §310.01.

16. The third standard of fieldwork requires that "sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit." AU §326.01. GAAS further provide that "representations from management are part of the evidential matter the independent auditor obtains, but they are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit." AU §333.02. "[W]hen evidential matter can be obtained from independent sources outside an entity, it provides greater assurance of reliability for the purposes of an independent audit than that secured solely within the entity." AU §326.21(a).

17. The first standard of reporting states, "The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles." AU §410.01. The third standard of reporting further provides that "informative disclosures in the

financial statements are to be regarded as reasonably adequate unless otherwise stated in the report." AU §431.01. "If management omits from the financial statements, including the accompanying notes, information that is required by generally accepted accounting principles, the auditor should express a qualified or an adverse opinion and should provide the information in his report, if practicable, unless its omission from the auditor's report is recognized as appropriate by a specific Statement on Auditing Standards." AU §431.03

18. As set forth below, McCurdy engaged in improper professional conduct in connection with the 2001 Liquid Green audit and the 1999 and 2000 Florida Street audits because he failed to comply with GAAS.

The 2001 Liquid Green Audit

19. Between March 20, 2001 and December 6, 2001, Liquid Green's portfolio manager followed an investment strategy of purchasing fixed-rate, government agency bonds with remaining maturities of between 2 1/2 and 12 years. The bonds were callable within 397 days at the discretion of the government agency, but not at the option of the purchaser. As of September 30, 2001, the last day of fiscal year 2001, these bonds made up over 53.1% of the fund's assets.

20. Under Rule 2a-7(c)(2)(i) under the Investment Company Act, a mutual fund cannot acquire securities with maturities in excess of 397 days and hold itself out as a money market fund unless the securities have a maturity-shortening feature as provided by the rule. Furthermore, Rule 2a-7(b)(1) expressly provides that it is a material misrepresentation under Section 34(b) of the Investment Company Act for a mutual fund to hold itself out as a money market fund when it does not meet the risk-limiting conditions of Rule 2a-7.

21. In this case, the callable bonds purchased by Liquid Green did not have a maturity-shortening feature as provided for by Rule 2a-7. Thus, during the time period when the fund held these bonds, Liquid Green was not permitted to hold itself out as a money market fund and it was a material misrepresentation for the fund to do so.

22. In addition, a money market fund that does not meet the requirements of Rule 2a-7 is not permitted to use the amortized cost method of valuing the securities in its investment portfolio but instead must calculate the current net asset value of its portfolio securities on a daily basis to reflect current market prices. Because Liquid Green did not meet the requirements of Rule 2a-7 during the time period when it held the ineligible bonds, the fund was not permitted to use the amortized cost method to value its securities.

23. AAT engaged McCurdy & Associates to provide audit and tax services to its series of funds, including Liquid Green. McCurdy assigned another member of his firm to be the engagement partner for the 2001 Liquid Green audit while he assigned himself the role of concurring review partner. As concurring review partner, McCurdy reviewed all of the audit workpapers, including the results of all of the fieldwork performed by the engagement partner.

24. The audit plan for the 2001 Liquid Green audit did not contain any procedures designed to test the fund's compliance with Rule 2a-7.

25. During the 2001 Liquid Green audit, McCurdy learned that more than one half of Liquid Green's investment portfolio consisted of callable bonds with stated maturities of greater than 397 days. McCurdy became aware of the callable bonds when he reviewed Liquid Green's financial statements, which included a schedule of investments that listed the callable bonds and their maturities.

26. Despite knowing that more than half of Liquid Green's portfolio consisted of callable bonds with stated maturities that appeared to make them ineligible for a money market fund under Rule 2a-7, McCurdy did not require the performance of any audit procedures to test the fund's compliance with the rule by the engagement partner; nor did he perform any such procedures himself.

27. As a result of his failure to properly follow up on red flags discovered during his review of the audit of Liquid Green's financial statements, McCurdy failed to require the fund to correct its audited financial statements containing material misrepresentations, including that Liquid Green was a "money market fund" and that it was proper for the fund to use the amortized cost method to value its portfolio securities.

28. McCurdy & Associates issued an audit report dated October 10, 2001, containing an unqualified opinion on Liquid Green's financial statements as of September 30, 2001, that was included in the fund's annual report filed with the Commission on November 28, 2001.[5]

29. The audit report stated that McCurdy & Associates "audited the statements of assets and liabilities, including the portfolios of investments, of Liquid Green Money Market Fund (formerly Unified Taxable Money Market Fund) as of September 30, 2001." The report further falsely represented that (i) the fund's financial statements were presented in conformity with GAAP, and (ii) that McCurdy & Associates had audited the fund's financial statements in accordance with GAAS.

30. As the concurring review partner on the 2001 Liquid Green audit, McCurdy was required to conduct himself in accordance with GAAS. McCurdy was also responsible for reviewing documentation of the resolution of any significant auditing, accounting and financial reporting matters that arose during the audit and using professional judgment to determine whether reviewing more documentation and employing other procedures were necessary.

31. With respect to the 2001 Liquid Green audit, McCurdy failed to exercise sound professional judgment to determine whether additional procedures were in fact necessary to determine whether Liquid Green was in compliance with Rule 2a-7.

32. McCurdy failed to conduct himself in accordance with the first standard of fieldwork under GAAS because he failed to require the engagement partner to include in the audit plan procedures to test the fund's Rule 2a-7 compliance, even after discovering that a large

[5] Liquid Green's 2001 annual report was originally filed on November 28, 2001 under the wrong investment company name. After the fund administrator discovered the error, the annual report was re-filed, with no changes, under the correct investment company name on December 26, 2001.

percentage of the securities in the fund's portfolio had stated maturity dates that appeared not to comply with Rule 2a-7.

33. McCurdy violated the third standard of fieldwork because he failed to ensure that the engagement partner obtained sufficient competent evidential matter regarding Liquid Green's compliance with Rule 2a-7 and did not have a reasonable basis for allowing the issuance of the firm's audit report containing the opinion that the fund's financial statements were fairly presented in conformity with GAAP.

34. McCurdy failed to exercise due professional care in accordance with the third general standard by (i) failing to ensure that the audit plan included procedures appropriate to test the fund's Rule 2a-7 compliance; (ii) failing to ensure that sufficient competent evidential matter was obtained to determine whether the fund was in compliance with Rule 2a-7; and (iii) allowing his firm to issue an audit report with an unqualified opinion on Liquid Green's financial statements, even though those financial statements improperly held Liquid Green out as a money market fund, represented that the amortized cost method was appropriate, and improperly used the amortized cost method to value securities in the fund.

35. McCurdy violated the reporting standards under GAAS when he allowed McCurdy & Associates to issue an audit report with an unqualified opinion on Liquid Green's financial statements as of September 30, 2001 even though the financial statements contained material misrepresentations and failed to disclose material matters.

The 1999 and 2000 Florida Street Audits

36. From at least August 1999 until November 2001, Florida Street failed properly to account for interest due from its portfolio of bonds. During that time period, Florida Street continued to accrue interest for bonds that had missed interest payments, were in default or were no longer owned by the fund.

37. Because of these improper interest accruals, the interest receivable reflected in Florida Street's accounting books and records included a significant amount of uncollectible interest. As of August 1, 1999, Florida Street's interest receivable included approximately $195,120 in uncollectible interest. By October 31, 2000, Florida Street's interest receivable balance was overstated by approximately $796,356. Between November 1, 2000 and October 31, 2001, Florida Street accrued additional uncollectible interest of approximately $473,275.

38. The uncollectible interest was included in Florida Street's trial balance and used to compute the fund's daily net asset value ("NAV"). From at least December 1, 1999 through June 25, 2001, Florida Street's daily NAV was overstated by between $.01 and $.34 per share. Throughout this period, the fund was redeeming and selling shares at inflated NAVs.

39. McCurdy & Associates audited Florida Street's financial statements for the fiscal year ended October 31, 1999. McCurdy assigned another member of his firm to serve as the engagement partner for the 1999 Florida Street audit even though she did not have adequate technical training, experience and proficiency as an auditor to serve as an engagement partner for

an audit of a high-yield bond fund.

40. McCurdy assumed the role of concurring review partner for the 1999 Florida Street audit. As concurring review partner, McCurdy reviewed all of the audit workpapers. In addition, McCurdy provided the engagement partner with the audit program to be used for the audit and trained her on how to carry out the audit procedures.

41. At the time of the 1999 Florida Street audit, the fund accountant could not provide the auditors with information to substantiate an interest receivable balance of over $913,264 that had been carried over from the predecessor accountant. The unsubstantiated balance was included on Florida Street's trial balance and was used to calculate the fund's NAVs. Florida Street's recording of the unsubstantiated interest was inconsistent with GAAP because revenue must be (1) recognizable and (2) measurable to be recorded. Statement of Financial Accounting Concepts No. 6 ¶145.

42. Based on her training by McCurdy, the engagement partner for the 1999 Florida Street audit did not perform audit procedures to test the collectibility of Florida Street's interest receivable balance. McCurdy knew that such audit procedures, such as confirmation of the receivable balance, were not performed.

43. Because the auditors failed to conduct the 1999 Florida Street audit properly, they failed to detect (i) that the fund was over-accruing interest for bonds that had missed interest payments, were in default, or had previously been sold and were no longer held by the fund, (ii) that a significant portion of the fund's interest receivable balance was in fact uncollectible, and (iii) that the financial statements were not prepared in conformity with GAAP.

44. McCurdy & Associates also audited Florida Street's financial statements for the fiscal year ended October 31, 2000. As with the prior year's audit, McCurdy assigned an inexperienced auditor from his firm to serve as the engagement partner for the 2000 Florida Street audit, and assigned himself the role of concurring review partner.

45. Florida Street's overstated interest receivable balance came to light during the 2000 Florida Street audit. As a result of the discovery, the fund was re-priced back to December 1, 1999 and the fund wrote off a total of $1,269,631 in uncollectible interest, approximately $796,356 of which was attributable to periods on or before October 31, 2000. As a result of the interest write-offs, Florida Street's distributions from net investment income exceeded the fund's net investment income in 2000, and therefore constituted a return of capital.

46. Florida Street failed to disclose the repricing, interest write offs and return of capital in its financial statements for the fiscal year ended October 31, 2000, which were included in Florida Street's annual report filed with the Commission on March 22, 2002. Furthermore, Florida Street erroneously classified the return of capital distributions in its financial statements as being derived from the fund's net investment income.

47. McCurdy reviewed Florida Street's 2000 annual report and allowed his firm to issue an audit report with an unqualified opinion on the financial statements, even though he knew that the financial statements did not disclose the repricing, interest write-offs and return of capital.

48. Furthermore, despite knowing that a portion of the interest Florida Street wrote off during the fiscal year ended October 31, 2000 related to the prior fiscal year ended October 31, 1999, McCurdy did not require the recording of a prior period adjustment or take any steps to determine whether Florida Street should restate its financial statements for prior periods.

49. McCurdy did not comply with the first general standard under GAAS during the 1999 and 2000 Florida Street audits because he failed to assign staff members to those audits who possessed adequate technical training and proficiency.

50. McCurdy violated the third standard of fieldwork with respect to the 1999 Florida Street audit because he failed to ensure that the audit staff performed tests to confirm the fund's interest receivable balance even though he knew that collectibility of interest was an area of risk for an audit of a high-yield bond fund.

51. McCurdy failed to exercise due professional care as provided by the third general standard during the 1999 and 2000 Florida Street audits because he (i) failed to assign staff with sufficient technical training and proficiency, (ii) failed to require sufficient competent evidential matter be obtained regarding the fund's interest receivable during the 1999 audit, and (iii) and allowed McCurdy & Associates to issue unqualified audit reports falsely stating that the financial statements conformed with GAAP and that the audits were conducted in accordance with GAAS.

52. McCurdy violated the first standard of reporting during the 1999 and 2000 Florida Street audits when he allowed McCurdy & Associates to issue audit reports with unqualified audit opinions on Florida Street's financial statements falsely stating that the financial statements conformed with GAAP and that the audits were conducted in accordance with GAAS.

E. VIOLATION

53. Rule 102(e)(1)(ii) of the Commission's Rules of practice provides, in pertinent part, that, "[t]he Commission may . . . deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found . . . to have engaged in . . . improper professional conduct."

54. With respect to persons licensed to practice as accountants, such as McCurdy, "improper professional conduct" under Rule 102(e)(1)(ii) includes:

> (A) intentional or knowing conduct, including reckless conduct, that resulted in violation of applicable professional standards; or
>
> (B) negligent conduct, consisting of (1) a single instance of highly unreasonable conduct that resulted in a violation of applicable professional standards in circumstances in which an accountant knows, or should have know, that heightened scrutiny was warranted, or (2) repeated instances of unreasonable conduct by an accountant, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission.

55. The conduct described above constitutes reckless conduct that resulted in a violation of applicable professional standards or at least negligent conduct as defined in Rule 102(e)(1)(iv)(B).

F. FINDINGS

56. Based on the foregoing, the Commission finds that McCurdy engaged in improper professional conduct pursuant to Rule 102(e)(1)(ii) of the Commission's Rules of Practice in connection with the 2001 Liquid Green Audit and the 1999 and 2000 Florida Street Audits.

IV.

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

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

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

B. After 3 years from the date of this order, Respondent may request that the Commission consider his reinstatement by submitting an application (attention: Office of the Chief Accountant) to resume appearing or practicing before the Commission as:

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

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

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

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

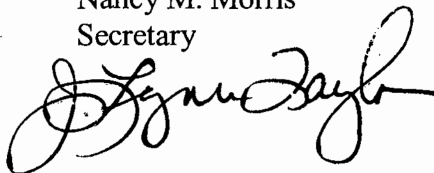
(c) Respondent has resolved all disciplinary issues with the Board, and has complied with all terms and conditions of any sanctions imposed by the Board (other than reinstatement by the Commission); and

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

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

By the Commission.

Nancy M. Morris
Secretary



By: J. Lynn Taylor
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 54954 / December 18, 2006

INVESTMENT ADVISERS ACT OF 1940
Release No. 2572 / December 18, 2006

INVESTMENT COMPANY ACT OF 1940
Release No. 27601 / December 18, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12509

In the Matter of

KAPLAN & CO.
SECURITIES, INC. AND
JED P. KAPLAN,

Respondents.

ORDER INSTITUTING PUBLIC ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTIONS 15(b) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934, SECTIONS 203(e) AND 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940, AND SECTIONS 9(b) AND 9(f) OF THE INVESTMENT COMPANY ACT OF 1940

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), Section 203(e) of the Investment Advisers Act of 1940 ("Advisers Act"), and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Investment Company Act") against Kaplan & Co. Securities, Inc. ("Kaplan & Co.") and pursuant to Sections 15(b) and 21C of the Exchange Act, Section 203(f) of the Advisers Act, and Sections 9(b) and 9(f) of the Investment Company Act against Jed P. Kaplan ("Kaplan"), (collectively referred to as "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

Document 28 of 58

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, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934, Sections 203(e) and 203(f) of the Investment Advisers Act of 1940, and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Order"), as set forth below.

III.

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

Respondents

1. Kaplan & Co., located in Boca Raton, Florida, has been registered with the Commission as a broker-dealer since September 15, 1995 and as an investment adviser since March 21, 2003. As a broker-dealer, Kaplan & Co. conducts retail brokerage business. During the relevant period, Kaplan & Co., through its institutional timing group, assisted institutional investors, mainly hedge funds, in purchasing and redeeming shares of third party mutual funds.

2. Kaplan is, and has been since September 15, 1995, the chief executive officer and control person of Kaplan & Co. Kaplan, 41 years old, is a resident of Boca Raton, Florida.

Overview

3. These proceedings arise out of Respondents' failure reasonably to supervise two former Kaplan & Co. registered representatives, Lawrence S. Powell and Delano N. Sta.Ana, with a view to preventing their violations of the federal securities laws during a three-year period from January 2000 through early September 2003. During that period, Powell and Sta.Ana established and co-headed Kaplan & Co.'s institutional timing group, and defrauded hundreds of mutual funds and their shareholders by engaging in deceptive practices designed to mislead funds as to the identity of Kaplan & Co.'s customers so that Powell and Sta.Ana could circumvent the funds' restrictions on market timing on behalf of Kaplan & Co. institutional customers. Powell and Sta.Ana employed a variety of deceptive acts and practices, including misrepresenting the nature of the trades to mutual funds by using multiple clearing firms, multiple account numbers, multiple representative numbers, and multiple office codes, to hide their customers' identities from the funds to avoid the funds' restrictions on market timing. In addition, Powell and Sta.Ana also engaged in a late-trading scheme that allowed their customers to enter mutual fund share trades based on post-market close news. Through these activities, Powell and Sta.Ana violated the antifraud provisions of the federal securities laws and aided and abetted and caused Kaplan & Co.'s violations of Rule 22c-1 promulgated under Section 22(c) of the Investment Company Act.[1]

---

[1] On January 11, 2005, the Commission instituted and simultaneously settled public administrative and cease-and-desist proceedings against Powell and Sta.Ana finding violations of Section 10(b) of the Exchange Act

4. Kaplan & Co. failed reasonably to supervise Powell and Sta.Ana with a view to preventing and detecting their violations of the federal securities laws. Kaplan & Co. failed to adopt adequate policies and procedures to monitor market timing and late trading so as to prevent and detect the fraudulent conduct described herein. In addition, Kaplan & Co. failed to have a system in place for implementing the limited policies and procedures that did exist.

5. Kaplan, the firm's principal, failed reasonably to supervise Powell and Sta.Ana with a view to preventing and detecting their violations of the federal securities laws. Kaplan delegated supervision of Powell and Sta.Ana to Powell, who held a Series 24 license, but Kaplan did not provide Powell with any specific instructions on how to fulfill the delegated responsibilities, failed to instruct Powell on any compliance or supervisory procedures, failed to train Powell on how to detect or avoid trading abuses, and did not follow-up on his supervisory delegation to Powell. Additionally, Kaplan did not develop adequate policies and procedures, and failed to follow existing policies and procedures to monitor Powell and Sta.Ana's activities. Further, Kaplan was aware that the institutional timing group submitted mutual fund trading orders that were sometimes rejected by mutual funds, and of other events that warranted inquiry, and failed to follow up and investigate these red flags.

6. Kaplan & Co. also violated Rule 22c-1 under the Investment Company Act in its capacity as a dealer in certain mutual fund shares, receiving and executing orders for the purchase of those shares after the 4:00 p.m. ET stock market close.

7. Kaplan & Co. also failed properly to maintain its brokerage business books and records by not maintaining records reflecting the time of entry and execution of mutual fund orders. Kaplan, as the firm's principal, failed to take steps so that Kaplan & Co. made and kept current certain brokerage business books and records that it was required to make and keep current, and was therefore responsible for the firm's failure.

Powell and Sta.Ana's Misconduct

Market Timing

8. Powell and Sta.Ana implemented a fraudulent market timing scheme by effecting timing transactions in mutual funds on behalf of Kaplan & Co.'s institutional timing customers using, as part of the overall scheme, four strategies intended to deceive the mutual funds as to the customers' identities: multiple clearing firms, multiple account numbers, multiple registered representative numbers, and multiple office branch codes. Utilizing multiple clearing firms enabled Kaplan & Co.'s customers to hide their identities from the mutual funds by using the new clearing firm identifiers and account numbers associated with each new clearing firm, thus allowing continued market timing to go undetected. Multiple account numbers allowed the customers to use new accounts to continue their market timing activities after existing accounts had

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and Rule 10b-5 thereunder, causing violations of Section 15(c)(1) of the Exchange Act, and causing violations of Rule 22c-1 of the Investment Company Act. Lawrence S. Powell and Delano N. Sta.Ana, Exch. Act Rel. No. 51017 (Jan. 11, 2005).

been banned for market timing because the mutual funds were misled into believing that the transactions did not originate from banned customers. Multiple registered representative numbers ("rep numbers") concealed the identities of the Kaplan & Co. registered representatives from mutual funds so that the funds could not identify a specific Kaplan & Co. rep number as a known market timer and ban further transactions effected by the registered representative associated with that rep number. Finally, multiple branch codes concealed the identity of the Kaplan & Co. Florida branch as the originating branch of the transactions to allow Kaplan & Co.'s customers to continue market timing in those funds that had previously banned them and Kaplan & Co.'s Florida branch.

Late Trading

9. Powell and Sta.Ana engaged in a fraudulent scheme to late trade mutual fund shares by effecting mutual fund trades for orders received after 4:00 p.m. ET, allowing their customers to receive the same-day net asset value ("NAV") pricing on those trades (as though the orders were received prior to the close of the stock market at 4:00 p.m. ET, the time as of which the funds calculated their NAV). This system allowed Kaplan & Co.'s customers to capitalize on news events or market changes occurring after the 4:00 p.m. ET stock market close. Kaplan & Co. was a dealer in certain mutual fund shares. Powell and Sta.Ana also engaged in the "next-day busting" of orders. On numerous occasions, the institutional timing group effected trades for customers and then called or e-mailed the clearing firm the following morning requesting that they contact the mutual fund and cancel or "bust" the trade. In some instances, the institutional timing group told the clearing firm that the order had been "erroneously entered," when in fact, the customer had simply changed its mind about placing the order.

Kaplan & Co. and Kaplan Failed Reasonably to Supervise Powell and Sta.Ana

10. Kaplan & Co. failed reasonably to supervise Powell and Sta.Ana with a view to preventing their violations of the federal securities laws. In particular, Kaplan & Co. failed to adopt, implement or follow adequate supervisory and compliance policies, procedures or systems which could have detected or prevented Powell and Sta.Ana's securities laws violations.

11. Kaplan & Co. had insufficient systems in place to detect and prevent Powell and Sta.Ana from using fraudulent and deceptive practices to circumvent mutual fund restrictions on market timing. Kaplan & Co.'s Supervisory Procedures Manual ("Procedures Manual") contained policies and procedures concerning the review of customer accounts and firm correspondence; however, Kaplan & Co. had no systems to implement and enforce these policies and procedures. In addition, Kaplan & Co. had insufficient procedures and systems in place to detect and adequately respond to red flags and warnings of improper conduct, namely the numerous communications from mutual funds objecting to or questioning market timing trades. The only language in the Procedures Manual arguably related to mutual fund market timing was a section noting that trading in mutual fund shares, particularly on a short term basis, may raise the question of a rule violation. Notwithstanding this warning, the Procedures Manual contained no procedures for preventing and detecting this activity. Finally, Kaplan & Co. had no procedures to detect and prevent late trading by its employees.

12. Kaplan failed reasonably to supervise Powell and Sta.Ana with a view to preventing their violations of the federal securities laws. During the relevant period, Kaplan was the firm's senior officer with supervisory responsibility over Powell and Sta.Ana. Kaplan did not reasonably delegate his supervisory responsibilities to Powell. Kaplan did not provide Powell with any specific instructions on how to fulfill the delegated responsibilities, failed to instruct Powell on any compliance or supervisory procedures and failed to train Powell on how to detect or avoid trading abuses. Additionally, Kaplan did not follow-up on his supervisory delegation to Powell, and, instead, improperly allowed Powell to supervise himself. Kaplan also failed to develop adequate policies and procedures designed to detect fraudulent market timing and late trading activities and did not follow what few policies and procedures did exist regarding review of correspondence and account statements, which may have detected Powell and Sta.Ana's market timing activities. He failed to periodically review Powell and Sta.Ana's correspondence, including e-mail correspondence, never reviewed the institutional timing group's business and failed to review the firm's mutual fund timing customers' account statements as delineated in the Procedures Manual.

13. In addition, Kaplan knew that some mutual funds had rejected trades from the firm's institutional timing group, and knew that Powell and Sta.Ana had negotiated trading agreements with some mutual funds. He also knew that Powell and Sta.Ana obtained the ability to enter trades after 4:00 p.m. ET. Kaplan failed to adequately respond to these red flags. He did not investigate the reasons for or frequency of the numerous rejected trades and failed to investigate the negotiated agreements. Further, Kaplan never questioned the mutual fund trades that were entered after 4:00 p.m. ET.

14. Kaplan also signed at least one dealer agreement with a distributor of various funds of a mutual fund family, under which Powell and Sta.Ana accepted and executed mutual fund share orders after 4:00 p.m. ET. Kaplan & Co. was a "dealer" under Rule 22c-1 of the Investment Company Act based on the direct agreement between a distributor of various funds of a mutual fund family and Kaplan & Co.

15. Kaplan profited from Powell and Sta.Ana's fraudulent late trading and market timing. The profit was in the form of monies Powell and Sta.Ana's customers paid Kaplan & Co. in asset-based fees.

Kaplan & Co. Violated Rule 22c-1 of the Investment Company Act

16. Kaplan & Co. violated Rule 22c-1 of the Investment company Act because it received and executed orders for the purchase of mutual fund shares after the 4:00 p.m. ET close of the market, and those orders received the pre-4:00 p.m. ET price. Kaplan signed at least one dealer agreement under which Powell and Sta.Ana received and executed mutual fund share orders after 4:00 p.m. ET.

Kaplan & Co. Failed to Properly Maintain Its Books and Records and Kaplan Aided and Abetted in that Failure

17. Kaplan & Co. failed to properly maintain its brokerage business books and

records because the institutional timing group did not create and maintain a memorandum of each brokerage order and other instruction given or received for the purchase or sale of a security for each mutual fund trade, in the format of trade blotters, order tickets, or otherwise. For the time period May 2, 2003 through September 2003, Kaplan & Co. failed to maintain the time of receipt of its institutional mutual fund orders. Kaplan did nothing to ensure that the firm properly maintained its books and records.

Powell and Sta.Ana's Violations

18. As a result of the conduct described above, Powell and Sta.Ana 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, willfully aided and abetted and caused violations of Section 15(c)(1) of the Exchange Act, which prohibits a broker-dealer from using interstate facilities or the mails to effect or induce transactions in securities "by means of any manipulative, deceptive, or other fraudulent device or contrivance," and willfully aided and abetted and caused Kaplan & Co.'s violations of Rule 22c-1 of the Investment Company Act, which prohibits dealers in a fund's securities from effecting a trade in that mutual fund's shares at the current day's NAV if they received the order after the mutual fund calculated that day's NAV.

Kaplan & Co.'s and Kaplan's Violations

Failure to Supervise

19. Section 15(b)(4)(E) of the Exchange Act requires broker-dealers reasonably to supervise persons subject to their supervision, with a view toward preventing violations of the federal securities laws. See e.g., Dean Witter Reynolds, Inc., Exchange Act Rel. No. 46578 (October 1, 2002). The Commission has emphasized that the "responsibility of broker-dealers to supervise their employees by means of effective, established procedures is a critical component in the federal investor protection scheme regulating the securities markets." Id. Section 15(b)(4)(E) of the Exchange Act provides for the imposition of a sanction against a broker or dealer who "has failed reasonably to supervise, with a view to preventing violations of the securities laws, another person who commits such a violation, if such other person is subject to his supervision." Section 15(b)(6)(A)(i) parallels Section 15(b)(4)(E) and provides for the imposition of sanctions against persons associated with a broker or dealer.

20. As a result of the conduct described above, Kaplan & Co. and Kaplan failed reasonably to supervise Powell and Sta.Ana with a view to detecting and preventing their violations of the federal securities laws.

Rule 22c-1 of the Investment Company Act

21. Rule 22c-1 of the Investment Company Act provides that "[n]o registered investment company issuing any redeemable security, no person designated in such issuer's prospectus as authorized to consummate transactions in any such security, and no principal

underwriter of, or dealer in any such security shall sell, redeem, or repurchase any such security except at a price based on the current net asset value of such security which is next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security."

22. As a result of the conduct described above, Kaplan & Co. willfully violated Rule 22c-1 promulgated under Section 22 of the Investment Company Act.

Books and Records

23. Section 17(a)(1) of the Exchange Act provides that each member of a national securities exchange, broker, or dealer "shall make and keep for prescribed periods such records, furnish copies thereof, and make and disseminate such reports as the Commission, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this title." Rule 17a-3(a)(6) requires all registered brokers and dealers to maintain a memorandum, such as a trade blotter, of each brokerage order and other instruction given or received for the purchase or sale of a security. Effective May 2, 2003, the rule specifically requires the broker or dealer to note on the memorandum the time at which it received the order.

24. As a result of the conduct described above, Kaplan & Co. willfully violated, and Kaplan willfully aided and abetted and caused Kaplan & Co.'s violations of, Section 17(a) of the Exchange Act and Rule 17a-3 thereunder.

Undertakings

25. Ongoing Cooperation by Kaplan & Co. Kaplan & Co. undertakes to cooperate fully with the Commission in any and all investigations, litigations or other proceedings relating to or arising from the matters described in this Order. In connection with such cooperation, Kaplan & Co. has undertaken:

A. To produce, without service of a notice or subpoena, any and all documents and other information reasonably requested by the Commission's staff;

B. To use its best efforts to cause its employees to be interviewed by the Commission's staff at such times as the staff reasonably may direct;

C. To use its best efforts to cause its employees to appear and testify truthfully and completely without service of a notice or subpoena in such investigations, depositions, hearings or trials as may be requested by the Commission's staff; and

D. That in connection with any testimony of Kaplan & Co. to be conducted at deposition, hearing or trial pursuant to a notice or subpoena, Kaplan & Co.:

i. Agrees that any such notice or subpoena for Kaplan & Co.'s appearance and testimony may be served by regular mail on its counsel, Ira Lee Sorkin, Esq.,

Dickstein Shapiro Morin & Oshinsky LLP, 1177 Avenue of the Americas, New York, New York 10036-2714; and

ii. Agrees that any such notice or subpoena for Kaplan & Co.'s appearance and testimony in an action pending in a United States District Court may be served, and may require testimony, beyond the territorial limits imposed by the Federal Rules of Civil Procedure.

26. Ongoing Cooperation by Kaplan. Kaplan undertakes to cooperate fully with the Commission in any and all investigations, litigations or other proceedings relating to or arising from the matters described in this Order. In connection with such cooperation, Kaplan has undertaken:

A. To produce, without service of a notice or subpoena, any and all documents and other information reasonably requested by the Commission's staff;

B. To be interviewed by the Commission's staff at such times as the staff reasonably may request and to appear and testify truthfully and completely without service of a notice or subpoena in such investigations, depositions, hearings or trials as may be requested by the Commission's staff; and

C. That in connection with any testimony of Kaplan to be conducted at deposition, hearing or trial pursuant to a notice or subpoena, Kaplan:

i. Agrees that any such notice or subpoena for his appearance and testimony may be served by regular mail on his counsel, Ira Lee Sorkin, Esq., Dickstein Shapiro Morin & Oshinsky LLP, 1177 Avenue of the Americas, New York, New York 10036-2714; and

ii. Agrees that any such notice or subpoena for his appearance and testimony in an action pending in a United States District Court may be served, and may require testimony, beyond the territorial limits imposed by the Federal Rules of Civil Procedure.

27. Independent Compliance Consultant. Kaplan & Co. undertakes to, within 30 days of the issuance of the Order, hire an independent compliance consultant ("Consultant"), not unacceptable to the Commission staff, to review and evaluate the effectiveness of Kaplan & Co.'s supervisory and compliance systems, policies and procedures designed to detect and prevent violations of the federal securities laws concerning: (1) review of incoming and outgoing correspondence, including electronic correspondence such as e-mail; (2) mutual fund market timing activity; (3) mutual fund late trading activity; and (4) supervision of branch offices. In connection with the hiring of the Consultant, Kaplan & Co. undertakes the following:

A. The Consultant's expenses shall be borne exclusively by Kaplan & Co. Kaplan & Co. shall cooperate fully with the Consultant and shall provide the Consultant with access to its files, books, records, and personnel as reasonably requested for the review. Kaplan & Co. shall cause the review to begin no later than 60 days after the issuance of this Order.

B. At the conclusion of the review, which in no event shall be more than 120 days after the date of this Order, Kaplan & Co. shall cause the Consultant to submit to Kaplan & Co. and to the Commission's staff a written Initial Report. The Initial Report shall describe the review performed and the conclusions reached, and will include any recommendations deemed necessary to make the policies, procedures, and system of supervision and compliance adequate.

C. Within 30 days of receipt of the Initial Report, Kaplan & Co. shall in writing respond to the Initial Report. In such response, Kaplan & Co. shall advise the Consultant and the Commission's staff of the recommendations from the Initial Report that it has determined to accept and the recommendations that it considers to be unduly burdensome. With respect to any recommendation that Kaplan & Co. deems unduly burdensome, Kaplan & Co. may propose an alternative policy, procedure or system designed to achieve the same objective or purpose.

D. Kaplan & Co. and the Consultant shall attempt in good faith to reach agreement within 180 days of the date of this Order with respect to any recommendation that Kaplan & Co. deems unduly burdensome. If the Consultant and Kaplan & Co. are unable to agree on an alternative proposal, Kaplan & Co. shall abide by the recommendation of the Consultant.

E. Within 200 days of the date of this Order, Kaplan & Co. shall, in writing, advise the Consultant and the Commission's staff of the recommendations and proposals that it is adopting.

F. Kaplan & Co. shall cause the Consultant to complete the aforementioned review and submit a written Final Report to Kaplan & Co. and to the Commission's staff within 230 days of the date of this Order. The Final Report shall recite the efforts the Consultant undertook to review Kaplan & Co.'s supervisory and compliance policies, procedures, and systems as set forth in paragraph 27; set forth its conclusions and recommendations; and describe how Kaplan & Co. is implementing those recommendations.

G. Kaplan & Co. shall take all necessary and appropriate steps to adopt and implement all recommendations contained in the Consultant's Final Report.

H. No later than one year after the date of the Consultant's Final Report, Kaplan & Co. shall cause the Consultant to conduct a follow-up review of Kaplan & Co.'s efforts to implement the recommendations contained in the Final Report, and Kaplan & Co. shall cause the Consultant to submit a follow-up report to the Commission's staff. The follow-up report shall set forth the details of Kaplan & Co.'s efforts to implement the recommendations contained in the Final Report, and shall state whether Kaplan & Co. has fully complied with the recommendations in the Final Report.

I. For good cause shown, and upon receipt of a timely application from the Consultant or Kaplan & Co., the Commission's staff may extend any of the procedural dates set forth above.

J. To ensure the independence of the Consultant, Kaplan & Co.: (a) shall not

have the authority to terminate the Consultant without the prior written approval of the Commission's staff; (b) shall compensate the Consultant, and persons engaged to assist the Consultant, for services rendered pursuant to this Order at their reasonable and customary rates; (c) shall not be in and shall not have an attorney-client relationship with the Consultant and shall not seek to invoke the attorney-client or any other privilege or doctrine to prevent the Consultant from transmitting any information, reports, or documents to the Commission staff; and (d) during the period of engagement and for a period of two years after the engagement, shall not enter into any employment, customer, consultant, attorney-client, auditing, or other professional relationship with the Consultant.

K. Kaplan & Co. shall cause 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 Kaplan & Co., or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity. 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 performance of his/her duties under this Order shall not, without prior written consent of the Southeast Regional Office Commission staff, enter into any employment, consultant, attorney-client, auditing or other professional relationship with Kaplan & Co., 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.

28. Kaplan's Agreement to Re-take the Series 24 License Examination. Kaplan shall re-take the Series 24 License Examination within nine months of the issuance of this Order.

29. Kaplan's Provision of Affidavit. Kaplan shall provide to the Commission, within 30 days after the end of the nine-month suspension period described below, an affidavit that he has complied fully with the sanctions described in Section IV.E. below.

IV.

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

Accordingly, pursuant to Sections 15(b) and 21C of the Exchange Act, Sections 203(e) and 203(f) of the Advisers Act, and Sections 9(b) and 9(f) of the Investment Company Act, it is hereby ORDERED that:

A. Kaplan & Co. shall cease and desist from committing or causing any violations and any future violations of Rule 22c-1 under the Investment Company Act;

B. Kaplan & Co. shall cease and desist from committing or causing any violations and any future violations of Section 17(a)(1) of the Exchange Act and Rule 17a-3 thereunder;

C. Kaplan shall cease and desist from causing any violations and any future violations of Section 17(a)(1) of the Exchange Act and Rule 17a-3 thereunder;

D. Kaplan & Co. and Kaplan are hereby censured;

E. Kaplan shall be, and hereby is, suspended from association in a supervisory capacity with any broker, dealer or investment adviser for a period of nine months, effective on the second Monday following the entry of this Order;

F. IT IS FURTHER ORDERED that Respondents Kaplan & Co. and Kaplan shall pay, jointly and severally, within 10 days of the entry of this Order, disgorgement of $46,521.60 and prejudgment interest of $3,478.40, for a total amount of $50,000, to the United States Treasury. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Kaplan & Co. and Kaplan as Respondents in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Glenn S. Gordon, Associate Regional Director, Division of Enforcement, Securities and Exchange Commission, Southeast Regional Office, 801 Brickell Avenue, 18th Floor, Miami, Florida 33131; and

G. IT IS FURTHER ORDERED that Respondent Kaplan & Co. shall, within 10 days of the entry of this Order, pay a civil money penalty in the amount of $50,000 to the United States Treasury. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Kaplan & Co. as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Glenn S. Gordon, Associate Regional Director, Division of Enforcement, Securities and Exchange Commission, Southeast Regional Office, 801 Brickell Avenue, 18th Floor, Miami, Florida 33131.

H. IT IS FURTHER ORDERED that Respondent Kaplan shall, within 10 days of the entry of this Order, pay a civil money penalty in the amount of $50,000 to the United States Treasury. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Kaplan as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Glenn S. Gordon, Associate Regional Director, Division of Enforcement,

Securities and Exchange Commission, Southeast Regional Office, 801 Brickell Avenue, 18th Floor, Miami, Florida 33131.

I. Kaplan & Co. shall comply with the undertaking specified in Paragraph 27 above.

J. Kaplan shall comply with the undertaking specified in Paragraph 29 above.

By the Commission.

Nancy M. Morris
Secretary

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

FEDERAL RESERVE SYSTEM

12 CFR Part 218

[Regulation R; Docket No. R-1274]

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 240 and 247

[Release No. 34-54946; File No. S7-22-06]

RIN 3235-AJ74

DEFINITIONS OF TERMS AND EXEMPTIONS RELATING TO THE "BROKER" EXCEPTIONS FOR BANKS

AGENCIES: Board of Governors of the Federal Reserve System ("Board") and Securities and Exchange Commission ("SEC" or "Commission") (collectively, the Agencies).

ACTION: Proposed rule.

SUMMARY: The Board and the Commission jointly are issuing, and requesting comment on, proposed rules that would implement certain of the exceptions for banks from the definition of the term "broker" under Section 3(a)(4) of the Securities Exchange Act of 1934 ("Exchange Act"), as amended by the Gramm-Leach-Bliley Act ("GLBA"). The proposed rules would define terms used in these statutory exceptions and include certain related exemptions. In developing this proposal, the Agencies have consulted with the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC") and the Office of Thrift Supervision ("OTS"). The proposal is intended, among other things, to facilitate banks' compliance with the GLBA.

DATES: Comments should be received on or before [INSERT DATE 90 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER].

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ADDRESSES:

BOARD: You may submit comments, identified by Docket No. R-1274, by any of the following methods:

- Board's Web site: http://www.federalreserve.gov. Follow the instructions for submitting comments at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm.
- Federal eRulemaking Portal: http//www.regulations.gov. Follow the instructions for submitting comments.
- E-mail: regs.comments@federalreserve.gov. Include docket number in the subject line of the message.
- Fax: (202) 452-3819 or (202) 452-3102.
- Mail: Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW, Washington, DC 20551.

All public comments are available from the Board's Web site at www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm as submitted, unless modified for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments also may be viewed electronically or in paper form in Room MP-500 of the Board's Martin Building (C and 20th Streets, NW) between 9:00 a.m. and 5:00 p.m. on weekdays.

SEC: Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml); or

- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-22-06 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-22-06. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (http://www.sec.gov/rules/proposed.shtml). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549. All comments received will be posted without change; 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:

BOARD: Kieran J. Fallon, Assistant General Counsel, (202) 452-5270, Andrew Miller, Counsel, (202) 452-3428, or Andrea Tokheim, Senior Attorney, (202) 452-2300, Legal Division, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW, Washington, DC 20551. Users of Telecommunication Device for Deaf (TTD) only, call (202) 263-4869.

SEC: Catherine McGuire, Chief Counsel, Linda Stamp Sundberg, Senior Special Counsel, Richard C. Strasser, Attorney Fellow, John Fahey, Special Counsel, Haimera Workie, Special Counsel, at (202) 551-5550, Office of the Chief Counsel, Division of

Market Regulation, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

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I. Introduction and Background

The GLBA amended several federal statutes governing the activities and supervision of banks, bank holding companies, and their affiliates.[1] Among other things, it lowered barriers between the banking and securities industries erected by the Banking Act of 1933 ("Glass-Steagall Act").[2] It also altered the way in which the supervisory responsibilities over the banking, securities, and insurance industries are allocated among financial regulators. Among other things, the GLBA repealed most of the separation of investment and commercial banking imposed by the Glass-Steagall Act. The GLBA also revised the provisions of the Exchange Act that had completely excluded banks from broker-dealer registration requirements.

In enacting the GLBA, Congress adopted functional regulation for bank securities activities, with certain exceptions from Commission oversight for specified securities activities. With respect to the definition of "broker," the Exchange Act, as amended by the GLBA, provides eleven specific exceptions for banks.[3] Each of these exceptions permits a bank to act as an agent with respect to specified securities products or in transactions that meet specific statutory conditions.

In particular, Section 3(a)(4)(B) of the Exchange Act provides conditional exceptions from the definition of broker for banks that engage in certain securities activities in connection with third-party brokerage arrangements;[4] trust and fiduciary

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[1] Pub. L. No. 106-102, 113 Stat. 1338 (1999).

[2] Pub. L. No. 73-66, ch. 89, 48 Stat. 162 (1933) (as codified in various Sections of 12 U.S.C.).

[3] 15 U.S.C. 78c(a)(4).

[4] Exchange Act Section 3(a)(4)(B)(i). This exception permits banks to enter into third-party brokerage, or "networking" arrangements with brokers under specific conditions.

activities;[5] permissible securities transactions;[6] certain stock purchase plans;[7] sweep accounts;[8] affiliate transactions;[9] private securities offerings;[10] safekeeping and custody activities;[11] identified banking products;[12] municipal securities;[13] and a de minimis number of other securities transactions.[14]

On October 13, 2006, President Bush signed into law the "Financial Services Regulatory Relief Act of 2006 ("Regulatory Relief Act")."[15] Among other things, the Regulatory Relief Act requires that the SEC and the Board jointly adopt a single set of

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5 Exchange Act Section 3(a)(4)(B)(ii). This exception permits banks to effect transactions as trustees or fiduciaries for securities customers under specific conditions.

6 Exchange Act Section 3(a)(4)(B)(iii). This exception permits banks to buy and sell commercial paper, bankers' acceptances, commercial bills, exempted securities, certain Canadian government obligations, and Brady bonds.

7 Exchange Act Section 3(a)(4)(B)(iv). This exception permits banks, as part of their transfer agency activities, to effect transactions for certain issuer plans.

8 Exchange Act Section 3(a)(4)(B)(v). This exception permits banks to sweep funds into no-load money market funds.

9 Exchange Act Section 3(a)(4)(B)(vi). This exception permits banks to effect transactions for affiliates, other than broker-dealers.

10 Exchange Act Section 3(a)(4)(B)(vii). This exception permits certain banks to effect transactions in certain privately placed securities, under certain conditions.

11 Exchange Act Section 3(a)(4)(B)(viii). This exception permits banks to engage in certain enumerated safekeeping or custody activities, including stock lending as custodian.

12 Exchange Act Section 3(a)(4)(B)(ix). This exception permits banks to buy and sell certain "identified banking products," as defined in Section 206 of the GLBA.

13 Exchange Act Section 3(a)(4)(B)(x). This exception permits banks to effect transactions in municipal securities.

14 Exchange Act Section 3(a)(4)(B)(xi). This exception permits banks to effect up to 500 transactions in securities in any calendar year in addition to transactions referred to in the other exceptions.

15 Pub. L. No. 109-351, 120 Stat. 1966 (2006).

rules to implement the bank broker exceptions in Section 3(a)(4) of the Exchange Act.[16] It also requires that not later than 180 days after the date of enactment of the Regulatory Relief Act, the SEC and the Board jointly issue a single set of proposed rules to implement these exceptions.

Section 401 of the Regulatory Relief Act also amended the definition of "bank" in Section 3(a)(6) of the Exchange Act to include any Federal savings association or other savings association the deposits of which are insured by the FDIC. Accordingly, as used in this proposal, the term "bank" includes any savings association that qualifies as a "bank" under Section 3(a)(6) of the Exchange Act, as amended.

In accordance with these statutory provisions, the SEC and Board are jointly requesting comment on proposed rules to implement the broker exceptions for banks relating to third-party networking arrangements, trust and fiduciary activities, sweep activities, and safekeeping and custody activities.[17] The proposed rules include certain exemptions related to these activities, as well as exemptions related to foreign securities transactions, securities lending transactions conducted in an agency capacity, the execution of transactions involving mutual fund shares, the potential liability of banks under Section 29 of the Exchange Act, and the date on which the GLB Act's "broker"

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16 See Exchange Act Section 3(a)(4)(F), as added by Section 101 of the Regulatory Relief Act. The Regulatory Relief Act also requires that the Board and SEC consult with, and seek the concurrence of, the OCC, FDIC and OTS prior to jointly adopting final rules. As noted above, the Board and the SEC also have consulted extensively with the OCC, FDIC and OTS in developing these joint proposed rules.

17 See 15 U.S.C. 78c(a)(4)(B)(i), (ii), (v) and (viii).

exceptions for banks will go into effect.[18] The proposed rules are designed to accommodate the business practices of banks and protect investors.

Any additions or changes to these rules that may be appropriate to implement Section 3(a)(4)(B) of the Exchange Act will be adopted jointly by the SEC and Board in accordance with the consultation provisions in Section 101(b) of the Regulatory Relief Act. Identical sets of the final rules will be published by the SEC in Title 17 of the Code of Federal Regulations and by the Board in Title 12 of the Code of Federal Regulations.

In developing this proposal, the Agencies considered, among other things, the language and legislative history of the "broker" exceptions for banks adopted in the GLBA, the rules previously issued or proposed by the Commission relating to these exceptions and the comments received in connection with those prior rulemakings. The Agencies request comment on all aspects of these proposals as well as on the specific provisions and issues identified below. In addition, the Agencies request comment on whether it would be useful or appropriate for the Agencies to adopt rules implementing the other bank "broker" exceptions in Section 3(a)(4)(B) of the Exchange Act that are not addressed in this proposal. If any rules (including exemptions) related to these other exceptions are adopted in the future, they would be adopted jointly by the SEC and Board.

As required by the GLBA, the Board, OCC, FDIC, and OTS (collectively, the Banking Agencies) will develop, and request public comment on, recordkeeping rules for banks that operate under the "broker" exceptions in Section 3(a)(4) of the Exchange

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[18] Employees of a bank that operates in accordance with the exceptions in Section 3(a)(4)(B) of the Exchange Act and, where applicable, the proposed rules also shall not be required to register as a "broker" to the extent that the employees' activities are covered by the relevant exception or rule.

Act.[19] These rules, which will be developed in consultation with the SEC, will establish recordkeeping requirements to enable banks to demonstrate compliance with the terms of the statutory exceptions and the final rules ultimately jointly adopted and that are designed to facilitate compliance with the statutory exceptions and those rules.

II. Networking Arrangements

The third-party brokerage ("networking") exception in Exchange Act Section 3(a)(4)(B)(i) permits a bank to avoid being considered a broker if, under certain conditions, it enters into a contractual or other written arrangement with a registered broker-dealer under which the broker-dealer offers brokerage services to bank customers ("networking arrangement").[20] The networking exception does not address the type or amount of compensation that a bank may receive from its broker-dealer partner under a networking arrangement. However, the networking exception generally provides that a bank may not pay its unregistered employees[21] incentive compensation for referring a customer to the broker-dealer or for any securities transaction conducted by the customer at the broker-dealer. Nevertheless, the statutory exception does permit a bank employee to receive a "nominal one-time cash fee of a fixed dollar amount" for referring bank customers to the broker-dealer if payment of the referral fee is not "contingent on whether the referral results in a transaction."[22] Congress included the limitation on

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[19] See 12 U.S.C. 1828(t)(1).

[20] 15 U.S.C. 78c(a)(4)(B)(i).

[21] An unregistered bank employee is an employee that is not an associated person of a broker or dealer and is not qualified pursuant to the rules of a self-regulatory organization.

[22] 15 U.S.C. 78c(a)(4)(B)(i)(VI).

incentive compensation to reduce securities sales practice concerns regarding unregistered bank employees.[23]

A. Proposed Definitions Related to the Payment of Referral Fees

The proposed rules define certain terms used in the networking exception in the Exchange Act related to referral fees and terms used in these proposed definitions. The proposed rules also provide an exemption from certain of the requirements in the networking exception with respect to payment for referrals of certain institutional customers and high net worth customers.

1. Proposed Definition of "Nominal One-Time Cash Fee of a Fixed Dollar Amount"

Under the proposal, the term "nominal one-time cash fee of a fixed dollar amount" would be defined as a cash payment for a referral in an amount that meets any one of three alternative standards.[24] The Agencies believe that these alternatives provide useful and appropriate flexibility to banks of all sizes and locations to use different business models and to take into account economic differences around the country in assessing whether a cash referral fee paid in a particular instance is a "nominal" amount for purposes of the networking exception. The three alternatives are consistent with the statutory "nominal" fee requirement because the amount of compensation permitted under each of the three formulations would be small in relation to the employee's overall compensation and therefore unlikely to create undue incentives for bank employees to pre-sell securities to bank customers.

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23 See H.R. Rep. No. 106-74, pt. 3, at 163 (1999) ("[T]he conditions contained in the networking exception . . . restrict the securities activities of unregistered bank personnel to reduce sales practice concerns.").

24 Proposed Exchange Act Rule 700(c).

Under the first alternative, a referral fee would be considered nominal if it did not exceed either twice the average of the minimum and maximum hourly wage established by the bank for the current or prior year for the job family that includes the relevant employee, or 1/1000th of the average of the minimum and maximum annual base salary established by the bank for the current or prior year for the job family that includes the relevant employee.[25] The proposed rules define a "job family" for these purposes as a group of jobs or positions involving similar responsibilities, or requiring similar skills, education or training, that a bank, or a separate unit, branch or department of a bank, has established and uses in the ordinary course of its business to distinguish among its employees for purposes of hiring, promotion, and compensation.[26] Depending on a bank's internal employee classification system, examples of a job family may include tellers, loan officers, or branch managers. A bank should not deviate from its ordinary classification of jobs for purposes of determining whether a referral fee would be considered nominal under this standard.

Under the second alternative, a referral fee would be considered "nominal" if it did not exceed twice the employee's actual base hourly wage.[27] Thus, unlike the first option, this alternative is based on the actual hourly base wage of the employee receiving the referral fee.

Under the third alternative, a referral fee would be considered "nominal" for purposes of the networking exception if the payment did not exceed twenty-five dollars

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25 Proposed Exchange Act Rule 700(c)(1).

26 Proposed Exchange Act Rule 700(d).

27 Proposed Exchange Act Rule 700(c)(2).

($25).[28] This dollar amount would be adjusted for inflation on April 1, 2012, and every five years thereafter, to reflect any changes in the value of the Employment Cost Index For Wages and Salaries, Private Industry Workers (or any successor index thereto), as published by the Bureau of Labor Statistics, from December 31, 2006.[29] The Agencies selected this index because it is a widely used and broad indicator of increases in the wages of private industry workers, which includes bank employees.

A bank employee may receive a referral fee under the networking exception and Proposed Exchange Act Rule 700 for each referral made to a broker-dealer, including separate referrals of the same individual or entity. Referral fees paid under the networking exception must be paid in cash and fixed. The networking exception and the proposed rules do not permit a bank to pay referral fees in non-cash forms, such as vacation packages, stock grants, annual leave, or consumer goods.[30] We request comments on whether these alternatives provide banks sufficient flexibility to pay nominal referral fees without creating inappropriate incentives.

2. Proposed Definition of "Contingent on Whether the Referral Results in a Transaction"

Under the statutory networking exception, a nominal fee paid to an unregistered bank employee for referring a customer to a broker or dealer may not be contingent on whether the referral results in a transaction. The objective is to reward bank employees for furthering the relationship with the broker without creating concerns about the

28 Proposed Exchange Act Rule 700(c)(3).

29 Each adjustment would be rounded to the nearest multiple of $1. Proposed Exchange Act Rule 700(f).

30 See Exchange Act Section 3(a)(4)(B)(i)(VI), permitting payment of a "nominal one-time cash fee."

securities sales practices of unregistered bank employees. Under the proposal, a fee would be considered "contingent on whether the referral results in a transaction" if payment of the fee is dependent on whether the referral results in a purchase or sale of a security; whether an account is opened with a broker or dealer; whether the referral results in a transaction involving a particular type of security; or whether the referral results in multiple securities transactions.[31] The proposed rules, however, also recognize that a referral fee may be contingent on whether a customer (1) contacts or keeps an appointment with a broker or dealer as a result of the referral; or (2) meets any objective, base-line qualification criteria established by the bank or broker or dealer for customer referrals, including such criteria as minimum assets, net worth, income, or marginal federal or state income tax rate, or any requirement for citizenship or residency that the broker or dealer, or the bank, may have established generally for referrals for securities brokerage accounts.[32]

3. Proposed Definition of "Incentive Compensation"

As noted above, the networking exception prohibits unregistered employees of a bank that refer customers to a broker or dealer under the exception from receiving "incentive compensation" for the referral or any securities transaction conducted by the customer at the broker-dealer other than a nominal, non-contingent referral fee. To provide banks and their employees additional guidance in this area, Proposed Rule 700(b) defines "incentive compensation" as compensation that is intended to encourage a bank

[31] Proposed Exchange Act Rule 700(a). "Referral" would be defined to mean the action taken by a bank employee to direct a customer of the bank to a broker or dealer for the purchase or sale of securities for the customer's account. Proposed Exchange Act Rule 700(e).

[32] Proposed Exchange Act Rule 700(a).

employee to refer potential customers to a broker or dealer or give a bank employee an interest in the success of a securities transaction at a broker or dealer.[33]

The proposed "incentive compensation" definition excludes certain types of bonus compensation. The purpose of the exclusions is to recognize that certain types of bonuses are not likely to give unregistered employees a promotional interest in the brokerage services offered by the broker-dealers with which the bank networks and to avoid affecting bonus plans of banks generally. The proposal excludes compensation paid by a bank under a bonus or similar plan that is paid on a discretionary basis and based on multiple factors or variables. These factors or variables must include significant factors or variables that are not related to securities transactions at the broker or dealer.[34] In addition, a referral made by the employee to a broker or dealer may not be a factor or variable in determining the employee's compensation under the plan and the employee's compensation under the plan may not be determined by reference to referrals made by any other person.[35]

In addition, the proposed rule provides that the definition of incentive compensation shall not be construed to prevent a bank from compensating an officer, director or employee on the basis of any measure of the overall profitability of (1) the

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33 Proposed Exchange Act Rule 700(b).

34 Proposed Exchange Act Rule 700(b)(1)(ii)(A). A non-securities factor or variable would be considered "significant" under this proposed provision if it plays a non-trivial role in determining an employee's compensation under the bonus or similar plan. Moreover, a bank would not be in compliance with this proposed provision to the extent that it established or maintained a "sham" non-securities factor or variable in its bonus or similar plan for the purpose of evading this proposed restriction.

35 Proposed Exchange Act Rule 700(b)(1)(ii)(C) and (D). The requirement that an employee's compensation not be based on "a referral" made by the employee or another person also means that the employee's compensation under the bonus or similar plan may not vary based on the number of securities referrals made by the employee or another person to a broker or dealer.

bank, either on a stand-alone or consolidated basis; (2) any of the bank's affiliates (other than a broker or dealer) or operating units; or (3) a broker or dealer if such profitability is only one of multiple factors or variables used to determine the compensation of the officer, director, or employee and those factors or variables include significant factors or variables that are not related to the profitability of the broker or dealer.[36] Under this definition, banks would be permitted to take account of the full range of business for high net worth or institutional customers that an employee has brought to the bank and its partner broker-dealers. Comment is solicited on whether existing bank bonus programs would fit, or could be easily adjusted to fit, within the proposed exclusions from the definition of incentive compensation discussed in this Section.

B. Proposed Exemption for Payment of More than a Nominal Fee for Referring Institutional Customers and High Net Worth Customers

The proposal also includes a conditional exemption that would permit a bank to pay an employee a contingent referral fee of more than a nominal amount for referring to a broker or dealer an institutional customer or high net worth customer with which the bank has a contractual or other written networking arrangement.[37] Banks that pay their employees only nominal, non-contingent fees in accordance with Proposed Rule 700 for referring customers—including institutional or high net worth customers—to a broker or dealer would not need to rely on this exemption for these purposes.

The purpose of the proposed exemption and its conditions is to recognize that sizable institutions and high net worth individuals, when provided appropriate information, are more likely to be able to understand and evaluate the relationship

[36] Proposed Exchange Act Rule 700(b)(2).

[37] Proposed Exchange Act Rule 701.

between the bank and its employees and its broker-dealer partner and any resulting securities transaction with the broker-dealer. To take advantage of the proposed exemption, the bank must comply with the conditions in the proposed exemption as well as the terms and conditions in the statutory networking exception (other than the compensation restrictions in Section 3(a)(4)(B)(i)(VI) of the Exchange Act's networking exception). The conditions in the proposed exemption are designed, among other things, to help ensure that institutional and high net worth customers receive appropriate investor protections and have the information to understand the financial interest of the bank employee so they can make informed choices. The following summarizes the conditions included in the proposed exemption.

1. Definitions of "Institutional Customer" and "High Net Worth Customer"

The proposed exemption defines an "institutional customer" to mean any corporation, partnership, limited liability company, trust, or other non-natural person that has at least $10 million in investments or $40 million in assets. A non-natural person also may qualify as an "institutional customer" with respect to a referral if the customer has $25 million in assets and the bank employee refers the customer to the broker or dealer for investment banking services.[38] The lower asset threshold for referrals for

[38] Proposed Exchange Act Rule 701(d)(2). "Investment banking services" are defined to include, without limitation; acting as an underwriter in an offering for an issuer, acting as a financial adviser in a merger, acquisition, tender-offer or similar transaction, providing venture capital, equity lines of credit, private investment-private equity transactions or similar investments, serving as placement agent for an issuer, and engaging in similar activities. Id. at 701(d)(3). When used in this proposal, the term "include, without limitation" means a non-exhaustive list. This usage is not intended to suggest that the term "including" as used in the Exchange Act and the rules under that Act means an exhaustive list. The use of the term "including, but not limited to" in Exchange Act Rules 10b-10 and 15b7-1 is also not intended to create a negative implication regarding the use of "including" without the term "but not limited to" in other Exchange Act rules. See Exchange Act Release No. 49879, 69 FR 39682 (June 30, 2004), at footnote 76.

investment banking services is designed to permit banks to facilitate access to capital markets by referring smaller businesses to broker-dealers. "High net worth customer" is defined to mean any natural person who, either individually or jointly with his or her spouse, has at least $5 million in net worth excluding the primary residence and associated liabilities of the person and, if applicable, his or her spouse.

The dollar amount threshold for both institutional customers and high net worth customers would be adjusted for inflation on April 1, 2012, and every five years thereafter, to reflect changes in the value of the Personal Consumption Expenditures Chain-Type Price Index, as published by the Department of Commerce, from December 21, 2006. The Agencies selected this index because it is a widely used and broad indicator of inflation in the U.S. economy.

A bank would be required to determine that a non-natural person referred to a broker or dealer under the exemption is an institutional customer before the referral fee is paid to the bank employee. In the case of a customer that is a natural person, the bank, prior to or at the time of any referral, would be required either to (1) determine that the customer is a high net worth customer; or (2) obtain a signed acknowledgment from the customer that the customer meets the standards to be considered a high net worth customer. The purpose of this condition is to provide the bank with a reasonable basis to believe the person meets the requirements of the exemption.[39]

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[39] Proposed Exchange Act Rule 701(a)(2)(ii). As discussed below (see infra at II.B.4.), the written agreement between the bank and the broker or dealer also must require the broker or dealer to determine whether a customer meets these qualification standards before the referral fee is paid to the bank employee.

2. Conditions Relating to Bank Employees

For a bank employee to receive a contingent or greater-than-nominal referral fee under the proposed exemption, the bank employee must meet other conditions designed to help ensure that the referral occurs in the ordinary course of the unregistered bank employee's activities and that the employee has not previously been disqualified under the Exchange Act. In particular, the bank employee--

- May not be qualified or otherwise required to be qualified pursuant to the rules of a self-regulatory organization ("SRO");[40]
- Must be predominantly engaged in banking activities other than making referrals to a broker-dealer;[41]
- Must not be subject to a "statutory disqualification" as that term is defined in Section 3(a)(39) of the Exchange Act (other than subparagraph (E) of that Section);[42] and
- Must encounter the "high net worth customer" or "institutional customer" in the ordinary course of the bank employee's assigned duties for the bank.[43]

3. Other Conditions Relating to the Banks

The proposed exemption also would require that the bank provide the high net worth customer or institutional customer being referred to the bank's broker-dealer partner certain written disclosures about the employee's interest in the referral prior to or

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40 Proposed Exchange Act Rule 701(a)(1)(i)(A).

41 Proposed Exchange Act Rule 701(a)(1)(i)(B).

42 Proposed Exchange Act Rule 701(a)(1)(i)(C).

43 Proposed Exchange Act Rule 701(a)(1)(ii).

at the time of the referral.[44] These disclosures would have to clearly and conspicuously disclose (1) the name of the broker or dealer; and (2) that the bank employee participates in an incentive compensation program under which the employee may receive a fee of more than a nominal amount for referring the customer to the broker or dealer and that payment of the fee may be contingent on whether the referral results in a transaction with the broker or dealer.[45]

In addition, to allow verification before the referral fee is paid to the bank employee, the bank would be required to provide the broker or dealer the name of the employee and such other identifying information that may be necessary for the broker or dealer to determine whether the bank employee is associated with a broker or dealer or is subject to statutory disqualification (as defined in Section 3(a)(39) of the Exchange Act, other than subparagraph (E)).[46]

The proposed exemption also provides that a bank that acts in good faith and that has reasonable policies and procedures in place to comply with the requirements of the proposed exemption would not be considered a "broker" under Section 3(a)(4) of the Exchange Act solely because the bank fails, in a particular instance, to determine that a customer is an institutional or high net worth customer, provide the customer the required disclosures, or provide the broker or dealer the required information concerning the bank employee receiving the referral fee within the time periods prescribed. If the bank is seeking to comply and takes reasonable and prompt steps to remedy the error, such as by

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[44] Proposed Exchange Act Rule 701(a)(2)(i).

[45] Proposed Exchange Act Rule 701(b).

[46] Proposed Exchange Act Rule 701(a)(2)(iii).

promptly making the required determination or promptly providing the broker or dealer the required information, the bank should not lose the exemption from registration in these circumstances. Similarly, to promote compliance with the terms of the exemption, the bank must make reasonable efforts to reclaim the portion of the referral fee paid to the bank employee for a referral that does not, following any required remedial actions, meet the requirements of the exemption and that exceeds the amount the bank otherwise would be permitted to pay under the statutory networking exception and proposed Exchange Act Rule 700.[47]

4. Provisions of Written Agreement

The proposed exemption also would require that the bank and its broker-dealer partner include certain provisions in their written agreement that obligate the bank or the broker or dealer to take certain actions. These provisions are designed to help ensure that banks and broker-dealers operate within the terms of the exemption and provide appropriate protections to customers referred under the exemption. Banks, brokers and dealers are expected to comply with the terms of their written networking agreements. If a broker or dealer or bank does not comply with the terms of the agreement, however, the bank would not become a "broker" under Section 3(a)(4) of the Exchange Act or lose its ability to operate under the proposed exemption.[48] A bank should not be required to register as a result of the actions of the broker or dealer.

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47 Proposed Exchange Act Rule 701(a)(2)(iv).

48 The Commission anticipates that it will be necessary for either NASD or the Commission to adopt a rule requiring broker-dealers to comply with the written agreements discussed in this Section.

a. Customer and Employee Qualifications

First, the proposed exemption provides that the written agreement between the bank and the broker or dealer must provide for the bank and the broker-dealer to determine, before a referral fee is paid to a bank employee under the exemption, that the employee is not subject to statutory disqualification, as that term is defined in Section 3(a)(39) of the Exchange Act (other than subparagraph (E) of that Section). In addition, as noted above, the written agreement must provide for the broker-dealer to determine, before the referral fee is paid, that the customer being referred is an institutional or high net worth customer.[49]

b. Suitability or Sophistication Analysis by Broker-Dealer

As a method of providing additional investor protections, the proposed exemption requires that the written agreement between the bank and broker or dealer must provide for the broker or dealer to perform a suitability or sophistication analysis of a securities transaction or the customer being referred, respectively. The type and timing of the analysis needed to be conducted by the broker or dealer depends on whether the referral fee is contingent on the completion of a securities transaction at the broker or dealer.

For contingent fees, the written agreement between the bank and the broker-dealer must provide for the broker or dealer to conduct a suitability analysis of any securities transaction that triggers any portion of the contingency fee in accordance with the rules of the broker's or dealer's applicable SRO as if the broker or dealer had recommended the

[49] Proposed Exchange Act Rule 701(a)(3)(i).

securities transaction.[50] This analysis must be performed by the broker or dealer before each securities transaction on which the referral fee is contingent is conducted.

For a non-contingent referral fee, the written agreement must provide for the broker or dealer to conduct, before the referral fee is paid, either (1) a "sophistication" analysis of the customer being referred; or (2) a suitability analysis with respect to all securities transactions requested by the customer contemporaneously with the referral. Under the "sophistication" analysis option, the broker or dealer would be required to determine that the customer has the capability to evaluate investment risk and make independent decisions, and determine that the customer is exercising independent judgment based on the customer's own independent assessment of the opportunities and risks presented by a potential investment, market factors, and other investment considerations.[51] This "sophistication" analysis is based on elements of NASD IM-2310-3 (Suitability Obligations to Institutional Customers).

Alternatively, the broker or dealer could perform a suitability analysis of all securities transactions requested by the customer contemporaneously with the referral in accordance with the rules of the broker's or dealer's applicable SRO as if the broker or dealer had recommended the securities transaction.[52] Thus, the proposed exemption gives a broker or dealer the flexibility to perform a suitability analysis in connection with all

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50 Proposed Exchange Act Rule 701(a)(3)(ii)(A). Because the proposed exemption provides for a broker or dealer to conduct its suitability analysis in accordance with the rules of its applicable SRO, the broker or dealer may follow and take advantage of any applicable SRO rules or interpretations that allow the broker or dealer to make an alternative suitability evaluation. See, e.g., NASD IM-2310-3 (discussing a member's suitability obligations with respect to certain institutional investors).

51 Proposed Exchange Act Rule 701(a)(3)(ii)(B)(1).

52 Proposed Exchange Act Rule 701(a)(3)(ii)(B)(2).

referrals made under the exemption (regardless of whether the referral fee is contingent or not) if the broker or dealer determines that such an approach is appropriate for business reasons.

c. Notice from Broker-Dealer to Bank Regarding Customer Qualification

Under the proposed exemption, the written agreement between the bank and the broker-dealer would also be required to provide that the broker-dealer must promptly inform the bank if the broker-dealer determines that (1) the customer referred to the broker-dealer is not a "high net worth customer" or an "institutional customer," as applicable; (2) the bank employee receiving the referral fee is subject to statutory disqualification, as that term is defined in Section 3(a)(39) of the Exchange Act, except subparagraph (E) of that Section; or (3) the customer or the securities transaction(s) to be conducted by the customer do not meet the applicable standard set forth in the suitability or sophistication determination Section above.[53] The notice will help banks monitor their compliance with the exemption and take remedial action when necessary.

5. Referral Fees Permitted under the Exemption

If the foregoing conditions are met, the proposed exemption would allow a bank employee to receive a referral fee for referring an institutional or high net worth customer to a broker or dealer that is greater than a "nominal" amount and that is contingent on whether the referral results in a transaction at the broker or dealer. The exemption places certain limits on how such a referral fee may be structured to reduce the potential "salesman's stake" of the bank employee in securities transactions conducted at the broker-dealer. Specifically, the exemption provides that the referral fee may be a dollar

[53] Proposed Exchange Act Rule 701(a)(3)(iii).

amount based on a fixed percentage of the revenues received by the broker or dealer for investment banking services provided to the customer.[54]

Alternatively, the referral fee may be a predetermined dollar amount, or a dollar amount determined in accordance with a predetermined formula, so long as the amount does not vary based on (1) the revenue generated by, or the profitability of, securities transactions conducted by the customer with the broker or dealer; (2) the quantity, price, or identity of securities purchased or sold over time by the customer with the broker or dealer; or (3) the number of customer referrals made.[55] For these purposes, "predetermined" means established or fixed before the referral is made.

As the exemption provides, these restrictions do not prevent a referral fee from being paid in multiple installments or from being based on a fixed percentage of the total dollar amount of assets placed in an account with the broker or dealer. Additionally, these restrictions do not prevent a referral fee from being based on the total dollar amount of assets maintained by the customer with the broker or dealer, or from being contingent on whether the customer opens an account with the broker or dealer or executes one or more transactions in the account during the initial phases of the account. A bank employee also may receive a permissible referral fee for each referral made under the exemption. We request comment on all aspects of the definition of a referral fee.

6. Permissible Bonus Compensation Not Restricted

The proposed exemption for high net worth and institutional customers expressly provides that nothing in the exemption would prevent or prohibit a bank from paying, or

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[54] Proposed Exchange Act Rule 701(d)(4)(ii).

[55] Proposed Exchange Act Rule 701(d)(4)(i).

a bank employee from receiving, any type of compensation under a bonus or similar plan that would not be considered incentive compensation under paragraph (b)(1), or that is described in paragraph (b)(2), of proposed Exchange Act Rule 700 (implementing the networking exception).[56] As explained above, these types of bonus arrangements do not tend to create the kind of financial incentives for bank employees that the statute was designed to address.

C. Scope of Networking Exception and Institutional/High Net Worth Exemption

Nothing in the statutory networking exception or the proposed rules limits or restricts the ability of a bank employee to refer customers to other departments or divisions of the bank itself, including, for example, the bank's trust, fiduciary or custodial department. Likewise, the networking exception and the proposed rules do not apply to referrals of retail, institutional or high net worth customers to a broker or dealer or other third party solely for transactions not involving securities, such as loans, futures contracts (other than a security future), foreign currency, or over-the-counter commodities.

III. Trust and Fiduciary Activities Exception

Section 3(a)(4)(B)(ii) of the Exchange Act (the "trust and fiduciary exception") permits a bank, under certain conditions, to effect securities transactions in a trustee or fiduciary capacity without being registered as a broker.[57] Under this exception from the definition of "broker," a bank must effect such transactions in its trust department, or other department that is regularly examined by bank examiners for compliance with

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[56] Proposed Exchange Act Rule 701(c).

[57] 15 U.S.C. 78c(a)(4)(B)(ii).

fiduciary principles and standards.[58] The bank also must be "chiefly compensated" for such transactions, consistent with fiduciary principles and standards, on the basis of: (1) an administration or annual fee; (2) a percentage of assets under management; (3) a flat or capped per order processing fee that does not exceed the cost the bank incurs in executing such securities transactions; or (4) any combination of such fees.[59] These fees are referred to as "relationship compensation" in the proposed rules.

Banks relying on this exception may not publicly solicit brokerage business, other than by advertising that they effect transactions in securities in conjunction with advertising their other trust activities.[60] In addition, a bank that effects a transaction in the United States of a publicly traded security under the exception must execute the transaction in accordance with Exchange Act Section 3(a)(4)(C).[61]

This Section requires that the bank direct the trade to a registered broker-dealer for execution, effect the trade through a cross trade or substantially similar trade either within the bank or between the bank and an affiliated fiduciary that is not in contravention of fiduciary principles established under applicable federal or state law, or effect the trade in some other manner that the Commission permits.[62] The purpose of the

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58 Id. The Agencies will rely on the appropriate Federal banking agency for a bank to determine whether the bank's activities are conducted in the bank's trust department or other department regularly examined by the agency's examiners for compliance with fiduciary principles and standards.

59 15 U.S.C. 78c(a)(4)(B)(ii)(I).

60 15 U.S.C. 78c(a)(4)(B)(ii)(II).

61 15 U.S.C. 78c(a)(4)(C).

62 15 U.S.C. 78c(a)(4)(C)(i) - (iii). As discussed below (see infra at VI.C.), the Agencies are proposing to adopt a rule that would permit banks to effect trades in investment company securities through the National Securities Clearing Corporation's Mutual Fund Services ("Fund/SERV") or directly with the investment company's transfer agent. Trades effected by a

rules in this area is to explain the Agencies' interpretation of certain terms and concepts used in the statute and to implement the exception. The trust and fiduciary exception recognizes the traditional securities role banks have performed for trust and fiduciary customers and includes conditions to help ensure that a bank does not operate a securities broker in the trust department.

A. "Chiefly Compensated" Test and Bank-Wide Exemption Based on Two-Year Rolling Averages

The proposed rules provide that a bank meets the "chiefly compensated" condition in the trust and fiduciary exception if the "relationship-total compensation percentage" for each trust or fiduciary account of the bank is greater than 50 percent.[63] The "relationship-total compensation percentage" for a trust or fiduciary account would be calculated by (1) dividing the relationship compensation attributable to the account during each of the immediately preceding two years by the total compensation attributable to the account during the relevant year; (2) translating the quotient obtained for each of the two years into a percentage; and (3) then averaging the percentages obtained for each of the two immediately preceding years.[64] Under the proposal, a "trust or fiduciary account" means an account for which the bank acts in a trustee or fiduciary capacity as defined in Section 3(a)(4)(D) of the Exchange Act.[65]

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bank in accordance with the proposed Fund/SERV rule would be conducted in accordance with Section 3(a)(4)(C) of the Exchange Act.

63 Proposed Exchange Act Rule 721(a)(1).

64 The rule provides for this process to be accomplished by calculating the "yearly compensation percentage" and the "relationship-total compensation percentage" for the account. Proposed Exchange Act Rule 721(a)(2) and (3).

65 Proposed Exchange Act Rule 721(a)(5). The definition of "fiduciary capacity" included in Section 3(a)(4)(D) of the Exchange Act is based on the definition of that term in part 9 of the OCC's regulations, which relates to the trust and fiduciary activities of national banks, in effect at the time of enactment of the GLB Act.

The proposed rules also include an exemption that would permit a bank to follow an alternate test to the account-by-account approach to the "chiefly compensated" condition. Under this exemption, the bank may calculate the compensation it receives from all of its trust and fiduciary accounts on a bank-wide basis. The alternative is designed to simplify compliance, alleviate concerns about inadvertent noncompliance, and reduce the costs and disruptions banks likely would incur under the account-by-account approach.

To use this bank-wide methodology, the bank would have to meet two conditions. First, the bank would have to comply with the conditions in the trust and fiduciary exception (other than the compensation test in Section 3(a)(4)(B)(ii)(I)) and comply with Section 3(a)(4)(C) (relating to trade execution) of the Exchange Act.[66] In addition, the "aggregate relationship-total compensation percentage" for the bank's trust and fiduciary business as a whole would have to be at least 70 percent.[67] We chose this percentage to ensure that a bank's trust department is not unduly dependent on non-relationship compensation from securities transactions. We invite comments generally on the appropriateness of the proposed exemption as well as this percentage and the other specific terms of the exemption.

The "aggregate relationship-total compensation percentage" of a bank operating under the bank-wide approach would be calculated in a similar manner as the "relationship-total compensation percentage" of an account under the account-by-account, except that the calculations would be based on the aggregate relationship

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[66] Proposed Exchange Act Rule 722(a)(1).

[67] Proposed Exchange Act Rule 722(a)(2).

compensation and total compensation received by the bank from all of its trust and fiduciary accounts during each of the two immediately preceding years. That is, it would be determined by (1) dividing the relationship compensation attributable to the bank's trust and fiduciary business as a whole during each of the immediately preceding two years by the total compensation attributable to the bank's trust and fiduciary business as a whole during the relevant year; (2) translating the quotient obtained for each of the two years into a percentage; and (3) then averaging the percentages obtained for each of the two immediately preceding years.[68]

Under either the account-by-account or bank-wide approach, a bank would have the flexibility to elect to use a calendar year or the bank's fiscal year for purposes of complying with these compensation provisions.[69] In addition, whether a bank decides to use the account-by-account approach or the bank-wide approach, the bank's compliance with the relevant compensation restriction would be based on a two-year rolling average of the compensation attributable to the trust or fiduciary account or the bank's trust or fiduciary business, respectively. This is to allow for short-term fluctuations that otherwise could lead a bank to fall out of compliance with the exception or exemption from year to year.

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[68] As a technical matter, the rule provides for this process to be accomplished by calculating the "yearly bank-wide compensation percentage" and the "aggregate relationship-total compensation percentage" for the bank's trust and fiduciary business as a whole. Proposed Exchange Act Rule 722(b) and (c).

[69] Proposed Exchange Act Rule 721(a)(6).

B. Proposed Definition of "Relationship Compensation"

Both the account-by-account and bank-wide approaches discussed above are based in part on the relationship compensation attributable to one or more of a bank's trust or fiduciary accounts. The proposal defines the term "relationship compensation" to mean any compensation a bank receives that consists of (1) an administration fee; (2) an annual fee (payable on a monthly, quarterly or other basis); (3) a fee based on a percentage of assets under management; (4) a flat or capped per order processing fee, paid by or on behalf of a customer or beneficiary, that is equal to not more than the cost incurred by the bank in connection with executing securities transactions for trust or fiduciary accounts; or (5) any combination of these fees.[70] These types of compensation are identified in the statute.

The proposed rules also provide examples of fees that would be considered an administration fee or a fee based on a percentage of assets under management for these purposes. Specifically, the rule provides that a fee based on a percentage of assets under management (an "AUM fee") includes, without limitation—

- A fee paid by an investment company pursuant to a plan under 17 CFR 270.12b-1. Although Rule 12b-1 fees are related to mutual funds, we believe they should be viewed as relationship compensation because they are paid on an assets under management basis, rather than on a transactional basis;[71]

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70 Proposed Exchange Act Rule 721(a)(4).

71 Proposed Exchange Act Rule 721(a)(4)(iii)(A).

- A fee paid by an investment company for personal service or the maintenance of shareholder accounts;[72] and
- A fee paid by an investment company based on a percentage of assets under management for any of the following services: (1) providing transfer agent or sub-transfer agent services for the beneficial owners of investment company shares; (2) aggregating and processing purchase and redemption orders for investment company shares; (3) providing the beneficial owners with account statements showing their purchases, sales, and positions in the investment company; (4) processing dividend payments to the account for the investment company; (5) providing sub-accounting services to the investment company for shares held beneficially in the account; (6) forwarding communications from the investment company to the beneficial owners, including proxies, shareholder reports, dividend and tax notices, and updated prospectuses; or (7) receiving, tabulating, and transmitting proxies executed by the beneficial owners of investment company shares in the account.[73]

In addition, the rule provides that the term "administration fee" includes, without limitation—

- A fee paid for personal services, tax preparation, or real estate settlement services; and

[72] Proposed Exchange Act Rule 721(a)(4)(iii)(B).

[73] Proposed Exchange Act Rule 721(a)(4)(iii)(C).

- A fee paid by an investment company for personal service, the maintenance of shareholder accounts or the types of sub-transfer agent or other services described above.[74]

The examples of an administration fee and an asset under management fee included in the proposed rules are provided only for illustrative purposes. Other types of fees or fees for other types of services could be an administration fee or an AUM fee. In addition, an administration fee, annual fee or AUM fee attributable to a trust or fiduciary account is considered relationship compensation regardless of what entity or person pays the fee, and regardless of whether the fee is related to only securities assets, to a combination of securities and non-securities assets, or to only non-securities assets. These fees are part of the compensation for acting as a trustee or fiduciary.

Under the proposal, relationship compensation also would include a flat or capped per order processing fee, paid by (or on behalf of) a customer or beneficiary, that is equal to not more than the cost incurred by the bank in connection with executing securities transactions for trust or fiduciary accounts.[75] If a bank seeks to include within this per order processing fee any fixed or variable processing costs incurred by the bank beyond those charged by the executing broker or dealer, the bank should maintain appropriate policies and procedures governing the allocation of these costs to the orders processed for

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74 Proposed Exchange Act Rule 721(a)(4)(i). To the extent these fees are paid by an investment company based on a percentage of assets under management, these fees would be a permissible AUM fee.

75 Proposed Exchange Act Rule 721(a)(4)(iv).

trust or fiduciary customers.[76] This should help ensure that profits derived from per trade charges are not masked as costs of processing the trades.

C. Advertising Restrictions

Section 3(a)(4)(B)(ii)(II) of the Exchange Act addresses advertisements and the proposed rules explain the Agencies' understanding of the terms used in the statute. The proposed rules provide that a bank complies with the advertising restriction if advertisements by or on behalf of the bank do not advertise that the bank provides securities brokerage services for trust or fiduciary accounts except as part of advertising the bank's broader trust or fiduciary services, and do not advertise the securities brokerage services provided by the bank to trust or fiduciary accounts more prominently than the other aspects of the trust or fiduciary services provided to such accounts.[77]

An "advertisement" for these purposes means any material that is published or used in any electronic or other public media, including any Web site, newspaper, magazine or other periodical, radio, television, telephone or tape recording, videotape display, signs or billboards, motion pictures, blast e-mail, or telephone directories (other than routine listings).[78] Other types of material or information that is not distributed

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76 A bank effecting transactions for trust or fiduciary customers through its trust or fiduciary departments may use other divisions or departments of the bank, or other affiliated or unaffiliated third parties, to handle aspects of these transactions. The bank must continue to act in a trustee or fiduciary capacity with respect to the account and, accordingly, should exercise appropriate diligence in selecting persons to provide services to the bank's trust or fiduciary customers and in overseeing the services provided in accordance with the bank's fiduciary obligations. No party, other than the bank (including, without limitation, a transfer agent or investment adviser), working in conjunction with the bank may rely on the bank's exception or exemption from "broker" status. To the extent that any such third party performs activities that would make that entity a broker under Section 3(a)(4) of the Exchange Act that entity would be required to register as a broker (in the absence of an applicable exemption or regulatory relief) notwithstanding any written or unwritten agreement the third party may have with the bank.

77 Proposed Exchange Act Rule 721(b).

78 Proposed Exchange Act Rule 721(b)(2) (referencing Proposed Exchange Act Rule 760(g)(2)).

through public media would not be considered an advertisement. In addition, in considering whether an advertisement advertises the securities brokerage services provided to trust or fiduciary customers more prominently than the bank's other trust or fiduciary services, the nature, context and prominence of the information presented—and not simply the length of text or information devoted to a particular subject—should be considered.

D. Proposed Exemptions for Special Accounts, Transferred Accounts, and a De Minimis Number of Accounts

The proposed rules also would permit a bank to exclude certain types of accounts for purposes of determining its compliance with the account-by-account or bank-wide compensation tests discussed above. These exclusions are intended to reduce administrative burdens and facilitate compliance in connection with accounts that do not present a pronounced risk that a bank is operating a securities broker within the trust department. We solicit comment on these exclusions and their specific proposed terms.

Under the proposal, a bank could, in determining its compliance with either the account-by-account or bank-wide compensation tests, exclude any trust or fiduciary account that had been open for a period of less than 3 months during the relevant year.[79] The proposal would also permit a bank to exclude, for purposes of determining its compliance with either of these compensation tests, any trust or fiduciary account that the bank acquired from another person as part of a merger, consolidation, acquisition, purchase of assets or similar transaction by the bank for 12 months after the date the bank acquired the account from the other person.[80] Of course, in excluding such accounts, the

79 Proposed Exchange Act Rule 723(a).

80 Proposed Exchange Act Rule 723(b).

bank would have to exclude all compensation it receives from such accounts from the relationship compensation to total compensation comparison. This approach would allow a bank to bring into compliance a group of acquired accounts.

Two additional exemptions would be provided for banks using the account-by-account approach. Specifically, a bank that uses the account-by-account approach would not be considered a broker for purposes of Section 3(a)(4) of the Exchange Act solely because a particular trust or fiduciary account does not meet the "chiefly compensated" test if, within 3 months of the end of the year in which the account fails to meet such standard, the bank transfers the account or the securities held by or on behalf of the account to a registered broker-dealer or another unaffiliated entity (such as an unaffiliated bank) that is not required to be registered as a broker or dealer.[81]

Moreover, a bank using the account-by-account approach could exclude a small number of trust or fiduciary accounts not exceeding the lesser of (1) 1 percent of the total number of trust or fiduciary accounts held by the bank provided that if the number so obtained is less than 1, the amount would be rounded up to 1; or (2) 500.[82] To rely on this exemption with respect to an account, the bank must not have relied on this exemption for such account during the immediately preceding year.[83] In addition, the bank would be required to maintain records demonstrating that the securities transactions conducted by

[81] Proposed Exchange Act Rule 723(c).

[82] Proposed Exchange Act Rule 723(d).

[83] Proposed Exchange Act Rule 723(d)(3).

or on behalf of the excluded account were undertaken by the bank in the exercise of its trust or fiduciary responsibilities with respect to the account.[84]

IV. Sweep Accounts and Transactions in Money Market Funds

Exchange Act Section 3(a)(4)(B)(v) excepts a bank from the definition of "broker" to the extent it "effects transactions as part of a program for the investment or re-investment of deposit funds into any no-load, open-end management investment company registered under the Investment Company Act that holds itself out as a money market fund."[85]

A. Proposed Sweep Account Definitions

To provide banks with guidance on the sweep accounts exception, the proposal defines various terms under the exception. One key term is "no-load." Under the proposal, no-load, in the context of an investment company or the securities it issues, means that the securities are part of a class or series in which a bank effects transactions that is not subject to a sales charge or a deferred sales charge. In addition, total charges against net assets of that class or series of securities for sales or sales promotion expenses, personal service, or the maintenance of shareholder accounts may not exceed 0.0025 of average net assets annually.[86]

Consistent with NASD rules,[87] under the proposed no-load definition, charges for the following would not be considered charges against net assets of a class or series of an

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[84] Proposed Exchange Act Rule 723(d)(1).

[85] See Exchange Act Section 3(a)(4)(B)(v).

[86] Proposed Exchange Act Rule 740(c).

[87] See NASD Rule 2830.

investment company's securities for sales or sales promotion expenses, personal service, or the maintenance of shareholder accounts:

(1) Providing transfer agent or sub-transfer agent services for beneficial owners of investment company shares;

(2) Aggregating and processing purchase and redemption orders for investment company shares;

(3) Providing beneficial owners with account statements showing their purchases, sales, and positions in the investment company;

(4) Processing dividend payments for the investment company;

(5) Providing sub-accounting services to the investment company for shares held beneficially;

(6) Forwarding communications from the investment company to the beneficial owners, including proxies, shareholder reports, dividend and tax notices, and updated prospectuses; or

(7) Receiving, tabulating, and transmitting proxies executed by beneficial owners of investment company shares.[88]

B. Proposed Exemption Regarding Money Market Fund Transactions

The proposal also includes a new exemption that would permit banks, without registering as a broker, to effect transactions on behalf of a customer in securities issued by a money market fund under certain conditions.[89] This proposed exemption recognizes that banks have long offered sweeps and other services that invest customer funds in

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[88] Proposed Exchange Act Rule 740(c)(2).

[89] Proposed Exchange Act Rule 741.

money market funds that do not qualify as no-load funds under Commission and NASD rules. In particular, to qualify for the proposed exemption from broker registration, the bank would be required to provide the customer, directly or indirectly, any other product or service, the provision of which would not, in and of itself, require the bank to register as a broker or dealer under Section 15(a) of the Exchange Act.[90] In addition, the class or series of money market fund securities that the bank provides the customer either would have to be no-load, or, if it is not no-load, the bank could not characterize or refer to the class or series of securities as no-load. For securities that are not no-load, the bank would be required to provide the customer, not later than at the time the customer authorizes the bank to effect the transactions, a prospectus for the securities.[91]

V. Safekeeping and Custody

A. Overview of Statutory Exception

Section 3(a)(4)(B)(viii) of the Exchange Act provides banks with an exception from the "broker" definition for certain bank custody and safekeeping activities ("custody and safekeeping exception"). In particular, this provision allows a bank to perform the following activities if performed as part of its customary banking activities without registering as a "broker":

- Providing safekeeping or custody services with respect to securities, including the exercise of warrants and other rights on behalf of customers;

90 Proposed Exchange Act Rule 741(a)(1).

91 Proposed Exchange Act Rule 741(a)(2)(ii)(A).

- Facilitating the transfer of funds or securities, as a custodian or a clearing agency, in connection with the clearance and settlement of its customers' transactions in securities;
- Effecting securities lending or borrowing transactions with or on behalf of customers as part of the above-described custodial services or investing cash collateral pledged in connection with such transactions;
- Holding securities pledged by a customer to another person or securities subject to purchase or resale agreements involving a customer, or facilitating the pledging or transfer of such securities by book entry or as otherwise provided under applicable law, if the bank maintains records separately identifying the securities and the customer; and
- Serving as a custodian or provider of other related administrative services to any individual retirement account, pension, retirement, profit sharing, bonus, thrift savings, incentive, or other similar benefit plan.[92]

B. Proposed Exemption

The proposed rules contain an exemption that allows banks, subject to certain conditions, to accept orders for securities transactions from employee benefit plan accounts and individual retirement and similar accounts for which the bank acts as a custodian.[93] In addition, the exemption allows banks, subject to certain conditions, to accept orders for securities transactions on an accommodation basis from other types of

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[92] 15 U.S.C. 78c(a)(4)(B)(viii).

[93] Proposed Exchange Act Rule 760(a).

custodial accounts.[94] These proposed exemptions are intended to allow a bank to perform the types of securities order-taking activities at times conducted in a custody department subject to conditions and limitations to protect investors and prevent a bank from using the exemptions to operate a securities broker in the bank.

The Agencies seek comment on all aspects of the proposed exemptions, including the conditions they contain. The proposed rules do not contain other rules to implement the custody and safekeeping exception. The Agencies request comment on whether other rules in this area are appropriate or needed.

A bank would have no need to rely on the custody exemption to the extent the bank conducts other custodial activities permitted by Section 3(a)(4)(B)(viii) (e.g., exercising warrants or other rights with respect to securities or effecting securities lending or borrowing transactions on behalf of custodial customers) or another of the proposed rules (e.g., proposed Exchange Act Rule 772, which permits banks to effect securities lending or borrowing transactions on behalf of certain non-custodial customers). In addition, a bank would not have to rely on the proposed exemption to the extent the bank holds securities in custody for a customer and provides clearance and settlement services to the account in connection with such securities, but the bank does not accept orders for securities transactions for the account or engage in other activities with respect to the account that would require the bank to be registered as a broker. The following discusses the scope and terms of the proposed custody exemption.

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[94] Proposed Exchange Act Rule 760(b).

1. Employee Benefit Plan Accounts and Individual Retirement or Similar Accounts

Under the proposed exemption, a bank would not be considered a broker for purposes of Section 3(a)(4) of the Exchange Act to the extent that, as part of its customary banking activities, the bank accepts orders to effect transactions in securities in an "employee benefit plan account"[95] or an "individual retirement account or similar account"[96] for which the bank acts as a custodian if the bank complies with the following.

a. Employee Compensation Restriction

The proposed custody exemption provides that, if a bank accepts securities orders for an employee benefit plan or individual retirement or similar account under the exemption, then no bank employee may receive compensation (including a fee paid pursuant to a 12b-1 plan) from the bank, the executing broker or dealer, or any other person that is based on (1) whether a securities transaction is executed for the account; or

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[95] "Employee benefit plan account" would mean a pension plan, retirement plan, profit sharing plan, bonus plan, thrift savings plan, incentive plan, or other similar plan, including, without limitation, an employer-sponsored plan qualified under Section 401(a) of the Internal Revenue Code (26 U.S.C. 401(a)), a governmental or other plan described in Section 457 of the Internal Revenue Code (26 U.S.C. 457), a tax-deferred plan described in Section 403(b) of the Internal Revenue Code (26 U.S.C. 403(b)), a church plan, governmental, multiemployer or other plan described in Section 414(d), (e) or (f) of the Internal Revenue Code (26 U.S.C. 414(d), (e) or (f)), an incentive stock option plan described in Section 422 of the Internal Revenue Code (26 U.S.C. 422); a Voluntary Employee Beneficiary Association Plan described in Section 501(c)(9) of the Internal Revenue Code (26 U.S.C. 501(c)(9)), a non-qualified deferred compensation plan (including a rabbi or secular trust), a supplemental or mirror plan, and a supplemental unemployment benefit plan.

[96] "Individual retirement account or similar account" would mean an individual retirement account as defined in Section 408 of the Internal Revenue Code (26 U.S.C. 408), Roth IRA as defined in Section 408A of the Internal Revenue Code (26 U.S.C. 408A), health savings account as defined in Section 223(d) of the Internal Revenue Code (26 U.S.C. 223(d)), Archer medical savings accounts as defined in Section 220(d) of the Internal Revenue Code (26 U.S.C. 220(d)), Coverdell education savings account as defined in Section 530 of the Internal Revenue Code (26 U.S.C. 530), or other similar account.

(2) the quantity, price, or identity of the securities purchased or sold by the account.[97] These proposed restrictions, which we believe are consistent with banking practices, are intended to reduce the financial incentives a bank employee might have to encourage a customer to submit securities orders to the bank and use a custody account as the functional equivalent of a securities brokerage account. They do not prohibit a bank employee from receiving compensation that is based on whether a customer establishes a custodial account with the bank, or that is based on the total amount of assets in a custodial account at account opening or at any other time.

The proposed custody exemption also expressly provides that these employee compensation restrictions do not prevent a bank employee from receiving payments under a bonus or similar plan that would be permissible under proposed Exchange Act Rule 700(b)(1) of the networking rules as if a referral had been made, or any profitability-based compensation described in proposed Exchange Act Rule 700(b)(2) of the networking rules. In addition, because these restrictions relate to securities transactions conducted in the relevant custody account, they would not prevent a bank employee from receiving a referral fee for referring the customer to a broker or dealer to engage in securities transactions at the broker-dealer that are unrelated to the custody account in accordance with the networking exception or the institutional customer and high net worth customer exemption (proposed Exchange Act Rule 701) for networking arrangements.

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[97] Proposed Exchange Act Rule 760(c).

b. Advertisements and Sales Literature

The proposed custody exemption provides that a bank relying on the exemption may not advertise that it accepts orders for securities transactions for employee benefit plan accounts or individual retirement accounts or similar accounts for which the bank acts as custodian, except as part of advertising the other custodial or safekeeping services the bank provides to these accounts. In addition, the bank may not advertise that such accounts are securities brokerage accounts or that the bank's safekeeping and custody services substitute for a securities brokerage account.[98] With respect only to individual retirement or similar accounts, advertisements and sales literature issued by or on behalf of the bank may not describe the securities order-taking services provided by the bank to these accounts more prominently than the other aspects of the custody or safekeeping services the bank provides.[99] The purpose of these restrictions is similar to the purpose of the advertising rules in the trust and fiduciary exception.

c. Other Conditions

The proposed custody exemption provides that a bank may accept orders for a securities transaction for an employee benefit plan account or an individual retirement account or similar account only if (1) the bank does not act in a trustee or fiduciary

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[98] Proposed Exchange Act Rule 760(a)(2)(i) and (ii). As discussed above, the proposed rules define the term "advertisement" to mean material that is published or used in any electronic or other public media, including any Web site, newspaper, magazine or other periodical, radio, television, telephone or tape recording, videotape display, signs or billboards, motion pictures, or telephone directories (other than routine listings). Proposed Exchange Act Rule 760(g)(2).

[99] Proposed Exchange Act Rule 760(a)(3). "Sales literature" would mean any written or electronic communication, other than an advertisement, that is generally distributed or made generally available to customers of the bank or the public, including circulars, form letters, brochures, telemarketing scripts, seminar texts, published articles, and press releases concerning the bank's products or services. Proposed Exchange Act Rule 760(g)(5).

capacity (as defined in Section 3(a)(4)(D) of the Exchange Act) with respect to that account; (2) the bank complies with Section 3(a)(4)(C) of the Exchange Act in handling any order for a securities transaction for the account;[100] and (3) the bank complies with Section 3(a)(4)(B)(viii)(II) of the Exchange Act relating to carrying broker activities.[101]

d. Non-Fiduciary and Non-Custodial Administrators or Recordkeepers

The proposed exemption also would allow a bank that acts as a non-fiduciary and non-custodial administrator or recordkeeper for an employee benefit plan to accept securities orders for the plan if the bank and the custodian bank comply with all the conditions discussed in Sections V.B.1.a, b and c above and, in addition, the administrator/recordkeeper bank does not execute a cross-trade with or for the employee benefit plan or net orders for securities for the plan, other than orders for shares of open-end investment companies not traded on an exchange.[102] Executing cross-trades involves setting prices for securities transactions. The Agencies request comment on whether these conditions are consistent with the existing practices of banks acting as non-fiduciary and non-custodial administrators or recordkeepers.

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[100] 15 U.S.C. 78c(a)(4)(C). This provision provides that, to meet one of the exceptions from the "broker" definition under the Exchange Act one of three conditions with respect to transactions effected under the applicable Section must be satisfied. In particular, the bank must direct such trade to a registered broker-dealer for execution. In the alternative, the trade must be a cross trade or other substantially similar trade of a security that is made by the bank or between the bank and an affiliated fiduciary and is not in contravention of fiduciary principles established under applicable Federal or State law. Alternatively, the trade must be conducted in some other manner permitted under rules, regulations, or orders as the Commission may prescribe or issue.

[101] 15 U.S.C. 78c(a)(4)(B)(viii)(II). This provision prohibits a custodian bank from acting as a carrying broker (as such term, and different formulations thereof, are used in Exchange Act Section 15(c)(3) and the rules and regulations under that Section) for any broker or dealer, unless such carrying broker activities are engaged in with respect to government securities.

[102] Proposed Exchange Act Rule 760(e).

2. Accommodation Transactions

Besides accepting securities orders for employee benefit plan and individual retirement and similar custodial accounts, banks also accept securities orders for other custodial accounts as an accommodation to the customer. The proposed custody exemption allows banks to continue to provide these order-taking services to other custodial accounts, subject to certain conditions designed to help ensure that these services continue to be provided only as an accommodation to customers and that a bank does not operate a securities broker out of its custody department. These conditions are discussed below.

a. Accommodation Basis

The proposed custody exemption expressly provides that a bank may accept securities orders for other custodial accounts only as an accommodation to the customer.[103] The Banking Agencies will develop guidance to assist Banking Agency examiners in reviewing, as part of the agencies' ongoing supervisory and examination process, the order-taking services provided to other custodial accounts. This guidance will describe the types of policies, procedures and systems that a bank should have in place to help ensure that the bank accepts securities orders for other custodial accounts only as an accommodation to the customer and in a manner consistent with both the terms and purposes of the custody exemption and the GLB Act.

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[103] Proposed Exchange Rule Act 760(b)(1).

b. Employee Compensation Restriction

In order for a bank to rely on the custody exemption to accept orders for custodial accounts on an accommodation basis, the bank must comply with the employee compensation restrictions described above in Section B.1.a that apply with respect to employee benefit plans and individual retirement and similar accounts.[104]

c. Bank Fees

The proposed exemption also expressly limits the types of fees a bank that accepts accommodation orders for an account may charge for effecting securities transactions for the account. Specifically, any fee charged or received by the bank for effecting a securities transaction for the account may not vary based on (1) whether the bank accepted the order for the transaction; or (2) the quantity or price of the securities to be bought or sold.[105] These restrictions do not prevent a bank from charging or receiving a fee that is based on the type of security purchased or sold by the account (e.g., a foreign security), provided the fee complies with the conditions set forth in the proposed exemption.

d. Advertising and Sales Literature Restrictions

Under the proposed exemption, the bank's advertisements may not state that the bank accepts orders for securities transactions for a custodial account (other than an employee benefit plan or individual retirement account or similar account). In addition, the bank's sales literature (1) may state that the bank accepts securities orders for such an account only as part of describing the other custodial or safekeeping services the bank

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[104] Proposed Exchange Act Rule 760(b)(2) and (c).

[105] Proposed Exchange Act Rule 760(b)(3).

provides to the account; and (2) may not describe the securities order-taking services provided to such an account more prominently than the other aspects of the custody or safekeeping services provided by the bank to the account.[106]

e. Investment Advice or Recommendations

Under the proposed exemption, a bank that accepts securities orders for a custodial account on an accommodation basis would not be permitted to provide investment advice or research concerning securities to the account, make recommendations concerning securities to the account, or otherwise solicit securities transactions from the account. These restrictions would not, however, prohibit the bank from advertising its custodial services and disseminating sales literature that comply with the restrictions in the proposed exemption. These restrictions also would not prevent a bank employee from responding to customer inquiries regarding the bank's safekeeping and custody services by providing advertisements or sales literature describing the safekeeping, custody and related services the bank offers (provided those advertisement and sales literature comply with the restrictions in the proposed exemption), a prospectus prepared by a registered investment company, sales literature prepared by a registered investment company or by the broker or dealer that is the principal underwriter of the registered investment company pertaining to the registered investment company's products, or information based on any of those materials. Moreover, the proposed exemption allows a bank's employees to respond to customer inquiries concerning the bank's safekeeping, custodial or other services, such as inquiries concerning the customer's account or the availability of sweep or other services, so long as the bank does

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106 Proposed Exchange Act Rule 760(b)(4) and (5).

not provide investment advice or research concerning securities to the account or make a recommendation to the account concerning securities.

The limitations and restrictions discussed in this part V.B.2, including those relating to investment advice and recommendations, relate only to those custodial accounts for which the bank accepts securities orders on an accommodation basis. Thus, for example, these limitations would not apply to (1) an employee benefit plan account or an individual retirement account or similar account; or (2) a trust or fiduciary account maintained by a customer with a bank even if that customer also maintains a custodial account with the bank. Similarly, the custody exemption does not prohibit a bank from cross-marketing the other products or services of the bank, including trust or fiduciary services, to its custodial customers.

f. Other Conditions

In addition to these conditions, a bank that accepts securities orders as an accommodation to a custodial account must comply with the conditions described in Section V.B.1.c. Thus, the bank may not rely on this proposed exemption to accept accommodation orders for a custodial account if the bank is acting in a trustee or fiduciary capacity (as defined in Section 3(a)(4)(D) of the Exchange Act) with respect to that account. In addition, the bank must comply with Section 3(a)(4)(C) of the Exchange Act in handling any order for a securities transaction for the account and with Section 3(a)(4)(B)(viii)(II) concerning carrying broker activities.[107] The reason for these additional conditions is to reinstate the statutory requirements for executing transactions and for the bank to refrain from acting as a carrying broker. In addition, a condition is

[107] Proposed Exchange Act Rule 760(d).

added that makes it clear that a bank may not use this exemption to avoid the conditions applicable to a trust or fiduciary account when it is acting in a trustee or fiduciary capacity with respect to that account.

3. Evasion

As the proposed rules provide, to prevent evasions of the custody exemption, the Agencies will consider both the form and substance of the relevant account(s), transaction(s) and activities (including advertising activities) in considering whether a bank meets the terms of the exemption.[108] As part of the regular examination process, the Banking Agencies will monitor the securities transactions in custodial accounts. If the appropriate Banking Agency were to find that a bank is evading the terms of the custody exemption to run a brokerage business out of its custody department, the agency would take appropriate action to address the problem.

VI. Other Proposed Exemptions

The proposal also includes certain other exemptions relating to the securities "broker" activities of banks. These are discussed below.

A. Proposed Exemption for Regulation S Transactions with Non-U.S. Persons

Persons that conduct a broker or dealer business while located in the United States must register as broker-dealers (absent an exception or exemption), even if they direct all of their selling efforts offshore.[109] A bank industry group requested an exemption from broker-dealer registration requirements to permit banks to sell to non-U.S. persons securities that are covered by Regulation S, the safe harbor from U.S. securities

108 Proposed Exchange Act Rule 760(e).

registration requirements.[110] The group also requested that the exemption extend to the resale of Regulation S securities held by non-U.S. persons to other non-U.S. persons in transactions pursuant to Regulation S.

Non-U.S. persons typically will not rely on the protections of the U.S. securities laws when purchasing Regulation S securities from U.S. banks.[111] Non-U.S. persons usually can purchase the same securities from banks located outside of the United States and would not have the protections of U.S. law when purchasing these securities offshore. The proposal therefore would exempt a bank from the definition of "broker" under Section 3(a)(4) of the Exchange Act, to the extent that, as agent, the bank effects one of three types of transactions. In particular, the proposed exemption would apply if the bank effects a sale in compliance with the requirements of 17 CFR 230.903 of an "eligible security" to a "purchaser" who is outside of the United States within the meaning of 17 CFR 230.903.

The proposed exemption would also be available if the bank effects a resale of an "eligible security" after its initial sale with a reasonable belief that the "eligible security"

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109 Exchange Act Release No. 27017 (July 11, 1989), 54 FR 30013.

110 Letter dated May 27, 2004, from Lawrence R. Uhlick, Executive Director & General Counsel, Institute of International Bankers to Catherine McGuire, Chief Counsel, Division of Market Regulation, Commission. Regulation S specifies the requirements for an offer or sale of securities to be deemed to occur outside the United States and therefore not subject to the registration requirements of Section 5 of the Securities Act. Regulation S permits the sale of newly issued off-shore securities and re-sales of off-shore securities from a non-U.S. person to a non-U.S. person. 17 CFR 230.901, et seq. The letter also requests a separate exemption from Section 3(b)(5) of the Exchange Act for riskless principal transactions, which are treated as a "dealer" (and not a "broker") activity under the Exchange Act. The Commission will solicit comments on that proposed rule in a separate contemporaneous release.

111 Although no rules have been adopted, the exemption provided by Exchange Act Section 30(b), pertaining to foreign securities, has been held unavailable if the United States is used as a base for securities fraud perpetuated on foreigners. See Arthur Lipper Corp. v. SEC, 547 F.2d 171 (2d Cir. 1976); see also Exchange Act Release No. 27017 supra note 110.

was initially sold outside of the United States within the meaning of and in compliance with the requirements of 17 CFR 230.903, by or on behalf of a person who is not a U.S. person under 17 CFR 230.902(k) to a "purchaser" who is outside the United States within the meaning of 17 CFR 230.903 or a registered broker-dealer. Under this provision of the proposal, if the sale is made prior to the expiration of the distribution compliance period specified in 17 CFR 230.903(b)(2) or (b)(3), the sale would have to be made in compliance with the requirements of 17 CFR 230.904.

Moreover, the proposed Regulation S exemption would apply if the bank effects a resale of an "eligible security" after its initial sale outside of the United States within the meaning of and in compliance with the requirements of 17 CFR 230.903, by or on behalf of a registered broker-dealer to a "purchaser" who is outside the United States within the meaning of 17 CFR 230.903. Under this proposed provision, if the sale is made prior to the expiration of the distribution compliance period specified in 17 CFR 230.903(b)(2) or (b)(3), the sale would have to be made in compliance with the requirements of 17 CFR 230.904.[112] We invite comment on whether U.S. broker-dealer registration should be required for these transactions.

B. Proposed Securities Lending Exemption

Another exemption in the proposal addresses certain securities lending activities conducted as agent. Under the proposal, a bank would be exempt from the definition of

[112] Under the proposal, "eligible security" would mean a security that: (1) is not being sold from the inventory of the bank or an affiliate of the bank; and (2) is not being underwritten by the bank or an affiliate of the bank on a firm-commitment basis, unless the bank acquired the security from an unaffiliated "distributor" that did not purchase the security from the bank or an affiliate of the bank. "Distributor" under the proposal would have the same meaning as in 17 CFR 230.902(d). "Purchaser" under the proposal would mean a person who purchases an "eligible security" and who is not a U.S. person under 17 CFR 230.902(k).

"broker" under Section 3(a)(4) of the Exchange Act, to the extent that, as an agent, it engages in or effects "securities lending transactions" and any "securities lending services" in connection with such transactions, with or on behalf of a person the bank reasonably believes to be (1) a qualified investor as defined in Section 3(a)(54)(A) of the Exchange Act;[113] or (2) any employee benefit plan that owns and invests on a discretionary basis, not less than $25,000,000 in investments.[114] We understand that the primary role of banks in securities lending transactions, whether operating with or without custody of the securities, is to act in an agency capacity. A non-custodial securities lending arrangement permits a customer to divide custody and securities lending management between two expert entities.

The proposed exemption would reinstate, without modification, an exemption from the definition of "broker" under Section 3(a)(4) of the Exchange Act that the Commission adopted in the release implementing the GLBA bank exceptions from the definition of "dealer." This exemption, would become void under the Regulatory Relief Act once the Agencies adopt a single set of final "broker" rules.[115] This exemption allows

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113 15 U.S.C. 78c(a)(54)(A).

114 Proposed Exchange Act Rule 772. Under the proposal, "securities lending transaction" would mean a transaction in which the owner of a security lends the security temporarily to another party pursuant to a written securities lending agreement under which the lender retains the economic interests of an owner of such securities, and has the right to terminate the transaction and to recall the loaned securities on terms agreed by the parties. Under the proposal, "securities lending services" would mean: (1) selecting and negotiating with a borrower and executing, or directing the execution of the loan with the borrower; (2) receiving, delivering, or directing the receipt or delivery of loaned securities; (3) receiving, delivering, or directing the receipt or delivery of collateral; (4) providing mark-to-market, corporate action, recordkeeping or other services incidental to the administration of the securities lending transaction; (5) investing, or directing the investment of, cash collateral; or (6) indemnifying the lender of securities with respect to various matters.

115 See 17 CFR 240.15a-11. See also Exchange Act Release No. 49879 (June 17, 2004), 69 FR 39682 (June 30, 2004). A bank that acts as custodian with respect to securities may effect

banks to engage in securities lending transactions as agent when they either do not have custody of the securities or have custody for less than the entire period of the stock loan. The exemption would permit banks to continue these activities without disruption. As discussed in an accompanying release, the Commission proposes to re-adopt, without modification, the "dealer" portions of Exchange Act Rule 15a-11 that relate to, among other things, conduit lending transactions.[116]

C. Proposed Exemption for the Way in Which Banks Effect Transactions in Investment Company Securities

The proposal also includes an exemption for the way in which banks may effect transactions in investment company securities. Under the proposal, a bank that meets the conditions for an exception or exemption from the definition of "broker" except for the condition in Section 3(a)(4)(C)(i) of the Exchange Act,[117] which requires banks, under certain circumstances, to direct securities transactions to a registered broker-dealer for execution, is exempt from such condition to the extent that the bank effects transactions in securities issued by an open-end company that is neither traded on a national securities exchange nor through the facilities of a national securities association or an interdealer quotation system if certain conditions are met. In particular, the proposed exemption would allow a bank to effect such transactions through the National Securities Clearing Corporation's Mutual Fund Services (Fund/SERV) or directly with a transfer agent acting

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securities lending transactions (and provide related securities lending services) with respect to such securities as agent under the statutory custody and safekeeping exception.

116 The Commission does not propose to modify or re-adopt the other portions of the "dealer" rules adopted for banks under the GLBA, including the exemption that permits banks to engage in riskless principal transactions subject to certain conditions. See 17 CFR 240.3a5-1.

117 15 U.S.C. 78c(a)(4)(C)(i).

for the open-end company. Under the proposed exemption, the securities would have to be distributed by a registered broker-dealer, or, in the alternative, the sales charge for the transaction would have to be no more than the amount a registered broker-dealer could charge pursuant to the rules of a registered securities association adopted pursuant to Section 22(b)(1) of the Investment Company Act.[118]

D. Proposed Temporary and Permanent Exemption for Contracts Entered Into by Banks from Being Considered Void or Voidable

Other proposed exemptions would address inadvertent failures by banks that could trigger rescission of contracts between a bank and a customer under Section 29(b) of the Exchange Act for a transition period.[119] Under the first proposed exemption, no contract entered into before 18 months after the effective date of the proposed exemption would be void or considered voidable by reason of Section 29 of the Exchange Act because any bank that is a party to the contract violated the registration requirements of Section 15(a) of the Exchange Act, any other applicable provision of that Act, or the rules and regulations adopted under the Exchange Act based solely on the bank's status as a broker when the contract was created.[120]

Under the second proposed exemption, no contract entered into would be void or considered voidable by reason of Section 29(b) of the Exchange Act without a time limit. This exemption would provide relief to a bank that violated the registration requirements

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118 15 U.S.C. 80a-22(b)(1). Under the proposal "interdealer quotation system" would have the same meaning as in 17 CFR 240.15c2-11. "Open-end company" would have the same meaning as in 17 CFR 247.740.

119 15 U.S.C. 78cc(b). Exchange Act Section 29(b) provides, in pertinent part, that every contract made in violation of the Exchange Act or of any rule or regulation adopted under the Exchange Act (with certain exceptions) shall be void.

120 Proposed Exchange Act Rule 780.

of Section 15(a) of the Exchange Act or the rules and regulations adopted thereunder based solely on the bank's status as a broker when a contract was created if two conditions are met (1) at the time the contract was created, the bank acted in good faith and had reasonable policies and procedures in place to comply with Section 3(a)(4)(B) of the Exchange Act, and the rules and regulations, thereunder; and (2) any violation of the registration requirements by the bank did not result in any significant harm, financial loss or cost to the person seeking to void the contract. This exemption is provided because a bank that is acting in good faith and has reasonable policies and procedures in effect at the time a securities contract is created should not be subject to rescission claims as a result of an inadvertent failure to comply with the requirements under Section 3(c)(4) of the Exchange Act if customers are not significantly harmed.

E. Extension of Time and Transition Period

The proposal also would extend the time that banks would have to come into compliance with the Exchange Act provisions relating to the definition of "broker." Under the proposed exemption, a bank would be exempt from the definition of "broker" under Section 3(a)(4) of Exchange Act until the first day of its first fiscal year commencing after June 30, 2008.

VII. Withdrawal of Proposed Regulation B and Removal of Exchange Act Rules 3a4-2 – 3a4-6, and 3b-17

Under the Regulatory Relief Act, a final single set of rules or regulations jointly adopted by the Board and Commission in accordance with that Act shall supersede any other proposed or final rule issued by the Commission on or after the date of enactment of Section 201 of the GLBA with regard to the definition of "broker" under Exchange

Act Section 3(a)(4).[121] Moreover, the new law states that "[n]o such other rule, whether or not issued in final form, shall have any force or effect on or after that date of enactment."

In 2001, the Commission adopted Interim Rules discussing the way in which the Commission would interpret the GLBA.[122] The rules that address the definition of "broker" under Section 3(a)(4) of the Exchange Act (and applicable exemptions) are Exchange Act Rules 3a4-2 through 3a4-6 and Rule 3b-17.[123] In 2004, the Commission proposed to revise and restructure the "broker" provisions of the Interim Rules and codify them in a new regulation, proposed Regulation B, which consists of proposed new Exchange Act Rules 710 through 781.[124] By operation of the Regulatory Relief Act, the joint adoption of new final rules will supersede Exchange Act Rules 3a4-2 through 3a4-6, 3b-17, and proposed Rules 710 through 781. Any discussion or interpretation of these prior rules in their accompanying releases would not apply to the single set of rules adopted by the Agencies.

VIII. Administrative Law Matters

A. Paperwork Reduction Act Analysis

Certain provisions of proposed Exchange Act Rules 701, 723, and 741, contain "collection of information" requirements within the meaning of the Paperwork Reduction

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121 President Clinton signed the GLBA into law on November 12, 1999.

122 Exchange Act Release No. 44291 (May 11, 2001), 66 FR 27760 (May 18, 2001).

123 17 CFR 240.3a4-2 through 3a4-6 and 17 CFR 240.3b-17.

124 17 CFR 242.710 through 781. See Exchange Act Release No. 49879 (June 17, 2004), 69 FR 39682 (June 30, 2004).

Act of 1995.[125] The Commission has submitted these information collections to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The Board has reviewed the proposed rules under authority delegated by OMB.[126]

The collections of information under proposed Exchange Act Rules 701, 723, and 741 are new. The title for the new collection of information under proposed Exchange Act Rule 701 is "Rule 701: Exemption from the definition of 'broker' for certain institutional referrals." The title for the new collection of information under proposed Exchange Act Rule 723 is "Rule 723: Exemptions for special accounts, transferred accounts, and a de minimis number of accounts." The title for the new collection of information under proposed Exchange Act Rule 741 is "Rule 741: Exemption for banks effecting transactions in money market funds." OMB has not yet assigned a control number to the new collections of information contained in proposed Exchange Act Rules 701, 723, and 741. 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.[127]

1. Proposed Exchange Act Rule 701

Proposed Exchange Act Rule 701 would provide a conditional exemption from the requirements under the networking exception under the Exchange Act. This proposed exemption would permit bank employees to receive payment of more than a nominal fee

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125 44 U.S.C. 3501, et seq.

126 5 CFR 1320.16; Appendix A.1.

127 44 U.S.C. 3512.

for referring institutional customers and high net worth customers to a broker or dealer and would permit such payments to be contingent on whether the customer effects a securities transaction with the broker or dealer.

a. Collection of Information

Proposed Exchange Act Rules 701(a)(2)(i) and (b) would require banks that wish to utilize the exemption provided in this proposed rule to make certain disclosures to high net worth or institutional customers. Specifically, these banks would need to clearly and conspicuously disclose (1) the name of the broker or dealer; and (2) that the bank employee participates in an incentive compensation program under which the bank employee may receive a fee of more than a nominal amount for referring the customer to the broker or dealer and payment of this fee may be contingent on whether the referral results in a transaction with the broker or dealer.[128]

In addition, one of the conditions of the exemption is that the broker or dealer and the bank need to have a contractual or other written arrangement containing certain elements, including notification and information requirements.[129] Proposed Exchange Act Rule 701(a)(3)(iii) requires a broker or dealer to notify its bank partner if the broker or dealer determines that (1) the customer referred under the exemption is not a high net worth or institutional customer, as applicable; (2) the bank employee making the referral is subject to statutory disqualification (as defined in Section 3(a)(39) of the Exchange Act);[130] or (3) the customer or the securities transaction(s) to be conducted by the

128 See proposed Exchange Act Rules 701(a)(2)(i) and (b).

129 See proposed Exchange Act Rule 701(a) and (a)(3).

130 This proposed requirement would not apply to subparagraph (E) of Section 3(a)(39) of the Exchange Act ((15 U.S.C. 78c(a)(39)).

customer do not meet the applicable suitability or sophistication determination standards set forth in the rule.[131] Similarly, the bank would be required to provide its broker or dealer partner with the name of the bank employee receiving the referral fee and certain other identifying information.[132]

b. Proposed Use of Information

The purpose of the collection of information in proposed Exchange Act Rule 701(a)(2)(i) and (b) is to provide a customer of a bank relying on the exemption with information to assist the customer in identifying and assessing any conflict of interest on the part of the bank employee making a referral to a broker or dealer. The collection of information in proposed Exchange Act Rule 701(a)(2)(iii) and (a)(3)(iii) is designed to help a bank determine whether it is acting in compliance with the proposed exemption.

c. Respondents

The proposed collection of information in proposed Exchange Act Rule 701 would apply to banks that wish to utilize the exemption provided in this proposed rule and broker-dealers with which those banks enter into networking arrangements.

d. Reporting and Recordkeeping Burden

The Agencies estimate that approximately 1,000 banks annually would use the exemption in proposed Exchange Act Rule 701 and each bank would on average make the required referral fee disclosures to 200 customers annually and provide one notice annually to its broker or dealer partner regarding the name of a bank employee and other identifying information. The Agencies also estimate that broker-dealers would, on

131 See proposed Exchange Act Rule 701(a)(3)(iii).

132 See proposed Exchange Act Rule 701(a)(2)(iii).

average, notify each of the 1,000 banks approximately two times annually about a determination regarding a customer's high net worth or institutional status or suitability or sophistication standing as well as a bank employee's statutory disqualification status.

Based on these estimates, the Agencies anticipate that proposed Exchange Act Rule 701 would result in approximately 200,000 disclosures to customers, 1,000 notices to brokers or dealers, and 2,000 notices to banks per year. The Agencies further estimate (based on the level of difficulty and complexity of the applicable activities) that a bank would spend approximately 5 minutes per customer to comply with the disclosure requirement and 15 minutes per notice to a broker or dealer. The Agencies also estimate that a broker or dealer would spend approximately 15 minutes per notice to a bank. Thus, the estimated total annual reporting and recordkeeping burden for these requirements in proposed Exchange Act Rule 701 are 16,917 hours for banks and 500 hours for brokers or dealers. We solicit comment on this point as well as on the validity of all of our estimates and statements in this Section.

e. Collection of Information Is Mandatory

This collection of information would be mandatory for banks relying on proposed Exchange Act Rule 701 and their broker-dealer partners.

f. Confidentiality

A bank relying on the exemption provided in proposed Exchange Act Rule 701 would be required to provide certain referral fee disclosures to its customers as required by this proposed rule. Banks relying on the exemption provided in proposed Exchange Act Rule 701 would be also be required to enter into agreements with a broker or dealer obligating the broker or dealer to notify the bank upon becoming aware of certain

information with respect to the customer, the bank employee, or the nature of the securities transaction. Similarly, a bank would be required to notify a broker or dealer about the name of the bank employee receiving a referral fee and certain other identifying information.

g. Record Retention Period

Proposed Exchange Act Rule 701 would not include a specific record retention requirement. Banks, however, would be required to retain the records in compliance with any existing or future recordkeeping requirements established by the Banking Agencies.

2. Proposed Exchange Act Rule 723

a. Collection of Information

Proposed Exchange Act Rule 723(d)(1) would require a bank that desires to exclude a trust or fiduciary account in determining its compliance with the chiefly compensated test, pursuant to a de minimis exclusion,[133] to maintain records demonstrating that the securities transactions conducted by or on behalf of the account were undertaken by the bank in the exercise of its trust or fiduciary responsibilities with respect to the account.[134]

b. Proposed Use of Information

The collection of information in proposed Exchange Act Rule 723 is designed to help ensure that a bank relying on the de minimis exclusion would be able to demonstrate

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[133] See proposed Exchange Act Rule 723(d)(2), which would require that the total number of accounts excluded by the bank, under the exclusion from the chiefly compensated test in proposed Rule 721(a)(1), do not exceed the lesser of 1 percent of the total number of trust or fiduciary accounts held by the bank (if the number so obtained is less than 1, the amount would be rounded up to 1) or 500.

[134] See proposed Exchange Act Rule 723(d)(1).

that it was acting in a trust or fiduciary capacity with respect to an account excluded from the chiefly compensated test in proposed Rule 721(a)(1).

c. Respondents

The proposed collection of information in Exchange Act Rule 723 would apply to banks relying on the de minimis exclusion from the chiefly compensated test.

d. Reporting and Recordkeeping Burden

Because the Agencies expect a small number of banks would use the account-by-account approach in monitoring their compensation, the Agencies estimate that approximately 50 banks annually would use the de minimis exclusion in proposed Exchange Act Rule 723 and each such bank would, on average, need to maintain records with respect to 10 trust or fiduciary accounts annually conducted in the exercise of the banks' trust or fiduciary responsibilities. Therefore, the Agencies estimate that proposed Exchange Act Rule 723 would result in approximately 500 accounts annually for which records are required to be maintained. The Agencies anticipate that these records would consist of records that are generally created as part of the securities transaction and the account relationship and minimal additional time would be required in maintaining these records. Based on this analysis, the Agencies estimate that a bank would spend approximately 15 minutes per account to comply with the record maintenance requirement of proposed Exchange Act Rule 723. Thus, the estimated total annual reporting and recordkeeping burden for proposed Exchange Act Rule 723 is 125 hours. We solicit comment on this point as well as on the validity of all of our estimates and statements in this Section.

e. Collection of Information Is Mandatory

This collection of information would be mandatory for banks desiring to rely on de minimis exclusion contained in proposed Exchange Act Rule 723.

f. Confidentiality

Proposed Exchange Act Rule 723 does not address or restrict the confidentiality of the documentation prepared by banks under the rule. Accordingly, banks would have to make the information available to regulatory authorities or other persons to the extent otherwise provided by law.

g. Record Retention Period

Proposed Exchange Act Rule 723 would include a requirement to maintain records related to certain securities transactions. Banks would be required to retain these records in compliance with any existing or future recordkeeping requirements established by the Banking Agencies.

3. Proposed Exchange Act Rule 741

a. Collection of Information

Proposed Exchange Act Rule 741(a)(2)(ii)(A) would require a bank relying on this proposed exemption (i.e., the exemption from the definition of the term "broker" under Section 3(a)(4) of the Exchange Act for effecting transactions on behalf of a customer in securities issued by a money market fund) to provide customers with a prospectus of the money market fund securities, not later than the time the customer authorizes the bank to effect the transaction in such securities, if they are not no-load.

b. Proposed Use of Information

The purpose of the collection of information in proposed Exchange Act Rule 741 is to help ensure that a customer of a bank relying on the exemption would have sufficient information upon which to make an informed investment decision, in particular, regarding the fees the customer would pay with respect to the securities.

c. Respondents

The proposed collection of information in Exchange Act Rule 741 would apply to banks relying on the exemption provided in the proposed rule.

d. Reporting and Recordkeeping Burden

The Agencies believe that banks generally sweep or invest their customer funds into no-load money market funds. Accordingly, the Agencies estimate that approximately 500 banks annually would use the exemption in proposed Exchange Act Rule 741 and each bank, on average, would deliver the prospectus required by the proposed rule to approximately 1,000 customers annually. Therefore, the Agencies estimate that proposed Exchange Act Rule 741 would result in approximately 500,000 disclosures per year. The Agencies estimate further that a bank would spend approximately 5 minutes per response to comply with the delivery requirement of proposed Exchange Act Rule 741. Thus, the estimated total annual reporting and recordkeeping burden for proposed Exchange Act Rule 741 is 41,667 hours. We solicit comment on this point as well as on the validity of all of our estimates and statements in this Section.

e. Collection of Information Is Mandatory

This collection of information would be mandatory for banks relying on the proposed exemption.

f. Confidentiality

The collection of information delivered pursuant to proposed Exchange Act Rule 741 would be provided by banks relying on the exemption in this rule to customers that are engaging in transactions in securities issued by a money market fund that is not a no-load fund.

g. Record Retention Period

Proposed Exchange Act Rule 741 would not include a record retention requirement.

4. Request For Comment

Pursuant to 44 U.S.C. 3506(c)(2)(B), the Agencies solicit comments to:

(1) Evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Agencies, including whether the information would have practical utility;

(2) Evaluate the accuracy of the Agencies' estimates of the burden of the proposed collections of information and provide the Agencies with data on proposed Exchange Act Rules 701, 723, and 741;

(3) Enhance the quality, utility, and clarity of the information to be collected; and

(4) Minimize the burden of the collections of information on those required to respond, including through the use of automated collection techniques or other forms of information technology.

In addition to the general solicitation of comments above regarding the collections of information contained in the proposed rules, the Agencies also solicit comments regarding how many banks would rely on the exemptions provided in proposed Exchange Act Rules 701, 723, and 741, and whether banks relying on such exemptions would be able to use existing systems, programs, and procedures to comply with the collections of information requirements contained in the proposed rules.

Persons desiring to submit comments on the collection of information requirements should direct them in the manner discussed below. The Agencies propose that the information collections and burden estimates discussed above will be associated with the Board for banks and with the Commission for brokers or dealers.

Commission. Comments should be directed to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should send a copy of their comments to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090, and refer to File No. S7-22-06. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication of this release in the Federal Register. Therefore, comments to OMB are best assured of having full effect if OMB receives them within 30 days of this publication. Requests for materials submitted to OMB by the Agencies with regard to this collection of information should be in writing, refer to File No. S7-22-06, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 100 F Street, NE, Washington, DC 20549.

Board. You may submit comments, identified by the Docket number, by any of the following methods:

- Agency Web site: http://www.federalreserve.gov. Follow the instructions for submitting comments on the http:// www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm.
- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.
- E-mail: regs.comments@federalreserve.gov. Include docket number in the subject line of the message.
- FAX: 202-452-3819 or 202-452-3102.
- Mail: Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW, Washington, DC 20551.

All public comments are available from the Board's Web site at http:// www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm as submitted, unless modified for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper form in Room MP-500 of the Board's Martin Building (20th and C Streets, NW) between 9 a.m. and 5 p.m. on weekdays.

B. Consideration of Benefits and Costs

1. Introduction

Prior to enactment of the GLBA, banks were exempted from the definition of "broker" in Section 3(a)(4) of the Exchange Act. Therefore, notwithstanding the fact that

banks may have conducted activities that would have brought them within the scope of the broker definition, they were not required by the Exchange Act to register as such. The GLBA replaced banks' historic exemption from the definition of "broker" with eleven exceptions.[135]

While banks' efforts to comply with the GLBA and the exemptions we propose would result in certain costs, the Agencies have sought to minimize these burdens to the extent possible consistent with the language and purposes of the GLBA. For example, the Agencies are proposing exemptions and interpretations which should provide banks with increased options and flexibility and help to reduce overall costs.

2. Discussion of Proposed Interpretations and Exemptions

The potential benefits and costs of the principal exemptions and interpretations in the proposal are discussed below.

a. Networking Exception

Exchange Act Section 3(a)(4)(B)(i) excepts banks from the definition of "broker" if they enter into a contractual or other written arrangement with a registered broker-dealer under which the broker-dealer offers brokerage services to bank customers. This networking exception is subject to several conditions. The Section also prohibits banks from paying unregistered bank employees--such as tellers, loan officers, and private bankers--"incentive compensation" for any brokerage transaction, except that bank

[135] See Exchange Act Section 3(a)(4)(B)(i) – (xi).

employees may receive a "nominal" referral fee for referring bank customers to their broker-dealer networking partners.[136]

Under the proposal, a "nominal" referral fee would be defined as a fee that does not exceed any of the following standards (1) twice the average of the minimum and maximum hourly wage established by the bank for the current or prior year for the job family that includes the employee or 1/1000th of the average of the minimum and maximum annual base salary established by the bank for the current or prior year for the job family that includes the employee; (2) twice the employee's actual base hourly wage; or (3) twenty-five dollars ($25), as adjusted for inflation pursuant to proposed Exchange Act Rule 700(f).

The Agencies believe these alternatives should provide banks appropriate flexibility while being consistent with the statute. For example, some banks, and particularly small banks, may find it most useful to establish a flat fee or inflation-adjusted fee for securities referrals as this method is easy to understand and requires no complicated calculations. In addition, permitting banks to pay referral fees based on either an employee's base hourly rate of pay or the average rate of pay for a job family would give banks objective and easily calculable approaches to paying their employees referrals while remaining consistent with the requirements of the GLBA that such fees be "nominal" in relation to the overall compensation of the referring employees. While some start-up costs may be incurred by banks in the process of developing a fee structure in line with the requirements of the GLBA, the ability to choose among alternative

[136] Exchange Act Section 3(a)(4)(B)(i)(VI) limits such referral fees to a "nominal one-time cash fee of a fixed dollar amount" and requires that the payment of the fees not be contingent on whether the referral results in a transaction.

methods (as reflected in proposed rules) should enable banks to minimize their overall costs based on their individual referral programs and cost structures.

In light of the statutory provision allowing banks to pay a "nominal one-time cash fee," the proposal requires that all referral fees paid under the exception be paid in cash. The Agencies request comment on whether existing bank securities referral programs would be able to operate, or could easily be adjusted to operate, in accordance with the terms of proposed Exchange Act Rule 700.

The proposed rules also include a conditional exemption that would permit a bank to pay an employee a contingent referral fee of more than a nominal amount for referring an institutional customer or high net worth customer to a broker or dealer with which the bank has a contractual or other written networking arrangement.

This exemption would provide a benefit to banks by expanding the types of referrals fees that banks could utilize with respect to institutional customers and high net worth customers. However, there likely would be costs associated with complying with the conditions in the proposed exemption (such as the requirement for banks to make certain disclosures to high net worth or institutional customers and the requirement for broker-dealers to make certain determinations and provide certain notifications to banks)[137] as well as the other terms and conditions in the statutory networking exception. However, these costs would be either a result of the statutory requirements or costs voluntarily incurred by banks because they want to take advantage of the proposed exemption.

[137] Proposed Exchange Act Rules 701(a)(2)(i), 701(a)(3)(iii), and 701(b).

Proposed Exchange Act Rule 700 also contains a definition of "incentive compensation" and excludes from this definition compensation paid by a bank under a bonus or similar plan that meets certain criteria. The bonus or similar program must be paid on a discretionary basis and based on multiple factors or variables. These factors or variables must include significant factors or variables that would not be related to securities transactions at the broker or dealer. Moreover, a referral made by the employee could not be a factor or variable in determining the employee's compensation under the plan and the employee's compensation under the plan could not be determined by reference to referrals made by any other person.

We request comments generally on the costs and benefits associated with the proposed provisions regarding the networking exception and the related exemption. We also invite banks to provide information, including data, to assist us in further evaluating the costs and benefits associated with the proposed provisions. We invite banks to include estimates of their start-up costs for updating their systems, and their annual ongoing costs for complying with the proposed changes discussed above. We invite commenters to provide us with data to assist in further evaluating these proposed rules. For example, we request comment on whether the proposed provisions relating to bonus and similar plans would be consistent with current compensation and bonus arrangements and any costs or burdens that would be incurred to bring existing plans into compliance with the provisions. We also request comment on any other costs banks would likely need to incur as a result of the proposal, and ask that commenters provide us with data to support their views.

b. Trust and Fiduciary Activities Exception

Exchange Act Section 3(a)(4)(B)(ii) permits a bank, under certain conditions, to effect transactions in a trustee or fiduciary capacity in its trust department or other department that is regularly examined by bank examiners for fiduciary principles and standards without registering as a broker. To qualify for the trust and fiduciary activities exception, Exchange Act Section 3(a)(4)(B)(ii) requires that the bank be "chiefly compensated" for such transactions on the basis of the types of fees specified in the GLBA and comply with certain advertising restrictions set forth in the statute.

The Agencies believe that the proposed rules dealing with the trust and fiduciary activities exception should provide a number of benefits to banks and their customers without imposing significant costs on either group.[138] The proposed provisions regarding the "chiefly compensated" condition and related exemptions, while imposing some costs related to systems necessary to perform the calculations and track compensation, should reduce banks' compliance costs and make the trust and fiduciary activities exception more useful. For example, the proposed rules would permit a bank to follow an alternate test to the account-by-account approach to the "chiefly compensated" condition. Under this proposed exemption, a bank could calculate the compensation it receives from all of its trust and fiduciary accounts on a bank-wide basis, subject to certain conditions.[139] This proposed alternative should provide banks with a potentially less costly approach for determining compliance with the trust and fiduciary activities exception. Similarly, the Agencies' proposal to provide exemptions from the "chiefly compensated" condition for

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138 The trust and fiduciary exception is addressed in proposed Exchange Act Rules 721-723.

139 See proposed Exchange Act Rule 722.

certain short-term accounts, accounts acquired as part of a business combination or asset acquisition, accounts transferred to a broker or dealer or other unaffiliated entity, and a de minimis number of accounts should also reduce banks' compliance costs by facilitating banks' ability to comply with the "chiefly compensated" condition.[140] While compliance with the conditions in these proposed exemptions would likely result in some costs, such as the recordkeeping requirement associated with the de minimis exclusion, these costs would likely be more than justified by the benefits associated with the exemptions given that banks could individually determine whether they wish to utilize the exemptions.

As previously noted, banks are likely to incur some costs to comply with the GLBA. The proposed rules, however, include a number of exemptions which should help to reduce overall costs. As a result, the Agencies do not believe that banks would incur significant additional costs to comply with the liberalized exemptions proposed in Exchange Act Rules 722 through 723 or the definitional guidance proposed in Exchange Act Rule 721.

We solicit comment on the costs and benefits, if any, banks expect to incur in complying with the "chiefly compensated" condition in the statute and the proposed rules. In particular, we would like information on the start-up and annual ongoing costs to update systems to track compensation under the account-by-account approach and under the proposed bank-wide approach. We also solicit comments on the costs and burdens associated with the advertising provisions of proposed Exchange Act Rule 721(b), which would apply to banks operating under both the account-by-account and bank-wide tests.

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[140] See proposed Exchange Act Rule 723.

c. Sweep Accounts and Transactions in Money Market Funds

Section 3(a)(4)(B)(v) of the Exchange Act provides banks with an exception from the definition of "broker" to the extent it effects transactions as part of a program for the investment or re-investment of deposit funds into any no-load, open-end management investment company registered under the Investment Company Act that holds itself out as a money market fund. The proposed rules provide guidance, consistent with NASD rules,[141] regarding the definition of "no-load" as used in the exception. This guidance should benefit banks by clarifying the types of charges that are permissible and by providing greater legal certainty.

The proposed rules also contain an exemption that would permit banks to effect transactions on behalf of a customer in securities issued by a money market fund, subject to certain conditions.[142] While compliance with the conditions associated with this proposed exemption, such as the prospectus delivery requirement in certain circumstances, could require banks to incur some costs, these costs are likely to be more than justified by the investor protection benefits enjoyed by the banks' customers and the enhanced flexibility granted banks by the exemption. Furthermore, because banks would be able to freely determine whether to incur these costs, the exemption should provide a net benefit for banks that wish to utilize the exemption. We solicit comment on the costs and benefits, if any, banks expect to incur in complying with the conditions in this proposed rule.

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141 See NASD Rule 2830.

142 See proposed Exchange Act Rule 741.

d. Safekeeping and Custody Exception

Section 3(a)(4)(B)(viii) of the Exchange Act provides banks with an exception from the definition of "broker" for certain bank custody and safekeeping activities. The proposed rules contain an exemption that would permit banks, subject to certain conditions, to accept orders to effect transactions in securities for accounts for which the bank acts as a custodian. Specifically, this proposed custody exemption (proposed Exchange Act Rule 760) would allow banks, subject to certain conditions, to accept orders for securities transactions from employee benefit plan accounts and individual retirement and similar accounts for which the bank acts as a custodian. In addition, the exemption allows banks, subject to certain conditions, to accept orders for securities transactions on an accommodation basis from other types of custodial accounts. This proposal would allow banks to accept orders from custody accounts while imposing conditions designed to prevent a bank from operating a securities broker out of its custody department.

The exemption should benefit banks by permitting certain order-taking activities for securities transactions. While banks may incur some costs in complying with the conditions contained in the exemption, such as developing systems for making determinations regarding compliance with advertising and compensation restrictions, the Agencies believe the conditions contained in the rules are consistent with the practices of banks and any costs would only be imposed on banks that choose to utilize the exemption.

We solicit comment on any costs and benefits banks expect to incur in complying with the conditions in the proposed exemption.

e. Other Proposed Changes

We are proposing certain special purpose exemptions. Specifically, we are proposing an exemption that would permit banks to effect transactions pursuant to Regulation S with non-U.S. persons.[143] Another proposed exemption also would, under certain conditions, allow a bank to effect transactions in investment company securities through Fund/SERV or directly with a transfer agent acting for an open-end company.[144] In addition, we are proposing an exemption that would permit banks, as an agent, to effect securities lending transactions (and engage in related securities lending services) for securities that they do not hold in custody with or on behalf of a person the bank reasonably believes is a qualified investor (as defined in Section 3(a)(54)(A) of the Exchange Act) or any employee benefit plan that owns and invests on a discretionary basis at least $25 million in investments.[145] Furthermore, we are proposing to extend the exemption from rescission liability under Exchange Act Section 29 to contracts entered into by banks acting in a broker capacity until a date that would be 18 months after the effective date of the final rule.[146] This proposed exemption also would, under certain circumstances, provide protections from rescission liability under Exchange Act Section 29 resulting solely from a bank's status as a broker, if the bank has acted in good faith, adopted reasonable policies and procedures, and any violation of broker registration requirements did not result in significant harm or financial loss to the person seeking to

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143 See proposed Exchange Act Rule 771.

144 See proposed Exchange Act Rule 775.

145 See proposed Exchange Act Rule 772.

146 See proposed Exchange Act Rule 780.

void the contract.[147] Finally, we are proposing a temporary general exemption from the definition of "broker" under Section 3(a)(4) of the Exchange Act until the first day of a bank's first fiscal year commencing after June 30, 2008.[148]

The Agencies believe these proposed changes could offer a number of benefits to banks and their customers. In particular, the proposed Regulation S exemption could help to ensure that U.S. banks that effect transactions in Regulation S securities with non-U.S. customers would be more competitive with foreign banks or other entities that offer those services. The proposed exemption from rescission liability under Exchange Act Section 29 should also provide banks some legal certainty, both temporarily and on a permanent basis, as they conduct their securities activities. The proposed exemption related to securities lending services should enable banks to engage in the types of services which they currently engage thereby minimizing compliance costs, while providing the banks' customers with continuity of service. The temporary general exemption from the definition of "broker" should also be of benefit to banks by providing them with an adequate period of time to transition to the requirements under the proposed rules.

We estimate that the costs of these proposed exemptions would be minimal and would be justified by the benefits the proposed exemptions would offer. For example, the Regulation S exemption could impose certain costs on banks that are designed to ensure that they remain in compliance with the conditions under the exemption. In particular, the proposed exemption would require banks to incur certain administrative

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[147] Id.

[148] See proposed Exchange Act Rule 781.

costs so that the proposed exemption is used only for "eligible securities" and for a purchaser who is outside of the United States within the meaning of Section 903 of Regulation S. Nevertheless, the proposed exemption is an accommodation to banks that wish to effect transactions in Regulation S securities and, as a result, the compliance costs would only be imposed on those banks that believe that it is in their best business interests to take advantage of the proposed exemption. We request comment on whether banks would incur any costs related to this proposed exemption.

Given that Exchange Act Section 29 is rarely used as a remedy, we do not anticipate that this proposed exemption would impose significant costs on the industry or on investors. We request comment on whether any bank would incur any costs or would benefit as a result of this proposed exemption. We also request comment on whether banks would incur any costs or benefits in association with the proposed exemptions concerning securities lending services and effecting transactions in investment company securities. Please provide any supporting data with respect to any costs or benefits. We would also welcome comments on the usefulness of the temporary general exemption from the definition of "broker" under Section 3(a)(4) of the Exchange Act.

C. Consideration of Burden on Competition, and on Promotion of Efficiency, Competition, and Capital Formation

Exchange Act Section 3(f) requires the Commission, whenever it engages in rulemaking and is required to consider or determine if an action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition, and capital formation.[149] Exchange Act Section 23(a)(2) requires the Commission, in adopting rules under that Act, to consider the impact that any such rule

[149] 15 U.S.C. 78c(f).

would have on competition. This Section also 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.[150]

The Agencies have designed the proposed interpretations, definitions, and exemptions to minimize any burden on competition. Indeed, the Agencies believe that by providing legal certainty to banks that conduct securities activities, by clarifying the GLBA requirements, and by exempting a number of activities from those requirements, the proposed rules should allow banks to continue to conduct securities activities they already conduct consistent with the GLBA. As a result, the Agencies believe that the proposed rules would permit banks to continue to compete with broker-dealers in providing a wide range of financial services, which should preserve competition and help to keep transaction costs low for investors and for companies.

The proposed rules define terms in the statutory exceptions to the definition of broker added to the Exchange Act by Congress in the GLBA, and provide guidance to banks as to the appropriate scope of those exceptions. In addition, the proposed rules contain a number of exemptions that should provide banks flexibility in conducting their securities activities, which should further promote competition and reduce costs.

The Commission is, however, interested in receiving comments regarding the effect of the proposed rules on efficiency, competition, and capital formation.

f. General Costs

Based on the burden hours discussed in the Paperwork Reduction Act Analysis Section the Agencies expect the ongoing requirements of the proposed rules to result in a

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[150] 15 U.S.C. 78w(a)(2).

total of 58,709 annual burden hours for banks and 500 annual burden hours for broker-dealers, for a grand total of 59,209 annual burden hours.[151] The Agencies estimate that the hourly costs for these burden hours will be approximately $68 per hour.[152] Therefore, the annual total costs would be approximately $4,026,212.

In addition to the costs associated with burden hours discussed in the Paperwork Reduction Act Analysis Section, the Agencies expect that many banks also could incur start-up costs for legal and other professional services.[153] Many banks would utilize their in-house counsel, accountants, compliance officers, and programmers in an effort to achieve compliance with the proposed rules. Industry sources indicate the following hourly labor costs: attorneys - $324 per hour, intermediate accountants - $162 per hour, compliance manager - $205 per hour, and senior programmer - $268.[154] Taking an average of these professional costs, the Agencies estimate a general hourly in-house labor cost of $240 per hour for professional services.

Based on our expectation that most start-up costs would involve bringing systems into compliance and that many banks would be able to do so either using existing systems or by slightly modifying existing systems, the Agencies estimate that the proposed rules

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[151] See infra at VIII.A.1.d., VIII.A.2.d., and VIII.A.3.d.

[152] $68/hour figure for a clerk (e.g. compliance clerk) is from the SIA Report on Office Salaries in the Securities Industry 2005, modified to account for an 1800-hour work-year and multiplied by 2.93 to account for bonuses, firm size, employee benefits and overhead.

[153] For example, banks may incur start-up costs in the process of reviewing or developing their networking arrangements in line with the requirements of the proposed rules. See infra at VIII.B.2.a. In addition, there would likely be costs for developing systems for making determinations regarding compliance with advertising and compensation restrictions pursuant to the proposed rules regarding safekeeping and custody. See infra at VIII.B.2.d.

[154] The hourly figures for an attorney, intermediate account, and compliance manager is from the SIA Report on Management & Professional Earnings in the Securities Industry 2005, modified to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

would require banks to utilize an average of 30 hours of professional services. The Agencies expect that most banks affected by the proposed rules would either use in-house counsel or employees resulting in an average total cost of $7,200 per affected bank.[155] The Agencies estimate that the proposed rules would apply to approximately 9,475 banks and approximately 25 percent of these banks would incur more than a de minimis cost. Using these values, the Agencies estimate total start-up costs of $17,055,000 (9,475 X .25 X $7,200). As previously discussed the Agencies have sought to minimize these costs to the extent possible consistent with the language and purposes of the GLBA.

Based on these estimates, the total costs for the first year would be approximately $21,081,212 ($17,055,000 + $4,026,212). The Agencies request comment on these cost estimates or any other applicable costs.

g. General Benefits

The Agencies believe that the proposed rules would provide greater legal certainty for banks in connection with their determination of whether they meet the terms and conditions for an exception to the definition of broker under the Exchange Act as well as provide additional relief through the proposed exemptions. Without the proposed rules, banks could have difficulty planning their businesses and determining whether their operations are in compliance with the GLBA. This, in turn, could hamper their business. The Agencies anticipate these benefits would prove to be useful to banks and provide saving in legal fees. Specifically, difficulties in interpreting the GBLA, absent any regulatory guidance, could result in the need for greater input from outside counsel.

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155 Some banks may choose to utilize outside counsel, either exclusively or as a supplement to in-house resources. The Agencies estimate these costs as being similar to the in-house costs (Industry sources indicate the following hourly costs for hiring external workers: Attorneys - $400, accountant - $250, auditor - $250, and programmer - $160.).

Based on the number of interactive issues raised by the GBLA, the Agencies estimate that absent any regulatory guidance, banks on average would use the services of outside counsel for approximately 25 more hours for the initial year and 5 more hours per year thereafter, than with the existence of the proposed rules. Industry sources indicate that the hourly costs for hiring outside counsel is approximately $400 per hour. The proposed rules would therefore result in an average total cost savings of approximately $10,000 per affected bank per year during the initial year and $2,000 per affected bank per year thereafter. The Agencies estimate that the proposed rules would apply to approximately 9,475 banks and approximately 25 percent of these banks would enjoy more than a de minimis cost savings benefit. Using these values, the Agencies estimate a total cost savings of $23,687,500 (9,475 X .25 X $10,000) for the initial year and $4,737,500 (9,475 X 0.25 X $2,000) per year thereafter. The Agencies request comment on these benefits or any other applicable benefit.

e. Request for Comments

The Agencies request comment on the costs and benefits of the proposed rules, and ask commenters to provide supporting empirical data for any positions advanced. Commenters should address in particular whether any of the new rules would generate the anticipated benefits or impose any costs on investors, banks, customers of banks, registered broker-dealers or other market participants. As always, commenters are specifically invited to share quantifiable costs and benefits.

D. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"[156] the Agencies must advise the Office of Management and Budget as to whether the proposed rules constitute a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in:

- An annual effect on the economy of $100 million or more (either in the form of an increase or a decrease);
- A major increase in costs or prices for consumers or individual industries; or
- A significant adverse effect on competition, investment, or innovation.

If a rule is "major," its effectiveness will generally be delayed for 60 days pending Congressional review. The Agencies do not believe that the proposed rules, in their current form, would constitute a major rule. We request comment on the potential impact of the proposed rules on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

E. Initial Regulatory Flexibility Analysis

The Agencies have prepared an Initial Regulatory Flexibility Analysis ("IRFA"), in accordance with the provisions of the Regulatory Flexibility Act ("RFA"),[157] regarding the proposed rules.

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

[157] 5 U.S.C. 603.

1. Reasons for the Proposed Action

Section 201 of the GLBA amended the definition of "broker" in Section 3(a)(4) of the Exchange Act to replace a blanket exemption from that term for "banks," as defined in Section 3(a)(6) of the Exchange Act. Congress replaced this blanket exemption with eleven specific exceptions for securities activities conducted by banks.[158] On October 13, 2006, President Bush signed into law the Regulatory Relief Act.[159] Section 101 of that Act, among other things, requires the Agencies jointly to issue a single set of proposed rules implementing the bank broker exceptions in Section 3(a)(4) of the Exchange Act within 180 days of the date of enactment of the Regulatory Relief Act.[160] These rules are being proposed by the Agencies to fulfill this requirement. The proposed rules are designed generally to provide guidance on GLBA exceptions from the definition of broker in Exchange Act Section 3(a)(4) and to provide conditional exemptions from the broker definition consistent with the purposes of the Exchange Act and the GLBA.

2. Objectives

The proposed rules would provide guidance to the industry with respect to the GLBA requirements. The proposal also provides certain conditional exemptions from the broker definition to allow banks to perform certain securities activities. The Supplementary Information Section above contains more detailed information on the objectives of the proposed rules.

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[158] 15 U.S.C. 78c(a)(4).

[159] Pub. L. No. 109-351, 120 Stat. 1966 (2006).

[160] See Exchange Act Section 3(a)(4)(F), as added by Section 101 of the Regulatory Relief Act. The Regulatory Relief Act also requires that the Board and SEC consult with, and seek the concurrence of, the OCC, FDIC and OTS prior to jointly adopting final rules. As noted above, the Board and the SEC also have consulted extensively with the OCC, FDIC and OTS in developing these joint proposed rules.

3. Legal Basis

Pursuant to Section 101 of the Regulatory Relief Act, the Agencies are issuing the proposed rules for comment. In addition, pursuant to the Exchange Act and, particularly, the Sections 3(b), 15, 23(a), and 36 thereof, the Commission is issuing the proposed rules for comment.[161]

4. Small Entities Subject to the Rule

The proposed rule would apply to "banks," which is defined in Section 3(a)(6) of the Exchange Act to include banking institutions organized in the United States, including members of the Federal Reserve System, Federal savings associations, as defined in Section 2(5) of the Home Owners' Loan Act, and other commercial banks, savings associations, and nondepository trust companies that are organized under the laws of a state or the United States and subject to supervision and examination by state or federal authorities having supervision over banks and savings associations.[162] Congress did not exempt small entity banks from the application of the GLBA. Moreover, because the proposed rules are intended to provide guidance to and exemptions for all banks that are subject to the GBLA, the Agencies determined that it would not be appropriate or necessary to exempt small entity banks from the operation of the proposed rules Therefore, the proposed rules generally apply to all banks, including banks that would be considered small entities (i.e., banks with total assets of $165 million or less) for purposes of the RFA.[163]

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161 15 U.S.C. 78c(b), 78o, 78w(a), and 78mm.

162 See 15 U.S.C. 78c(a)(6); Pub. L. No. 109-351, 120 Stat. 1966 (2006).

163 Small Business Administration regulations define "small entities" to include banks and savings associations with total assets of $165 million or less. 13 CFR 121.201.

The Agencies estimate that the proposed rules would apply to approximately 9,475 banks, approximately 5,816 of which could be considered small banks with assets of $165 million or less. We do not anticipate any significant costs to small entity banks as a result of the proposed rules.

5. Reporting, Recordkeeping and Other Compliance Requirements

The proposed rules would not impose any significant reporting, recordkeeping, or other compliance requirements on banks that are small entities.[164]

Nevertheless, the Agencies request comment on the costs of compliance with any recordkeeping, reporting, or other requirements under the proposed rules. The Agencies also request comment on any anticipated ongoing costs associated with complying with the proposed rules.[165] Commenters should provide detailed estimates of these costs.

6. Duplicative, Overlapping, or Conflicting Federal Rules

The Agencies believe that there are no rules that duplicate, overlap, or conflict with the proposed rules.

7. Significant Alternatives

Pursuant to Section 3(a) of the RFA,[166] the Agencies must consider the following types of 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 proposed rule for small entities; (3) the use of performance rather

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164 The Agencies' estimates related to recordkeeping and disclosure are detailed in the "Paperwork Reduction Act Analysis" Section of this Release.

165 The Agencies' estimates of the costs and benefits of the proposed rule amendments are detailed in the "Consideration of Costs and Benefits" Section of this release.

166 5 U.S.C. 603(c).

than design standards; and (4) an exemption from coverage of the proposed rules, or any part thereof, for small entities.

As discussed above, the GLBA does not exempt small entity banks from the Exchange Act broker registration requirements and because the proposed rules are intended to provide guidance to, and exemptions for, all banks that are subject to the GLBA, the Agencies determined that it would not be appropriate or necessary to exempt small entity banks from the operation of the proposed rules. Moreover, providing one or more special exemptions for small banks could place broker-dealers, including small broker-dealers, or larger banks at a competitive disadvantage versus small banks.

The proposed rules are intended to clarify and simplify compliance with the GLBA by providing guidance with respect to exceptions and by providing additional exemptions. As such, the proposed rules should facilitate compliance by banks of all sizes, including small entity banks.

The Agencies do not believe that it is necessary to consider whether small entity banks should be permitted to use performance rather than design standards to comply with the proposed rules because the proposed rules already use performance standards. Moreover, the proposed rules do not dictate for entities of any size any particular design standards (e.g., technology) that must be employed to achieve the objectives of the proposed rules.

8. Request for Comments

The Agencies encourage written comments on matters discussed in the IRFA. In particular, the Agencies request comments on (1) the number of small entities that would be affected by the proposed rules; (2) the nature of any impact the proposed rules would

have on small entities and empirical data supporting the extent of the impact; and (3) how to quantify the number of small entities that would be affected by and/or how to quantify the impact of the proposed rules. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed rules are adopted, and will be placed in the same public file as comments on the proposal itself. Persons wishing to submit written comments should refer to the instructions for submitting comments in the front of this release.

F. Plain Language

Section 722 of the GLBA (12 U.S.C. 4809) requires the Board to use plain language in all proposed and final rules published by the Board after January 1, 2000. The Board has sought to present the proposed rules, to the maximum extent possible, in a simple and straightforward manner. The Board invites comments on whether there are additional steps that could be taken to make the proposed rules easier to understand.

IX. Statutory Authority

Pursuant to authority set forth in the Exchange Act and particularly Sections 3(a)(4), 3(b), 15, 17, 23(a), and 36 thereof (15 U.S.C. 78c(a)(4), 78c(b), 78o, 78q, 78w(a), and 78mm, respectively) the Commission proposes to repeal by operation of statute current Rules 3a4-2, 3a4-3, 3a4-4, 3a4-5, 3a4-6, and 3b-17 (§§ 240.3a4-2, 240.3a4-3, 240.3a4-4, 240.3a4-5, 240.3a4-6, and 240.3b-17, respectively). The Commission is proposing to repeal Exchange Act Rules 15a-7 and 15a-8 (§ 240.15a-7 and §240.15a-8, respectively). The Commission, jointly with the Board of Governors of the Federal Reserve System, is also proposing new Rules 700, 701, 721, 722, 723, 740, 741, 760, 771, 772, 775, 780, and

781 under the Exchange Act (§§ 247.700, 247.701, 247.721, 247.722, 247.723, 247.740, 247.741, 247.760, 247.771, 247.772, 247.775, 247.780, and 247.881, respectively).

X. Text of Proposed Rules and Rule Amendments

List of Subjects

12 CFR Part 218

Banks, Brokers, Securities.

17 CFR Part 240

Broker-dealers, Reporting and recordkeeping requirements, Securities.

17 CFR Part 247

Banks, Brokers, Securities.

Federal Reserve System

Authority and Issuance

For the reasons set forth in the preamble, the Board proposes to amend Title 12, Chapter II of the Code of Federal Regulations by adding a new Part 218 as set forth under Common Rules at the end of this document:

PART 218— EXCEPTIONS FOR BANKS FROM THE DEFINITION OF BROKER IN THE SECURITIES EXCHANGE ACT OF 1934 (REGULATION R)

Sec.

218.100 Definition.

218.700 Defined terms relating to the networking exception from the definition of "broker."

218.701 Exemption from the definition of "broker" for certain institutional referrals.

218.721 Defined terms relating to the trust and fiduciary activities exception from the definition of "broker."

218.722	Exemption allowing banks to calculate trust and fiduciary compensation on a bank-wide basis.
218.723	Exemptions for special accounts, transferred accounts, and a de minimis number of accounts.
218.740	Defined terms relating to the sweep accounts exception from the definition of "broker."
218.741	Exemption for banks effecting transactions in money market funds.
218.760	Exemption from definition of "broker" for banks accepting orders to effect transactions in securities from or on behalf of custody accounts.
218.771	Exemption from the definition of "broker" for banks effecting transactions in securities issued pursuant to Regulation S.
218.772	Exemption from the definition of "broker" for banks engaging in securities lending transactions.
218.775	Exemption from the definition of "broker" for the way banks effect excepted or exempted transactions in investment company securities.
218.780	Exemption for banks from liability under section 29 of the Securities Exchange Act of 1934.
218.781	Exemption from the definition of "broker" for banks for a limited period of time.

Authority: 15 U.S.C. 78c(a)(4)(F).

Securities and Exchange Commission

Authority and Issuance

For the reasons set forth in the preamble, the Commission proposes to amend Title 17, Chapter II of the Code of Federal Regulations as follows:

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

1. The authority citation for Part 240 continues to read, in part, as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p,

78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

2. Sections 240.3a4-2 through 240.3a4-6, 240.3b-17, 240.15a-7, and 240.15a-8 are removed and reserved.

3. Part 247 is added as set forth under Common Rules at the end of this document:

PART 247— REGULATION R – EXEMPTIONS AND DEFINITIONS RELATED TO THE EXCEPTIONS FOR BANKS FROM THE DEFINITION OF BROKER

Sec.

247.100 Definition.

247.700 Defined terms relating to the networking exception from the definition of "broker."

247.701 Exemption from the definition of "broker" for certain institutional referrals.

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247.760 Exemption from definition of "broker" for banks accepting orders to effect transactions in securities from or on behalf of custody accounts.

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247.775	Exemption from the definition of "broker" for the way banks effect excepted or exempted transactions in investment company securities.
247.780	Exemption for banks from liability under section 29 of the Securities Exchange Act of 1934.
247.781	Exemption from the definition of "broker" for banks for a limited period of time.

Authority: 15 U.S.C. 78c, 78o, 78q, 78w, and 78mm.

Common Rules

The common rules that are proposed to be adopted by the Board as Part 218 of Title 12, Chapter II of the Code of Federal Regulations and by the Commission as Part 247 of Title 17, Chapter II of the Code of Federal Regulations follow:

§ ___.100 Definition.

For purposes of this part the following definition shall apply: Act means the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.).

§ ___.700 Defined terms relating to the networking exception from the definition of "broker."

When used with respect to the Third Party Brokerage Arrangements ("Networking") Exception from the definition of the term "broker" in section 3(a)(4)(B)(i) of the Act (15 U.S.C. 78c(a)(4)(B)(i)) in the context of transactions with a customer, the following terms shall have the meaning provided:

(a) Contingent on whether the referral results in a transaction means dependent on whether the referral results in a purchase or sale of a security; whether an account is opened with a broker or dealer; whether the referral results in a transaction involving a

particular type of security; or whether it results in multiple securities transactions; provided, however, that a referral fee may be contingent on whether a customer:

(1) Contacts or keeps an appointment with a broker or dealer as a result of the referral; or

(2) Meets any objective, base-line qualification criteria established by the bank or broker or dealer for customer referrals, including such criteria as minimum assets, net worth, income, or marginal federal or state income tax rate, or any requirement for citizenship or residency that the broker or dealer, or the bank, may have established generally for referrals for securities brokerage accounts.

(b) (1) Incentive compensation means compensation that is intended to encourage a bank employee to refer potential customers to a broker or dealer or give a bank employee an interest in the success of a securities transaction at a broker or dealer. The term does not include compensation paid by a bank under a bonus or similar plan that is:

(i) Paid on a discretionary basis; and

(ii) Based on multiple factors or variables and:

(A) Those factors or variables include significant factors or variables that are not related to securities transactions at the broker or dealer;

(B) A referral made by the employee is not a factor or variable in determining the employee's compensation under the plan; and

(C) The employee's compensation under the plan is not determined by reference to referrals made by any other person.

(2) Nothing in this paragraph (b) shall be construed to prevent a bank from compensating an officer, director or employee on the basis of any measure of the overall profitability of:

(i) The bank, either on a stand-alone or consolidated basis;

(ii) Any of the bank's affiliates (other than a broker or dealer) or operating units; or

(iii) A broker or dealer if:

(A) Such profitability is only one of multiple factors or variables used to determine the compensation of the officer, director or employee; and

(B) The factors or variables used to determine the compensation of the officer, director or employee include significant factors or variables that are not related to the profitability of the broker or dealer.

(c) <u>Nominal one-time cash fee of a fixed dollar amount</u> means a cash payment for a referral in an amount that meets any of the following standards:

(1) The payment does not exceed:

(i) Twice the average of the minimum and maximum hourly wage established by the bank for the current or prior year for the job family that includes the employee; or

(ii) 1/1000th of the average of the minimum and maximum annual base salary established by the bank for the current or prior year for the job family that includes the employee; or

(2) The payment does not exceed twice the employee's actual base hourly wage; or

(3) The payment does not exceed twenty-five dollars ($25), as adjusted in accordance with paragraph (f) of this section.

(d) Job family means a group of jobs or positions involving similar responsibilities, or requiring similar skills, education or training, that a bank, or a separate unit, branch or department of a bank, has established and uses in the ordinary course of its business to distinguish among its employees for purposes of hiring, promotion, and compensation.

(e) Referral means the action taken by a bank employee to direct a customer of the bank to a broker or dealer for the purchase or sale of securities for the customer's account.

(f) Inflation adjustment.

(1) In general. On April 1, 2012, and on the 1st day of each subsequent 5-year period, the dollar amount referred to in paragraph (c)(3) of this section shall be adjusted by:

(i) Dividing the annual value of the Employment Cost Index For Wages and Salaries, Private Industry Workers (or any successor index thereto), as published by the Bureau of Labor Statistics, for the calendar year preceding the calendar year in which the adjustment is being made by the annual value of such index (or successor) for the calendar year ending December 31, 2006; and

(ii) Multiplying the dollar amount by the quotient obtained in paragraph (f)(1)(i) of this section.

(2) Rounding. If the adjusted dollar amount determined under paragraph (f)(1) of this section for any period is not a multiple of $1, the amount so determined shall be rounded to the nearest multiple of $1.

§ ___.701 Exemption from the definition of "broker" for certain institutional referrals.

(a) General. A bank that meets the requirements for the exception from the definition of "broker" under section 3(a)(4)(B)(i) of the Act (15 U.S.C. 78c(a)(4)(B)(i)), other than section 3(a)(4)(B)(i)(VI) of the Act (15 U.S.C. 78c(a)(4)(B)(i)(VI)), is exempt from the conditions of section 3(a)(4)(B)(i)(VI) of the Act solely to the extent that a bank employee receives a referral fee for referring a high net worth customer or institutional customer to a broker or dealer with which the bank has a contractual or other written arrangement of the type specified in section 3(a)(4)(B)(i) of the Act, if:

(1) Bank employee.

(i) The bank employee is:

(A) Not qualified or otherwise required to be qualified pursuant to the rules of a self-regulatory organization;

(B) Predominantly engaged in banking activities, other than making referrals to a broker or dealer; and

(C) Not subject to statutory disqualification, as that term is defined in section 3(a)(39) of the Act (15 U.S.C. 78c(a)(39)), except subparagraph (E) of that section; and

(ii) The high net worth customer or institutional customer is encountered by the bank employee in the ordinary course of the employee's assigned duties for the bank.

(2) Bank determinations and obligations.

(i) Disclosures. Prior to or at the time of the referral, the bank provides the customer with the information set forth in paragraph (b) of this section.

(ii) Customer qualification.

(A) In the case of a customer that is a not a natural person, the bank determines, before the referral fee is paid to the bank employee, that the customer is an institutional customer.

(B) In the case of a customer that is a natural person, the bank, prior to or at the time of the referral, either:

(1) Determines that the customer is a high net worth customer; or

(2) Obtains a signed acknowledgment from the customer that the customer meets the standards to be considered a high net worth customer.

(iii) Employee qualification information. Before the referral fee is paid to the bank employee, the bank provides the broker or dealer the name of the employee and such other identifying information that may be necessary for the broker or dealer to determine whether the bank employee is associated with a broker or dealer or is subject to statutory disqualification, as that term is defined in section 3(a)(39) of the Act (15 U.S.C. 78c(a)(39)), except subparagraph (E) of that section.

(iv) Good faith compliance and corrections. A bank that acts in good faith and that has reasonable policies and procedures in place to comply with the requirements of this section shall not be considered a "broker" under section 3(a)(4) of the Act (15 U.S.C. 78c(a)(4)) solely because the bank fails to comply with the provisions of this paragraph (a)(2) with respect to a particular customer if the bank:

(A) Takes reasonable and prompt steps to remedy the error (such as, for example, by promptly making the required determination or promptly providing the broker or dealer the required information); and

(B) Makes reasonable efforts to reclaim the portion of the referral fee paid to the bank employee for the referral that does not, following any required remedial action, meet the requirements of this section and that exceeds the amount otherwise permitted under section 3(a)(4)(B)(i)(VI) of the Act (15 U.S.C. 78c(a)(4)(B)(i)(VI)) and § ___.700.

(3) Provisions of written agreement. The written agreement between the bank and the broker or dealer provides for the following:

(i) Customer and employee qualifications. Before the referral fee is paid to the bank employee:

(A) The bank and broker or dealer must determine that the bank employee is not subject to statutory disqualification, as that term is defined in section 3(a)(39) of the Act (15 U.S.C. 78c(a)(39)), except subparagraph (E) of that section; and

(B) The broker or dealer must determine that the customer is a high net worth customer or an institutional customer.

(ii) Suitability or sophistication determination by broker or dealer.

(A) Contingent referral fees. In any case in which payment of the referral fee is contingent on completion of a securities transaction at the broker or dealer, the broker or dealer must, before such securities transaction is conducted, perform a suitability analysis of the securities transaction in accordance with the rules of the broker or dealer's applicable self-regulatory organization as if the broker or dealer had recommended the securities transaction.

(B) Non-contingent referral fees. In any case in which payment of the referral fee is not contingent on the completion of a securities transaction at the broker or dealer, the broker or dealer must, before the referral fee is paid, either:

(1) Determine that the customer:

(i) Has the capability to evaluate investment risk and make independent decisions; and

(ii) Is exercising independent judgment based on the customer's own independent assessment of the opportunities and risks presented by a potential investment, market factors and other investment considerations; or

(2) Perform a suitability analysis of all securities transactions requested by the customer contemporaneously with the referral in accordance with the rules of the broker or dealer's applicable self-regulatory organization as if the broker or dealer had recommended the securities transaction.

(iii) Notice. The broker or dealer must promptly inform the bank if the broker or dealer determines that:

(A) The customer is not a high net worth customer or institutional customer, as applicable;

(B) The bank employee is subject to statutory disqualification, as that term is defined in section 3(a)(39) of the Act (15 U.S.C. 78c(a)(39)), except subparagraph (E) of that section; or

(C) The customer or the securities transaction(s) to be conducted by the customer do not meet the applicable standard set forth in paragraph (a)(3)(ii) of this section.

(b) Required disclosures. The information provided to the high net worth customer or institutional customer pursuant to paragraph (a)(2)(i) of this section shall clearly and conspicuously disclose:

(1) The name of the broker or dealer; and

(2) That the bank employee participates in an incentive compensation program under which the bank employee may receive a fee of more than a nominal amount for referring the customer to the broker or dealer and payment of this fee may be contingent on whether the referral results in a transaction with the broker or dealer.

(c) Receipt of other compensation. Nothing in this section prevents or prohibits a bank from paying or a bank employee from receiving any type of compensation that would not be considered incentive compensation under § ___.700(b)(1) or that is described in § ___.700(b)(2).

(d) Definitions. When used in this section:

(1) High net worth customer means any natural person who, either individually or jointly with his or her spouse, has at least $5 million in net worth excluding the primary residence and associated liabilities of the person and, if applicable, his or her spouse. In determining whether any person is a high net worth customer, there may be included in the assets of such person assets held individually and fifty percent of any assets held jointly with such person's spouse and any assets in which such person shares with such person's spouse a community property or similar shared ownership interest. In determining whether spouses acting jointly are high net worth customers, there may be included in the amount of each spouse's assets any assets of the other spouse (whether or not such assets are held jointly).

(2) Institutional customer means any corporation, partnership, limited liability company, trust or other non-natural person that has at least:

(i) $10 million in investments; or

(ii) $40 million in assets; or

(iii) $25 million in assets if the bank employee refers the customer to the broker or dealer for investment banking services.

(3) Investment banking services includes, without limitation, acting as an underwriter in an offering for an issuer; acting as a financial adviser in a merger, acquisition, tender-offer or similar transaction; providing venture capital, equity lines of credit, private investment-private equity transactions or similar investments; serving as placement agent for an issuer; and engaging in similar activities.

(4) Referral fee means a fee (paid in one or more installments) for the referral of a customer to a broker or dealer that is:

(i) A predetermined dollar amount, or a dollar amount determined in accordance with a predetermined formula (such as a fixed percentage of the dollar amount of total assets placed in an account with the broker or dealer), that does not vary based on:

(A) The revenue generated by or the profitability of securities transactions conducted by the customer with the broker or dealer; or

(B) The quantity, price, or identity of securities transactions conducted over time by the customer with the broker or dealer; or

(C) The number of customer referrals made; or

(ii) A dollar amount based on a fixed percentage of the revenues received by the broker or dealer for investment banking services provided to the customer.

(e) Inflation adjustments.

(1) In general. On April 1, 2012, and on the 1st day of each subsequent 5-year period, each dollar amount in paragraphs (d)(1) and (d)(2) of this section shall be adjusted by:

(i) Dividing the annual value of the Personal Consumption Expenditures Chain-Type Price Index (or any successor index thereto), as published by the Department of Commerce, for the calendar year preceding the calendar year in which the adjustment is being made by the annual value of such index (or successor) for the calendar year ending December 31, 2006; and

(ii) Multiplying the dollar amount by the quotient obtained in paragraph (e)(1)(i) of this section.

(2) Rounding. If the adjusted dollar amount determined under paragraph (e)(1) of this section for any period is not a multiple of $100,000, the amount so determined shall be rounded to the nearest multiple of $100,000.

§ ___.721 Defined terms relating to the trust and fiduciary activities exception from the definition of "broker."

(a) Defined terms for chiefly compensated test. For purposes of this part and section 3(a)(4)(B)(ii) of the Act (15 U.S.C. 78c(a)(4)(B)(ii)), the following terms shall have the meaning provided:

(1) Chiefly compensated—account-by-account test. Chiefly compensated shall mean the relationship-total compensation percentage for each trust or fiduciary account of the bank is greater than 50 percent.

(2) The relationship-total compensation percentage for a trust or fiduciary account shall be the mean of the yearly compensation percentage for the account for the

immediately preceding year and the yearly compensation percentage for the account for the year immediately preceding that year.

(3) The yearly compensation percentage for a trust or fiduciary account shall be equal to the relationship compensation attributable to the trust or fiduciary account during the year divided by the total compensation attributable to the trust or fiduciary account during that year, with the quotient expressed as a percentage.

(4) Relationship compensation means any compensation a bank receives that consists of:

(i) An administration fee, including, without limitation, a fee paid for personal services, tax preparation, or real estate settlement services, or a fee paid by an investment company for personal service, the maintenance of shareholder accounts or any service described in paragraph (a)(4)(iii)(C) of this section;

(ii) An annual fee (payable on a monthly, quarterly or other basis);

(iii) A fee based on a percentage of assets under management, including, without limitation:

(A) A fee paid by an investment company pursuant to a plan under 17 CFR 270.12b-1;

(B) A fee paid by an investment company for personal service or the maintenance of shareholder accounts; or

(C) A fee paid by an investment company based on a percentage of assets under management for any of the following services:

(1) Providing transfer agent or sub-transfer agent services for beneficial owners of investment company shares;

(2) Aggregating and processing purchase and redemption orders for investment company shares;

(3) Providing beneficial owners with account statements showing their purchases, sales, and positions in the investment company;

(4) Processing dividend payments for the investment company;

(5) Providing sub-accounting services to the investment company for shares held beneficially;

(6) Forwarding communications from the investment company to the beneficial owners, including proxies, shareholder reports, dividend and tax notices, and updated prospectuses; or

(7) Receiving, tabulating, and transmitting proxies executed by beneficial owners of investment company shares;

(iv) A flat or capped per order processing fee, paid by or on behalf of a customer or beneficiary, that is equal to not more than the cost incurred by the bank in connection with executing securities transactions for trust or fiduciary accounts; or

(v) Any combination of such fees.

(5) Trust or fiduciary account means an account for which the bank acts in a trustee or fiduciary capacity as defined in section 3(a)(4)(D) of the Act (15 U.S.C. 78c(a)(4)(D)).

(6) Year means a calendar year, or fiscal year consistently used by the bank for recordkeeping and reporting purposes.

(b) Advertising restrictions.

(1) In general. A bank complies with the advertising restriction in section 3(a)(4)(B)(ii)(II) of the Act (15 U.S.C. 78c(a)(4)(B)(ii)(II)) if advertisements by or on behalf of the bank do not advertise:

(i) That the bank provides securities brokerage services for trust or fiduciary accounts except as part of advertising the bank's broader trust or fiduciary services; and

(ii) The securities brokerage services provided by the bank to trust or fiduciary accounts more prominently than the other aspects of the trust or fiduciary services provided to such accounts.

(2) Advertisement. For purposes of this section, the term advertisement has the same meaning as in § ___.760(g)(2).

§ ___.722 Exemption allowing banks to calculate trust and fiduciary compensation on a bank-wide basis.

(a) General. A bank is exempt from meeting the "chiefly compensated" condition in section 3(a)(4)(B)(ii)(I) of the Act (15 U.S.C. 78c(a)(4)(B)(ii)(I)) to the extent that it effects transactions in securities for any account in a trustee or fiduciary capacity within the scope of section 3(a)(4)(D) of the Act (15 U.S.C. 78c(a)(4)(D)) if:

(1) The bank meets the other conditions for the exception from the definition of the term "broker" under sections 3(a)(4)(B)(ii) and 3(a)(4)(C) of the Act (15 U.S.C. 78c(a)(4)(B)(ii) and 15 U.S.C. 78c(a)(4)(C)); and

(2) The aggregate relationship-total compensation percentage for the bank's trust and fiduciary business is at least 70 percent.

(b) Aggregate relationship-total compensation percentage. For purposes of this section, the aggregate relationship-total compensation percentage for a bank's trust and fiduciary business shall be the mean of the bank's yearly bank-wide compensation percentage for the immediately preceding year and the bank's yearly bank-wide compensation percentage for the year immediately preceding that year.

(c) Yearly bank-wide compensation percentage. For purposes of this section, a bank's yearly bank-wide compensation percentage for a year shall equal the relationship compensation attributable to the bank's trust and fiduciary business as a whole during the year divided by the total compensation attributable to the bank's trust and fiduciary business as a whole during that year, with the quotient expressed as a percentage.

§ ____.723 Exemptions for special accounts, transferred accounts, and a de minimis number of accounts.

(a) Short-term accounts. A bank may, in determining its compliance with the chiefly compensated test in § ____.721(a)(1) and § ____.722(a)(2), exclude any trust or fiduciary account that had been open for a period of less than 3 months during the relevant year.

(b) Accounts acquired as part of a business combination or asset acquisition. For purposes of determining compliance with the chiefly compensated test in § ____.721(a)(1) or § ____.722(a)(2), any trust or fiduciary account that a bank acquired from another person as part of a merger, consolidation, acquisition, purchase of assets or similar

transaction may be excluded by the bank for 12 months after the date the bank acquired the account from the other person.

(c) Accounts transferred to a broker or dealer or other unaffiliated entity. Notwithstanding section 3(a)(4)(B)(ii)(I) of the Act (15 U.S.C. 78c(a)(4)(B)(ii)(I)) and § ___.721(a)(1), a bank shall not be considered a broker for purposes of section 3(a)(4) of the Act (15 U.S.C. 78c(a)(4)) solely because a trust or fiduciary account does not meet the chiefly compensated standard in § ___.721(a)(1) if, within 3 months of the end of the year in which the account fails to meet such standard, the bank transfers the account or the securities held by or on behalf of the account to a broker or dealer registered under section 15 of the Act (15 U.S.C. 78o) or another entity that is not an affiliate of the bank and is not required to be registered as a broker or dealer.

(d) De minimis exclusion. A bank may, in determining its compliance with the chiefly compensated test in § ___.721(a)(1), exclude a trust or fiduciary account if:

(1) The bank maintains records demonstrating that the securities transactions conducted by or on behalf of the account were undertaken by the bank in the exercise of its trust or fiduciary responsibilities with respect to the account;

(2) The total number of accounts excluded by the bank under this paragraph (d) does not exceed the lesser of:

(i) 1 percent of the total number of trust or fiduciary accounts held by the bank, provided that if the number so obtained is less than 1, the amount shall be rounded up to 1; or

(ii) 500; and

(3) The bank did not rely on this paragraph (d) with respect to such account during the immediately preceding year.

§ ___.740 Defined terms relating to the sweep accounts exception from the definition of "broker."

For purposes of section 3(a)(4)(B)(v) of the Act (15 U.S.C. 78c(a)(4)(B)(v)), the following terms shall have the meaning provided:

(a) Deferred sales load has the same meaning as in 17 CFR 270.6c-10.

(b) Money market fund means an open-end company registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.) that is regulated as a money market fund pursuant to 17 CFR 270.2a-7.

(c)(1) No-load, in the context of an investment company or the securities issued by an investment company, means, for securities of the class or series in which a bank effects transactions, that:

(i) That class or series is not subject to a sales load or a deferred sales load; and

(ii) Total charges against net assets of that class or series of the investment company's securities for sales or sales promotion expenses, for personal service, or for the maintenance of shareholder accounts do not exceed 0.25 of 1% of average net assets annually.

(2) For purposes of this definition, charges for the following will not be considered charges against net assets of a class or series of an investment company's securities for sales or sales promotion expenses, for personal service, or for the maintenance of shareholder accounts:

(i) Providing transfer agent or sub-transfer agent services for beneficial owners of investment company shares;

(ii) Aggregating and processing purchase and redemption orders for investment company shares;

(iii) Providing beneficial owners with account statements showing their purchases, sales, and positions in the investment company;

(iv) Processing dividend payments for the investment company;

(v) Providing sub-accounting services to the investment company for shares held beneficially;

(vi) Forwarding communications from the investment company to the beneficial owners, including proxies, shareholder reports, dividend and tax notices, and updated prospectuses; or

(vii) Receiving, tabulating, and transmitting proxies executed by beneficial owners of investment company shares.

(d) Open-end company has the same meaning as in section 5(a)(1) of the Investment Company Act of 1940 (15 U.S.C. 80a-5(a)(1)).

(e) Sales load has the same meaning as in section 2(a)(35) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(35)).

§ ___.741 Exemption for banks effecting transactions in money market funds.

(a) A bank is exempt from the definition of the term "broker" under section 3(a)(4) of the Act (15 U.S.C. 78c(a)(4)) to the extent that it effects transactions on behalf of a customer in securities issued by a money market fund, provided that:

(1) The bank provides the customer, directly or indirectly, any other product or service, the provision of which would not, in and of itself, require the bank to register as a broker or dealer under section 15(a) of the Act (15 U.S.C. 78o(a)); and

(2)(i) The class or series of securities is no-load; or

(ii) If the class or series of securities is not no-load,

(A) The bank provides the customer, not later than at the time the customer authorizes the bank to effect the transactions, a prospectus for the securities; and

(B) The bank does not characterize or refer to the class or series of securities as no-load.

(b) Definitions. For purposes of this section:

(1) Money market fund has the same meaning as in § ___.740(b).

(2) No-load has the same meaning as in § ___.740(c).

§ ___.760 Exemption from definition of "broker" for banks accepting orders to effect transactions in securities from or on behalf of custody accounts.

(a) Employee benefit plan accounts and individual retirement accounts or similar accounts. A bank is exempt from the definition of the term "broker" under section 3(a)(4) of the Act (15 U.S.C. 78c(a)(4)) to the extent that, as part of its customary banking activities, the bank accepts orders to effect transactions in securities for an

employee benefit plan account or an individual retirement account or similar account for which the bank acts as a custodian if:

(1) Employee compensation restriction. The bank complies with the employee compensation restrictions in paragraph (c) of this section;

(2) Advertisements. Advertisements by or on behalf of the bank do not:

(i) Advertise that the bank accepts orders for securities transactions for employee benefit plan accounts or individual retirement accounts or similar accounts, except as part of advertising the other custodial or safekeeping services the bank provides to these accounts; or

(ii) Advertise that such accounts are securities brokerage accounts or that the bank's safekeeping and custody services substitute for a securities brokerage account; and

(3) Advertisements and sales literature for individual retirement or similar accounts. Advertisements and sales literature issued by or on behalf of the bank do not describe the securities order-taking services provided by the bank to individual retirement or similar accounts more prominently than the other aspects of the custody or safekeeping services provided by the bank to these accounts.

(b) Accommodation trades for other custodial accounts. A bank is exempt from the definition of the term "broker" under section 3(a)(4) of the Act (15 U.S.C. 78c(a)(4)) to the extent that, as part of its customary banking activities, the bank accepts orders to effect transactions in securities for an account for which the bank acts as custodian other

than an employee benefit plan account or an individual retirement account or similar account if:

(1) Accommodation. The bank accepts orders to effect transactions in securities for the account only as an accommodation to the customer;

(2) Employee compensation restriction. The bank complies with the employee compensation restrictions in paragraph (c) of this section;

(3) Bank fees. Any fee charged or received by the bank for effecting a securities transaction for the account does not vary based on:

(i) Whether the bank accepted the order for the transaction; or

(ii) The quantity or price of the securities to be bought or sold;

(4) Advertisements. Advertisements by or on behalf of the bank do not state that the bank accepts orders for securities transactions for the account;

(5) Sales literature. Sales literature issued by or on behalf of the bank:

(i) Does not state that the bank accepts orders for securities transactions for the account except as part of describing the other custodial or safekeeping services the bank provides to the account; and

(ii) Does not describe the securities order-taking services provided to the account more prominently than the other aspects of the custody or safekeeping services provided by the bank to the account; and

(6) Investment advice and recommendations. The bank does not provide investment advice or research concerning securities to the account, make recommendations to the account concerning securities or otherwise solicit securities

transactions from the account; provided, however, that nothing in this paragraph (b)(6) shall prevent a bank from:

(i) Publishing, using or disseminating advertisements and sales literature in accordance with paragraphs (b)(4) and (b)(5) of this section; and

(ii) Responding to customer inquiries regarding the bank's safekeeping and custody services by providing:

(A) Advertisements or sales literature consistent with the provisions of paragraphs (b)(4) and (b)(5) of this section describing the safekeeping, custody and related services that the bank offers;

(B) A prospectus prepared by a registered investment company, or sales literature prepared by a registered investment company or by the broker or dealer that is the principal underwriter of the registered investment company pertaining to the registered investment company's products;

(C) Information based on the materials described in paragraphs (b)(6)(ii)(A) and (B) of this section; or

(iii) Responding to inquiries regarding the bank's safekeeping, custody or other services, such as inquiries concerning the customer's account or the availability of sweep or other services, so long as the bank does not provide investment advice or research concerning securities to the account or make a recommendation to the account concerning securities.

(c) Employee compensation restriction. A bank may accept orders pursuant to this section for a securities transaction for an account described in paragraph (a) or (b) of this section only if no bank employee receives compensation, including a fee paid

pursuant to a plan under 17 CFR 270.12b-1, from the bank, the executing broker or dealer, or any other person that is based on whether a securities transaction is executed for the account or that is based on the quantity, price, or identity of securities purchased or sold by such account, provided that nothing in this paragraph shall prohibit a bank employee from receiving compensation that would not be considered incentive compensation under § ___.700(b)(1) as if a referral had been made by the bank employee, or any compensation described in § ___.700(b)(2).

(d) Other conditions. A bank may accept orders for a securities transaction for an account for which the bank acts as a custodian under this section only if the bank:

(1) Does not act in a trustee or fiduciary capacity (as defined in section 3(a)(4)(D) of the Act (15 U.S.C. 78c(a)(4)(D)) with respect to the account;

(2) Complies with section 3(a)(4)(C) of the Act (15 U.S.C. 78c(a)(4)(C)) in handling any order for a securities transaction for the account; and

(3) Complies with section 3(a)(4)(B)(viii)(II) of the Act (15 U.S.C. 78c(a)(4)(B)(viii)(II)) regarding carrying broker activities.

(e) Non-fiduciary administrators and recordkeepers. A bank that acts as a non-fiduciary and non-custodial administrator or recordkeeper for an employee benefit plan for which another bank acts as custodian may rely on the exemption provided in this section if:

(1) Both the custodian bank and the administrator or recordkeeper bank meet the requirements of this section; and

(2) The administrator or recordkeeper bank does not execute a cross-trade with or for the employee benefit plan or net orders for securities for the plan, other than orders for shares of open-end investment companies not traded on an exchange.

(f) Evasions. In considering whether a bank meets the terms of this section, both the form and substance of the relevant account(s), transaction(s) and activities (including advertising activities) of the bank will be considered in order to prevent evasions of the requirements of this section.

(g) Definitions. When used in this section:

(1) Account for which the bank acts as a custodian means an account that is:

(i) An employee benefit plan account for which the bank acts as a custodian;

(ii) An individual retirement account or similar account for which the bank acts as a custodian; or

(iii) An account established by a written agreement between the bank and the customer that sets forth the terms that will govern the fees payable to, and rights and obligations of, the bank regarding the safekeeping or custody of securities.

(2) Advertisement means any material that is published or used in any electronic or other public media, including any Web site, newspaper, magazine or other periodical, radio, television, telephone or tape recording, videotape display, signs or billboards, motion pictures, or telephone directories (other than routine listings).

(3) Employee benefit plan account means a pension plan, retirement plan, profit sharing plan, bonus plan, thrift savings plan, incentive plan, or other similar plan, including, without limitation, an employer-sponsored plan qualified under section 401(a)

of the Internal Revenue Code (26 U.S.C. 401(a)), a governmental or other plan described in section 457 of the Internal Revenue Code (26 U.S.C. 457), a tax-deferred plan described in section 403(b) of the Internal Revenue Code (26 U.S.C. 403(b)), a church plan, governmental, multiemployer or other plan described in section 414(d), (e) or (f) of the Internal Revenue Code (26 U.S.C. 414(d), (e) or (f)), an incentive stock option plan described in section 422 of the Internal Revenue Code (26 U.S.C. 422); a Voluntary Employee Beneficiary Association Plan described in section 501(c)(9) of the Internal Revenue Code (26 U.S.C. 501(c)(9)), a non-qualified deferred compensation plan (including a rabbi or secular trust), a supplemental or mirror plan, and a supplemental unemployment benefit plan.

(4) Individual retirement account or similar account means an individual retirement account as defined in section 408 of the Internal Revenue Code (26 U.S.C. 408), Roth IRA as defined in section 408A of the Internal Revenue Code (26 U.S.C. 408A), health savings account as defined in section 223(d) of the Internal Revenue Code (26 U.S.C. 223(d)), Archer medical savings account as defined in section 220(d) of the Internal Revenue Code (26 U.S.C. 220(d)), Coverdell education savings account as defined in section 530 of the Internal Revenue Code (26 U.S.C. 530), or other similar account.

(5) Sales literature means any written or electronic communication, other than an advertisement, that is generally distributed or made generally available to customers of the bank or the public, including circulars, form letters, brochures, telemarketing scripts, seminar texts, published articles, and press releases concerning the bank's products or services.

(6) Principal underwriter has the same meaning as in section 2(a)(29) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(29)).

§ ___.771 Exemption from the definition of "broker" for banks effecting transactions in securities issued pursuant to Regulation S.

(a) A bank is exempt from the definition of the term "broker" under section 3(a)(4) of the Act (15 U.S.C. 78c(a)(4)), to the extent that, as agent, the bank:

(1) Effects a sale in compliance with the requirements of 17 CFR 230.903 of an eligible security to a purchaser who is outside of the United States within the meaning of 17 CFR 230.903;

(2) Effects a resale of an eligible security after its initial sale with a reasonable belief that the eligible security was initially sold outside of the United States within the meaning of and in compliance with the requirements of 17 CFR 230.903, by or on behalf of a person who is not a U.S. person under 17 CFR 230.902(k) to a purchaser who is outside the United States within the meaning of 17 CFR 230.903 or a registered broker or dealer, provided that if the sale is made prior to the expiration of the distribution compliance period specified in 17 CFR 230.903(b)(2) or (b)(3), the sale is made in compliance with the requirements of 17 CFR 230.904; or

(3) Effects a resale of an eligible security after its initial sale outside of the United States within the meaning of and in compliance with the requirements of 17 CFR 230.903, by or on behalf of a registered broker or dealer to a purchaser who is outside the United States within the meaning of 17 CFR 230.903, provided that if the sale is made prior to the expiration of the distribution compliance period specified in 17

CFR 230.903(b)(2) or (b)(3), the sale is made in compliance with the requirements of 17 CFR 230.904.

(b) Definitions. For purposes of this section:

(1) Distributor has the same meaning as in 17 CFR 230.902(d).

(2) Eligible security means a security that:

(i) Is not being sold from the inventory of the bank or an affiliate of the bank; and

(ii) Is not being underwritten by the bank or an affiliate of the bank on a firm-commitment basis, unless the bank acquired the security from an unaffiliated distributor that did not purchase the security from the bank or an affiliate of the bank.

(3) Purchaser means a person who purchases an eligible security and who is not a U.S. person under 17 CFR 230.902(k).

§ ____.772 Exemption from the definition of "broker" for banks engaging in securities lending transactions.

(a) A bank is exempt from the definition of the term "broker" under section 3(a)(4) of the Act (15 U.S.C. 78c(a)(4)), to the extent that, as an agent, it engages in or effects securities lending transactions, and any securities lending services in connection with such transactions, with or on behalf of a person the bank reasonably believes to be:

(1) A qualified investor as defined in section 3(a)(54)(A) of the Act (15 U.S.C. 78c(a)(54)(A)); or

(2) Any employee benefit plan that owns and invests on a discretionary basis, not less than $ 25,000,000 in investments.

(b) Securities lending transaction means a transaction in which the owner of a security lends the security temporarily to another party pursuant to a written securities lending agreement under which the lender retains the economic interests of an owner of such securities, and has the right to terminate the transaction and to recall the loaned securities on terms agreed by the parties.

(c) Securities lending services means:

(1) Selecting and negotiating with a borrower and executing, or directing the execution of the loan with the borrower;

(2) Receiving, delivering, or directing the receipt or delivery of loaned securities;

(3) Receiving, delivering, or directing the receipt or delivery of collateral;

(4) Providing mark-to-market, corporate action, recordkeeping or other services incidental to the administration of the securities lending transaction;

(5) Investing, or directing the investment of, cash collateral; or

(6) Indemnifying the lender of securities with respect to various matters.

§ ___.775 Exemption from the definition of "broker" for the way banks effect excepted or exempted transactions in investment company securities.

(a) A bank that meets the conditions for an exception or exemption from the definition of the term "broker" except for the condition in section 3(a)(4)(C)(i) of the Act (15 U.S.C. 78c(a)(4)(C)(i)), is exempt from such condition to the extent that it effects transactions in securities issued by an open-end company that is neither traded on a national securities exchange nor through the facilities of a national securities association or an interdealer quotation system, provided that:

(1) Such transactions are effected through the National Securities Clearing Corporation's Mutual Fund Services or directly with a transfer agent acting for the open-end company; and

(2) The securities are distributed by a registered broker or dealer, or the sales charge is no more than the amount a registered broker or dealer may charge pursuant to the rules of a securities association registered under section 15A of the Act (15 U.S.C. 78o-3) adopted pursuant to section 22(b)(1) of the Investment Company Act of 1940 (15 U.S.C. 80a-22(b)(1)).

(b) Definitions. For purposes of this section:

(1) Interdealer quotation system has the same meaning as in 17 CFR 240.15c2-11.

(2) Open-end company has the same meaning as in § ___.740.

§ ___.780 Exemption for banks from liability under section 29 of the Securities Exchange Act of 1934.

(a) No contract entered into before [insert date 18 months after effective date of the final rule], shall be void or considered voidable by reason of section 29(b) of the Act (15 U.S.C. 78cc(b)) because any bank that is a party to the contract violated the registration requirements of section 15(a) of the Act (15 U.S.C. 78o(a)), any other applicable provision of the Act, or the rules and regulations thereunder based solely on the bank's status as a broker when the contract was created.

(b) No contract shall be void or considered voidable by reason of section 29(b) of the Act (15 U.S.C. 78cc(b)) because any bank that is a party to the contract violated the registration requirements of section 15(a) of the Act (15 U.S.C. 78o(a)) or the rules and regulations thereunder based solely on the bank's status as a broker when the contract was created, if:

(1) At the time the contract was created, the bank acted in good faith and had reasonable policies and procedures in place to comply with section 3(a)(4)(B) of the Act (15 U.S.C. 78c(a)(4)(B)) and the rules and regulations thereunder; and

(2) At the time the contract was created, any violation of the registration requirements of section 15(a) of the Act by the bank did not result in any significant harm or financial loss or cost to the person seeking to void the contract.

§ ___.781 Exemption from the definition of "broker" for banks for a limited period of time.

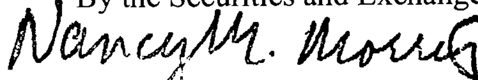
A bank is exempt from the definition of the term "broker" under section 3(a)(4) of the Act (15 U.S.C. 78c(a)(4)) until the first day of its first fiscal year commencing after June 30, 2008.

By order of the Board of Governors of the Federal Reserve System, December 18, 2006.

Jennifer J. Johnson,
Secretary of the Board.

Dated: December 18, 2006

By the Securities and Exchange Commission.



Nancy M. Morris
Secretary

SECURITIES AND EXCHANGE COMMISSION

Release No. 34-54948; File No. S7-12-01

December 18, 2006

Order Extending Temporary Exemption of Banks from the Definition of "Broker" under Section 3(a)(4) of the Securities Exchange Act of 1934

I. Background

The Gramm-Leach-Bliley Act ("GLBA") repealed the blanket exception of banks from the definitions of "broker" and "dealer" under the Securities Exchange Act of 1934 ("Exchange Act")[1] and replaced it with functional exceptions incorporated in amended definitions of "broker" and "dealer." Under the GLBA, banks that engage in securities activities either must conduct those activities through a registered broker-dealer or ensure that their securities activities fit within the terms of a functional exception to the amended definition of "broker."

The GLBA provided that the amended definitions of "broker" and "dealer" were to become effective May 12, 2001. Starting on May 11, 2001, in connection with various rulemaking proposals,[2] the Securities and Exchange Commission ("Commission") extended, most recently until January 15, 2007, a temporary exemption that gave banks

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1 As defined in Exchange Act Sections 3(a)(4) and 3(a)(5) [15 U.S.C. 78c(a)(4) and 78c(a)(5)].

2 See Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, Exchange Act Release No. 44291 (May 11, 2001), 66 FR 27760 (May 18, 2001) (the "Interim Rules"). See also Exchange Act Release No. 49879 (June 17, 2004), 69 FR 39682 (June 30, 2004) ("Regulation B"). In the Interim Rules, the Commission adopted Exchange Act Rule 15a-7, 17 CFR 240.15a-7, which, as proposed to be amended, would provide banks and other financial institutions until January 1, 2006, to begin complying with the GLBA. In proposing Regulation B, the Commission proposed Rule 781 as a re-designation of Rule 15a-7. See 17 CFR 242.781.

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time to come into full compliance with the more narrowly-tailored exceptions from broker-dealer registration under the GLBA.[3]

On October 13, 2006, President Bush signed into law the "Financial Services Regulatory Relief Act of 2006 ("Regulatory Relief Act")."[4] Among other things, the Regulatory Relief Act requires the Commission and the Board of Governors of the Federal Reserve ("Board") jointly to adopt final rules implementing the bank broker exceptions in Section 3(a)(4) of the Exchange Act. It also requires that within 180 days of passage of the Regulatory Relief Act, the Commission and the Board jointly issue proposed rules.[5]

Consistent with the Regulatory Relief Act, the Commission today proposes implementing rules jointly with the Board.[6] As a result, the Commission is also granting banks[7] an exemption from compliance with the definition of broker until July 2, 2007, to

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3 See Exchange Act Release No. 44570 (July 18, 2001); Exchange Act Release No. 45897 (May 8, 2002); Exchange Act Release No. 46751 (Oct. 30, 2002); Exchange Act Release No. 47649 (April 8, 2003); Exchange Act Release No. 50618 (Nov. 1, 2004); Exchange Act Release No. 51328 (March 8, 2005); Exchange Act Release No. 52405 (Sept. 9, 2005); and Exchange Act Release No. 54544 (September 29, 2006), 71 FR 58891 (October 5, 2006) (extending the exemption from the definition of "broker" until January 15, 2006); During this time, the Commission also extended the temporary exemption from the definition of "dealer" to September 30, 2003. See Exchange Act Release No. 47366 (Feb. 13, 2003). On February 13, 2003, the Commission adopted amendments to certain parts of the Interim Rules that define terms used in the dealer exceptions, as well as certain dealer exemptions ("Dealer Release"), see Exchange Act Release No. 47364 (Feb. 13, 2003), 68 FR 8686 (Feb. 24, 2003). Therefore, this order is limited to an extension of the temporary exemption from the definition of "broker."

4 Pub. L. No. 109-351, 120 Stat. 1966 (2006).

5 Under the Regulatory Relief Act, a final single set of rules or regulations jointly adopted in accordance with that Act shall supersede any other proposed or final rule issued by the Commission on or after the date of enactment of Section 201 of the GLBA with regard to the definition of "broker" under Exchange Act Section 3(a)(4).

6 Exchange Act Release No. 54946 (Dec. 18, 2006).

7 Section 401 of the Regulatory Relief Act also amended the definition of "bank" in Section 3(a)(6) of the Exchange Act to include any Federal savings association or other savings association the deposits of which are insured by the FDIC. Accordingly, as used in this order, the term "bank" includes any savings association that qualifies as a "bank" under Section 3(a)(6) of the Exchange Act, as amended.

permit the Commission and the Board time to receive comments, evaluate the comments on the implementing rules, and to take final action on the implementing rules.

II. Extension of Temporary Exemption from Definition of "Broker"

In connection with the proposal of the implementing rules pursuant to the Regulatory Relief Act, the Commission finds that extending the temporary exemption for banks from the definition of "broker" is necessary and appropriate in the public interest, and is consistent with the protection of investors. In connection with this extension, the Commission notes that the implementing rules are being proposed with a request for comment and that the Commission and the Board will need time to give careful consideration to the comments and determine what changes, if any, should be made to the implementing rules. Recognizing that banks will need substantial time to come into compliance with final rules adopted by the Commission and the Board, we believe that extending the exemption from the definition of "broker" for banks until July 2, 2007, will prevent banks from unnecessarily incurring costs to comply before final implementing rules are jointly adopted. Further, the extension will give the Commission and the Board time to consider fully comments received on the implementing rules and take any final action on the proposal as necessary.

III. Conclusion

Accordingly, pursuant to Section 36 of the Exchange Act,[8]

IT IS HEREBY ORDERED that banks are exempt from the definition of the term "broker" under the Exchange Act until July 2, 2007.

By the Commission.

Nancy M. Morris
Secretary

By: Jill M. Peterson
Assistant Secretary

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[8] 15 U.S.C. 78mm.

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

Release No. 34-54947; File No. S7-23-06

RIN 3235-AJ77

Exemptions for Banks Under Section 3(a)(5) of the Securities Exchange Act of 1934 and Related Rules

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission is publishing for comment proposed rules and rule amendments regarding exemptions from the definitions of "broker" and "dealer" under the Securities Exchange Act of 1934 ("Exchange Act") for banks' securities activities. In particular, the Commission is re-proposing a conditional exemption originally proposed in 2004 that would allow banks to effect riskless principal transactions with non-U.S. persons pursuant to Regulation S under the Securities Act of 1933 ("Securities Act"). The Commission also is proposing to amend and redesignate an existing exemption from the definition of "dealer" for banks' securities lending activities as a conduit lender. In addition, the Commission is proposing to amend a rule that grants a limited exemption from U.S. broker-dealer registration for foreign broker-dealers, conforming the rule to amended definitions of "broker" and "dealer" under the Exchange Act. Finally, the Commission is requesting comment on its intention to withdraw a rule defining the term "bank" for purposes of Sections 3(a)(4) and 3(a)(5) of the Exchange Act, because of judicial invalidation, a time-limited exemption for banks' securities activities, because of the passage of time, and an exemption from the definition of

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"broker" and "dealer" for savings associations and savings banks, an exemption no longer necessary because of the passage of the Regulatory Relief Act.

DATES: Comments should be received on or before [INSERT DATE 90 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER].

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

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-23-06 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-23-06. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (http://www.sec.gov/rules/proposed.shtml). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549. All comments received will be posted without change; 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: Catherine McGuire, Chief Counsel; Linda Stamp Sundberg, Senior Special Counsel, at (202) 551-5550, Office of the Chief Counsel, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission is requesting public comment on proposed Rules 3a5-2, 3a5-3, and 15a-6 under the Exchange Act.

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I. Introduction and Background

Today, the Commission and the Board of Governors of the Federal Reserve System ("Board") are requesting comment on jointly proposed rules to implement the broker exceptions for banks relating to third-party networking arrangements, trust and fiduciary activities, sweep activities, and safekeeping and custody activities.[1]

The proposals in this release are intended to complement the Joint Proposal.[2] In particular, we re-propose (and propose to redesignate as Rule 3a5-2) a conditional exemption from the definition of dealer for banks to purchase from and sell to non-U.S. persons offerings in securities exempt under Regulation S.[3] In addition, we propose a clarifying amendment to Exchange Act Rule 15a-6,[4] which provides a conditional exemption from U.S. broker-dealer registration for certain foreign broker-dealers. This amendment would conform the language of Rule 15a-6 to more closely track the statutory changes made by the GLBA. We also propose to redesignate as new Rule 3a5-3

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1 Exchange Act Release No. 54946 (Dec. 18, 2006) ("Joint Proposal").

2 On May 11, 2001, the Commission adopted interim final rules ("the Interim Rules") regarding the Gramm-Leach-Bliley Act ("GLBA") definitions of broker and dealer. See Exchange Act Release No. 44291 (May 11, 2001), 66 FR 27760 (May 18, 2001) (http://www.sec.gov/rules/final/34-44291.htm). On June 17, 2004, the Commission proposed Regulation B. See Exchange Act Release No. 49879 (June 17, 2004), 69 FR 39682 (June 30, 2004) (http://www.sec.gov/rules/proposed/34-49879.htm). Both the Interim Rules as they apply to the broker activities of banks and Regulation B are superseded by the current joint rulemaking. The Regulatory Relief Act does not directly affect the operation of the rules the Commission adopted concerning banks' dealer activities. See Exchange Act Release No. 47364 (Feb.13, 2003), 68 FR 8686 (Feb. 24, 2003) (http://www.sec.gov/rules/final/34-47364.htm). However, we are proposing some limited amendments to separate and redesignate certain rules that provide exemptions to the definitions of both broker and dealer.

3 The rule was proposed in 2004 but no further action on the proposed rule was taken by the Commission.

4 17 CFR 240.15a-6.

existing Rule 15a-11 and to amend this exemption from the definition of dealer for banks' conduit securities lending activities. Finally, we propose to withdraw Exchange Act Rule 3b-9,[5] in which the Commission defined the term "bank" for purposes of Sections 3(a)(4)[6] and 3(a)(5)[7] of the Exchange Act, due to judicial invalidation, Exchange Act Rule 15a-8,[8] a time-limited exemption for banks' securities activities, because of the passage of time, and Exchange Act Rule 15a-9,[9] an exemption from the definitions of "broker" and "dealer" for savings associations and savings banks, an exemption no longer necessary after passage of the Regulatory Relief Act.

II. The Proposed Rules and Rule Amendments

A. Regulation S Transactions with Non-U.S. Persons

In response to an industry request,[10] the Commission proposed Exchange Act Rule 771 in 2004.[11] We are re-proposing at this time the exemption we proposed in

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5 17 CFR 240.3b-9.

6 15 U.S.C. 78c(a)(4).

7 15 U.S.C. 78c(a)(5).

8 17 CFR 240.15a-8.

9 17 CFR 240.15a-9.

10 See letter dated May 27, 2004, from Lawrence R. Uhlick, Executive Director and General Counsel, Institute of International Bankers to Catherine McGuire, Chief Counsel, Division of Market Regulation, Securities and Exchange Commission (http://www.sec.gov/rules/proposed/s72604.shtml). Regulation S [17 CFR 230.901, et seq.] specifies the requirements for an offer or sale of securities to be deemed to occur outside the United States and therefore not subject to the registration requirements of Section 5 of the Securities Act. Regulation S permits the sale of newly issued off-shore securities and re-sales of off-shore securities from a non-U.S. person to a non-U.S. person.

11 See Exchange Act Release No. 49879, supra note 2. The Commission originally proposed this exemption to cover both a banks' broker and dealer securities activities. The Commission and the Board are jointly are re-proposing this exemption for banks' broker activities in response to passage of the Financial Services Regulatory Relief Act of

2004, as applied to banks' dealer activities, substantially as proposed. As originally proposed, this rule would provide banks with a conditional exemption from the definition of "dealer" to engage in transactions with non-U.S. persons pursuant to Regulation S under the Securities Act of 1933.[12] In particular, a bank could purchase and sell "eligible securities"[13] to offshore, non-U.S. persons on a "riskless principal" basis.[14] A bank could also resell any eligible Regulation S security, after its purchase and after its initial issuance, to a non-U.S. person as long as the bank continues to comply with the requirements of Regulation S.[15] After the requirements of Regulation S cease to apply to an issuance, a bank could resell such a security to another non-U.S. person or a broker-dealer, as long as the transaction complies with another bank broker or dealer exception or exemption.

2006, Pub. L. No. 109-351, 120 Stat. 1966 (2006) ("Regulatory Relief Act"), which requires a joint proposal and provides that the final rules will supersede the existing bank broker rules. See text at note 36 infra.

12 Persons that conduct a broker or dealer business while located in the United States must register as broker-dealers (absent an exemption), even if they direct all of their selling efforts offshore. Exchange Act Release No. 27017 (July 11, 1989), 54 FR 30013, 30016 (July 19, 1989). Nothing in proposed Rule 771 would affect the necessity of complying with Regulation S (17 CFR 230.904) or any other requirements of or exemptions from the Securities Act. Since the original proposal covered both agency and riskless principal transactions, an exemption for agency (brokerage) transactions is being separately proposed as a part of the Joint Proposal.

13 Proposed Rule 771 would define an "eligible security" as a security not being sold from the inventory of the bank or an affiliate of the bank, and not being underwritten by the bank or an affiliate of the bank on a firm-commitment basis unless the bank acquired the security from an unaffiliated distributor that did not purchase the security from the bank or a bank affiliate.

14 Proposed Rule 771 would define a "riskless principal transaction" as a transaction in which, after receiving an order to buy from a customer, the bank purchased the security from another person to offset a contemporaneous sale to such customer or, after having received an order to sell from a customer, the bank sold the security to another person to offset a contemporaneous purchase from such customer.

15 Rule 904 of Regulation S (17 CFR 230.904).

In explaining the need for an exemption, the industry group expressed the view to the Commission staff that non-U.S. persons expect to deal with one private banker, and that these customers would not choose to deal with a registered broker-dealer to conduct securities transactions in Regulation S securities, but would instead look to foreign banks to effect these transactions.

We are re-proposing this exemption for the same reasons we proposed it in 2004. In proposing this exemption, we noted that the limited conditions in the proposed rule reflected our belief that non-U.S. persons generally will not be relying on the protections of the U.S. securities laws when purchasing Regulation S securities from U.S. banks.[16] By their terms, these securities are not intended to be sold within the U.S. We also expressed our understanding that non-U.S. persons can purchase the same securities from banks located outside of the U.S. We invited comment on whether U.S. broker-dealer registration should be required with respect to transactions with these non-U.S. persons who are purchasing new offering securities offshore, or may be selling or purchasing seasoned securities.

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16 Exchange Act Release No. 49879, supra note 2, 69 FR 39720. We also explained that although we generally believe that U.S. broker-dealers should be subject to the same standards of conduct when dealing with non-U.S. persons, this principle is less compelling when the foreign person has chosen to deal with a U.S. bank with respect to Regulation S securities that are designed to be sold to non-U.S. persons offshore.

Moreover, while no rules have been adopted, the exemption provided by Exchange Act Section 30(b), concerning foreign securities, has been held unavailable if the United States is used as a base for securities fraud perpetrated on foreigners, Arthur Lipper Corp. v. SEC, 547 F.2d 171 (2d Cir. 1976), reh. denied, 551 F.2d 915 (2d Cir. 1977), cert. denied 434 U.S. 1009.

We received few comments on this proposed exemption.[17] Commenters generally supported proposed Rule 771, stating that it would allow banks to compete with foreign banks not subject to Commission regulation.[18] However, several commenters urged the Commission to broaden the proposed exemption. For example, one commenter suggested that the Commission modify the proposed exemption to include transactions for foreign investors in all securities sold in the United States.[19] Two commenters urged the Commission to amend the proposed definition of "eligible security" to eliminate the restriction on banks' selling securities from the inventory of affiliates or those underwritten by affiliates.[20] Two commenters suggested that the Commission expand the exemption to cover all secondary market trading with offshore persons in any "foreign securities" not effected on a U.S. exchange or Nasdaq, stating that it is burdensome for a bank to determine whether a security was initially sold in compliance with Regulation S.[21] One commenter also stated that to the extent the proposed rule requires a bank to make any determination or conduct any investigation of the way in which a

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17 See, e.g., letter dated September 1, 2004 from Jeffrey P. Neubert, President and CEO, the Clearing House ("Clearing House letter"); letter dated September 1, 2004 from Lawrence R. Uhlick, Executive Director and Chief Counsel, Institute of International Bankers ("IIB letter"); letter dated September 1, 2004 from Agustin Abalo, President, Florida International Bankers Association, Inc. ("FIBA letter"); letter dated September 1, 2004 from Sarah A. Miller, Director, Center for Securities, Trust and Investment, American Bankers Association and General Counsel, ABA Securities Association ("ABA/ABASA letter"); and letter dated September 1, 2004 from Charles C. Cutrell, III, Executive Vice President and General Counsel, State Street Bank and Trust Company ("State Street letter").

18 See, e.g., Clearing House letter, IIB letter.

19 State Street letter.

20 See Clearing House letter; ABA/ABASA letter.

21 IIB letter, FIBA letter.

security was initially offered, the rule should only require the bank to have a "reasonable belief" that the eligible security was initially sold in compliance with Regulation S.[22] In this commenter's view, a bank may not have direct access to all of the information necessary to determine whether a security was initially offered under Regulation S or part of a class that was offered under Regulation S.[23]

After carefully considering the comments, we are proposing the exemption for banks' riskless principal transactions in Regulation S securities, as new Rule 3a5-2, substantially as initially proposed. This proposed rule, however, incorporates the reasonable belief standard suggested by one of the commenters because we are persuaded that a bank should not suffer the loss of the exemption when due care is taken to identify the source of a security, even if an error in the identification occurs.[24] We request comment on all aspects of Proposed Rule 3a5-2.

B. Amendment to Exchange Act Rule 15a-6

In 2004, the Commission also proposed a clarifying amendment to Exchange Act Rule 15a-6, which provides a conditional exemption from U.S. broker-dealer registration for certain foreign broker-dealers.[25] Exchange Act Rule 15a-6(a)(4)(i) allows a foreign

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22 IIB letter.

23 IIB letter. This commenter noted, however, that a bank may be able to obtain certain information regarding the security from third party information vendors or may need to rely on information statements or offering memoranda, filings, or other third-party sources to determine how the security was offered. This commenter said that the bank's exemption should not be jeopardized if this information is inaccurate or misleading as long as the bank had a reasonable belief that the information upon which it was relying was accurate and complete.

24 In addition to adding the reasonable belief standard, the re-proposal includes some non-substantive clarifying changes to the text of the rule as proposed in 2004.

25 Even when the GLBA permits a bank to engage in securities-related activities without itself registering as a broker-dealer, a broker-dealer engaged in the business of effecting

broker-dealer, without registering in the United States, to effect transactions in securities with or for a U.S.-registered broker-dealer or bank acting "in a broker-dealer capacity as permitted by U.S. law."[26] Thus, in transactions between a U.S. bank and its foreign broker-dealer affiliate, acting as principal, the U.S. bank could rely on the affiliate transactions exception in the GLBA,[27] and the foreign affiliate could rely on Rule 15a-6(a)(4)(i). As the Commission explained in 2001, however, Exchange Act Rule 15a-6(a)(4)(i) does not permit a foreign broker-dealer or bank to have direct contact with customers of the U.S. bank.[28] Moreover, the GLBA affiliate transactions exception from the definition of broker for banks would not permit the U.S. bank to effect transactions with the bank's foreign affiliate's customers.[29] We received no comments on our 2001 discussion of the interplay between Exchange Act Rule 15a-6 and the affiliate transactions exemption and we are taking the same approach in the current proposal.

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transactions for such bank still must register -- absent an exemption or other exclusion from the broker-dealer registration requirements of the Exchange Act. For instance, a foreign broker-dealer that executes trades for a bank under Exchange Act Section 3(a)(4)(C) would need to register as a U.S. broker-dealer if it does not meet the conditions of Exchange Act Rule 15a-6, or it does not otherwise qualify for an exemption from registration. Foreign banks cannot rely on the GLBA bank exceptions because they do not meet the definition of "bank" in Exchange Act Section 3(a)(6). However, U.S. branches and agencies of foreign banks would meet the definition of bank. See Exchange Act Release No. 27017, supra note 12, 54 FR 30015.

[26] 17 CFR 240.15a-6(a)(4)(i).

[27] 15 U.S.C. 78c(a)(4)(B)(vi).

[28] Exchange Act Release No. 44291, supra note 2.

[29] Id. If the Commission were to adopt the exemptions for Regulation S securities, proposed supra, a bank would be permitted to sell Regulation S securities to non-U.S. persons, including customers of a foreign affiliate, as long as it met the conditions of that exemption.

In light of the amended definitions of "broker" and "dealer," the Commission proposed an amendment to Exchange Act Rule 15a-6 in 2004.[30] Currently, Exchange Act Rule 15a-6(a)(4)(i) refers to "a bank acting in a broker or dealer capacity as permitted by U.S. law." As amended, however, the definitions of "broker" and "dealer" in Exchange Act Section 3(a)(4) and 3(a)(5), respectively, provide that banks engaging in the activities permitted under the conditional exceptions in those definitions "shall not be considered to be" brokers or dealers. To reflect this change, we proposed to amend Exchange Act Rule 15a-6(a)(4)(i) by replacing the phrase "in a broker or dealer capacity as permitted by U.S. law" with the phrase "pursuant to an exception or exemption from the definition of "broker" or "dealer" in Sections 3(a)(4)(B) or 3(a)(5)(C) of the Act."[31] We are now proposing to conform Rule 15a-6 to the changes made by the GLBA by incorporating the rules applicable to banks' broker and dealer activities as well as the statutory provisions with the addition of the phrase, "or the rules thereunder." We are therefore re-proposing this modified clarifying amendment to Rule 15a-6. We request comment on all aspects of this proposal.

C. Securities Lending by Bank Dealers

In 2003, the Commission adopted Exchange Act Rule 15a-11, which provides a conditional exemption from the definitions of both "broker" and "dealer" for banks

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30 Release No. 49879, supra note 2.

31 Nothing in this release should be construed as modifying the Exchange Act Section 3(a)(6) definition of "bank" as it applies to foreign banks. Currently, foreign banks generally would not meet this definition and would be considered broker-dealers under the U.S. securities laws. As such, foreign banks generally would be required to register as U.S. broker-dealers unless they qualify for an exemption from registration under Exchange Act Rule 15a-6.

engaging in securities lending transactions.[32] Rule 15a-11 provides that a bank is exempt from the definition of "broker" and "dealer" under Sections 3(a)(4) and 3(a)(5) of the Exchange Act to the extent that, as a conduit lender,[33] it engages in securities lending transactions and any securities lending services in connection with such transactions, with or on behalf of a person the bank reasonably believes to be: (1) a qualified investor as defined in Section 3(a)(54)(A) of the Exchange Act;[34] or (2) any employee benefit plan that owns and invests, on a discretionary basis, not less than $25,000,000 in investments.[35]

As explained in the Joint Proposal, the exemption as applied to banks' broker activities was voided by the Regulatory Relief Act. The Commission and the Board are proposing to reinstate—as Rule 772—this exemption with respect to the definition of

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32 See Exchange Act Release No. 47364, supra note 2.

33 Under Rule 15a-11 as adopted, as well as under the proposed amendment, "conduit lender" would mean a bank that borrows or loans securities, as principal, for its own account, and contemporaneously loans or borrows the same securities, as principal, for its own account.

34 15 U.S.C. 78c(a)(54)(A).

35 Under Rule 15a-11 as adopted, as well as under the proposed amendment, "securities lending transaction" would mean a transaction in which the owner of a security lends the security temporarily to another party pursuant to a written securities lending agreement under which the lender retains the economic interests of an owner of such securities, and has the right to terminate the transaction and to recall the loaned securities on terms agreed by the parties. Under the proposal, "securities lending services" would mean: (1) selecting and negotiating with a borrower and executing, or directing the execution of, the loan with the borrower; (2) receiving, delivering, or directing the receipt or delivery of loaned securities; (3) receiving, delivering, or directing the receipt or delivery of collateral; (4) providing mark-to-market, corporate action, recordkeeping or other services incidental to the administration of the securities lending transaction; (5) investing, or directing the investment of, cash collateral; or (6) indemnifying the lender of securities with respect to various matters.

"broker" in the Joint Proposal.[36] We are proposing in this release to redesignate what was Rule 15a-11 as Rule 3a5-3 and to amend former Rule 15a-11 to eliminate its applicability to a bank's "broker" activities, while proposing to maintain its ongoing availability for a bank's "dealer" activities. We request comment on all aspects of these changes.

D. Proposed Withdrawal of Exchange Act Rule 3b-9, Rule 15a-8, and Rule 15a-9

We intend to withdraw Exchange Act Rule 3b-9, in which the Commission defined the term "bank" for purposes of Section 3(a)(4) and 3(a)(5) of the Exchange Act. Rule 3b-9 was invalidated by the U.S. Court of Appeals for the District of Columbia Circuit.[37] We also intend to withdraw Rule 15a-8, which provided a temporary exemption from Exchange Act Section 29 liability for banks' securities activities. This exemption expired. In addition, we intend to withdraw Rule 15a-9, an exemption from the definition of "broker" and "dealer" for savings associations and savings banks. The Regulatory Relief Act caused savings associations and savings banks to be treated as "banks," eliminating the need to differentiate between these entities for the purposes of the Exchange Act. As a result, current Rule 15a-9 is no longer necessary. We request comment on all aspects of withdrawing Rule 3b-9, Rule 15a-8, and Rule 15a-9.

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[36] As applicable to banks' broker activities, the Rule 15a-11 exemption was never operable because of the temporary exemption applicable to all bank broker activities.

[37] American Bankers Association v. SEC, 804 F.2d 739 (1986).

III. Administrative Law Matters

A. General Request for Comments

Interested persons are invited to submit written data, views and arguments concerning this proposal. The Commission will consider the comments we previously received. Commenters may reiterate or cross-reference previously submitted comments.

B. Paperwork Reduction Act Analysis

These proposed amendments to two rules and this re-proposal of a new rule would not impose recordkeeping or information collection requirements, or other collections of information that require approval of the Office of Management and Budget under 44 U.S.C. 3501, et. seq. Accordingly, the Paperwork Reduction Act does not apply.[38]

C. Consideration of Benefits and Costs

We believe that these two proposed rule amendments and the re-proposal of a new rule would be consistent with Congress's intent in enacting the GLBA and would provide banks with greater legal certainty regarding their conduct with respect to securities transactions. The rule amendments and the re-proposal are very limited in scope. The Commission is re-proposing an exemption that would permit banks to purchase from and sell to non-U.S. persons securities exempt under Regulation S. The proposed rule would facilitate banks' compliance with the federal securities laws and provide banks greater legal certainty regarding such conduct. The proposed addition of the reasonable belief standard would prevent banks from losing the exemption due to

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[38] We note that, as a practical matter, banks likely already keep records that could be used to show they meet the terms of the proposed exemption. We also note that Section 203 of the GLBA specifically requires the bank regulators to promulgate recordkeeping requirements.

inadvertent errors in identifying the source of securities sold under the exemption, so long as the other conditions of the rule were met. We do not expect banks to incur any costs related to the re-proposal. The proposed clarifying amendment to Exchange Act Rule 15a-6 would conform the rule to the revised statutory definition of "broker" and "dealer" under the Exchange Act as well as to the rules adopted thereunder. With regard to securities lending activities, the Commission proposes to amend existing Exchange Act Rule 15a-11, and to redesignate it as Rule 3a5-3, to eliminate the rule's reference to banks' "broker" activities, and to clarify the rule's continued availability for banks' "dealer" activities. We do not expect banks to incur any costs related to these proposed amendments. The proposed withdrawal of Exchange Act Rules 3b-9 and 15a-8 reflects the invalidation of Rule 3b-9 by the U.S. Court of Appeals for the District of Columbia Circuit,[39] and the expiration of the 15a-8 exemption, respectively. Similarly, the proposed withdrawal of Exchange Act Rule 15a-9 is proposed because the exemption is no longer necessary after passage of the Regulatory Relief Act. Withdrawing these rules would provide administrative certainty and clarity, as rules no longer in effect would be removed from the Code of Federal Regulations. The withdrawals are administrative in effect, and thus would impose no costs. We request comments generally on the costs and benefits associated with the re-proposal, the proposed amendments, and the proposed rule withdrawals.

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[39] See text at note 37 supra.

D. Consideration of Burden on Competition, and on Promotion of Efficiency, Competition, and Capital Formation

In accordance with our responsibilities under Section 3(f) of the Exchange Act,[40] we have considered both the protection of investors and whether these rule amendments and the re-proposal would promote efficiency, competition, and capital formation and have determined that they are consistent with the public interest.[41] In addition, Section 23(a)(2) of the Exchange Act requires us, in adopting rules under the Exchange Act, to consider the anticompetitive effects of such rules, if any, and to refrain from adopting a rule that will impose a burden on competition not necessary or appropriate in furthering the purpose of the Exchange Act.

We do not believe that the amendments and the re-proposal, as well as the elimination of Rules 3b-9, 15a-8, and 15a-9, would result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act. The proposed amendments and the re-proposal would provide guidance to banks regarding the scope of exceptions added to the Exchange Act by Congress in the GLBA. The rule amendments and re-proposal also would not impose any additional competitive burdens on banks engaging in a securities business, other than those imposed by Congress through functional regulation in the GLBA. Further, the proposed elimination of Rules 3b-9, 15a-8, and 15a-9 is administrative in nature.

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40 15 U.S.C. 78w(a)(2). "Whenever pursuant to this title the Commission is engaged in rulemaking…and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."

41 15 U.S.C. 78c(f).

Because the types of activities that are the subject of these amendments are not the types of activities in which small banks or small broker-dealers directly participate, there should be no competitive costs to small banks or small broker-dealers.

We do not believe that those rules impose any adverse effects on efficiency, competition, or capital formation that are not a consequence of the GLBA statutory provisions. The exemptive rules would make it easier for banks to conduct their securities lending and sales of Regulation S securities after the GLBA changes to the federal securities laws. These proposed rules also would give banks enhanced legal certainty for these securities activities. We do not believe that those rules impose any adverse effects on efficiency, competition, or capital formation that are not a result of the GLBA statute. When Congress passed the GLBA, it effectively determined that regulation of banks conducting a securities operation outside of certain exceptions was necessary, appropriate, and in the public interest. Further, we believe that the proposed elimination of Rules 3b-9, 15a-8, and 15a-9 would not have any impact on efficiency, competition, or capital formation.

The Commission requests comment on whether the proposed amendments would promote efficiency, competition, and capital formation. The Commission is particularly interested in hearing whether the existence of any of the proposed bank exemptions would have a negative impact on competition. Please provide detailed information and data on exactly how banks and broker-dealers compete and how the particular exemptions would impact broker-dealers' business.

E. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"[42] the Commission must advise the Office of Management and Budget as to whether the proposed amendments and the re-proposal constitute a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in: an annual effect on the economy of $100 million or more (either in the form of an increase or a decrease); a major increase in costs or prices for consumers or individual industries; or a significant adverse effect on competition, investment, or innovation. If a rule is "major," its effectiveness will generally be delayed for 60 days pending Congressional review. We request comment on the potential impact of the proposed amendments, the re-proposal, and the rule withdrawals on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

F. Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis ("IRFA"), in accordance with the provisions of the Regulatory Flexibility Act ("RFA"),[43] regarding the proposed amendments and the re-proposal.

1. Reasons for the Proposed Action

The Commission is proposing the amendments to address issues raised by the passage of the GLBA and the Regulatory Relief Act. In addition, the exemption in proposed Rule 3a5-2 is being re-proposed to permit banks to purchase from and sell to

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[42] Pub. L. 104–121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

[43] 5 U.S.C. 603.

non-U.S. persons securities exempt under Regulation S. Finally, we are proposing the elimination of Rules 3b-9, 15a-8, and 15a-9 for administrative clarity and in conformance with the Regulatory Relief Act.

2. Objectives

The proposed amendments, the re-proposal, and the proposed rule withdrawals are intended to provide legal certainty to the industry with respect to the GLBA requirements. The Commission also seeks to make the restrictions imposed by the GLBA more accommodating of current securities activities carried out by banks while preserving investor protection principles.

3. Legal Basis

Pursuant to the Exchange Act and, particularly, Sections 3(a)(4), 3(b), 15, 17, 23(a), and 36 thereof, the Commission proposes to adopt the amendments and the re-proposal and to eliminate the obsolete or unnecessary rules.

4. Small Entities Subject to the Rule

Congress did not exempt small entity banks from the application of the GLBA. Moreover, because amendments and the re-proposal are intended to provide guidance to all banks that are subject to the GBLA, the Commission determined that it would not be appropriate to exempt small entity banks from their operation. Therefore, the amendments and the re-proposal generally apply to banks that would be considered small entities. Nonetheless, as noted above, the types of activities that are the subject of the amendments are not the types of activities in which small banks or small broker-dealers generally directly participate.

5. Reporting, Recordkeeping and other Compliance Requirements

The proposed amendments would not impose any new reporting, recordkeeping, or other compliance requirements on banks that are small entities.

6. Duplicative, Overlapping, or Conflicting Federal Rules

The Commission believes that there are no rules that duplicate, overlap, or conflict with the proposed amendments.

7. Significant Alternatives

Pursuant to Section 3(a) of the RFA,[44] the Commission must consider the following types of alternatives: (a) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (b) the clarification, consolidation, or simplification of compliance and reporting requirements under the proposed rule for small entities; (c) the use of performance rather than design standards; and (d) an exemption from coverage of the proposed rule, or any part thereof, for small entities.

As discussed above, the GLBA does not exempt small banks from the Exchange Act broker-dealer registration requirements, and the Commission does not believe that an unconditional exemption would be consistent with the investor protection principles of the GLBA. Moreover, such an exemption could place broker-dealers at a competitive disadvantage versus small banks.

The proposed amendments, the re-proposal and the proposed rule withdrawals are intended to clarify and simplify compliance with the GLBA. As such, the proposals should ease compliance on banks of all sizes, including smaller entities.

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[44] 5 U.S.C. 603(c).

The Commission does not believe that it is necessary to consider whether small entities should be permitted to use performance rather than design standards to comply with the proposed amendments because they already propose performance standards and do not dictate for entities of any size any particular design standards (e.g., technology) that must be employed to achieve the objectives of the proposed amendments.

8. Request for Comments

The Commission encourages written comments on matters discussed in the IRFA. In particular, the Commission requests comments on: (a) the number of small entities that would be affected by the proposed amendments; (b) the nature of any impact the proposed amendments would have on small entities and empirical data supporting the extent of the impact; and (c) how to quantify the number of small entities that would be affected by and/or how to quantify the impact of the proposed amendments. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed rule is adopted, and will be placed in the same public file as comments on the proposed rule itself. Persons wishing to submit written comments should refer to the instructions for submitting comments in the front of this release.

IV. Statutory Authority

Pursuant to authority set forth in the Exchange Act and particularly Sections 3(a)(4), 3(b), 15, 17, 23(a), and 36 thereof (15 U.S.C. 78c(a)(4), 78c(b), 78o, 78q, 78w(a), and 78mm, respectively) the Commission proposes to repeal current Rules 3b-9, 15a-8, and 15a-9 (§§ 240.3b-9, 240.15a-8, and 240.15a-9, respectively). The Commission also is re-proposing Exchange Act Rule 3a5-2 (§ 240.3a5-2), proposing to

amend Exchange Act Rule 15a-6 (§ 240.15a-6), and proposing to amend and redesignate Exchange Act Rule 15a-11 as Rule 3a5-3 (§ 240.15a-11 and §240.3a5-3, respectively).

V. Text of Proposed Rules and Rule Amendments

List of Subjects in 17 CFR Part 240

Broker-dealers, Reporting and recordkeeping requirements, Securities.

For the reasons set forth in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

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

1. The authority citation for Part 240 continues to read, in part, as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

2. Sections 240.3a5-2 and 240.3a5-3 are added to read as follows:

§ 240.3a5-2 Exemption from the definition of "dealer" for banks effecting transactions in securities issued pursuant to Regulation S.

(a) A bank is exempt from the definition of the term "dealer" under section 3(a)(5) of the Act (15 U.S.C. 78c(a)(5)), to the extent that, in a riskless principal transaction, the bank:

(1) Sells an eligible security in compliance with the requirements of 17 CFR 230.903 to a purchaser who is outside of the United States within the meaning of 17 CFR 230.903 or to a registered broker or dealer, provided that if the sale is made prior to the expiration of the distribution compliance period specified in 17 CFR 230.903(b)(2) or (b)(3), the sale is made in compliance with the requirements of 17 CFR 230.904.

(2) Purchases from a person who is not a U.S. person under 17 CFR 230.902(k) an eligible security after its initial sale with a reasonable belief that the eligible security was initially sold outside of the United States within the meaning of and in compliance with the requirements of 17 CFR 230.903.

(3) Purchases from a registered broker or dealer an eligible security after its initial sale outside of the United States within the meaning of and in compliance with the requirements of 17 CFR 230.903, and sells to a purchaser who is outside the United States within the meaning of 17 CFR 230.903.

(b) Definitions. For purposes of this section:

(1) Distributor has the same meaning as in 17 CFR 230.902(d).

(2) Eligible security means a security that:

(i) Is not being sold from the inventory of the bank or an affiliate of the bank; and

(ii) Is not being underwritten by the bank or an affiliate of the bank on a firm-commitment basis, unless the bank acquired the security from an unaffiliated distributor that did not purchase the security from the bank or an affiliate of the bank.

(3) Purchaser means a person who purchases an eligible security and who is not a U.S. person under 17 CFR 230.902(k).

(4) Riskless principal transaction means a transaction in which, after having received an order to buy from a customer, the bank purchased the security from another person to offset a contemporaneous sale to such customer or, after having received an order to sell from a customer, the bank sold the security to another person to offset a contemporaneous purchase from such customer.

§ 240.3a5-3 Exemption from the definition of "dealer" for banks engaging in securities lending transactions.

(a) A bank is exempt from the definition of the term "dealer" under section 3(a)(5) of the Act (15 U.S.C. 78c(a)(5)), to the extent that, as a conduit lender, it engages in or effects securities lending transactions, and any securities lending services in connection with such transactions, with or on behalf of a person the bank reasonably believes to be:

(1) A qualified investor as defined in section 3(a)(54)(A) of the Act (15 U.S.C. 78c(a)(54)(A)); or

(2) Any employee benefit plan that owns and invests, on a discretionary basis, not less than $25,000,000 in investments.

(b) Securities lending transaction means a transaction in which the owner of a security lends the security temporarily to another party pursuant to a written securities lending agreement under which the lender retains the economic interests of an owner of such securities, and has the right to terminate the transaction and to recall the loaned securities on terms agreed by the parties.

(c) Securities lending services means:

(1) Selecting and negotiating with a borrower and executing, or directing the execution of the loan with the borrower;

(2) Receiving, delivering, or directing the receipt or delivery of loaned securities;

(3) Receiving, delivering, or directing the receipt or delivery of collateral;

(4) Providing mark-to-market, corporate action, recordkeeping or other services incidental to the administration of the securities lending transaction;

(5) Investing, or directing the investment of, cash collateral; or

(6) Indemnifying the lender of securities with respect to various matters.

(d) For the purposes of this section, the term conduit lender means a bank that borrows or loans securities, as principal, for its own account, and contemporaneously loans or borrows the same securities, as principal, for its own account. A bank that qualifies under this definition as a conduit lender at the commencement of a transaction will continue to qualify, notwithstanding whether:

(1) The lending or borrowing transaction terminates and so long as the transaction is replaced within one business day by another lending or borrowing transaction involving the same securities; and

(2) Any substitutions of collateral occur.

3. Section 240.3b-9 is removed and reserved.

4. Section 240.15a-6 is amended by revising paragraph (a)(4)(i) to read as follows:

§ 240.15a-6 – Exemption of certain foreign brokers or dealers.

(a) * * *

(4) * * *

(i) A registered broker or dealer, whether the registered broker or dealer is acting as principal for its own account or as agent for others, or a bank acting pursuant to an exception or exemption from the definition of "broker" or "dealer" in sections 3(a)(4)(B), 3(a)(4)(E), or 3(a)(5)(C) of the Act (15 U.S.C. 78c(a)(4)(B), 15 U.S.C. 78c(a)(4)(E), or 15 U.S.C. 78c(a)(5)(C)) or the rules thereunder;

* * * * *

5. Section 240.15a-8 is removed and reserved.
6. Section 240.15a-9 is removed and reserved.
7. Section 240.15a-11 is removed and reserved.

By the Commission.

Nancy M. Morris
Secretary

Dated: December 18, 2006

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Nazareth.
Not Participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 2571 / December 18, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12508

In the Matter of **JAMES BARLOW SMITH,** **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 James Barlow Smith ("Smith" or "Respondent").

II.

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

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III.

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

1. Smith, age 46, is a resident of Saxonburg, Pennsylvania. In 1994, he joined Advanced Investment Management Inc. ("AIM") as an equity trader. He subsequently became a portfolio manager and, in January 2002, Smith became a six percent shareholder and Vice President of Equity Trading. AIM was registered as an investment adviser with the Commission and as a commodity pool operator with the Commodity Futures Trading Commission from 1992 to February 2003. AIM ceased operations in December 2002 and, in February 2003, filed a Form ADV-W, which became effective.

2. On December 7, 2006, a final judgment was entered by consent against Smith, permanently enjoining him from future violations of Sections 17(a) of the Securities Act of 1933, 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. John Barlow Smith, Civil Action Number 2:05CV453, in the United States District Court for the Western District of Pennsylvania.

3. The Commission's complaint alleged that the officers and principals of AIM, including Smith, leveraged client assets in violation of investment advisory agreements, and concealed the unauthorized trading in the client accounts. As a result of the fraud, the complaint further alleges that clients suffered more than $415 million in losses. Specifically, the complaint alleges that the majority shareholder, President, and Chief Investment Officer of AIM, formerly a registered investment adviser, orchestrated and conducted the improper trading scheme between January 2002 and July 2002 with the assistance of fellow owner Smith, AIM's Vice President of Equity Trading.

4. As described in the complaint, the Commission alleges that AIM offered a sophisticated investment product known as "Enhanced Indexing"; this investment strategy involved using derivatives to mirror the S&P 500 Index, and using the cash saved from purchasing derivatives to buy high quality debt instruments to "enhance" any return on the S&P 500 Index. The Commission's complaint alleges that Smith and other officers and principals violated client agreements by purchasing derivatives that caused excessive leverage without client knowledge, authorization or consent, and then selling the unauthorized positions before month-end so the monthly statements did not reflect the unauthorized positions. As alleged in the Commission's complaint, as the market steadily declined through the spring and early summer 2002 and the portfolios began underperforming the S&P 500; the complaint finally alleges that Smith and other officers and principals escalated their use of leverage in a failed attempt to recover lost performance, causing hundreds of millions of dollars in losses by July 2002.

IV.

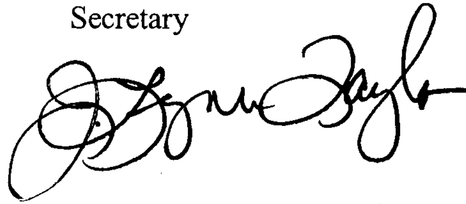
In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Smith's Offer.

Accordingly, it is hereby ORDERED:

Pursuant to Section 203(f) of the Advisers Act, that Respondent Smith be, and hereby is, suspended from association with any investment adviser for a period of 12 months.

By the Commission.

Nancy M. Morris
Secretary



By: J. Lynn Taylor
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR PARTS 210, 240 and 241

[RELEASE NOS. 33-8762; 34-54976; File No. S7-24-06]

RIN 3235-AJ58

MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

AGENCY: Securities and Exchange Commission.

ACTION: Proposed interpretation; Proposed rule.

SUMMARY: We are proposing interpretive guidance for management regarding its evaluation of internal control over financial reporting. The interpretive guidance sets forth an approach by which management can conduct a top-down, risk-based evaluation of internal control over financial reporting. The proposed guidance is intended to assist companies of all sizes to complete their annual evaluation in an effective and efficient manner and it provides guidance on a number of areas commonly cited as concerns over the past two years. In addition, we are proposing an amendment to our rules requiring management's annual evaluation of internal control over financial reporting to make it clear that an evaluation that complies with the interpretive guidance is one way to satisfy those rules. Further, we are proposing an amendment to our rules to revise the requirements regarding the auditor's attestation report on the assessment of internal control over financial reporting.

DATES: Comment Date: Comments should be received on or before [insert date 60 days after publication in the Federal Register].

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

Electronic comments:

Document 33 of 58

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-24-06 on the subject line; or
- Use the Federal eRulemaking Portal (http://www.regulations.gov). Follow the instructions for submitting comments.

Paper comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-24-06. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site. (http://www.sec.gov/rules/proposed.shtml). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549. All comments received will be posted without change; 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: Michael G. Gaynor, Professional Accounting Fellow, Office of the Chief Accountant, at (202) 551-5300, or N. Sean Harrison, Special Counsel, Division of Corporation Finance, at (202) 551-3430 U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: We are proposing amendments to Rule 13a-15(c),[1] and Rule 15d-15(c)[2] under the Securities Exchange Act of 1934 (the "Exchange Act");[3] and Rules 1-02(a)(2)[4] and 2-02(f)[5] of Regulation S-X.[6]

I. BACKGROUND

Section 404(a) of the Sarbanes-Oxley Act of 2002[7] ("Sarbanes-Oxley") directed the Commission to prescribe rules that require each annual report that a company, other than a registered investment company, files pursuant to Section 13(a) or 15(d)[8] of the Exchange Act to contain an internal control report: (1) stating management's responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) containing an assessment, as of the end of the company's most recent fiscal year, of the effectiveness of the company's internal control structure and procedures for financial reporting. On June 5, 2003, the Commission adopted rules implementing Section 404 with regard to management's obligations to report on its internal control structure and procedures and, in so doing, created the term "internal control over financial reporting" ("ICFR").[9]

The establishment and maintenance of internal accounting controls has been required of public companies since the enactment of the Foreign Corrupt Practices Act of

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[1] 17 CFR 240.13a-15(c).
[2] 17 CFR 240.15d-15(c).
[3] 15 U.S.C. 78a et seq.
[4] 17 CFR 210.1-02.
[5] 17 CFR 210.2-02(f).
[6] 17 CFR 210.1-01 et seq.
[7] 15 U.S.C. 7262.
[8] 15 U.S.C. 78m(a) or 78o(d).
[9] See Release No. 33-8238 (June 5, 2003) [68 FR 36636] (hereinafter the "Adopting Release"). See Release No. 33-8392 (February 24, 2004) [69 FR 9722] for compliance dates applicable to accelerated filers. See Release No. 33-8760 (December 15, 2006) for compliance dates applicable to non-accelerated filers.

1977 ("FCPA").[10] The significance of Section 404 of Sarbanes-Oxley is that it re-emphasizes the important relationship between the maintenance of effective ICFR and the preparation of reliable financial statements. Effective ICFR can also help companies deter fraudulent financial accounting practices or detect them earlier and perhaps reduce their adverse effects. While controls are susceptible to manipulation, especially in instances of fraud involving the collusion of two or more people, including senior management, these are known limitations of internal control systems. Therefore, it is possible to design ICFR to reduce, though not eliminate, instances of fraud.

When the Commission adopted rules in June 2003 to implement Section 404 of Sarbanes-Oxley, we emphasized two broad principles: (1) that the evaluation must be based on procedures sufficient both to evaluate the design and to test the operating effectiveness[11] of ICFR; and (2) that the assessment, including testing, must be supported by reasonable evidential matter.[12] Instead of providing specific guidance regarding the evaluation, we expressed our belief that the methods of conducting evaluations of ICFR will, and should, vary from company to company and will depend on the circumstances

[10] Title I of Pub. L. 95-213 (1977). Under the FCPA, companies that have a class of securities registered under Section 12 of the Exchange Act, or that are required to file reports under Section 15(d) of the Exchange Act, are required to (a) make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer; and (b) to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that:

> (i) transactions are executed in accordance with management's general or specific authorization;
> (ii) transactions are recorded as necessary (1) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (2) to maintain accountability for assets;
> (iii) access to assets is permitted only in accordance with management's general or specific authorization; and
> (iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

The definition of internal control over financial reporting is consistent with the description of internal accounting controls under the FCPA.

[11] See Adopting Release at Section II.B.3.d.

[12] Id.

of the company and the significance of the controls.[13] We continue to believe that it is impractical to prescribe a single methodology that meets the needs of every company.

Since the Commission first adopted the ICFR requirements, companies and third parties have devoted considerable attention to the methods that management may use to evaluate ICFR. Efforts to comply with the Commission's rules have resulted in many public companies internally developing their own evaluation processes, while other companies have retained consultants or purchased commercial software and other products to establish or improve their ICFR evaluation process.[14] Management must bring its own experience and informed judgment to bear in order to design an evaluation process that meets the needs of its company and that provides reasonable assurance for its assessment. This proposed guidance is intended to allow management the flexibility to design such an evaluation process.

In order to facilitate the comparability of the assessment reports among companies, our rules implementing Section 404 require management to base its assessment of a company's internal control on a suitable evaluation framework. While the establishment and maintenance of internal accounting controls have been required since the enactment of the FCPA, as discussed above, the Commission's rules implementing Section 404 required management for the first time to use a framework for evaluating ICFR. It is important to note that our rules do not mandate the use of a

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[13] Id.

[14] Exchange Act Rules 13a-15 and 15d-15 require management to evaluate the effectiveness of ICFR as of the end of the fiscal year. For purposes of this document, the term "evaluation" or "evaluation process" refers to the methods and procedures that management implements to comply with these rules. The term "assessment" is used in this document to describe the disclosure required by Item 308 of Regulations S-B and S-K [17 CFR 228.308 and 229.308]. This disclosure must include discussion of any material weaknesses which exist as of the end of the most recent fiscal year and management's assessment of the effectiveness of ICFR, including a statement as to whether or not ICFR is effective. Management is not permitted to conclude that ICFR is effective if there are one or more material weaknesses in ICFR.

particular framework, since multiple viable frameworks exist and others may be developed in the future. However, in the release adopting the Section 404 requirements, the Commission identified the Internal Control—Integrated Framework created by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") as an example of a suitable framework.[15, 16]

While the COSO framework identifies the components and objectives of an effective system of internal control, it does not set forth an approach for management to follow in evaluating the effectiveness of a company's ICFR.[17] We, therefore, distinguish between the COSO framework as a definition of what constitutes an effective system of internal control and guidance on how to evaluate ICFR for purposes of our rules. The guidance that we are proposing in this release is not intended to replace or modify the COSO framework or any other suitable framework.

[15] See COSO, Internal Control-Integrated Framework (1992). In 1994, COSO published an addendum to the Reporting to External Parties volume of the COSO Report. The addendum discusses the issue of, and provides a vehicle for, expanding the scope of a public management report on internal control to address additional controls pertaining to safeguarding of assets. In 1996, COSO issued a supplement to its original framework to address the application of internal control over financial derivative activities.

The COSO framework is the result of an extensive study of internal control to establish a common definition of internal control that would serve the needs of companies, independent public accountants, legislators, and regulatory agencies, and to provide a broad framework of criteria against which companies could evaluate and improve their control systems. The COSO framework divides internal control into three broad objectives: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. Our rules relate only to reliability of financial reporting. Each of the objectives in the COSO framework is further broken down into five interrelated components: control environment, risk assessment, control activities, information and communication, and monitoring.

[16] In that release, we also cited the Guidance on Assessing Control published by the Canadian Institute of Chartered Accountants ("CoCo") and the report published by the Institute of Chartered Accountants in England & Wales Internal Control: Guidance for Directors on the Combined Code (known as the Turnbull Report) as examples of other suitable frameworks that issuers could choose in evaluating the effectiveness of their internal control over financial reporting. We encourage companies to examine and select a framework that may be useful in their own circumstances; we also encourage the further development of alternative frameworks.

[17] On July 11, 2006, COSO issued guidance entitled "Internal Control Over Financial Reporting - Guidance for Smaller Public Companies" that was designed primarily to help management of smaller public companies with establishing and maintaining effective ICFR. The guidance includes evaluation tools; however, these tools are intended only to be illustrative.

In determining the need for additional guidance to management on how to conduct its evaluation, it is important to consider the steps that have been taken by the Commission and others to provide guidance to companies and audit firms. The Commission held its first roundtable discussion about implementation of the internal control reporting provisions on April 13, 2005. The 2005 roundtable sought input to consider the impact of the implementation of the Section 404 reporting requirements in view of the fact that Section 404 resulted in a major change for management and auditors. A broad range of interested parties, including representatives of managements and boards of domestic and foreign public companies, auditors, investors, legal counsel, and board members of the Public Company Accounting Oversight Board ("PCAOB"), participated in the discussion. We also invited and received written submissions from the public regarding Section 404 in advance of the roundtable.

Feedback obtained from the 2005 roundtable indicated that the internal control reporting requirements had led to an increased focus by management on ICFR. However, the feedback also identified particular areas which were in need of further clarification to reduce unnecessary costs and burdens while at the same time not jeopardizing the benefits of Section 404. In addition, feedback indicated that a number of the implementation issues arose from an overly conservative application of the Commission rules and PCAOB Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements ("AS No. 2"), and the requirements of AS No. 2 itself, as well as questions regarding the appropriate role of the auditor in management's evaluation process.

In response to this feedback, the Commission and its staff issued guidance on May 16, 2005,[18] emphasizing that management, not the auditor, is responsible for determining the appropriate nature and form of internal controls for the company as well as their evaluation methods and procedures. The May 2005 Staff Guidance emphasized and clarified existing provisions of the rules and other Commission guidance relating to the exercise of professional judgment, the concept of reasonable assurance, and the permitted communications between management and auditors. Feedback has indicated that the May 2005 Staff Guidance was appropriate, and while we have incorporated certain sections of that guidance into the proposed interpretive guidance set forth in this release, the May 2005 Staff Guidance remains relevant.[19]

In its Final Report to the Commission, issued on April 23, 2006, the Commission's Advisory Committee on Smaller Public Companies ("Advisory Committee") raised a number of concerns regarding the ability of smaller companies to comply cost-effectively with the requirements of Section 404. The Advisory Committee identified as an overarching concern the difference in how smaller and larger public companies operate. The Advisory Committee focused in particular on three characteristics: (1) the limited number of personnel in smaller companies, which

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[18] Commission Statement on Implementation of Internal Control Reporting Requirements, Press Release No. 2005-74 (May 16, 2005); Division of Corporation Finance and Office of the Chief Accountant: Staff Statement on Management's Report on Internal Control Over Financial Reporting (May 16, 2005) (hereinafter "May 2005 Staff Guidance") available at http://www.sec.gov/spotlight/soxcom/.htm.

Also on May 16, 2005, the PCAOB and its staff issued guidance to auditors on their audits under AS No. 2. The PCAOB's guidance focused on areas in which the efficiency of the audit could be substantially improved. Topics included the importance of the integrated audit, the role of risk assessment throughout the process, the importance of taking a top-down approach, and auditors' use of the work of others.

[19] The incorporation of our May 16, 2005 guidance into this guidance was generally supported in comments received in response to the Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting, Release No. 34-54122 (July 11, 2006) [71 FR 40866] available at http://www.sec.gov/rules/concept/2006/34-54122.pdf (hereinafter "Concept Release") . See, for example, letters received from the American Electronics Association, Computer Sciences Corporation, American Institute of Certified Public Accountants, Institute of Management Accountants and Schering AG (available at http://www.sec.gov/comments/s7-11-06/s71106.shtml).

constrains the companies' ability to segregate conflicting duties; (2) top management's wider span of control and more direct channels of communication, which increase the risk of management override; and (3) the dynamic and evolving nature of smaller companies, which limits their ability to have static processes that are well-documented.[20]

The Advisory Committee suggested that these characteristics create unique differences in how smaller companies achieve effective ICFR that may not be adequately accommodated in AS No. 2 or other implementation guidance as currently applied in practice.[21] In addition, the Advisory Committee noted serious ramifications for smaller public companies stemming from the cost of frequent documentation changes and sustained review and testing of controls perceived to be necessary to comply with the Section 404 requirements. Indeed, the Advisory Committee noted that costs in relation to revenue have been disproportionately borne by smaller public companies.[22]

The Advisory Committee Final Report sets forth several recommendations for the Commission to consider regarding the application of the Section 404 requirements to smaller public companies. The Advisory Committee recommended partial or complete exemptions from the internal control reporting requirements for specified types of smaller public companies under certain conditions, unless and until a framework is developed for assessing ICFR that recognizes the characteristics and needs of those companies. The Advisory Committee also recommended, among other things, that the Commission, COSO and the PCAOB provide additional guidance to management to help facilitate the

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[20] Final Report of the Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission (April 23, 2006) at 35-36, available at http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf (hereinafter "Advisory Committee Final Report").
[21] Id. at 37.
[22] Id. at 33.

design and evaluation of ICFR and make processes related to internal control more cost-effective.[23] In addition, some commenters on the Advisory Committee's exposure draft of its report suggested that the Commission reexamine the appropriate role of outside auditors in connection with the management assessment required by the rules implementing Section 404.[24]

Further, in April 2006, the U.S. Government Accountability Office issued a Report to the Committee on Small Business and Entrepreneurship, U.S. Senate, entitled Sarbanes-Oxley Act, Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies, which recommended that in considering the concerns of the Advisory Committee, the Commission should assess the available guidance for management to determine whether it is sufficient or whether additional action is needed. That report stated that management's implementation and evaluation efforts were largely driven by AS No. 2 because guidance was not available for management.[25] Further, the GAO Report recommended that the Commission coordinate with the PCAOB to help ensure that the Section 404-related audit standards and guidance are consistent with any additional management guidance issued.[26]

On May 10, 2006, the Commission and PCAOB conducted a second Roundtable on Internal Control Reporting and Auditing Provisions to solicit feedback on accelerated filers' second year of compliance with the Section 404 requirements. Several participants

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[23] Id. at 52.

[24] See, e.g., letter from BDO Seidman, LLP (April 3, 2006), available at http://www.sec.gov/rules/other/265-23/bdoseidman9239.pdf

[25] United States Government Accountability Office Report to the Committee on Small Business and Entrepreneurship, U.S. Senate: Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies (April 2006) at 52-53, available at http://www.gao.gov/new.items/d06361.pdf (hereinafter "GAO Report").

[26] Id. at 58.

indicated that their evaluation processes had improved from year one, but that additional improvements were needed. Although some expressed concern about being required to change the evaluation processes they have already implemented, a number of the participants expressed, at the roundtable and in their written comments, the view that additional management guidance was needed.[27]

On July 11, 2006, COSO published additional application guidance for its control framework, Internal Control over Financial Reporting – Guidance for Smaller Public Companies. This guidance is intended to assist the management of smaller companies in understanding and applying the COSO framework. It outlines principles fundamental to the five components of internal control described in the COSO framework. Further, this guidance defines each of these principles and describes the attributes of each. It also lists a variety of approaches that smaller companies can use to apply the principles and includes examples of how smaller companies have applied the principles. The Commission anticipates that the guidance will help organizations of all sizes that use the COSO framework to better understand and apply it to ICFR.

On July 11, 2006, the Commission issued a Concept Release to seek public feedback on the Commission's planned issuance of guidance regarding management's evaluation and assessment of the effectiveness of ICFR.[28] The Concept Release sought specific feedback in three areas described below, as well as inquired about whether there were other areas where guidance should also be provided.

[27] See transcript of Roundtable Discussion on Second Year Experiences with Internal Control Reporting and Auditing Provisions, May 10, 2006, Panels 1, 2, 3, and 5; letter from The Institute of Internal Auditors (IIA) (May 1, 2006); letter from Institute of Management Accountants (IMA) (May 4, 2006); letter from Canadian Bankers Association (CBA) (April 28, 2006); letter from Deloitte & Touche LLP (May 1, 2006); letter from Ernst & Young LLP (May 1, 2006); letter from KPMG LLP (May 1, 2006); letter from PricewaterhouseCoopers LLP (May 1, 2006) and letter from Pfizer Inc. (May 1, 2006), all available at http://www.sec.gov/news/press/4-511.shtml.

[28] See footnote 19 above for reference.

- Risk and control identification (such as how management considers entity-level controls, financial statement account and disclosure level considerations, as well as fraud risks);[29]
- The methods or approaches available to management to gather evidence to support its assessment, and factors management should consider in determining the nature, timing and extent of its evaluation procedures; and
- Documentation requirements, including overall objectives of the documentation and factors that might influence documentation requirements.

The Commission received 167 comment letters in response to the Concept Release, a majority of which supported additional Commission guidance to management that is applicable to companies of all sizes and complexities.[30] The Commission considered the feedback received in those comment letters in drafting this proposed interpretive guidance.

Further, the Commission has also received feedback that its guidance and ICFR rules have been interpreted as applying to non-profit and non-public organizations. The Commission does not regulate such organizations, and none of the Commission's guidance or rules is intended to apply to such organizations.

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[29] The term "entity-level controls" as used in this document describes aspects of a system of internal control that have a pervasive effect on the entity's system of internal control such as controls related to the control environment (e.g., management's philosophy and operating style, integrity and ethical values, board or audit committee oversight; and assignment of authority and responsibility); controls over management override; the company's risk assessment process; centralized processing and controls, including shared service environments; controls to monitor results of operations; controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs; controls over the period-end financial reporting process; and policies that address significant business control and risk management practices. The term "company-level" is also commonly used to describe these controls.

[30] The public comments we received are available for inspection in the Commission's Public Reference Room at 100 F Street, NE, Washington DC 20549 in File No. S7-11-06. They are also available on-line at http://www.sec.gov/comments/s7-11-06/s71106.shtml.

II. INTRODUCTION

To implement Section 404(a) of the Sarbanes-Oxley Act, the Commission adopted rules requiring that management annually issue a report that contains an assessment of the effectiveness of ICFR.[31] An overall objective of ICFR is to foster the preparation of reliable financial statements. Reliable financial statements must be materially accurate. Therefore, the central purpose of the evaluation is to assess whether there is a reasonable possibility of a material misstatement in the financial statements not being prevented or detected on a timely basis by the company's ICFR.[32]

Management's assessment is based on whether any material weaknesses exist as of the end of the fiscal year. A material weakness is a deficiency, or combination of deficiencies, in ICFR 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 by the company's ICFR.[33]

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[31] Exchange Act Rules 13a-15(f) and 15d-15(f) [17 CFR 240.13a-15(f) and 15d-15(b)] define internal control over financial reporting as:

> A process designed by, or under the supervision of, the issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by the registrant's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:
>
> (1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the registrant;
> (2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the registrant are being made only in accordance with authorizations of management and directors of the registrant; and
> (3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the registrant's assets that could have a material effect on the financial statements.

[32] There is a reasonable possibility of an event when the likelihood of the event is either "reasonably possible" or "probable" as those terms are used in Financial Accounting Standards Board Statement No. 5, Accounting for Contingencies.

[33] Existing PCAOB auditing literature describes a material weakness as a control deficiency, or combination of control deficiencies, that result in more than a remote likelihood that a material misstatement of the company's annual or interim financial statements will not be prevented or detected.

Management should implement and conduct an evaluation that is sufficient to provide it with a reasonable basis for its annual assessment. Management should use its own experience and informed judgment in designing an evaluation process that aligns with the operations, financial reporting risks and processes of the company.[34] If the evaluation process identifies material weaknesses that exist as of the end of the fiscal year, such weaknesses must be disclosed in management's annual report with a statement that ICFR is ineffective.[35] If the evaluation identifies no internal control deficiencies that constitute a material weakness, management assesses ICFR as effective.[36]

Management is required to assess as of the end of the fiscal year whether the company's ICFR is effective in providing reasonable assurance regarding the reliability of financial reporting.[37] Management is not required by Section 404 of Sarbanes-Oxley to assess other internal controls, such as controls solely implemented to meet a company's operational objectives. Further, "reasonable assurance" does not mean absolute assurance. ICFR cannot prevent or detect all misstatements, whether

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Our use of the phrase "reasonable possibility" rather than "more than remote" to describe the likelihood of a material error is intended to more clearly communicate the likelihood element. We note that the PCAOB has indicated that it intends to revise its definitions to use the phrase "reasonable possibility." AS No. 2 establishes that a control is deficient when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. The definition formulated here is intended to be consistent with its use in existing auditing literature and practice.

[34] This point also is made in one of the publicly available and commonly used assessment tools – the third volume of the report by COSO, Internal Control – Integrated Framework: Evaluation Tools. That volume cautioned that "because facts and circumstances vary between entities and industries, evaluation methodologies and documentation will also vary. Accordingly, entities may use different evaluation tools, or use other methodologies utilizing different evaluative techniques."

[35] This focus on material weaknesses will lead to a better understanding by investors of internal control over financial reporting, as well as its inherent limitations. Further, the Commission's rules implementing Section 404, by providing for public disclosure of material weaknesses, concentrate attention on the most important internal control issues.

[36] If management's evaluation process identifies material weaknesses, but all material weaknesses are remediated by the end of the fiscal year, management may exclude disclosure of those from its assessment and state that ICFR is effective as of the end of the fiscal year. However, management should consider whether disclosure of the remediated material weaknesses is appropriate or required under Item 307 or Item 308 of Regulations S-K or S-B or other Commission disclosure rules.

[37] See Exchange Act Rules 13a-15 and 15d-15.

unintentional errors or fraud. Rather, the "reasonable assurance" referred to in the Commission's implementing rules relates to similar language in the FCPA. Exchange Act Section 13(b)(7) defines "reasonable assurance" and "reasonable detail" as "such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs."[38] The Commission has long held that "reasonableness" is not an "absolute standard of exactitude for corporate records."[39] In addition, the Commission recognizes that while "reasonableness" is an objective standard, there is a range of judgments that an issuer might make as to what is "reasonable" in implementing Section 404 and the Commission's rules. Thus, the terms "reasonable," "reasonably" and "reasonableness" in the context of Section 404 implementation do not imply a single conclusion or methodology, but encompass the full range of appropriate potential conduct, conclusions or methodologies upon which an issuer may reasonably base its decisions.

This release proposes guidance regarding matters we believe will help management design and conduct its evaluation and assess the effectiveness of ICFR. The guidance assumes management has established and maintains a system of internal accounting controls as required by the FCPA. Further, it does not explain how management should design its ICFR to comply with the control framework it has chosen. To allow appropriate flexibility, the guidance does not provide a checklist of steps management should perform in completing its evaluation. Rather, it describes a top-down, risk-based approach that allows for the exercise of significant judgment so that

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[38] 15 U.S.C. 78m(b)(7). The conference committee report on amendments to the FCPA also noted that the standard "does not connote an unrealistic degree of exactitude or precision. The concept of reasonableness of necessity contemplates the weighing of a number of relevant factors, including the costs of compliance." Cong. Rec. H2116 (daily ed. April 20, 1988).

[39] Release No. 34-17500 (January 29, 1981) [46 FR 11544].

management can design and conduct an evaluation that is tailored to its company's individual circumstances.[40,41]

The proposed guidance is organized around two broad principles. The first principle is that management should evaluate the design of the controls that it has implemented to determine whether they adequately address the risk that a material misstatement in the financial statements would not be prevented or detected in a timely manner. The guidance describes a top-down, risk-based approach to this principle, including the role of entity-level controls in assessing financial reporting risks and the adequacy of controls. The proposed guidance promotes efficiency by allowing management to focus on those controls that are needed to adequately address the risk of a material misstatement in its financial statements. There is no requirement in our guidance to identify every control in a process or document the business processes impacting ICFR. Rather, under the approach described herein, management focuses its evaluation process and the documentation supporting the assessment on those controls that it believes adequately address the risk of a material misstatement in the financial statements. For example, if management determines that the risks for a particular financial reporting element are adequately addressed by an entity-level control, no further evaluation of other controls is required.

The second principle is that management's evaluation of evidence about the operation of its controls should be based on its assessment of risk. The proposed

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[40] Because management is responsible for maintaining effective internal control over financial reporting, this proposed interpretive guidance does not specifically address the role of the board of directors or audit committee in a company's evaluation and assessment of ICFR. However, we would ordinarily expect a board of directors or audit committee, as part of its oversight responsibilities for the company's financial reporting, to be knowledgeable and informed about the evaluation process and management's assessment, as necessary in the circumstances.

[41] See footnote 42 below.

guidance provides an approach for making risk-based judgments about the evidence needed for the evaluation. This allows management to align the nature and extent of its evaluation procedures with those areas of financial reporting that pose the greatest risks to reliable financial reporting (i.e., whether the financial statements are materially accurate). As a result, management may be able to use more efficient approaches to gathering evidence, such as self-assessments, in low-risk areas and perform more extensive testing in high-risk areas.

By following these two principles, we believe companies of all sizes and complexities will be able to implement our rules effectively and efficiently.[42] As smaller public companies generally have less complex internal control systems than larger public companies, this top-down, risk-based approach should enable smaller public companies in particular to scale and tailor their evaluation methods and procedures to fit their own facts and circumstances.[43] We encourage smaller public companies to take advantage of the flexibility and scalability of this approach to conduct an efficient evaluation of internal control over financial reporting.[44] Further, we believe the proposed guidance will assist companies of all sizes in completing the annual evaluation of ICFR in an effective and efficient manner by addressing a number of the common areas of concern that have been identified over the past two years. For example, the proposed guidance:

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[42] Commenters on the Concept Release were supportive of principles-based guidance that applies to all companies. See for example, letters regarding file number S7-11-06 of: Financial Executives International, Metlife, and Siemens AG at http://www.sec.gov/comments/s7-11-06/s71106.shtml.

[43] See Advisory Committee Final Report at 35-38.

[44] While a company's individual facts and circumstances should be considered in determining whether a company is a smaller public company, a company's market capitalization and annual revenues are useful indicators of its size and complexity. In light of the Advisory Committee Final Report and the SEC's rules defining "accelerated filers" and "large accelerated filers," companies with a market capitalization of approximately $700 million or less, with reported annual revenues of approximately $250 million or less, should be presumed to be "smaller companies," with the smallest of these companies, with a market capitalization of approximately $75 million or less, described as "microcaps."

- Explains how to vary approaches for gathering evidence to support the evaluation based on risk assessments;
- Explains the use of "daily interaction," self-assessment, and other on-going monitoring activities as evidence in the evaluation;
- Explains the purpose of documentation and how management has flexibility in approaches to documenting support for its assessment;
- Provides management significant flexibility in making judgments regarding what constitutes adequate evidence in low-risk areas; and
- Allows for management and the auditor to have different testing approaches.

The information management gathers and analyzes from its evaluation process serves as the basis for its assessment on the effectiveness of its ICFR. The extent of effort required for a reasonable evaluation process will largely depend on the company's existing policies, procedures and practices. For example, in some situations management may determine that its existing activities, which may be undertaken for other reasons, provide information that is relevant to the assessment. In other situations, management may have to implement additional procedures to gather and analyze the information needed to provide a reasonable basis for its annual assessment.

III. PROPOSED INTERPRETIVE GUIDANCE

The proposed interpretive guidance addresses the following topics:

A. The Evaluation Process

1. Identifying Financial Reporting Risks and Controls

a. Identifying Financial Reporting Risks

b. Identifying Controls that Adequately Address Financial Reporting Risks

c. Consideration of Entity-level Controls

d. Role of General Information Technology Controls

e. Evidential Matter to Support the Assessment

2. Evaluating Evidence of the Operating Effectiveness of ICFR

a. Determining the Evidence Needed to Support the Assessment

b. Implementing Procedures to Evaluate Evidence of the Operation of ICFR

c. Evidential Matter to Support the Assessment

3. Multiple Location Considerations

B. Reporting Considerations

1. Evaluation of Control Deficiencies

2. Expression of Assessment of Effectiveness of ICFR by Management and the Registered Public Accounting Firm

3. Disclosures About Material Weaknesses

4. Impact of a Restatement of Previously Issued Financial Statements on Management's Report on ICFR

5. Inability to Assess Certain Aspects of ICFR

A. The Evaluation Process

The objective of the evaluation of ICFR is to provide management with a reasonable basis for its annual assessment as to whether any material weaknesses in ICFR exist as of the end of the fiscal year. To meet this objective, management identifies the risks to reliable financial reporting, evaluates whether the design of the controls which address those risks is such that there is a reasonable possibility that a material misstatement in the financial statements would not be prevented or detected in a timely

manner, and evaluates evidence about the operation of the controls included in the evaluation based on its assessment of risk. The evaluation process will vary from company to company; however, the approach we discuss is a top-down, risk-based approach which we believe is typically most efficient and effective.

The evaluation process guidance is presented in two sections. The first section explains an approach to identifying financial reporting risks and evaluating whether the controls management has implemented are designed to address those risks. The second section describes an approach for making judgments about the methods and procedures for evaluating whether the operation of ICFR is effective. Both sections explain how entity-level controls[45] impact the evaluation process as well as how management focuses its evaluation efforts on the greatest risks.

Under the Commission's rules, management's annual assessment must be made in accordance with a suitable control framework's definition of effective internal control.[46] These control frameworks define elements of internal control that are expected to be present and functioning in an effective internal control system. In assessing effectiveness, management evaluates whether its ICFR includes policies, procedures and activities that address all of the elements of internal control that the applicable control framework describes as necessary for an internal control system to be effective. The framework elements describe the characteristics of an internal control system that may be relevant to individual areas of the company's ICFR, pervasive to many areas, or entity-

[45] See footnote 29 above.

[46] For example, both the COSO framework and the Turnbull Report state that determining whether a system of internal control is effective is a subjective judgment resulting from an assessment of whether the five components (i.e., control environment, risk assessment, control activities, monitoring, and information and communication) are present and functioning effectively. Although CoCo states that an assessment of effectiveness be made against twenty specific criteria, it acknowledges that the criteria can be regrouped into different structures, and includes a table showing how the criteria can be regrouped into the five-component structure of COSO. Thus, these five components are also criteria for effective internal control.

wide. Therefore, management's evaluation process includes not only controls involving particular areas of financial reporting, but also the entity-wide and other pervasive elements of internal control that are defined by the control frameworks. This guidance is not intended to replace the elements of an effective system of internal control as defined within a control framework.

1. Identifying Financial Reporting Risks and Controls

The approach described herein allows management to identify controls and maintain supporting evidential matter for its controls in a manner that is tailored to a company's financial reporting risks (as defined below). Thus, management can avoid identifying and documenting controls that are not important to achieving the objectives of ICFR. Management should assess whether its controls are designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles ("GAAP").[47] The evaluation begins with the identification and assessment of the risks to reliable financial reporting (i.e., materially accurate financial statements), including changes in those risks. Management then evaluates whether it has controls placed in operation that are designed to adequately address those risks. Management ordinarily would consider the company's entity-level controls in both its assessment of risk and in identifying which controls adequately address the risk. The controls that management identifies as adequately addressing the financial reporting risks

[47] Management of foreign private issuers that file financial statements prepared in accordance with home country generally accepted accounting principles or International Financial Reporting Standards with a reconciliation to U.S. GAAP should plan and conduct their evaluation process based on their primary financial statements (i.e., home country GAAP or IFRS) rather than the reconciliation to U.S. GAAP.

are then subject to procedures to evaluate evidence of the operating effectiveness, as determined pursuant to Section III.A.2.

The effort necessary to conduct an initial evaluation of financial reporting risks (as defined below) and the related controls will vary among companies, partly because this effort will depend on management's existing financial reporting risk assessment and monitoring activities.[48] Even so, in subsequent years for most companies, management's effort should ordinarily be significantly less because subsequent evaluations should be more focused on changes in risks and controls rather than identification of all financial reporting risks and the related controls. Further, in each subsequent year, the evidence necessary to reasonably support the assessment will only need to be updated from the prior year(s), not recreated anew.

a. Identifying Financial Reporting Risks

Ordinarily, the identification of financial reporting risks begins with evaluating how the requirements of GAAP apply to the company's business, operations and transactions. Management must provide investors with financial statements that fairly present the company's financial position, results of operations and cash flows in accordance with GAAP. A lack of fair presentation involves material misstatements (including omissions) in one or more of the financial statement amounts or disclosures ("financial reporting elements").

[48] Monitoring activities are those that assess the quality of internal control performance over time. These activities involve assessing the design and operation of controls on a timely basis and taking necessary corrective actions. This process is accomplished through on-going monitoring activities, separate evaluations by internal audit or personnel performing similar functions, or a combination of the two. On-going monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory review activities.

Management uses its knowledge and understanding of the business, its organization, operations, and processes to consider the sources and potential likelihood of misstatements in financial reporting elements and identifies those that could result in a material misstatement to the financial statements ("financial reporting risks"). Internal and external risk factors that impact the business, including the nature and extent of any changes in those risks, may give rise to financial reporting risks. Financial reporting risks may also arise from sources such as the initiation, authorization, processing and recording of transactions and other adjustments that are reflected in financial reporting elements. Management's evaluation of financial reporting risks should also consider the vulnerability of the entity to fraudulent activity (e.g., fraudulent financial reporting, misappropriation of assets and corruption) and whether any of those exposures could result in a material misstatement of the financial statements.[49]

The methods and procedures for identifying financial reporting risks will vary based on the characteristics of the company.[50] These characteristics include, among others, the size, complexity, and organizational structure of the company and its processes and financial reporting environment, as well as the control framework used by management. For example, to effectively identify financial reporting risks in larger businesses or in situations involving complex business processes, management's evaluation may need to involve employees with specialized knowledge who collectively

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[49] See "Management Antifraud Programs and Controls – Guidance to Help Prevent, Deter, and Detect Fraud," which was issued jointly by seven professional organizations and is included as an exhibit to AU Sec. 316, Consideration of Fraud in a Financial Statement Audit (as adopted on an interim basis by the PCAOB in PCAOB Rule 3200T).

[50] To provide management the flexibility needed to implement an evaluation process that best suits its particular circumstances; the guidance in this proposed interpretative release does not prescribe a particular methodology for the identification of risks and controls. While the May 2005 Staff Guidance used the term "significant account," which is used in AS No. 2, we are not requiring that companies use the guidance in the auditing literature to conduct their evaluation approach. The Commission encourages the development of methodologies and tools that meet the objectives of the ICFR evaluation.

have the necessary understanding of the requirements of GAAP, the underlying business transactions, the process activities, including the role of computer technology, that are required to initiate, authorize, record and process transactions, and the points within the process at which a material misstatement, including a misstatement due to fraud, may occur. In contrast, in a small company with less complex business processes that operate on a centralized basis and with little change in the risks or processes, management's daily involvement with the business may provide it with adequate knowledge to appropriately identify financial reporting risks.

b. Identifying Controls that Adequately Address Financial Reporting Risks

Management should evaluate whether it has controls placed in operation (i.e., in use) that are designed to address the company's financial reporting risks.[51] The determination of whether an individual control, or a combination of controls, adequately addresses a financial reporting risk involves judgments about both the likelihood and potential magnitude of misstatements arising from the financial reporting risk. For purposes of the evaluation of ICFR, the controls are not adequate when their design is such that there is a reasonable possibility that a misstatement in the related financial reporting element that could result in a material misstatement of the financial statements will not be prevented or detected on a timely basis.[52] If management determines that its

[51] A control consists of a specific set of policies, procedures, and activities designed to meet an objective. A control may exist within a designated function or activity in a process. A control's impact on ICFR may be entity-wide or specific to a class of transactions or application. Controls have unique characteristics – they can be: automated or manual; reconciliations; segregation of duties; review and approval authorizations; safeguarding and accountability of assets, preventing error or fraud detection, or disclosure. Controls within a process may consist of financial reporting controls and operational controls (i.e., those designed to achieve operational objectives).

[52] The use of the phrase "reasonable possibility that a misstatement in the related financial reporting element that could result in a material misstatement of the financial statements" is intended solely to assist management in identifying matters for disclosure under Item 308 of Regulation S-K. It is not intended to

controls are not adequately designed, a deficiency exists that must be evaluated to determine whether it is a material weakness. The guidance in Section III.B.1. is designed to assist management with that evaluation.[53]

Management may identify controls for a financial reporting element that are preventive, detective or a combination of both.[54] It is not necessary to identify all controls that exist. Rather, the objective of this evaluation step is to identify controls that adequately address the risk of misstatement for the financial reporting element that could result in a material misstatement in the financial statements. To illustrate, management may determine for a financial reporting element that a control within the company's period-end financial reporting process (i.e., an entity-level control) is designed in a manner that adequately addresses the risk that a misstatement in interest expense, that could result in a material misstatement in the financial statements, may occur and not be detected. In such a case, management may not need to identify any additional controls related to interest expense.

Management may consider the efficiency with which evidence of the operation of a control can be evaluated when identifying the controls that adequately address the financial reporting risks. For example, when more than one control exists that individually addresses a particular risk (i.e., redundant controls), management may

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interpret or describe management's responsibility under FCPA or modify a control framework's definition of what constitutes an effective system of internal control.

[53] A deficiency in the design of ICFR exists when (a) necessary controls are missing or (b) existing controls are not properly designed so that, even if the control operates as designed, the financial reporting risks would not be addressed. AS No. 2 states that a deficiency in the design of ICFR exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective is not always met. See AS No. 2 ¶ 8.

[54] Preventive controls have the objective of preventing the occurrence of errors or fraud that could result in a misstatement of the financial statements. Detective controls have the objective of detecting errors or fraud that has already occurred that could result in a misstatement of the financial statements. Preventive and detective controls may be completely manual, involve some degree of computer automation, or be completely automated.

decide to select the control for which evidence of operating effectiveness can be obtained more efficiently. Moreover, when adequate general information technology ("IT") controls exist, and management has determined the operation of such controls is effective, management may determine that automated controls may be more efficient to evaluate than manual controls. Considering the efficiency with which the operation of a control can be evaluated will often enhance the overall efficiency of the evaluation process.

When identifying the controls that address financial reporting risks, management may learn information about the characteristics of the controls, such as the judgment required to operate them or their complexity, that are considered in its judgments about the risk that the control will fail to operate as designed. Section III.A.2. discusses how these characteristics are considered in determining the nature and extent of evidence of the operation of the control that management evaluates.

At the end of this identification process, management will have identified for testing only those controls that are needed to adequately address the risk of a material misstatement in its financial statements and for which evidence about their operation can be obtained most efficiently.

c. Consideration of Entity-level Controls

Management considers entity-level controls when identifying and assessing financial reporting risks and related controls for a financial reporting element. In doing so, it is important for management to consider the nature of the entity-level controls and how they relate to the financial reporting element.[55] Some entity-level controls are

[55] Controls can be either directly or indirectly related to a financial reporting element. Controls that are designed to have a specific effect on a financial reporting element are considered directly related. For

designed to operate at the process, transaction or application level and might adequately prevent or detect on a timely basis misstatements in one or more financial reporting elements that could result in a material misstatement to the financial statements. On the other hand, an entity-level control may be designed to identify possible breakdowns in lower-level controls, but not in a manner that would, by itself, sufficiently address the risk that misstatements to financial reporting elements that could result in a material misstatement to the financial statements will be prevented or detected on a timely basis.

The more indirect the relationship to a financial reporting element, the less effective a control may be in preventing or detecting a misstatement. Some entity-level controls, such as the control environment (e.g., tone at the top and entity-wide programs such as codes of conduct and fraud prevention), are indirectly related to a financial reporting element and may not, by themselves, be effective at preventing or detecting a misstatement in a financial reporting element. Therefore, while management ordinarily would consider entity-level controls of this nature when assessing financial reporting risks and evaluating the adequacy of controls, it is unlikely management will identify only this type of entity-level control as adequately addressing a financial reporting risk identified for a financial reporting element.[56]

d. Role of General Information Technology Controls

Controls that management identifies as addressing financial reporting risks may be automated (e.g., application controls that update accounts in the general ledger for

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example, controls established to ensure that personnel are properly counting and recording the annual physical inventory relate directly to the existence of the inventory.

[56] Many commenters on the Concept Release requested clarification of the role of entity-level controls in management's evaluation. See for example, letters regarding file number S7-11-06 of Aerospace Industries Association, Sprint Nextel Corporation, Unum Provident, Dupont, Deutsche Telekom, Ernst & Young LLP, Deloitte & Touche LLP, and Grant Thornton LLP at http://www.sec.gov/comments/s7-11-06/s71106.shtml. See Section III.A.2.a. for additional guidance on entity-level controls.

subledger activity) or dependent upon IT functionality (e.g., a control that manually investigates items contained in a computer generated exception report). In these situations, management's evaluation process generally considers the design and operation of the automated or IT dependent controls management identifies and the relevant general IT controls over the applications providing the IT functionality. While general IT controls ordinarily do not directly prevent or detect material misstatements in the financial statements, the proper and consistent operation of automated or IT dependent controls depends upon effective general IT controls.

Aspects of general IT controls that may be relevant to the evaluation of ICFR will vary depending upon a company's facts and circumstances. Ordinarily, management should consider whether, and the extent to which, general IT control objectives related to program development, program changes, computer operations, and access to programs and data apply to its facts and circumstances. For purposes of the evaluation of ICFR, management only needs to evaluate those general IT controls that are necessary to adequately address financial reporting risks.

e. Evidential Matter to Support the Assessment

As part of its evaluation of ICFR, management must maintain reasonable support for its assessment.[57] Documentation of the design of the controls management has placed in operation to adequately address the financial reporting risks is an integral part of the reasonable support. The form and extent of the documentation will vary depending on the size, nature, and complexity of the company. It can take many forms (e.g., paper documents, electronic, or other media) and it can be presented in a number of ways (e.g., policy manuals, process models, flowcharts, job descriptions, documents,

[57] See instructions to Item 308 of Regulations S-K and S-B.

internal memorandums, forms, etc). The documentation does not need to include all controls that exist within a process that impacts financial reporting. Rather, and more importantly, the documentation can be focused on those controls that management concludes are adequate to address the financial reporting risks.[58]

In addition to providing support for the assessment of ICFR, documentation of the design of controls also supports other objectives of an effective system of internal control. For example, it serves as evidence that controls within ICFR, including changes to those controls, have been identified, are capable of being communicated to those responsible for their performance, and are capable of being monitored by the company. The documentation also provides the foundation for appropriate communication concerning responsibilities for performing controls and for the company's evaluation and monitoring of the operation of controls.

Management should also consider the need to maintain evidential matter, including documentation, of the entity-wide and other pervasive elements of its ICFR that it believes address the elements of internal control that its chosen control framework prescribes as necessary for an effective system of internal control.[59]

2. Evaluating Evidence of the Operating Effectiveness of ICFR

Management should evaluate evidence of the effective operation of ICFR. A control operates effectively when it is performed in a manner consistent with its design by individuals with the necessary authority and competency. Management ordinarily

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[58] Commenters on the Concept Release were supportive of guidance regarding the form, nature, and extent of documentation. See for example letters regarding file number S7-11-06 of EDS, Controllers' Leadership Roundtable, Sasol Group, New York State Society of Certified Public Accountants, Grant Thornton LLP, and Financial Executives International at http://www.sec.gov/comments/s7-11-06/s71106.shtml. Section III.A.2.c also provides guidance with regard to the documentation required to support management's evaluation of operating effectiveness.
[59] Id.

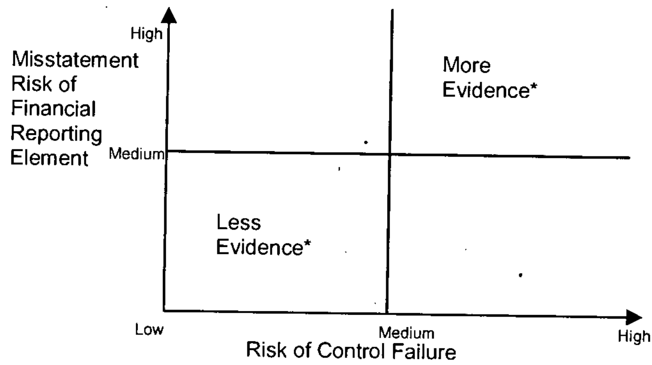
focuses its evaluation of the operation of controls on those areas of ICFR that pose the highest risk to reliable financial reporting. The evaluation procedures that management uses to gather evidence about the effective operation of ICFR should be tailored to its assessment of the risk characteristics of both the individual financial reporting elements and the related controls (collectively, ICFR risk). Management's assessment of ICFR risk also considers the impact of entity-level controls, such as the relative strengths and weaknesses of the control environment, which may influence management's judgments about the risks of failure for particular controls. Management varies the nature, timing and extent of the evaluation methods it implements in response to its judgments about ICFR risk.

Evidence about the effective operation of controls may be obtained from direct-testing of controls and on-going monitoring activities. The nature, timing and extent of evaluation procedures necessary for management to obtain sufficient evidence of the effective operation of a control depends on the assessed ICFR risk. In determining whether the evidence obtained is sufficient to provide a reasonable basis for its evaluation of the operation of ICFR, management should consider not only the quantity of evidence (e.g., sample size) but also qualitative characteristics of the evidence. The qualitative characteristics of the evidence include the nature of the evaluation procedures performed, the period of time to which the evidence relates, the objectivity of those evaluating the controls, and, in the case of monitoring controls, the extent of validation through direct testing of underlying controls. For any individual control, different combinations of the nature, timing, and extent of evaluation procedures may provide sufficient evidence. The sufficiency of evidence is not determined by any of these attributes individually.

a. Determining the Evidence Needed to Support the Assessment

Management should evaluate the ICFR risk of the controls identified in Section III.A.1. to determine the evidence needed to support the assessment. The risk assessment should consider the impact of the characteristics of the financial reporting elements to which the controls relate and the characteristics of the controls themselves. This concept is demonstrated in the following diagram.

Determining the Sufficiency of Evidence Based on ICFR Risk



* The references to "more" or "less" include both the quantitative and qualitative characteristics of the evidence (i.e., its sufficiency).

Characteristics of the financial reporting element that management considers include both the materiality of the financial reporting element and the susceptibility of the underlying account balances, transactions or other supporting information to material misstatement. As the materiality of the financial reporting element increases in relation to the amount of misstatement that would be considered material to the financial statements, management's assessment of risk generally would correspondingly increase. In addition, financial reporting elements would generally have higher risk when they include transactions, account balances or other supporting information that is prone to misstatement. For example, elements which: (1) involve judgment in determining the recorded amounts; (2) are susceptible to fraud; (3) have complexity in the underlying accounting requirements; or (4) are subject to environmental factors, such as technological and/or economic developments, would generally be assessed as higher risk.

Management also considers the likelihood that a control might fail to operate effectively. That likelihood may depend on, among other things, the type of control (i.e., manual or automated), the complexity of the control, the risk of management override, the judgment required to operate the control, the nature and materiality of misstatements that the control is intended to prevent or detect, and the degree to which the control relies on the effectiveness of other controls (e.g., general IT controls). For example, management's risk assessment would be higher for a financial reporting element that involves controls whose operation requires significant judgment than for a financial reporting element that involves non-complex controls requiring little judgment on behalf of management.

Certain financial reporting elements, such as those involving significant accounting estimates,[60] related party transactions, or critical accounting policies[61] generally would be assessed as having higher risk for both the risk of material misstatement to the financial reporting element and the risk of control failure. When the controls related to these financial reporting elements are subject to the risk of management override, involve significant judgment, or are complex, they should generally be assessed as having higher ICFR risk.

When a combination of controls is required to adequately address the risks of a financial reporting element, management should analyze the risk characteristics of each control. This is because the controls associated with a given financial reporting element may not necessarily share the same risk characteristics. For example, a financial reporting element involving significant estimation may require a combination of automated controls that accumulate source data and manual controls that require highly judgmental determinations of assumptions. In this case, the automated controls may be subject to a system that is stable (i.e., has not undergone significant change) and is supported by effective general controls and are therefore assessed as lower risk, whereas the manual controls would be assessed as higher risk.

[60] "Significant accounting estimates" referred to here relate to accounting estimates or assumptions where the nature of the estimates or assumptions is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change; and the impact of the estimates and assumptions on financial condition or operating performance is material. See Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations. Release No. 33-8350 (December 19, 2003).

[61] "Critical accounting policies" are defined as those policies that are most important to the financial statement presentation, and require management's most difficult, subjective, or complex judgments, often as the result of a need to make estimates about the effect of matters that are inherently uncertain. See Action: Cautionary Advice Regarding Disclosure About Critical Accounting Policies. Release No. 33-8040 (December 12, 2001).

The existence of entity-level controls (e.g., controls within the control environment) may influence management's determination of the evidence needed to sufficiently support its assessment. For example, management's judgment about the likelihood that a control fails to operate effectively may be influenced by a highly effective control environment and thereby impact the evidence evaluated for that control. However, a strong control environment would not eliminate the need for evaluation procedures that consider the effective operation of the control in some manner.[62]

b. Implementing Procedures to Evaluate Evidence of the Operation of ICFR

The methods and procedures management uses to gather evidence about the effective operation of controls are based on its assessment of the ICFR risk. Therefore, the methods and procedures, including the timing of when they are performed, are a function of the evidence that management considers necessary to provide reasonable support for its assessment of ICFR based on the assessment of ICFR risk. These procedures may be integrated with the daily responsibilities of its employees or implemented specifically for purposes of the ICFR evaluation. Evidence that is relevant to the assessment may come from activities that are performed for other reasons (e.g., day-to-day activities to manage the operations of the business). Further, activities performed to meet the monitoring objectives of the control framework will provide evidence to support the assessment.[63]

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[62] See references at footnote 56 to comments received related to the role of entity-level controls within management's evaluation.

[63] Many commenters on the Concept Release requested guidance clarifying that evidence relevant to supporting the evaluation may come from activities that are integrated into management's daily activities or performed for other reasons. See, for example, letters regarding file number S7-11-06 of EDS, American Electric Power and the Hundred Group of Finance Directors at http://www.sec.gov/comments/s7-11-06/s71106.shtml.

The evidence management evaluates may come from a combination of on-going monitoring and direct testing of controls. On-going monitoring includes activities that provide information about the operation of controls and may be obtained, for example, through self-assessment[64] procedures and the analysis of performance measures designed to track the operation of controls.[65] Direct tests of controls are tests performed periodically to provide evidence as of a point in time and may provide information about the reliability of on-going monitoring activities.

The risk assessments discussed in Section III.A.2.a. can assist management in determining the evaluation procedures that provide reasonable support for the assessment. As the assessed risk increases, management will ordinarily adjust the nature of the evidence that is obtained. For example, management can vary the nature of evidence from on-going monitoring by adjusting the extent of validation through periodic direct testing of the underlying controls and/or adjusting the objectivity of those performing the self-assessments. Management can also vary the nature of evidence obtained by adjusting the period of time covered by direct testing. When ICFR risk is assessed as high, management's evaluation would ordinarily include evidence obtained

[64] Self-assessment is a broad term that refers to different types of procedures performed by various parties. It includes an assessment made by the same personnel who are responsible for performing the control. However, self-assessment may also be used to refer to assessments and tests of controls performed by persons who are members of management but are not the same personnel who are responsible for performing the control. In this manner, an assessment may be carried out with varying degrees of objectivity. The sufficiency of the evidence derived from self-assessment depends on how it is implemented and the objectivity of those performing the assessment. COSO's 1992 framework defines self-assessments as "evaluations where persons responsible for a particular unit or function will determine the effectiveness of controls for their activities."

[65] Management's evaluation process may also consider the results of key performance indicators ("KPI's") in which management reconciles operating and financial information with its knowledge of the business. While these KPI's may indicate a potential misstatement in a financial reporting element and therefore are relevant to meeting the objectives of ICFR, they generally do not monitor the effective operation of other controls. The procedures that management implements pursuant to this section should evaluate the effective operation of these KPI type controls when they are identified pursuant to Section III.A.1.b. as addressing financial reporting risk.

from direct testing. Further, management's evaluation would ordinarily consider evidence from a reasonable period of time during the year, including the fiscal year-end. For lower risk areas, management may conclude that evidence from on-going monitoring is sufficient and that no direct testing is required.[66]

In smaller companies, management's daily interaction with its controls may provide it with sufficient knowledge about their operation to evaluate the operation of ICFR. Knowledge from daily interaction includes information obtained by those responsible for evaluating the effectiveness of ICFR through their on-going direct knowledge and direct supervision of control operation. Management should consider its particular facts and circumstances when determining whether or not its daily interaction with controls provides sufficient evidence for the evaluation. For example, daily interaction may provide sufficient evidence when the operation of controls is centralized and the number of personnel involved in their operation is limited. Conversely, daily interaction in companies with multiple management reporting layers or operating segments would generally not provide sufficient evidence because those responsible for assessing the effectiveness of ICFR would not ordinarily be sufficiently knowledgeable about the operation of the controls. In these situations, management would ordinarily utilize direct testing or on-going monitoring type evaluation procedures to have reasonable support for the assessment.[67]

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[66] Commenters on the Concept Release were supportive of guidance on factors that should be considered in using a risk-based evaluation. See, for example, letters regarding file number S7-11-06 of Aerospace Industries Association, American Institute of Certified Public Accountants, American Electric Power, Edison Electric Institute, and PricewaterhouseCoopers LLP at http://www.sec.gov/comments/s7-11-06/s71106.shtml. Section III.A.2.a. also provides guidance on a risked-based evaluation.

[67] Commenters on the Concept Release were supportive of guidance on how management's daily interaction can support the evaluation. See, for example, letters regarding file number S7-11-06 of US Oncology, Inc., EDS, American Electric Power, MetLife, Texas Society of Certified Public Accountants, and the Controllers' Leadership Roundtable at http://www.sec.gov/comments/s7-11-06/s71106.shtml.

Management evaluates the evidence it gathers to determine whether the operation of a control is effective. This evaluation considers whether the control operated as designed and includes matters such as how the control was applied, the consistency with which it was applied, and whether the person performing the control possesses the necessary authority and competence to perform the control effectively. If management determines that the operation of the control is not effective, a deficiency exists that must be evaluated to determine whether it is a material weakness.

c. Evidential Matter to Support the Assessment

Management's assessment must be supported by evidential matter that provides reasonable support for its assessment. The nature of the evidential matter may vary based on the assessed level of risk of the underlying controls and other circumstances, but we would expect reasonable support for an assessment to include the basis for management's assessment, including documentation of the methods and procedures it utilizes to gather and evaluate evidence. The evidential matter may take many forms and will vary depending on the assessed level of risk for controls over each of its financial reporting elements. For example, management may document its overall strategy in a comprehensive memorandum that establishes the evaluation approach, the evaluation procedures, and the basis for conclusions for each financial reporting element. Management may determine that it is not necessary to separately maintain copies of the evidence it evaluates; however, the evidential matter within the company's books and records should be sufficient to provide reasonable support for its assessment. For example, in smaller companies, where management's daily interaction with its controls provides the basis for its assessment, management may have limited documentation

created specifically for the evaluation of ICFR. However, in these instances, management should consider whether reasonable support for its assessment would include documentation of how its interaction provided it with sufficient evidence. This documentation might include memoranda, e-mails, and instructions or directions from management to company employees.[68]

Further, management should also consider the degree of complexity of the control, the level of judgment required to operate the control, and the risk of misstatement in the financial reporting element that could result in a material misstatement in the financial statements in determining the nature of supporting evidential matter. As these factors increase, management may determine that evidential matter supporting the assessment should be separately maintained.[69] For example, management may decide that separately maintained documentation will assist the audit committee in exercising its oversight of the company's financial reporting.

If management believes that the operation of the entity-wide and other pervasive elements of its ICFR address the elements of internal control that its applicable framework describes as necessary for an effective system, then the evidential matter constituting reasonable support for management's assessment would ordinarily include documentation of how management formed that belief.[70]

3. Multiple Location Considerations[71]

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[68] See footnote 58 for references to Concept Release comment letters requesting guidance on documentation.
[69] Id.
[70] Id.
[71] Guidance in this area was requested in numerous comments received in response to the Concept Release. See, for example, letters regarding file number S7-11-06 of Eli Lilly, Deloitte & Touche LLP, Ernst & Young LLP, Sasol Group, and the Institute of Management Accountants at http://www.sec.gov/comments/s7-11-06/s71106.shtml.

Management's consideration of financial reporting risks generally includes all of its locations or business units.[72] Management may determine that financial reporting risks are adequately addressed by controls which operate centrally, in which case the evaluation approach is similar to that of a business with a single location or business unit. When the controls necessary to address financial reporting risks operate at more than one location or business unit, management would generally evaluate evidence of the operation of the controls at the individual locations or business units.

In situations where management determines that the ICFR risk of the controls (as determined through Section III.A.2.a) that operate at individual locations or business units is low, management may determine that evidence gathered through self-assessment routines or other on-going monitoring activities, when combined with the evidence derived from a centralized control that monitors the results of operations at individual locations, may constitute sufficient evidence for the evaluation. In other situations, management may determine that, because of the complexity or judgment in the operation of the controls at the individual location, the risks of the controls are high, and therefore more evidence is needed about the effective operation of the controls at the location.

When performing its evaluation of the risk characteristics of the controls identified, management should consider whether there are location-specific risks that might impact the risk that a control might fail to operate effectively. Additionally, there may be pervasive factors at a given location that cause all controls, or a majority of controls, at that location to be considered higher risk. Management should generally consider the risk characteristics of the controls for each financial reporting element,

[72] Consistent with the guidance in Section III.A.1., management may determine when identifying financial reporting risks that some locations are so insignificant that no further evaluation procedures are needed.

rather than making a single judgment for all controls at that location when deciding whether the nature and extent of evidence is sufficient.

B. Reporting Considerations

1. Evaluation of Control Deficiencies

In order to determine whether a control deficiency, or combination of control deficiencies, is a material weakness, management evaluates each control deficiency that comes to its attention.[73] Control deficiencies that are determined to be a material weakness must be disclosed in management's annual report on its assessment of the effectiveness of ICFR.[74] Management may not disclose that it has assessed ICFR as effective if there is one or more control deficiencies determined to be a material weakness in ICFR. As part of the evaluation of ICFR, management considers whether the deficiencies, individually or in combination, are material weaknesses as of the end of the fiscal year. Multiple control deficiencies that affect the same financial statement account

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[73] Because of the importance to investors of the reconciliation to U.S. GAAP, when management of foreign private issuers that file in home country GAAP or IFRS determine the severity of an identified control deficiency, management should consider the impact of the control deficiency to the U.S. GAAP reconciliation disclosure. Hence, management should take into consideration both the amounts reported in the primary financial statements and the amounts reported in the reconciliation to U.S. GAAP in evaluating the severity of the control deficiency. For example, it would be inappropriate to determine, without further consideration, that a control deficiency associated with an item included in the reconciliation to U.S. GAAP, is not material to the primary financial statements, and therefore cannot be, by definition, a material weakness.

[74] Pursuant to Rules 13a-14 and 15d-14 management discloses to the auditors and to the audit committee of the board of directors (or persons fulfilling the equivalent function) all significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls. The interaction of qualitative considerations that affect ICFR with quantitative considerations ordinarily results in deficiencies in the following areas being at least significant deficiencies in internal control over financial reporting: controls over the selection and application of accounting policies that are in conformity with generally accepted accounting principles; antifraud programs and controls; controls over non-routine and non-systematic transactions; and controls over the period-end financial reporting process. If management determines that the deficiency would prevent prudent officials in the conduct of their own affairs from concluding that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles, then management should deem the deficiency to be at least a significant deficiency.

balance or disclosure increase the likelihood of misstatement and may, in combination, constitute a material weakness if there is a reasonable possibility[75] that a material misstatement to the financial statements would not be prevented or detected in a timely manner, even though such deficiencies may be individually insignificant. Therefore, management should evaluate individual control deficiencies that affect the same account balance, disclosure, relevant assertion, or component of internal control, to determine whether they collectively result in a material weakness.[76]

The evaluation of a control deficiency should include both quantitative and qualitative factors. Management can evaluate a deficiency in ICFR by considering the likelihood that the company's ICFR will fail to prevent or detect a misstatement of a financial statement element, or component thereof, on a timely basis; and the magnitude of the potential misstatement resulting from the deficiency or deficiencies. This evaluation is based on whether the company's controls will fail to prevent or detect a misstatement on a timely basis, not necessarily on whether a misstatement actually has occurred.

Several factors affect the likelihood that a deficiency, or a combination of deficiencies, will result in a misstatement in a financial reporting element not being prevented or detected on a timely basis. The factors include, but are not limited to, the following:

- The nature of the financial statement elements, or components thereof, involved (e.g., suspense accounts and related party transactions involve greater risk);

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[75] See footnote 32.
[76] A similar approach to aggregating individually insignificant control deficiencies was used by the AICPA in Statement on Auditing Standard No. 112.

- The susceptibility of the related asset or liability to loss or fraud (i.e., greater susceptibility increases risk);
- The subjectivity, complexity, or extent of judgment required to determine the amount involved (i.e., greater subjectivity, complexity, or judgment, like that related to an accounting estimate, increases risk);
- The interaction or relationship of the control with other controls (i.e., the interdependence or redundancy of the control);
- The interaction of the deficiencies (i.e., when evaluating a combination of two or more deficiencies, whether the deficiencies could affect the same financial statement accounts and assertions); and
- The possible future consequences of the deficiency.

Management should evaluate how the controls interact with other controls when evaluating the likelihood that the company's controls will fail to prevent or detect on a timely basis a misstatement that is material to the company's financial statements. There are controls, such as general IT controls, on which other controls depend. Some controls function together as a group of controls. Other controls overlap, in the sense that more than one control may individually achieve the same objective.

Several factors affect the magnitude of the misstatement that might result from a deficiency or deficiencies in controls. The factors include, but are not limited to, the following:

- The financial statement amounts or total of transactions exposed to the deficiency; and

- The volume of activity in the account balance or class of transactions exposed to the deficiency that has occurred in the current period or that is expected in future periods.

In evaluating the magnitude of the potential misstatement to the company's financial statements as a whole, management should recognize that the maximum amount that an account balance or total of transactions can be overstated is the recorded amount, while understatements could be larger. Moreover, in many cases, the probability of a small misstatement will be greater than the probability of a large misstatement. For example, if the deficiency is that errors identified during an account reconciliation are not being investigated in a timely manner, management should consider the possibility that larger errors are more likely to be investigated or identified through other controls than smaller ones.

Management should evaluate the effect of compensating controls[77] when determining whether a control deficiency or combination of deficiencies is a material weakness. When evaluating a deficiency in ICFR, management also should determine the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP.

The following circumstances are strong indicators that a material weakness in ICFR exists:

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[77] Compensating controls are controls that serve to accomplish the objective of another control that did not function properly, helping to reduce risk to an acceptable level. To have a mitigating effect, the compensating control should operate at a level of precision that would prevent or detect a misstatement that was material.

- An ineffective control environment. Circumstances that may indicate that the company's control environment is ineffective include, but are not limited to:
  - Identification of fraud of any magnitude on the part of senior management.
  - Significant deficiencies that have been identified and remain unaddressed after some reasonable period of time.
  - Ineffective oversight of the company's external financial reporting and ICFR by the company's audit committee.[78]
- Restatement of previously issued financial statements to reflect the correction of a material misstatement.

  Note: The correction of a material misstatement includes misstatements due to error or fraud; it does not include retrospective application of a change in accounting principle to comply with a new accounting principle or a voluntary change from one generally accepted accounting principle to another generally accepted accounting principle.
- Identification by the auditor of a material misstatement in financial statements in the current period under circumstances that indicate the misstatement would not have been discovered by the company's ICFR.
- For complex entities in highly regulated industries, an ineffective regulatory compliance function. This relates solely to those aspects of the ineffective

[78] If no audit committee exists, all references to the audit committee apply to the entire board of directors of the company. When a company is not required by law or applicable listing standards to have independent directors on its audit committee, the lack of independent directors at these companies is not indicative, by itself, of a control deficiency. In all cases, management should interpret the terms "board of directors" and "audit committee" as being consistent with provisions for the use of those terms as defined in relevant SEC rules.

regulatory compliance function in which associated violations of laws and regulations could have a material effect on the reliability of financial reporting.

2. Expression of Assessment of Effectiveness of ICFR by Management and the Registered Public Accounting Firm

Management should disclose a clear expression of its assessment related to the effectiveness of ICFR and, therefore, should not qualify its assessment by saying that the company's ICFR is effective subject to certain qualifications or exceptions or express similar positions. For example, management should not state that the company's controls and procedures are effective except to the extent that certain material weakness(es) have been identified. In addition, if a material weakness exists, management may not state that the company's ICFR is effective. However, management may state that controls are ineffective due solely to, and only to the extent of, the identified material weakness(es). Prior to making this statement, however, management should consider the nature and pervasiveness of the material weakness. In addition, management may disclose any remediation efforts to the identified material weakness(es) in Item 9A of Form 10-K, Item 15 of Form 20-F, or General Instruction B of Form 40-F.

3. Disclosures About Material Weaknesses

The Commission's rule implementing Section 404 was intended to bring information about material weaknesses in ICFR into public view. Because of the significance of the disclosure requirements surrounding material weaknesses beyond specifically stating that the material weaknesses exist, companies should also consider including the following in their disclosures:[79]

- the nature of any material weakness,

[79] Significant deficiencies in ICFR are not required to be disclosed in management's annual report on its evaluation of ICFR required by Item 308(a).

- its impact on financial reporting and the control environment, and
- management's current plans, if any, for remediating the weakness.

Disclosure of the existence of a material weakness is important, but there is other information that also may be material and necessary to form an overall picture that is not misleading.[80] There are many different types of material weaknesses and many different factors that may be important to the assessment of the potential effect of any particular material weakness. While management is required to conclude and state in its report that ICFR is ineffective when there is one or more material weaknesses, companies should also consider providing disclosure that allows investors to understand the root cause of the control deficiency and to assess the potential impact of each particular material weakness. This disclosure will be more useful to investors if management differentiates the potential impact and importance to the financial statements of the identified material weaknesses, including distinguishing those material weaknesses that may have a pervasive impact on ICFR from those material weaknesses that do not. The goal underlying all disclosure in this area is to provide an investor with disclosure and analysis beyond the mere existence of a material weakness.

4. Impact of a Restatement of Previously Issued Financial Statements on Management's Report on ICFR

Item 308 of Regulation S-K requires disclosure of management's assessment of the effectiveness of the company's ICFR as of the end of the company's most recent fiscal year. When a material misstatement in previously issued financial statements is discovered, a company is required to restate those financial statements. However, the restatement of financial statements does not, by itself, necessitate that management

[80] See Exchange Act Rule 12b-20 [17 CFR 240.12b-20].

consider the effect of the restatement on the company's prior conclusion related to the effectiveness of ICFR.

While there is no requirement for management to reassess or revise its conclusion related to the effectiveness of ICFR, management should consider whether its original disclosures are still appropriate and should modify or supplement its original disclosure to include any other material information that is necessary for such disclosures not to be misleading in light of the restatement. The company should also disclose any material changes to ICFR, as required by Item 308(c) of Regulation S-K.

Similarly, while there is no requirement that management reassess or revise its conclusion related to the effectiveness of its disclosure controls and procedures, management should consider whether its original disclosures regarding effectiveness of disclosure controls and procedures need to be modified or supplemented to include any other material information that is necessary for such disclosures not to be misleading. With respect to the disclosures concerning ICFR and disclosure controls and procedures, the company may need to disclose in this context what impact, if any, the restatement has on its original conclusions regarding effectiveness of ICFR and disclosure controls and procedures.

5. Inability to Assess Certain Aspects of ICFR

In certain circumstances, management may encounter difficulty in assessing certain aspects of its ICFR. For example, management may outsource a significant process to a service organization and determine that evidence of the operating effectiveness of the controls over that process is necessary. However, the service organization may be unwilling to provide either a Type 2 SAS 70 report or to provide

management access to the controls in place at the service organization so that management could assess effectiveness.[81] Finally, management may not have compensating controls in place that allow a determination of the effectiveness of the controls over the process in an alternative manner. The Commission's disclosure requirements state that management's annual report on ICFR must include a statement as to whether or not ICFR is effective and do not permit management to issue a report on ICFR with a scope limitation.[82] Therefore, management must determine whether the inability to assess controls over a particular process is significant enough to conclude in its report that ICFR is not effective.

Request for Comment

We request and encourage any interested parties to submit comments on the proposed interpretive guidance. In addition to seeking general feedback on the proposed interpretive guidance, the Commission seeks comments on the following:

- Will the proposed interpretive guidance be helpful to management in completing its annual evaluation process? Does the proposed guidance allow for management to conduct an efficient and effective evaluation? If not, why not?
- Are there particular areas within the proposed interpretive guidance where further clarification is needed? If yes, what clarification is necessary?

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[81] AU Sec. 324, Service Organizations (as adopted on an interim basis by the PCAOB in PCAOB Rule 3200T), defines a report on controls placed in operation and test of operating effectiveness, commonly referred to as a "Type 2 SAS 70 report." This report is a service auditor's report on a service organization's description of the controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements, on whether such controls were suitably designed to achieve specified control objectives, on whether they had been placed in operation as of a specific date, and on whether the controls that were tested were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the related control objectives were achieved during the period specified.

[82] See Item 308 of Regulations S-K and S-B [17 CFR 229.308(a)(3) and 228.308(a)(3)].

- Are there aspects of management's annual evaluation process that have not been addressed by the proposed interpretive guidance that commenters believe should be addressed by the Commission? If so, what are those areas and what type of guidance would be beneficial?
- Do the topics addressed in the existing staff guidance (May 2005 Staff Guidance and Frequently Asked Questions (revised October 6, 2004)) continue to be relevant or should such guidance be retracted? If yes, which topics should be kept or retracted?
- Will the proposed guidance require unnecessary changes to evaluation processes that companies have already established? If yes, please describe.
- Considering the PCAOB's proposed new auditing standards, An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements and Considering and Using the Work of Others In an Audit, are there any areas of incompatibility that limit the effectiveness or efficiency of an evaluation conducted in accordance with the proposed guidance? If so, what are those areas and how would you propose to resolve the incompatibility?
- Are there any definitions included in the proposed interpretive guidance that are confusing or inappropriate and how would you change the definitions so identified?
- Will the guidance for disclosures about material weaknesses result in sufficient information to investors and if not, how would you change the guidance?
- Should the guidance be issued as an interpretation or should it, or any part, be codified as a Commission rule?

- Are there any considerations unique to the evaluation of ICFR by a foreign private issuer that should be addressed in the guidance? If yes, what are they?

IV. PROPOSED RULE AMENDMENTS

Exchange Act Rules 13a-15(c) and 15d-15(c) require the management of each issuer subject to the Exchange Act reporting requirements, other than a registered investment company, to evaluate, with the participation of the issuer's principal executive and principal financial officers, or persons performing similar functions, the effectiveness, as of the end of each fiscal year, of the issuer's ICFR.[83] We are proposing to amend these rules to state that, although there are many different ways to conduct an evaluation of the effectiveness of ICFR to meet the requirement in the rule, an evaluation conducted in accordance with the interpretive guidance issued by the Commission, if the Commission adopts the interpretive guidance in final form, would satisfy the annual management evaluation required by those rules.[84] The proposed amendments would not limit the ability of management to use its judgment to determine a method of evaluation that is appropriate for its company. The proposed amendments would be similar to a non-exclusive safe-harbor in that they would not require management to conduct the evaluation in accordance with the interpretive guidance, but would provide certainty to management that chooses to follow the guidance that it has satisfied its obligation to conduct an evaluation for purposes of the requirements in Rules 13a-15(c) and 15d-15(c).

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[83] We recently adopted amendments that, among other things, provide a transition period for newly public companies before they become subject to the ICFR requirements. Under the new amendments, a newly public company will not become subject to the ICFR requirements until it either had been required to file an annual report for the prior fiscal year with the Commission or had filed an annual report with the Commission for the prior fiscal year. See Release No. 33-8760 (December 15, 2006) available at http://www.sec.gov/rules/final.shtml.

[84] See proposed revisions to Rules 13a-15(c) and 15d-15(c).

Our rules implementing Section 404(b) of Sarbanes-Oxley require every registered public accounting firm that issues or prepares an audit report on a company's financial statements for inclusion in an annual report that contains an assessment by management of the effectiveness of the registrant's ICFR to attest to, and report on, such assessment. Pursuant to Rule 2-02(f), the accountant's attestation report must clearly state the "opinion of the accountant as to whether management's assessment of the effectiveness of the registrant's ICFR is fairly stated in all material respects." Over the past three years we have received feedback that the current form of the auditor's opinion may not effectively communicate the auditor's responsibility in relation to management's evaluation process. Therefore, we are proposing to revise Rule 2-02(f) to require the auditor to express an opinion directly on the effectiveness of ICFR. In addition, we are proposing revisions to Rule 2-02(f) to clarify the circumstances in which we would expect that the accountant cannot express an opinion.

We are also proposing conforming revisions to the definition of attestation report in Rule 1-02(a)(2) of Regulation S-X. We believe this opinion necessarily conveys whether management's assessment is fairly stated. We understand the PCAOB will be proposing a conforming revision to its auditing standard to reflect this revision as well.

Request for Comment

We request and encourage any interested person to submit comments on the proposed revision to Exchange Act Rules 13a-15(c) and 15d-15(c) and Rules 1-02 and 2-02 of Regulation S-X. In addition to seeking general feedback on the proposed rule revision, the Commission seeks comments on the following:

- Should compliance with the interpretive guidance, if issued in final form, be voluntary, as proposed, or mandatory?
- Is it necessary or useful to amend the rules if the proposed interpretive guidance is issued in final form, or are rule revisions unnecessary?
- Should the rules be amended in a different manner in view of the proposed interpretive guidance?
- Is it appropriate to provide the proposed assurance in Rules 13a-15 and 15d-15 that an evaluation conducted in accordance with the interpretive guidance will satisfy the evaluation requirement in the rules?
- Does the proposed revision offer too much or too little assurance to management that it is conducting a satisfactory evaluation if it complies with the interpretive guidance?
- Are the proposed revisions to Exchange Act Rules 13a-15(c) and 15d-15(c) sufficiently clear that management can conduct its evaluation using methods that differ from our interpretive guidance?
- Do the proposed revisions to Rules 1-02(a)(2) and 2-02(f) of Regulation S-X effectively communicate the auditor's responsibility? Would another formulation better convey the auditor's role with respect to management's assessment and/or the auditor's reporting obligation?
- Should we consider changes to other definitions or rules in light of these proposed revisions?
- The proposed revision to Rule 2-02(f) highlights that disclaimers by the auditor would only be appropriate in the rare circumstance of a scope limitation. Does

this adequately convey the narrow circumstances under which an auditor may disclaim an opinion under our proposed rule? Would another formulation provide better guidance to auditors?

V. PAPERWORK REDUCTION ACT

Certain provisions of our ICFR requirements contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA"). We submitted these collections of information to the Office of Management and Budget ("OMB") for review in accordance with the PRA and received approval for the collections of information. We do not believe the rule amendments that we are proposing in this release will impose any new recordkeeping or information collection requirements, or other collections of information requiring OMB's approval.

VI. COST-BENEFIT ANALYSIS

A. Background

Section 404(a) of Sarbanes-Oxley directed the Commission to prescribe rules to require each annual report that a company, other than a registered investment company, files pursuant to Exchange Act Section 13(a) or 15(d) to contain an internal control report: (1) stating management's responsibilities for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) containing an assessment, as of the end of the company's most recent fiscal year, of the effectiveness of the company's internal control structure and procedures for financial reporting. On June 5, 2003, the Commission adopted final rules implementing the requirements of Section 404(a).[85]

[85] See footnote 9 above for reference.

The final rules did not prescribe any specific method or set of procedures for management to follow in performing its evaluation of ICFR. This gave managers some flexibility, while leaving it to management's judgment about what constitutes "reasonable support" for its assessment of internal controls. In the absence of specific guidance, managers of many companies have relied upon AS No. 2. This choice reflected the pressure on managers to meet the expectations of the auditors who were charged with attesting to the effectiveness of the company's ICFR and management's annual assessment of ICFR. The limited alternative guidance available to management has not given it the information that is necessary to assuage its concerns about the risk of being unable to satisfy the expectations of its auditor under AS No. 2.

The proposed interpretive guidance is intended to enable management to conduct a more effective and efficient evaluation of ICFR. Further, under the proposed rule amendments, the auditor would express only a single opinion on the effectiveness of the company's internal controls in its attestation report rather than expressing separate opinions directly on the effectiveness of the company's ICFR and on management's assessment.

Managers may choose to rely on the interpretive guidance, as an alternative to what is provided in existing auditing standards or elsewhere, for two key reasons. First, we are proposing a rule that would give managers who follow the interpretive guidance comfort that they have conducted a sufficient ICFR evaluation. Second, elimination of the auditor's opinion on management's assessment of ICFR in the auditor's attestation report should significantly lessen, if not eliminate, the pressures that managers have felt to look to auditing standards for guidance in performing those evaluations.

While the focus of the Cost-Benefit Analysis in this release is on the costs and benefits related to the rule amendments that we are proposing in this release, rather than the costs and benefits of the proposed interpretive guidance that we describe in this release,[86] in view of the fact that the effect of the proposed rule amendments will be to endorse the interpretive guidance as one approach to compliance, we also have considered the effect that the proposed guidance may have on evaluation costs.

By encouraging managers to rely on guidance that is less prescriptive and better aligned with the objectives of Section 404, the proposed rule should reduce management's effort relative to current practice under existing auditing standards. The expenditure of effort by audit firms also may decline, in response, relative to what would occur otherwise. We are thus soliciting comments on how the proposed guidance and the proposed new auditing standard will affect the expenditure of effort, and division of labor, between the managers and employees of public companies and their audit firms.

The benefits and costs of the proposed rule amendments will be affected by the number of companies that choose to follow the interpretive guidance. Managers will be free to weigh the benefits and costs to shareholders in choosing whether to follow the guidance or some other approach. This feature does not apply to the proposed revisions to Regulation S-X, however, because compliance with these amendments will be mandatory.

[86] To reduce the costs of implementation, we developed proposed interpretive guidance to aid management in the planning and performance of an evaluation of ICFR. In connection with this interpretive guidance, we are proposing an amendment to Exchange Act Rules 13a-15(c) and 15d-15(c) that would make it clear that an evaluation that is conducted in accordance with the interpretive guidance is one way to satisfy the annual management evaluation requirement in those rules and forms. In addition, we are proposing revisions to Rule 2-02(f) of Regulation S-X to indicate that an auditor should only express a single opinion directly on the effectiveness of a company's ICFR, rather than an opinion on the effectiveness and a separate opinion on management's assessment. We are also proposing conforming revisions to Rule 1-02(a)(2) of Regulation S-X which defines the term "attestation report on management's assessment of internal control over financial reporting."

B. Benefits

As explained above, the proposed amendments would state that an evaluation by management of ICFR that is conducted in accordance with the interpretive guidance is one of many ways to satisfy the evaluation requirement in Exchange Act Rules 13a-15(c) and 15d-15(c), and would clarify that the auditor should only express an opinion directly on the effectiveness of a company's ICFR. We expect the primary benefits of the proposed rule amendments to Exchange Act Rules 13a-15(c) and 15d-15(c) to be two-fold. First, there will be a greater likelihood that management choosing to follow the guidance will more effectively detect material weaknesses. Second, there should be a reduction in the costs of excessive testing and documentation that have arisen from management aversion to risk in determining the level and type of effort that is sufficient to conduct an evaluation of ICFR. We believe the proposed revisions to Rule 2-02(f) of Regulation S-X should better communicate to investors the nature of the assurance provided to them through the work performed by the auditor.

The proposed amendments to Rules 13a-15(c) and 15d-15(c) are similar to a non-exclusive safe-harbor in that they would not require management to comply with the evaluation requirement in a particular manner (i.e., by following the interpretive guidance), but would provide certainty to management choosing to follow the guidance that management has satisfied its obligation to conduct an evaluation in an appropriate manner.

The proposed rule amendments are intended to make implementation of the internal control reporting requirements more efficient and cost-effective for all

registrants. We believe that benefits to investors will arise from the following potential consequences of the proposed rule amendments:

- Management can choose to follow guidance that is an efficient and effective means of satisfying the evaluation requirement;
- All public companies, especially smaller public companies, that choose to follow the guidance would be afforded considerable flexibility to scale and tailor their evaluation methods and procedures to fit their own facts and circumstances;
- Management would have the comfort that an evaluation that complies with our interpretive guidance is one way to satisfy the evaluation required by Exchange Act Rule 13a-15(c) and Exchange Act Rule 15d-15(c), and reduce any second-guessing as to whether management's process was adequate;
- There may be reduced risk of costly and time-consuming disagreement between the auditor and management regarding the extent of documentation and testing needed to satisfy the ICFR evaluation requirement;
- Companies are likely to save costs and reduce the amount of effort and resources associated with an evaluation by relying on a set of guidelines that clarify the nature, timing and extent of management's procedures and that recognizes the many different types of evidence-gathering methods available to management (such as direct interaction with control components);[87] and
- Management would have greater clarity regarding the Commission's expectations concerning an evaluation of ICFR.

[87] See, e.g., transcript of Roundtable Discussion on Second Year Experiences with Internal Control Reporting and Auditing Provisions, May 10, 2006 available at http://www.sec.gov/spotlight/soxcomp.htm.

Improved implementation of the ICFR requirements could facilitate a more timely flow of information within the company and, ultimately, to investors and the marketplace. We believe that an effective internal control evaluation would help management to better identify potential weaknesses and inefficiencies that could result in cost-savings in a company's operations.

C. Costs

Some larger public companies may face a transitory increase in compliance costs if they choose to follow the guidance. This is because many of the larger companies that have already evaluated their internal controls have reported cost reductions, or the anticipation of cost reductions, in the second and subsequent years of compliance with the internal control reporting provisions. For companies that choose to follow the interpretive guidance, the proposed rule amendments may cause some accelerated and large accelerated filers who have completed one or more evaluations of their ICFR to adjust their evaluation procedures in order to take advantage of the proposed rule amendments which could lead to an increase in the compliance costs.[88]

In addition, the benefits of the proposed amendments may be partially offset if the company's auditor obtains more audit evidence directly itself rather than using evidence generated by management's evaluation process, which could lead to an increase in audit costs.[89]

D. Request for Comment

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[88] Presumably such companies would only adjust their evaluation methods if they perceived the benefit of the proposed amendments would exceed the increased compliance cost.

[89] Any near term increase in audit costs may be mitigated if the PCAOB's proposed new auditing standards, An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements and Considering and Using the Work of Others In an Audit, are approved..

We request comment on the nature of the costs and benefits of the proposed amendments, including the likely responses of public companies and auditors concerning the introduction of new management guidance. We seek evidentiary support for the conclusions on the nature and magnitude of those costs and benefits, including data to quantify the costs and the value of the benefits described above. We seek estimates of these costs and benefits, as well as any costs and benefits not already identified, that may result from the adoption of these proposed amendments and issuance of interpretive guidance. With increased reliance on management judgment, will there be unintended consequences? We also request qualitative feedback and related evidentiary support relating to any benefits and costs we may have overlooked.

VII. CONSIDERATION OF IMPACT ON THE ECONOMY, BURDEN ON COMPETITION AND PROMOTION OF EFFICIENCY, COMPETITION AND CAPITAL FORMATION

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"[90] we solicit data to determine whether the proposed rule amendments constitute a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in:

- An annual effect on the economy of $100 million or more (either in the form of an increase or a decrease);
- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effects on competition, investment or innovation.

Section 3(f) of the Exchange Act[91] requires the Commission, whenever it engages in rulemaking, and is required to consider or determine if an action is necessary or

[90] 5 U.S.C. 603.
[91] 15 U.S.C. 78c(f).

appropriate in the public interest, also to consider whether the action will promote efficiency, competition, and capital formation. Section 23(a)(2) of the Exchange Act[92] also requires us, when adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition. In addition, Section 23(a)(2) prohibits us from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

We believe the proposed amendments, if adopted, would promote competition, efficiency, and capital formation. Under the Sarbanes-Oxley Act, all companies, except registered investment companies, are subject to the requirement to conduct an evaluation of their ICFR. Compliance with the proposed amendments to Exchange Act Rules 13a-15 and 15d-15, however, would be voluntary rather than mandatory and, as such, companies could choose whether or not to follow the interpretive guidance. The rule therefore should not impose any new cost. Accordingly, companies that have already completed one or more evaluations can continue to use their existing procedures to satisfy the evaluation required by our rules, or companies can choose to follow the guidance.

The proposed rule amendments should increase the efficiency with respect to the effort and resources associated with an evaluation of ICFR and facilitate more efficient allocation of resources within a company. The guidance is also designed to be scalable depending on the size of the company. Reducing the potentially disproportionate costs to smaller companies required to comply with the evaluation requirements should also increase efficiency. Finally, the rules may promote competition among companies in developing the most efficient means to satisfy the evaluation requirement.

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[92] 15 U.S.C. 78w(a)(2).

Capital formation may be promoted in the following ways. To the extent the cost of compliance with the evaluation requirement is lowered to a more economically feasible threshold, smaller private companies may be able to access public capital markets earlier in their growth. They may therefore obtain enhanced sources of capital at lower cost.

The proposed amendments may also introduce new competition from outside professionals and software vendors in the supply of services and products to assist the managers of public companies in their evaluations of ICFR. We seek comment on whether the proposed guidance and accompanying rule would stimulate new entry into any such market.

We request comment on the potential impact of the proposed amendments 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 also request comment on whether the proposed amendments would promote efficiency, competition, and capital formation. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

VIII. INITIAL REGULATORY FLEXIBILITY ANALYSIS

This Initial Regulatory Flexibility Analysis ("IRFA") has been prepared in accordance with the Regulatory Flexibility Act.[93] This IRFA involves proposed amendments to Exchange Act Rules 13a-15(c) and 15d-15(c) and Rules 1-02(a)(2) and 2-02(f) of Regulation S-X. These rules require the management of an Exchange Act reporting company, other than registered investment companies, to prepare an annual evaluation of the company's ICFR, and that the registered public accounting firm that

[93] 5 U.S.C. 601.

issues an audit report on the company's financial statements to attest to, and report on, management's assessment. The proposed rule amendments would clarify that an evaluation that is conducted in accordance with the interpretive guidance would satisfy the annual management evaluation of the company's ICFR.[94]

A. Reasons for the Proposed Action

We are proposing rule amendments that would make it clear that an evaluation conducted in accordance with our interpretive guidance is one of many ways to satisfy the requirements of Exchange Act Rules 13a-15(c) and 15d-15(c), clarify the auditor report required Rule 2-02(f) of Regulation S-X, and revise the definition of the term attestation report in Rule 1-02(a)(2) of Regulation S-X.

B. Objectives

The proposed rule amendments are intended to make implementation of the internal control reporting requirements more efficient and cost-effective by reducing ambiguities that have arisen due to the lack of certainty available to companies on how to conduct an annual evaluation of ICFR.

C. Legal Basis

We are issuing the proposed rule amendments under the authority set forth in Sections 12, 13, 15 and 23 of the Exchange Act, and Sections 3(a) and 404 of the Sarbanes-Oxley Act of 2002.

D. Small Entities Subject to the Proposed Revisions

[94] In connection with the proposed rule amendments, we are also proposing interpretive guidance for management to use in conducting an annual evaluation of the company's internal control over financial reporting. The proposed interpretive guidance itself is not subject to the Regulatory Flexibility Act. Accordingly, for purposes of the IRFA, our analysis is focused on the proposed rule amendments.

The proposed amendments would affect some issuers that are small entities. Exchange Act Rule 0-10(a)[95] defines an issuer, other than an investment company, to be a "small business" or "small organization" if it had total assets of $5 million or less on the last day of its most recent fiscal year. We estimate that there are approximately 2,500 issuers, other than registered investment companies, that may be considered small entities. The proposed amendments would apply to any small entity that is subject to Exchange Act reporting requirements.

E. Reporting, Recordkeeping, and other Compliance Requirements

The proposed rule amendments would not impose any new reporting, recordkeeping or compliance requirements. The amendments provide a voluntary, non-exclusive certainty, in the nature of a safe-harbor.

F. Duplicative, Overlapping, or Conflicting Federal Rules

The proposed amendments do not duplicate, overlap, or conflict with other federal rules.

G. Significant Alternatives

The Regulatory Flexibility Act directs us to consider alternatives that would accomplish our stated objectives, while minimizing any significant adverse impact on small entities. In connection with the proposed extension, we considered the following alternatives:

- Establishing different compliance or reporting requirements or timetables that take into account the resources available to small entities;
- Clarifying, consolidating or simplifying compliance and reporting requirements under the rules for small entities;

[95] 17 CFR 240.0-10(a).

- Using performance rather than design standards; and
- Exempting small entities from all or part of the requirements.

The proposed rule amendments should allow a company to conduct an evaluation of internal control with greater certainty that it has satisfied our rule. We believe the proposed rule change would affect both large and small entities equally. The proposed rule amendments set forth primarily performance standards to aid companies in conducting an evaluation of ICFR. The purpose of the proposed amendments is to give comfort that following the clarified, consolidated and simplified guidance will satisfy the evaluation requirement. The proposed rule is designed to afford small entities that choose to rely on the interpretive guidance the flexibility to scale and tailor their evaluation methods to fit their particular circumstances. We are not proposing an exemption for small entities, because we are not persuaded at this time that an exemption would further the primary goal of the Sarbanes-Oxley Act to enhance the quality of reporting and increasing investor confidence in the fairness and integrity of the securities markets.

H. Solicitation of Comments

We encourage the submission of comments with respect to any aspect of this Initial Regulatory Flexibility Analysis. In particular, we request comments regarding:

- The number of small entity issuers that may be affected by the proposed extension;
- The existence or nature of the potential impact of the proposed amendments on small entity issuers discussed in the analysis; and
- How to quantify the impact of the proposed amendments.

Respondents are asked to describe the nature of any impact 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 proposed rule amendments are adopted, and will be placed in the same public file as comments on the proposed amendments themselves.

IX. STATUTORY AUTHORITY AND TEXT OF PROPOSED RULE AMENDMENTS

The amendments described in this release are being proposed under the authority set forth in Sections 12, 13, 15, 23 of the Exchange Act, and Sections 3(a) and 404 of the Sarbanes-Oxley Act.

List of Subjects

17 CFR Part 210

Accountants, Accounting, Reporting and recordkeeping requirements, Securities.

17 CFR Part 240

Reporting and recordkeeping requirements, Securities.

17 CFR Part 241

Securities.

TEXT OF AMENDMENTS

For the reasons set out in the preamble, the Commission proposes to amend title 17, chapter II, of the Code of Federal Regulations as follows:

PART 210 - FORM AND CONTENT OF AND REQUIREMENTS FOR FINANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, PUBLIC UTILITY HOLDING COMPANY ACT OF 1935, INVESTMENT COMPANY ACT OF 1940, INVESTMENT ADVISERS ACT OF 1940, AND ENERGY POLICY AND CONSERVATION ACT OF 1975

1. The authority citation for Part 210 is revised to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 78c, 78j-1, 78l, 78m, 78n, 78o(d), 78q, 78u-5, 78w(a), 78ll, 78mm, 80a-8, 80a-20, 80a-29, 80a-30, 80a-31, 80a-37(a), 80b-3, 80b-11, 7202 and 7262, unless otherwise noted.

2. Amend §210.1-02 by revising paragraph (a)(2) to read as follows:

§210.1-02 Definition of terms used in Regulation S-X (17 CFR part 210).

* * * * *

(a)(1) * * *

(2) Attestation report on management's assessment of internal control over financial reporting. The term attestation report on management's assessment of internal control over financial reporting means a report in which a registered public accounting firm expresses an opinion, either unqualified or adverse, as to whether the registrant maintained, in all material respects, effective internal control over financial reporting (as defined in § 240.13a-15(f) or 240-15d-15(f)), except in the rare circumstance of a scope limitation that cannot be overcome by the registrant or the registered public accounting firm which would result in the accounting firm disclaiming an opinion.

* * * * *

3. Amend §210.2-02 by revising paragraph (f) to read as follows:

§210.2-02 Accountants' reports and attestation reports.

* * * * *

(f) Attestation report on management's assessment of internal control over financial reporting. Every registered public accounting firm that issues or prepares an accountant's report for a registrant, other than an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8), that is

included in an annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) containing an assessment by management of the effectiveness of the registrant's internal control over financial reporting must attest to, and report on, such assessment. The attestation report on management's assessment of internal control over financial reporting shall be dated, signed manually, identify the period covered by the report, indicate that the accountant has audited management's assessment, and clearly state the opinion of the accountant, either unqualified or adverse, as to whether the registrant maintained, in all material respects, effective internal control over financial reporting, except in the rare circumstance of a scope limitation that cannot be overcome by the registrant or the registered public accounting firm which would result in the accounting firm disclaiming an opinion. The attestation report on management's assessment of internal control over financial reporting may be separate from the accountant's report.

* * * * *

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

4. The authority citation for Part 240 continues to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et seq., and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

5. Amend §240.13a-15 by revising paragraph (c) to read as follows:

§240.13a-15 Controls and procedures.

* * * * *

(c) The management of each such issuer, that either had been required to file an annual report pursuant to section 13(a) or 15(d) of the Act (15 U.S.C. 78m(a) or 78o(d)) for the prior fiscal year or previously had filed an annual report with the Commission for the prior fiscal year, other than an investment company registered under section 8 of the Investment Company Act of 1940, must evaluate, with the participation of the issuer's principal executive and principal financial officers, or persons performing similar functions, the effectiveness, as of the end of each fiscal year, of the issuer's internal control over financial reporting. The framework on which management's evaluation of the issuer's internal control over financial reporting is based must be a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment. Although there are many different ways to conduct an evaluation of the effectiveness of internal control over financial reporting to meet the requirements of this paragraph, an evaluation that is conducted in accordance with the interpretive guidance issued by the Commission in Release No. 34-XXXXX will satisfy the evaluation required by this paragraph.

* * * * *

6. Amend §240.15d-15 by revising paragraph (c) to read as follows:

§240.15d-15 Controls and procedures.

* * * * *

(c) The management of each such issuer, that either had been required to file an annual report pursuant to section 13(a) or 15(d) of the Act (15 U.S.C. 78m(a) or

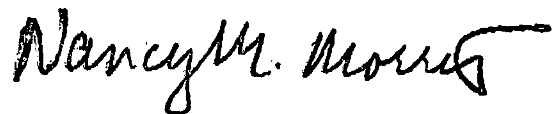
78o(d)) for the prior fiscal year or previously had filed an annual report with the Commission for the prior fiscal year, other than an investment company registered under section 8 of the Investment Company Act of 1940, must evaluate, with the participation of the issuer's principal executive and principal financial officers, or persons performing similar functions, the effectiveness, as of the end of each fiscal year, of the issuer's internal control over financial reporting. The framework on which management's evaluation of the issuer's internal control over financial reporting is based must be a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment. Although there are many different ways to conduct an evaluation of the effectiveness of internal control over financial reporting to meet the requirements of this paragraph, an evaluation that is conducted in accordance with the interpretive guidance issued by the Commission in Release No. 34-XXXXX will satisfy the evaluation required by this paragraph.

* * * * *

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

7. Part 241 is amended by adding Release No. 34-XXXXX and the release date of December XX, 2006 to the list of interpretative releases.

By the Commission.



Nancy M. Morris
Secretary

December 20, 2006

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 8763 / December 20, 2006

INVESTMENT ADVISERS ACT OF 1940
Release No. 2573 / December 20, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12512

In the Matter of Spinner Asset Management, LLC and Spinner Global Technology Fund, Ltd., Respondents.	:	ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933 AND SECTION 203(e) OF THE INVESTMENT ADVISERS ACT OF 1940

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 203(e) of the Investment Advisers Act of 1940 ("Advisers Act") against Spinner Asset Management, LLC and Spinner Global Technology Fund, Ltd. (collectively, "Respondents").

II.

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

Document 34 of 58

Order Pursuant to Section 8A of the Securities Act of 1933 and Section 203(e) of the Investment Advisers Act of 1940 ("Order"), as set forth below.

III.

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

1. Spinner Asset Management, LLC ("Spinner Asset Management"), a New York limited liability company that registered with the Commission as an investment adviser on or about February 6, 2006, serves as the investment adviser for Spinner Global Technology Fund, Ltd. ("SGTF" or "Fund"), an international business company chartered in the British Virgin Islands in 1993 and qualified as a professional fund. SGTF is governed by a seven-member board of directors, a majority of whom are independent from the investment adviser that manages SGTF. As an international business company, SGTF issues shares to investors and the value of those shares is quoted on the Irish Stock Exchange, where SGTF maintains a listing (although there is no secondary market for SGTF shares).

2. During 2002, a former portfolio manager employed by Spinner Asset Management through 2003 invested SGTF in three unregistered securities offerings, which are commonly referred to as "PIPEs" (Private Investment in Public Equities). The three PIPE investments were in Hypercom Corp., Novatel Wireless, Inc., and Tripath Technology, Inc. (collectively, "the PIPE Issuers"). During the relevant period, the common stock of each PIPE Issuer was registered with the Commission pursuant to either Section 12(b) or Section 12(g) of the Securities Exchange Act of 1934 and either was quoted on the NASDAQ or traded on the New York Stock Exchange. In connection with these PIPE offerings, the portfolio manager executed a series of trades that violated the federal securities laws. As a result of the portfolio manager's unlawful conduct, SGTF realized $361,437 in ill-gotten gains.

3. Issuers utilize the PIPEs market when more traditional means of financing are for various reasons impractical. PIPE securities are generally issued pursuant to Section 4(2) of the Securities Act or Regulation D under the Securities Act, which provide an exemption from registration for a non-public offering by an issuer. Because PIPEs are unregistered offerings, PIPE investors receive restricted securities when a transaction closes. Before investors can trade those restricted securities, the issuer must file, and the Commission must declare effective, a resale registration statement, a process that may take 60 to 120 days to complete. PIPE investors therefore must wait a certain period of time before they can freely trade the securities that they received in the PIPE. The sale of the securities to the PIPE investor is typically conditioned upon effectiveness of the resale registration statement. To compensate investors for this temporary illiquidity, PIPE issuers customarily offer the restricted securities at a discount to market price.

4. Many PIPE investors "hedge" their investment by selling short the PIPE issuer's securities before the resale registration statement is declared effective. There is nothing per se illegal about "hedging" a PIPE investment by selling short the issuer's securities. Such short

sales do not violate the registration provisions of the Securities Act if, among other things, the investor closes out the short position with shares purchased in the open market. An investor violates Section 5 of the Securities Act, however, when it covers its pre-effective date short position with the actual shares received in the PIPE. This is because shares used to cover a short sale are deemed to have been sold when the short sale was made.

5. In SGTF's case, the former portfolio manager's conduct resulted in SGTF and Spinner Asset Management violating Section 5 of the Securities Act in this manner. The former portfolio manager had trading discretion over a portion of SGTF's holdings, including primary responsibility for the Canadian brokerage account in which SGTF maintained most of its short holdings. In connection with the three PIPE offerings, the portfolio manager sold short the issuer's stock through a Canadian broker-dealer. Using that broker-dealer, the portfolio manager executed "naked" short sales — i.e., selling shares without owning and without borrowing or arranging to borrow, a practice that was permissible in Canada during the relevant period. Later, once the Commission declared the resale registration statement for the offering effective, the portfolio manager used SGTF's PIPE shares to close out, or "unwind," some or all of the pre-effective date short positions in violation of the registration provisions of the federal securities laws.

6. To accomplish this "unwind," the former portfolio manager engaged in pre-arranged trades with SGTF's Canadian broker to make it appear that he was covering the short positions with open market shares. In fact, the portfolio manager did not cover the short positions with open market shares because SGTF was on both sides of the trades. The portfolio manager would contact his Canadian broker to inform him that SGTF intended to sell a certain number of its PIPE shares from its domestic prime brokerage account at a particular time and price using a particular broker and/or exchange, and would instruct the broker to enter a buy order for SGTF's Canadian account for the same number of shares at the same time and price and using the same broker and/or exchange. Most or all of the buy and sell orders would meet, and the Canadian broker would use the PIPE shares that he had just purchased from SGTF's domestic account to close out some or all of SGTF's pre-effective date Canadian short positions.

7. As a result of the former portfolio manager's conduct, Spinner Asset Management willfully violated Sections 5(a), 5(b), and 5(c) of the Securities Act and SGTF violated Sections 5(a), 5(b), and 5(c) of the Securities Act, in that, by causing SGTF to establish pre-effective date short positions that it later covered with the PIPE shares, SGTF and Spinner Asset Management offered and sold restricted securities without qualifying for an exemption from registration, and therefore also failed to deliver a valid prospectus when the securities were sold.

8. In determining to accept the Offers, the Commission considered remedial acts promptly undertaken by Respondents and cooperation afforded the Commission staff.

IV.

On the basis 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 that:

(i) Respondent Spinner Asset Management, LLC shall be, and hereby is, censured;

(ii) Respondents Spinner Asset Management, LLC and Spinner Global Technology Fund, Ltd. shall cease and desist from committing or causing any violations and any future violations of Section 5 of the Securities Act;

(iii) Respondent Spinner Asset Management, LLC shall, within thirty (30) days from the date of the entry of the Order, pay a $60,000 civil penalty to the United States Treasury. Such payment shall be: (a) made by United States postal money order, certified check, bank cashier's check, or bank money order; (b) made payable to the U.S. Securities and Exchange Commission; (c) hand-delivered or mailed to the Office of Financial Management, U.S. Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (d) submitted under cover letter that identified Spinner Global Technology Fund, Ltd. as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Scott W. Friestad, Associate Director, U.S. Securities and Exchange Commission, Division of Enforcement, 100 F Street, NE, Washington, DC 20549-5631; and

(iv) Respondent Spinner Global Technology Fund, Ltd. shall, within thirty (30) days from the date of the entry of the Order, pay $435,596, consisting of $361,437 in disgorgement and $74,159 in prejudgment interest, to the United States Treasury. Such payment shall be: (a) made by United States postal money order, certified check, bank cashier's check, or bank money order; (b) made payable to the U.S. Securities and Exchange Commission; (c) hand-delivered or mailed to the Office of Financial Management, U.S. Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (d) submitted under cover letter that identified Spinner Global Technology Fund, Ltd. as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Scott W. Friestad, Associate Director, U.S. Securities and Exchange Commission, Division of Enforcement, 100 F Street, NE, Washington, DC 20549-5631.

By the Commission.

Nancy M. Morris
Secretary

By: Jill M. Peterson
Assistant Secretary

Commissioner Casey Not Participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 54974 / December 20, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12511

In the Matter of DAVID R. LUND, 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 David R. Lund ("Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") that the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him, the subject matter of these proceedings, and the findings contained in Section III.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. Respondent was the sole owner and controlling person of Investors First Financial Services, Inc. and Investors Guild, Inc. (collectively the "Managers"). Respondent, through the Managers, controlled Credit First Fund, LP, Credit First, LLC, and Credit First Income

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Plus, LLC (collectively the "Funds"). From August 1991 through April 2004, Respondent was a registered representative associated with various broker-dealers and held Series 7, 22, and 63 securities licenses. Respondent, age 33, resides in Newport Beach, California.

2. On November 28, 2006, a final judgment was entered by consent against Respondent, permanently enjoining him from future violations of Sections 5 and 17(a) of the Securities Act of 1933 and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, in the civil action entitled Securities and Exchange Commission v. Credit First Fund, LP, et al., Civil Action Number CV-05-8741 DSF (PJWx), in the United States District Court for the Central District of California.

3. The Commission's complaint alleged that, since approximately April 2001, Respondent was engaged in the fraudulent and unregistered offering of securities issued by the Funds. The complaint alleged that Respondent and his salespersons represented that the Funds' debt collection business was profitable and that investors would be paid a 1%-3% return on their investment with proceeds from the Funds' operations. The complaint alleged that the Funds have consistently lost money, and the cash generated from the business was insufficient to pay the promised returns.

IV.

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

Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b)(6) of the Exchange Act, that Respondent be, and hereby is barred from association with any broker or dealer with the right to reapply for association after five 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.

Nancy M. Morris
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. 8761 / December 20, 2006

SECURITIES EXCHANGE ACT OF 1934
Release No. 54972 / December 20, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12510

In the Matter of **SCOTT E. DREYER,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933 AND SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AS TO SCOTT E. DREYER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") against Scott E. Dreyer ("Respondent" or "Dreyer").

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, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Section 8A of the Securities Act of 1933 and 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] that:

Respondent

1. Scott E. Dreyer, age 48, resides in Washington, DC. Dreyer was a Managing Director of Friedman, Billings, Ramsey & Co., Inc. ("FBR") and the head of FBR's trading desk from 1991, when he joined the firm, until April 26, 2005, the effective date of his resignation. From 1991 until September 2002, Dreyer also was a member of FBR's institutional sales staff, servicing a limited number of customer accounts. Dreyer entered the securities industry in 1981. Prior to joining FBR, Dreyer was associated with four other registered broker-dealers, including Johnston, Lemon & Co., Inc.

Other Relevant Entities

2. Friedman, Billings, Ramsey & Co., Inc. is a broker-dealer registered with the Commission since July 25, 1989. FBR, a Delaware corporation, is a subsidiary of Friedman, Billings, Ramsey Group, Inc. ("FBG"), a holding company for several entities that provide investment banking, institutional brokerage, specialized asset management and banking products and services. FBG is a Virginia corporation with its principal place of business in Arlington, Virginia, whose stock is registered under Section 12(b) of the Exchange Act and is traded on the New York Stock Exchange under the symbol "FBR."

3. CompuDyne Corporation ("CompuDyne"), a Nevada corporation with its principal place of business in Annapolis, Maryland, is a public safety and security business that provides, among other things, attack protection services, federal security systems, institutional security systems, and services enhancing public safety and justice. At all times relevant to this proceeding, CompuDyne's stock was registered pursuant to Section 12(g) of the Exchange Act and was traded on the NASDAQ under the symbol "CDCY."

Dreyer's Relevant Conduct

4. This matter involves Dreyer's unregistered sales of securities on behalf of FBR.

5. In September 2001, FBR entered into an investment banking relationship with CompuDyne whereby FBR agreed to serve as placement agent for a Private Investment in Public Equity Offering ("PIPE").[2] On September 24, 2001, FBR's Chairman and Co-Chief Executive

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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] In a PIPE transaction, a "placement agent" or underwriter privately places restricted securities of a public company with investors meeting certain criteria ("accredited investors"). Accredited investors enter into a purchase agreement with the public company committing the

Officer directed Dreyer, in his role as head of FBR's trading desk, to make a "deep market" in CompuDyne stock. At the time Dreyer received this directive, he knew that FBR owned no shares of CompuDyne stock, there was buying pressure in the market for CompuDyne stock, which was driving up the stock price, and he likely would need to sell short in order to comply with this directive.[3]

6. In accordance with this directive, Dreyer registered FBR with the NASDAQ as a market maker in CompuDyne, commenced trading in CompuDyne, and by the end of the day had sold short 8,475 shares of CompuDyne stock in FBR's proprietary account. During the period between September 25 and October 1, Dreyer reduced FBR's short position in CompuDyne stock.

7. In the first few days of October 2001, FBR's Chairman and Co-Chief Executive Officer again told Dreyer that FBR needed to be "very, very, active" in CompuDyne stock and that if the stock price continued moving up, FBR should sell short. Dreyer then sought advice from the head of FBR's Compliance Department to ensure that increasing FBR's short position was not improper under Regulation M.[4] The head of Compliance authorized him to proceed. In response to the directive, Dreyer became "very, very active" in CompuDyne, resulting in an increased short position in CompuDyne stock in FBR's proprietary account.

8. At around the same time in early October, Dreyer learned that FBR's investment bankers were having difficulty obtaining investors for the CompuDyne PIPE offering. As a result, FBR's Chairman and Co-Chief Executive Officer asked Dreyer whether he could solicit one of the few FBR customers, who he serviced in his role as a member of FBR's institutional sales staff, to invest in the PIPE. The customer agreed to purchase 100,000 shares in the PIPE offering. Dreyer received a sales commission of $10,000 from FBR for soliciting this customer's purchase of the PIPE shares.

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investors to purchase a certain number of shares at a specified price. The public company agrees, in turn, to file a resale registration statement with the Commission within a specified period so that the investors can resell the shares to the public. The investors do not pay for the shares until the closing of the transaction, which does not occur until a short time before or after the resale registration statement is declared effective.

[3] "Selling short" is a technique used by investors to, among other things, take advantage of an anticipated decline in the price of a stock. In general, a "short seller" sells shares of stock that he or she does not own, ultimately "covering" the sale with shares that the seller purchases at a later date. The hope is that the stock price will fall so the short seller can purchase the stock to cover the short sale at a lower price.

[4] Rule 101 of Regulation M under the Exchange Act prohibits participants in a distribution of securities from, among other things, purchasing the securities during a certain restricted period prior to the determination of the offering price.

9. At approximately 11:44 a.m. on October 9, 2001, CompuDyne issued a press release announcing the CompuDyne PIPE offering. At the time of this announcement on October 9, FBR maintained a short position of 179,095 shares. After this announcement and through the end of trading on October 26, Dreyer, on behalf of FBR, purchased 173,800 and sold short 138,700 CompuDyne shares, resulting in a short position of 143,995 for FBR's proprietary account on October 26. At the time of these short sales, Dreyer anticipated using shares FBR's customers obtained in the PIPE offering to cover the shares he had sold short. Dreyer did not seek Compliance approval for this trading.

10. The resale registration statement for the PIPE shares was declared effective after the market close on October 29, at approximately 4:15 p.m. The closing price of CompuDyne stock on October 29 was $13.90. Between 4:16 p.m. and 4:27 p.m., Dreyer, on behalf of FBR, purchased through principal transactions all 100,000 of this customer's PIPE shares as well as an additional 40,000 shares from two other FBR customers, who had acquired their shares through the PIPE, all for $13.50 per share. By covering the then existing short position with PIPE shares from FBR's customers, Dreyer generated a profit for FBR of $97,831.

11. As a result, by short selling CompuDyne stock prior to the effective date of the resale registration statement for the CompuDyne PIPE shares and covering those sales with shares purchased from FBR's customers who acquired shares in the PIPE offering, Dreyer, on behalf of FBR, in effect, sold FBR's customers' PIPE shares prior to their registration. At the time Dreyer executed the short sales of CompuDyne securities on behalf of FBR, there was no resale registration statement in effect with respect to the CompuDyne PIPE shares and sales of those shares were not exempt from registration.

12. As a result of the conduct described above, Dreyer willfully[5] violated Section 5 of the Securities Act, which prohibits sales and offers of securities made without a registration statement being in effect or filed with the Commission.

Undertakings

In determining whether to accept the Offer, the Commission has considered the following undertakings by Dreyer:

13. Ongoing Cooperation. Respondent shall cooperate fully with the Commission in any and all investigations, litigations or other proceedings relating to or arising from the matters described in this Order. In connection with such cooperation, Dreyer has undertaken:

a. To produce, without service of a notice or subpoena, any and all documents and other information reasonably requested by the Commission's staff;

[5] "Willfully" as used in this Offer means intentionally committing the act which constitutes the violation, Cf. Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000); Tager v. SEC, 344 F.2d 5, 8 (2d Cir. 1965). There is no requirement that the actor also be aware that he is violating one of the Rules or Acts.

b. To be interviewed by the Commission's staff at such times as the staff reasonably may request and to appear and testify truthfully and completely without service of a notice or subpoena in such investigations, depositions, hearings or trials as may be requested by the Commission's staff; and

c. That in connection with any testimony of Respondent to be conducted at deposition, hearing or trial pursuant to a notice or subpoena, Respondent:

i. Agrees that any such notice or subpoena for his appearance and testimony may be served by regular mail on his counsel, Samuel J. Winer, Esq., Foley & Lardner LLP, 3000 K Street, N.W., Suite 500, Washington, D.C. 20007; and

ii. Agrees that any such notice or subpoena for his appearance and testimony in an action pending in a United States District Court may be served, and may require testimony, beyond the territorial limits imposed by the Federal Rules of Civil Procedure.

IV.

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

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

A. Dreyer is censured.

B. Dreyer shall cease and desist from committing or causing any violations and any future violations of Section 5 of the Securities Act.

C. Within 30 days of the entry of this Order, Dreyer shall pay disgorgement of $10,000 and prejudgment interest of $3,370 to the United States Treasury. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Scott E. Dreyer as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Daniel M. Hawke, District Administrator, Philadelphia District Office, Securities and Exchange Commission, Mellon Independence Center, 701 Market Street, Suite 2000, Philadelphia, Pennsylvania 19106.

D. Within 30 days of the entry of this Order, Dreyer shall pay a civil money penalty in the amount of $6,500 to the United States Treasury. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center,

6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Scott E. Dreyer as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Daniel M. Hawke, District Administrator, Philadelphia District Office, Securities and Exchange Commission, Mellon Independence Center, 701 Market Street, Suite 2000, Philadelphia, Pennsylvania 19106.

By the Commission.

Nancy M. Morris
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Commissioner Nazareth Not Participating
Commissioner Campos Dissented

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 54993 / December 21, 2006

INVESTMENT COMPANY ACT OF 1940
Release No. 27607 / December 21, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12514

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

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b) and 21B of the Securities Exchange Act of 1934 ("Exchange Act") and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Investment Company Act") against Deutsche Bank Securities, Inc. ("DBSI" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") that 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 in which the Commission is a party, and without admitting or denying the findings, except those findings pertaining to the jurisdiction of the Commission over it and the subject matter of these proceedings, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial

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Sanctions and a Cease-and-Desist Order Pursuant to Sections 15(b) and 21B of the Securities Exchange Act of 1934 and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Order"), as set forth below.

III.

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

Summary

1. This proceeding concerns late trading and deceptive market timing of mutual funds by a registered representative ("RR") at DBSI. DBSI is a registered broker-dealer and a subsidiary of Deutsche Bank AG ("Deutsche Bank"), a German financial services and bank holding company.

2. Between March 2003 and September 2003, a DBSI RR defrauded mutual funds and fund shareholders by engaging in deceptive practices designed to mislead mutual funds as to the identity of his customers. For example, various mutual funds identified the RR's customers as market timers, and funds rejected the customers' trades. In response, the RR opened new accounts for the customers and then executed trades for the customers in the same mutual funds that had rejected the customers' trades. The RR opened the new accounts to conceal the true identity of his customers and to mislead certain mutual funds into believing that the trades were coming from other DBSI customers, whose trading the funds had not blocked.

3. In total, the RR executed numerous market timing trades using deceptive means. The mutual funds would have rejected these trades had they known the RR's customers' true identities or trading strategies.

4. In addition, the RR entered late trades for at least one customer. The RR received and entered orders to purchase, redeem, or exchange mutual fund shares after the 4:00 p.m. Eastern Time market close, but entered the orders as if they had been received prior to 4:00 p.m. This enabled the customer to receive the share price based on the prior net asset value ("NAV") determined as of 4:00 p.m. The RR entered the late trades on occasions when fund companies identified the customer as a market timer and blocked the customer's original orders. On more than 55 occasions, the RR and DBSI received substitute orders after 4:00 p.m. ET, but treated them as though they had been received at the time of the original, rejected orders. This conduct violated Rule 22c-1(a) adopted pursuant to Section 22(c) of the Investment Company Act.

5. DBSI had no procedures and systems to prevent and detect the RR's fraudulent conduct. DBSI also had no procedures and systems for monitoring whether employees submitted orders for processing at that day's NAV only if they were received from customers before the market close.

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

6. As a result of this conduct, the RR violated Section 17(a) of the Securities Act of 1933, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. DBSI violated Rule 22c-1, as adopted under Section 22(c) of the Investment Company Act, and the RR aided and abetted DBSI's violations of Rule 22c-1. In addition, DBSI failed reasonably to supervise the RR, with a view to preventing his violations of the antifraud provisions and Rule 22c-1 of the federal securities laws, pursuant to Section 15(b)(4) of the Exchange Act.

Respondent

7. **DBSI**, a Delaware corporation headquartered in New York, is a broker-dealer registered with the Commission pursuant to Section 15(b) of the Exchange Act. DBSI operated a number of branch offices, including an office located at 280 Park Avenue, New York, New York.

Facts

Background

8. Market timing includes: (i) frequent buying and selling of shares of the same mutual fund or (ii) buying or selling mutual fund shares in order to exploit inefficiencies in mutual fund pricing. Market timing can harm other mutual fund shareholders because it can dilute the value of their shares. Market timing, while not illegal per se, can also disrupt the management of the mutual fund's investment portfolio and cause the targeted mutual fund to incur considerable extra costs associated with excessive trading and, as a result, cause damage to other shareholders in the funds. Market timing may be illegal, for example, if deception is used to induce a mutual fund to accept trades that it otherwise would not accept under its own market timing policies.

9. Rule 22c-1(a) adopted pursuant to Section 22(c) of the Investment Company Act requires registered investment companies issuing redeemable securities, principal underwriters and dealers, and any person designated in the fund's prospectus as authorized to consummate transactions in securities issued by the fund to sell and redeem fund shares at a price based on the current NAV next computed after receipt of an order to buy or redeem. Mutual funds generally determine the daily price of mutual fund shares as of 4:00 p.m. ET. Mutual funds' prospectuses generally state that orders received before 4:00 p.m. are executed at the price determined as of 4:00 p.m. that day, and that orders received after 4:00 p.m. are executed at the price determined as of 4:00 p.m. the next trading day.

10. "Late trading" refers to the practice of placing orders to buy, redeem, or exchange mutual fund shares after the time as of which mutual funds calculate their NAV, usually as of the close of trading at 4:00 p.m. ET, but receiving the price based on the prior NAV determined as of 4:00 p.m. Late trading violates Rule 22c-1(a) under the Investment Company Act.

11. DBSI entered into agreements with each of more than 100 mutual fund distributors or principal underwriters, which authorized DBSI to sell the particular company's mutual funds ("Dealer Agreements"). The Dealer Agreements typically required that shares of the company's mutual funds be sold in accordance with the federal securities laws and the terms of the funds' prospectuses. Further, the prospectuses for many mutual funds, including funds

covered by the Dealer Agreements, contained language prohibiting market timing. For example, some prospectuses prohibited frequent trading, while others contained limitations on the number of trades that an investor could make within a specific time period. In addition, the mutual fund prospectuses also typically required that orders to purchase, redeem, or exchange shares of a fund must be received no later than 4:00 p.m. ET to be effected at that day's NAV.

DBSI's RR Engaged In Deceptive Market Timing of Mutual Funds

12. Beginning in March 2003 and continuing until September 2003, a DBSI RR, who worked at the firm's branch office at 280 Park Avenue, engaged in a fraudulent mutual fund trading scheme on behalf of certain customers, including an investment adviser to several hedge funds. The RR deceived mutual funds into accepting his customers' market timing trades, which the mutual funds would have rejected had they known the RR's customers' true identities or trading strategies.

13. More specifically, the RR deliberately employed deceptive practices that helped his customers hide their identities from mutual funds. These practices included opening new accounts when the customers' trades were blocked. In fact, the RR and his sales assistant prepared a daily "blocked list" identifying mutual fund families that had blocked a customer's account, which enabled the customer to place orders in the same mutual funds, but through new accounts. Additionally, the RR and his sales assistant journaled funds from a blocked account to a new account so the customers could continue to trade the same mutual funds.

14. For example, in March 2003, the RR opened six accounts for his investment adviser customer. The customer then used four of these accounts to engage in market timing.

15. Within a matter of weeks, mutual funds determined that the accounts were engaged in market timing, which the funds either prohibited or discouraged, and the mutual funds began to block certain accounts from future purchases of the funds' shares.

16. In response, beginning in April 2003, the RR directed his sales assistant to open additional accounts for the customer. The RR did this in order to misrepresent the customer's identity and to mislead mutual funds into believing that the purchases were coming from other DBSI customers, whose trading had not been blocked. The customer then continued market timing the same mutual funds until the mutual funds blocked the newly opened account.

17. In another instance, on May 12, 2003, a mutual fund sent a block letter to the RR. The letter advised DBSI that market timing was harmful to mutual funds and that the fund had rejected one of the RR's customer's market timing trades:

> [Our] funds are intended for long-term investment. We believe that excessive trading in fund shares adversely affects fund expenses and investor returns. The prospectuses of each of [our] funds also state that the funds reserve the right to refuse any purchase request.
>
> Please take this letter as your formal notification that, based on the pattern of short term trading in shares of [our] funds, [we have] determined that we must refuse the above-referenced transaction.

We regret the necessity of this action and trust that you appreciate that we are acting to help the funds avoid unnecessary or excessive portfolio turnover with the interests of all fund shareholders in mind.

18. Despite receiving this letter, the RR continued to execute market timing trades for his customer in these funds. On June 5, 2003, the RR's sales assistant opened two additional accounts, and transferred funds from the blocked accounts to the new accounts. The customer then continued market timing these mutual funds through one of the newly opened accounts. On July 2, 2003, the fund sent another block letter to the RR concerning trading in the new account.

19. This pattern of restricting accounts and opening new accounts continued through August 2003.

20. In total, the RR and his sales assistant opened 27 accounts for the investment adviser customer, 14 of which the RR's customer used to place mutual fund trades. By creating new accounts, the RR enabled his customer to evade restrictions that mutual funds' had placed on the customer's trading.

21. During the period from March 2003 through September 2003, at least 15 mutual fund families, representing hundreds of individual mutual funds, detected the RR's customers' market timing and sent block notices to DBSI, barring future purchases by those accounts.

22. From March 2003 through September 2003, the RR executed numerous market timing trades using deceptive means in various mutual funds for his customers.

23. DBSI earned over $200,000 in fees from the RR's market timing customers.

The RR and DBSI Engaged in Late Trading

24. The RR accepted substitution trades from his investment adviser customer after 4:00 p.m. ET, but the RR and DBSI executed the trades as if they had been received prior to the market close.

25. From March 2003 to September 2003, the RR and his sales assistant entered more than 50 mutual fund trades that his customer submitted after the 4:00 p.m. ET market close. In each instance, the trade the RR or his sales assistant entered was a replacement, or "substitution," for an order that the customer had placed before 4:00 p.m. but that the mutual fund had blocked because it had identified the customer as a market timer. After the RR or his sales assistant notified the customer that a trade had been blocked, they would allow the customer to trade shares of a different mutual fund. The RR and his sales assistant then entered the orders to trade a different mutual fund at that day's NAV, even though on numerous occasions they only received the substitution order after 4:00 p.m. ET.

26. During the same period, DBSI had in place a policy that provided that mutual fund orders received after 4:00 p.m. ET had to be executed at the next day's NAV.

DBSI failed to reasonably supervise the RR

27. While the RR was engaged in the conduct described in paragraphs 12 through 26 above, DBSI had no procedures and systems in place to prevent and detect deceptive market timing engaged in by the RR or the RR's facilitation of late trading, which violated the federal securities laws.

28. For example, in 2001, DBSI had in place a Market Timing Policy that indicated that responsibility for policing market timing rested solely with the mutual funds, and that DBSI exercised "no control over the implementation of timing policies by a mutual fund company." DBSI, however, still had an obligation to sell mutual fund shares in accordance with the federal securities laws.

29. DBSI was aware that customers of the branch office at 280 Park Avenue were engaged in market timing.

30. Further, DBSI received numerous notices from mutual funds that they were blocking customers' trades for engaging in market timing. Many of these letters came to the attention of the DBSI branch management for the 280 Park Avenue office.

31. Despite this knowledge, DBSI failed to establish reasonable procedures designed to prevent and detect deceptive market timing. In particular, DBSI failed to have any procedures in place for identifying and responding to indicia of deceptive market timing, such as evidence indicating that an RR executed market timing trades for his customers in the mutual funds that had blocked his customers' trading because of market timing.

32. Beginning in March 2003, certain RRs were given direct desktop access to DBSI's order processing system for the purpose of entering mutual fund orders. (Previously, the RRs had been required to prepare order tickets and then have the orders manually entered into a software system that routed the orders to DBSI's clearing broker and then into DBSI's mutual fund processing system, which then cleared mutual fund purchases and redemptions through NSCC's FundServ clearance process. Because certain customers placed voluminous mutual fund orders, DBSI's branch management decided to give the RRs for these customers direct desktop access to DBSI's mutual fund processing system, as described above.) At the time, DBSI's principal means of monitoring purchases and redemptions of mutual fund shares consisted of relying on a computer software "rules engine," which required approval of trades within certain specified parameters. This software could automatically block further processing of trades exceeding share or dollar value limits. Thus, if a particular trade exceeded the share or dollar value limits (which was the case with many market timing trades), the trade would be blocked and a supervisor would have to review the trade. This process thus gave the supervisor the opportunity to review trades and should have enabled the supervisor to detect market timing trading, and more specifically, deceptive trading. This safeguard, however, was in place only on the manual software system, and not on the RRs' desktop system. Consequently, when branch management gave the RRs direct access to the mutual fund order processing system, this removed the market timing trades from being subject to the "rules engine" software. Thus, many market timing mutual fund trades were not submitted to branch management for approval prior to execution.

33. DBSI's decision to provide the RRs with direct access to DBSI's order processing system allowed the RR to enter substitution trades up until 4:30 p.m. ET, but receive the same day's NAV.

34. Finally, DBSI failed to have in place or adopt reasonable procedures for monitoring whether RRs submitted mutual fund orders for processing at that day's NAV only if they were received from customers before the market close.

35. If DBSI had had in place procedures and systems for identifying and responding to indicia of deceptive market timing by RRs and for monitoring whether RRs submitted for processing at that day's NAV only those mutual fund orders that were received from customers before market close, it is likely that DBSI could have prevented and detected the RR's deceptive market timing and the RR's facilitation of late trading.

DBSI's Remedial Efforts and Cooperation

36. After DBSI learned of the SEC's inquiry into frequent trading by DBSI customers, DBSI conducted an independent internal investigation, sharing the results of that investigation with the Commission's staff, and implementing certain remedial measures.

Violations

37. As a result of the conduct described in paragraphs 12 through 26 above, the RR violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder.

38. Rule 22c-1 under the Investment Company Act provides that no registered investment company issuing any redeemable security, and no dealer in any such security shall sell, redeem, or repurchase any such security except at a price based on the current net asset value of such security which is next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security. DBSI, by virtue of dealer agreements with the mutual funds, was a dealer within the meaning of Rule 22c-1. DBSI, through the RR, regularly accepted and executed trades after the close of the U.S. equity markets at a price other than the current NAV which was next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security. As a result of the conduct described above, DBSI willfully[2] violated Rule 22c-1 under the Investment Company Act, and the RR aided and abetted these violations.

39. Section 15(b)(4)(E) of the Exchange Act provides for the imposition of a sanction against a broker or dealer who "has failed reasonably to supervise, with a view to preventing violations of the securities laws, another person who commits such a violation, if such other person is subject to his supervision." As a result of the conduct described in paragraphs 12

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[2] "Willfully" as used in this Offer means intentionally committing the act which constitutes the violation, see Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000); Tager v. SEC, 344 F.2d 5, 8 (2d Cir. 1965). There is no requirement that the actor also be aware that he is violating one of the Rules or Acts.

through 35 above, DBSI failed reasonably to supervise the RR with a view to preventing his violations of the federal securities laws.

IV.

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

Accordingly, it is hereby ORDERED that:

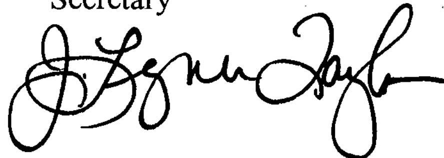
A. Pursuant to Section 15(b)(4) of the Exchange Act, DBSI is hereby censured;

B. Pursuant to Section 9(f) of the Investment Company Act, DBSI shall cease and desist from committing or causing any violations and any future violations of Rule 22c-1(a) as adopted under Section 22(c) of the Investment Company Act;

C. DBSI shall, within 30 days of the entry of this Order, pay $202,835 in disgorgement and $37,284 in prejudgment interest, plus a civil money penalty in the amount of $202,835, for a total of payment of $442,954. Such payment shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) wired, hand-delivered, or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22132; and (D) submitted under cover letter that identifies DBSI as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter, wire transfer instruction, money order or check shall be sent to Mark K. Schonfeld, Regional Director, Securities and Exchange Commission, Northeast Regional Office, 3 World Financial Center, Room 4300, New York, New York 10281-1022.

By the Commission.

Nancy M. Morris
Secretary



By: J. Lynn Taylor
Assistant Secretary

Commissioner Nazareth Not Participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 8764 / December 21, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12513

In the Matter of DEUTSCHE ASSET MANAGEMENT, INC., DEUTSCHE INVESTMENT MANAGEMENT AMERICAS, INC., AND DEUTSCHE BANK SECURITIES INC., Respondents.	ORDER UNDER RULE 602(e) OF THE SECURITIES ACT OF 1933 GRANTING A WAIVER OF THE DISQUALIFICATION PROVISION OF RULE 602(c)(3)

I.

Deutsche Asset Management, Inc. ("DAMI"), Deutsche Investment Management Americas, Inc. ("DIMA"), and Deutsche Bank Securities Inc. ("DBSI") (collectively "Respondents") have submitted letters, dated June 22, 2006, requesting waivers of the rule 602(c)(3) disqualification from the exemption under Regulation E under the Securities Act of 1933 ("Securities Act") arising from the settlement of public administrative and cease-and-desist proceedings commenced by the Commission. On December 21, 2006, pursuant to DAMI's and DIMA's Offer of Settlement in a market timing case, the Commission issued an Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Investment Company Act") against DAMI and DIMA (the "DAMI and DIMA OIP"). Additionally, on December 21, 2006, pursuant to DBSI's Offer of Settlement in a market timing and late trading case, the Commission issued an Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 15(b) and 21B of the Securities Exchange Act of

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1934 and Sections 9(b) and 9(f) of the Investment Company Act against DBSI (the "DBSI OIP").

The DAMI and DIMA OIP: (1) finds that DAMI and DIMA willfully violated Sections 206(1) and (2) of the Advisers Act, and Section 34(b) of the Investment Company Act; (2) requires DAMI and DIMA to cease and desist from committing or causing any violations and any future violations of Sections 206(1) and (2) of the Advisers Act and Section 34(b) of the Investment Company Act; (3) requires DAMI and DIMA to pay $17.2 million in disgorgement; and (4) censures DAMI and DIMA.

The DBSI OIP: (1) finds that DBSI willfully violated Rule 22c-1 as adopted under Section 22(c) of the Investment Company Act; (2) requires DBSI to cease and desist from committing or causing any violations and any future violations of Rule 22c-1(a) under the Investment Company Act; (3) requires DBSI to pay $240,119 in disgorgement and prejudgment interest, and a $202,835 civil penalty; and (4) censures DBSI.

Regulation E provides an exemption from registration under the Securities Act, subject to certain conditions, for securities issued by certain small business investment companies and business development companies. The Regulation E exemption is not available for the securities of an issuer if, among other things, any investment adviser or underwriter for the securities to be offered is subject to an order of the Commission entered pursuant to Section 15(b) of the Exchange Act or Section 203(e) of the Advisers Act. See Rule 602(c)(3) under the Securities Act. The Commission may waive the disqualification upon a showing of good cause. See Rule 602(e) under the Securities Act.

Based on the representations set forth in Respondents' June 22, 2006 requests, the Commission has determined that, pursuant to Rule 602(e), a showing of good cause has been made and that the requests for a waiver of the disqualification should be granted.

Accordingly, **IT IS ORDERED**, pursuant to Rule 602(e) under the Securities Act, that a waiver of the disqualification provision of Rule 602(c)(3) under the Securities Act resulting from the entry of the OIPs is hereby granted.

By the Commission.

Nancy M. Morris

Secretary

By: J. Lynn Taylor
Assistant Secretary

Commissioner Nazareth
Not Participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 2575 / December 21, 2006

INVESTMENT COMPANY ACT OF 1940
Release No. 27606 / December 21, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12513

In the Matter of DEUTSCHE ASSET MANAGEMENT, INC., and DEUTSCHE INVESTMENT MANAGEMENT AMERICAS, INC., Respondents.	ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO 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

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Investment Company Act") against Deutsche Asset Management, Inc. ("DAMI"), and Deutsche Investment Management Americas, Inc. ("DIMA") (collectively "Respondents").

II.

In anticipation of the institution of these proceedings, Respondents have submitted an Offer of Settlement (the "Offer") that 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 in which the Commission is a party, and without admitting or denying the

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findings, except those findings pertaining to the jurisdiction of the Commission over them and the subject matter of these proceedings, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to 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 ("Order"), as set forth below.

III.

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

A. SUMMARY

1. This is a market timing case against DAMI and DIMA, two registered investment advisory subsidiaries of Deutsche Bank AG ("Deutsche Bank"), the German financial services and bank holding company.

2. From approximately late 1997 through March 2003, DAMI and DIMA (and their predecessor advisers, which are described in Section III.B of this Order) allowed certain investors to engage in short-term or excessive trading in a manner inconsistent with the respective mutual funds' prospectus disclosures, and also failed to disclose these market timing arrangements to the funds' trustees.

3. Specifically, from July 2000 through March 2003, DAMI entered into a "sticky asset" arrangement with a hedge fund. Pursuant to this arrangement, DAMI permitted the hedge fund to market time three Deutsche Bank mutual funds, in exchange for the hedge fund maintaining a static investment in the same mutual funds. This arrangement, which DAMI failed to disclose, violated restrictions on market timing set forth in the funds' prospectuses.

4. In addition, beginning at least as early as 1997 and continuing into 2002, DIMA entered into trading arrangements with six investors allowing them to market time at least 15 different mutual funds.

5. During the course of these market timing arrangements, DAMI and DIMA were well aware that market timing could be detrimental to the mutual funds they advised. Among other things, DAMI and DIMA understood that market timing could cause dilution, compromise the investment strategies of portfolio managers and increase costs for long-term shareholders.

6. DAMI and DIMA benefited from the market timing. For example, through the trading arrangements, DAMI and DIMA increased the total amount of assets under management in the funds they advised, thereby increasing the advisory fees that DAMI and DIMA earned.

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

7. While DAMI and DIMA were earning these fees, the market timing trading harmed the other shareholders in the mutual funds by, among other things, causing significant dilution.

8. By virtue of the activities described herein, DAMI and DIMA willfully violated Sections 206(1) and 206(2) of the Advisers Act and Section 34(b) of the Investment Company Act.

B. RESPONDENTS

9. DAMI, a Delaware corporation headquartered in New York, New York, is an investment adviser registered with the Commission. DAMI and its affiliates are the investment adviser to 44 retail mutual funds marketed in the United States bearing the Deutsche name (the "Deutsche Funds"). DAMI is composed of the legacy advisers to the former Bankers Trust, Flag, and Morgan Grenfell funds. DAMI provides advisory services to the Deutsche Funds, for which the funds pay an advisory fee calculated as a percentage of the average daily net assets the funds held.

10. DIMA, a Delaware corporation headquartered in New York, New York, is an investment adviser registered with the Commission. In April 2002, Deutsche Bank purchased Zurich Scudder Investments ("ZSI") and acquired the investment adviser to a complex of mutual funds. Zurich Financial Services ("Zurich") had previously acquired Kemper Financial Services, Inc., the investment adviser to a complex of funds (the "Kemper Funds") in 1994 and Scudder, Stevens & Clark, the investment adviser to a complex of mutual funds (the "Scudder Funds") in 1997. The two firms' sales and marketing functions operated separately until 2001, when Zurich consolidated the entities into ZSI. After Deutsche Bank purchased ZSI, ZSI was renamed as DIMA and DIMA served as the adviser to the legacy Scudder and Kemper Funds. DIMA provides investment advisory services to 107 retail mutual funds, for which the funds pay an advisory fee calculated as a percentage of the average daily net assets the funds held. (As used herein, DIMA refers to all of DIMA's predecessor advisers).

C. FACTS

Market Timing

11. Market timing includes: (i) frequent buying and selling of shares of the same mutual fund or (ii) buying or selling mutual fund shares in order to exploit inefficiencies in mutual fund pricing. Market timing can harm other mutual fund shareholders because it can dilute the value of their shares. Market timing, while not illegal per se, can also disrupt the management of the mutual fund's investment portfolio and cause the targeted mutual fund to incur considerable extra costs associated with excessive trading and, as a result, cause damage to other shareholders in the funds.

The Mutual Fund Prospectuses Restricted Market Timing

12. During the relevant time, the prospectuses for the mutual funds restricted market timing. The various Kemper and Deutsche Fund prospectuses contained different types of restrictions on market timing.

Kemper Fund Prospectuses

13. Beginning in 1997, Kemper Funds' prospectuses expressly prohibited shareholders from exchanging shares worth more than $1 million unless they held the shares for 15 days.

14. For example, the February 21, 1997 prospectus for the legacy Kemper International Fund stated:

> EXCHANGE PRIVILEGE. Shareholders of Class A, Class B and Class C shares may exchange their shares for shares of the corresponding class of other Kemper Mutual Funds in accordance with the provisions below.
>
> . . . .
>
> General. Shares of a Kemper Mutual Fund with a value in excess of $1,000,000 (except Kemper Cash Reserves Fund) acquired by exchange from another Kemper Mutual Fund, or from a Money Market Fund, may not be exchanged thereafter until they have been owned for 15 days (the "15 Day Hold Period"). For purposes of determining whether the 15 Day Hold Policy applies to a particular exchange, the value of the shares to be exchanged shall be computed by aggregating the value of shares being exchanged for all accounts under common control, direction or advice, including without limitation, accounts administered by a financial services firm offering market timing, asset allocation or similar services.

15. In 1999, Kemper Funds' prospectuses extended this restriction to exchanges for less than $1 million and gave the investment managers discretion to restrict exchanges if they felt the exchange was part of a market timing strategy that could have an adverse effect on the fund.

16. For example, the February 26, 1999 prospectus for the legacy Kemper International Fund contained the following:

> Exchange Privilege -- General. Shareholders of Class A, Class B and Class C shares may exchange their shares for shares of the corresponding class of Kemper Mutual Funds. Currently, shares of a Kemper Fund with a value in excess of $1,000,000 (except Kemper Cash Reserves Fund) acquired by exchange from another Kemper Fund, or from a Money Market Fund, may not be exchanged thereafter until they have been owned for 15 days (the "15 Day Hold Policy"). Effective June 1, 1999, shares of a Kemper Fund with a value of $1,000,000 or less (except Kemper Cash Reserves Fund) acquired by exchange from another Kemper Fund, or from a Money Market Fund, may not be exchanged thereafter until they have been owned for 15 days if, in the investment manager's judgement (sic), the exchange activity may have an adverse effect on the fund. In particular, a pattern of exchanges that coincides with a "market timing" strategy may be disruptive to the Fund and therefore may be subject to the 15-Day Hold Policy. For purposes of determining whether the 15 Day Hold Policy applies to a particular exchange, the value of the shares to be exchanged shall be computed by aggregating the value of shares being exchanged for all accounts under common

> control, direction or advice, including without limitation accounts administered by a financial services firm offering market timing, asset allocation or similar services.

Deutsche Fund Prospectuses

17. Most of the legacy Deutsche Fund prospectuses also had language restricting market timing activity. Some of the Deutsche Fund prospectuses restricted shareholders to four exchanges.

18. For example, the February 28, 2000 prospectus for the legacy Morgan Grenfell International Select Equity Fund contained the following disclosure:

> Exchange Privilege. You can exchange all or part of your shares for shares in another Deutsche Asset Management mutual fund up to four times a year (from the date of the first exchange). When you exchange shares, you are selling shares in one fund to purchase shares in another.

DAMI and DIMA Adopted Anti-Market Timing Policies

19. As advisers to the Deutsche Bank mutual funds (including the Deutsche Funds and the Kemper Funds), both DAMI and DIMA had internal procedures designed to identify and prevent market timing in the mutual funds they advised.

20. For example, in 2000, DAMI formed a Market Timing Committee to combat the market timing in the legacy Deutsche Funds. The Committee met weekly and identified numerous entities and individuals that traded excessively. The Committee then created a "blacklist" of brokers and individuals that engaged in frequent trading and restricted future purchases from accounts associated with these individuals.

21. In approximately 2001, DIMA designated employees to act as "timing police" in order to monitor trading in the Kemper Funds. If the timing police identified a market timer, they placed a stop on the account and on all associated accounts, thereby preventing subsequent exchanges or purchases, regardless of whether timing activity was found in the associated accounts. DIMA employees then sent a letter to the shareholder describing the action taken and explaining that "the Fund does not permit short-term or excessive trading. Excessive purchases, redemptions, or exchanges affect the advisor's ability to manage the Fund in the best interests of all shareholders."

DAMI and DIMA Allowed Certain Investors to Market Time

22. As discussed below, despite the restrictions set forth in the mutual funds' prospectuses, DAMI and DIMA allowed certain entities and individuals to market time the Deutsche and Kemper mutual funds. Moreover, DAMI and DIMA failed to disclose the market timing arrangements with these investors to the Deutsche and Kemper Funds' trustees.

DAMI Permitted a San Francisco Hedge Fund to Market Time Deutsche Funds

23. In July 2000, DAMI's Head of Retail Mutual Funds agreed to allow a San Francisco-based hedge fund ("Hedge Fund A") to market time three Deutsche Funds pursuant to a "sticky-asset" arrangement. Specifically, Hedge Fund A agreed to place up to $30 million in three international equity funds, with three-quarters of that amount in each fund remaining static and one-quarter being actively traded. Between July 2000 and March 2001, Hedge Fund A made approximately 70 round trips.

24. In April 2001, DAMI's timing police identified the client account through which Hedge Fund A was trading and placed a stop on the account because the trading violated restrictions set forth in the mutual funds' prospectuses and DAMI's anti-market timing policies. Specifically, as set forth in the relevant prospectuses, the Deutsche Funds restricted shareholders to four exchanges per year, and reserved the right to reject any exchange request if the adviser determined that a purchase would be detrimental to the funds shareholders or involved excessive trading. DAMI, however, then lifted its restriction and permitted Hedge Fund A to continue trading in the Deutsche Funds after learning that DAMI's Head of Retail Mutual Funds had approved the arrangement.

25. In June 2001, members of DAMI's Market Timing Committee reviewed Hedge Fund A's trading. The Timing Committee found that Hedge Fund A had made approximately 65 round-trip trades for the last six months of 2000, and 50 round-trip trades during the first five months of 2001. For example, on June 19, 2001, a member of the Market Timing Committee sent DAMI's Head of Retail Mutual Funds an e-mail that outlined the pattern of trading, and also noted that Hedge Fund A generated approximately $475,000 in annual fees to DAMI. On the same day, another employee sent DAMI's Head of Retail Mutual Funds an e-mail indicating that "the true investment numbers [for Hedge Fund A] . . . are approximately $50 [million] generated approximately $750,000 in annual fees." Further, the employee indicated that two members of the Market Timing Committee would discuss whether "we have liability by allowing them to market time when we do not allow other smaller investors to do so."

26. After reviewing this trading and calculating the amount of fees that DAMI generated from the arrangement, DAMI decided to permit the arrangement to continue. Hedge Fund A then continued to market time the Deutsche Funds in violation of the prospectus limitations and DAMI's own policies.

27. DAMI finally restricted Hedge Fund A's accounts in early 2003 and stopped the market timing activity.

DIMA Allowed Customers of a Nashville-based Broker-Dealer to Market Time Kemper Funds

28. From October 1998 through early 2002, senior DIMA managers allowed two registered representatives ("RRs") at a Nashville-based broker-dealer ("Broker-Dealer A"), to market time six Kemper Funds on behalf of their customers in exchange for putting the Kemper Funds on Broker-Dealer A's list of preferred mutual funds, which the broker-dealer sold to its customers.

29. More specifically, during the fall of 1998, Broker-Dealer A's RRs negotiated an arrangement with DIMA to permit their customers to market time six Kemper domestic equity funds. The RRs agreed to place approximately $23 million in assets in the Kemper Funds. As set forth in the prospectuses, the Kemper Funds prohibited shareholders from exchanging shares with a value in excess of $1 million within a 15 day time period. Broker-Dealer A's customers' trading, individually, exceeded these market timing limitations. Specifically, from October 1998 through April 1999, certain of Broker-Dealer A's customers individually bought and sold shares of the Kemper Funds on successive days in amounts exceeding the $1 million limitation.

30. By April 1999, DIMA had concerns that Broker-Dealer A's frequent trading was becoming disruptive to the management of the funds. At the time, however, Broker-Dealer A sought additional market timing capacity. Following a meeting between senior executives at DIMA and Broker-Dealer A, DIMA agreed to revise the arrangement, permitting Broker-Dealer A to make as many as twenty-four roundtrip transactions per twelve-month period, but no more than eight roundtrips in any one quarter, on behalf of its customers. DIMA also permitted Broker-Dealer A to increase the total market timing capacity for its customers to $30 million. Broker-Dealer A's customers then continued their market timing activities in violation of the prospectus limitations and DIMA's anti-market timing policies.

31. By 2001, employees of DIMA acknowledged that while the arrangement benefited DIMA, it conflicted with the anti-market timing language contained in Kemper Funds' prospectuses.

32. For example, in an e-mail dated January 26, 2001, a DIMA employee wrote:

> Our reason for allowing the [RRs'] exception was to build the relationship with [Broker-Dealer A]. Now that [the RRs are] at [another broker-dealer], there is no reason to continue this legally-questionable, time-consuming exception?

33. A year later, the same DIMA employee sent an e-mail to DIMA's National Sales Manager, reiterating the point:

> Our current policy ("no exceptions") does not allow for the type of special arrangement we've had with [the RRs]. I would like to see us unwind this arrangement, over a reasonable period of time, assuming no undue impact on relationships. This awkward, time-consuming and off-policy arrangement was originally tolerated in hopes of building business with [Broker-Dealer A]. Since the shift to [another broker-dealer], this rationale would seem to be obsolete.

34. In January 2002, DIMA terminated the arrangement and restricted future purchases from Broker-Dealer A's market timing customers.

DIMA Also Permitted Others to Market Time Kemper Funds

35. From December 1997 through October 2001, DIMA allowed additional RRs and an investment adviser to market time various Kemper Funds on behalf of their customers and clients.

36. For example, DIMA permitted a RR at a large New York City broker-dealer ("Broker-Dealer B") to market time two Kemper bond funds on behalf of his customers. This trading exceeded the limits on frequent trading set forth in the Kemper Funds' prospectuses and violated DIMA's anti-market timing policies because the RR consistently made multiple trades for his customers on the same day in nearly identical amounts just under $1 million (collectively, the customers' accounts, whose trading was directed by the same RR, exceeded the $1 million threshold) and sold shares of the Kemper Funds within 15 days of purchasing them.

37. From approximately January 2000 to July 2000, DIMA implicitly allowed an investment adviser ("Investment Adviser A") to market time six Kemper Funds on behalf of his clients. (Investment Adviser A had discretionary authority over these clients' accounts.) Investment Adviser A's trading violated the limits on market timing set forth in the Kemper Funds' prospectuses for various reasons. For example, Investment Adviser A's trading in two of the funds involved exchanges within the 15 day holding period in amounts well above the $1 million threshold.

38. From approximately May 2001 through October 2001, DIMA permitted two other RRs at another New York City-based broker-dealer ("Broker-Dealer C") to engage in frequent short-term trading in six Kemper equity funds on behalf of their customers. This trading violated the limits on market timing set forth in the Kemper Funds' prospectuses and DIMA's anti-market timing policies. For example, in June and July 2001, certain of the RRs' customers each made numerous roundtrip trades in amounts greater than the $1 million threshold in a European equity fund, and the customers sold the shares of this fund within five days of being purchased.

DIMA Permitted Exceptions to Its Market Timing Policies for Timing Service Agreement Firms

39. In addition to the arrangements described above, DIMA permitted frequent trading by investment advisers that engaged in trading on behalf of multiple client accounts pursuant to written telephone exchange agreements.

40. Beginning in the early 1990's, to attract additional business, DIMA entered into telephone exchange agreements that permitted registered investment advisers to exchange their clients' assets between specified Kemper funds with one phone call instead of making separate phone calls for each client ("list moves"). The telephone exchange agreements, also referred to as timing service agreements, required that approved advisers comply with the Kemper Funds' prospectuses, as well as DIMA's anti-market timing policies. Kemper's transfer agent maintained and serviced the agreements, and handled telephone exchanges or "list moves."

41. As noted above, as set forth in the relevant prospectuses, the Kemper Funds prohibited shareholders from exchanging shares with a value in excess of $1 million until the shares had been held for 15 days. The funds explicitly computed the value of the shares to be exchanged by aggregating the value of shares for all accounts under common control, direction or advice, including accounts administered by a financial services firm offering market timing or asset allocation services.

42. In April 2000, DIMA began to permit an investment adviser to place list moves in aggregate amounts that exceeded the $1 million threshold more frequently than 15 days. From April 2000 through December 2002, the investment adviser, who had discretionary authority over the clients' accounts, made "list moves" that exceeded the $1 million threshold, and these moves often failed to comply with the 15 day hold period.

43. Similarly, in May 2000, DIMA permitted another investment adviser, who had discretionary authority over his clients' accounts, to trade more frequently than 15 days in amounts that exceeded the relevant thresholds for two Kemper Funds. DIMA terminated the arrangement in March 2002.

DAMI and DIMA Benefited While Mutual Fund Shareholders Were Harmed

44. Market timing in funds that DAMI and DIMA advised, including the arrangements described above, caused substantial harm to the funds and the shareholders, including significant dilution in the Deutsche and Kemper Funds.

45. At the same time that DAMI and DIMA were allowing select investors to engage in market timing, DAMI and DIMA were benefiting from providing advisory services to the Deutsche and Kemper Funds.

DAMI's and DIMA's Cooperation and Remedial Efforts

46. After DAMI and DIMA learned of regulatory inquiries into the above-described arrangements, DAMI and DIMA conducted an independent internal investigation into market timing in its respective fund, sharing the results of that investigation with the Commission's staff, and implementing certain remedial measures.

Violations

47. As a result of the conduct described above, DAMI and DIMA willfully violated Sections 206(1) and 206(2) of the Advisers Act in that, while acting as investment advisers, they employed devices, schemes, or artifices to defraud clients or prospective clients, and engaged in transactions, practices, or courses of business which operated or would operate as a fraud or deceit upon clients or prospective clients. DAMI and DIMA breached their fiduciary duties to the Deutsche and Kemper Funds when they permitted harmful excessive trading contrary to the relevant funds' prospectus disclosures without disclosing to the funds' trustees that they had entered into market timing arrangements with certain investors that created a conflict of interest.

48. As a result of the conduct described above, DAMI and DIMA willfully violated Section 34(b) of the Investment Company Act in that they made an untrue statement of material

fact in a registration statement, application, report, account, record, or other document filed or transmitted pursuant to the Investment Company Act, or omitted to state therein any fact necessary in order to prevent the statements made therein, in the light of the circumstances under which they were made, from being materially misleading. For example, in 1998, the prospectus for the Kemper International Fund, which DIMA filed, stated that "[s]hares of a Kemper Mutual Fund with a value in excess of $1,000,000 . . . acquired by exchange from another Kemper Mutual Fund . . . may not be exchanged thereafter until they have been owned for 15 days." Despite this prohibition, DIMA permitted select investors owning shares with a value in excess of $1,000,000 to exchange them more frequently than 15 days, and DIMA failed to disclose this information in the relevant prospectus. Additionally, from July 2000 through April 2003, the prospectuses for the legacy Morgan Grenfell International Select Equity Fund, which DAMI filed, informed shareholders that they could "exchange all or part of [their] shares for shares in another [DAMI] mutual fund up to four times a year (from the date of the first exchange)." DAMI, however, permitted certain investors to exchange more frequently than four times a year, and DAMI failed to disclose this information in the relevant prospectus.

Undertakings

49. Ongoing Cooperation. In determining to accept the Offer, the Commission has considered the following undertakings by DAMI and DIMA ("Adviser"):

Adviser shall cooperate fully with the Commission in any and all investigations, litigations or other proceedings to which the Commission is a party relating to or arising from the matters described in this Order. In connection with such cooperation and subject to any claims of attorney-client, work product, or any other applicable privilege, Adviser has undertaken:

a. To produce, without service of a notice or subpoena, any and all documents and other information requested by the Commission's staff;

b. To use its best efforts to cause its employees to be interviewed by the Commission's staff at such times as the staff reasonably may direct;

c. To use its best efforts to cause its employees to appear and testify truthfully and completely without service of a notice or subpoena in such investigations, depositions, hearings or trials as may be requested by the Commission's staff; and

d. That in connection with any testimony of Adviser to be conducted at deposition, hearing or trial pursuant to a notice or subpoena, Adviser:

   i. Agrees that any such notice or subpoena for Adviser's appearance and testimony may be served by regular mail on its attorney; and

   ii. Agrees that any such notice or subpoena for Adviser's appearance and testimony in an action pending in a United States District Court may be served, and may require testimony, beyond the territorial limits imposed by the Federal Rules of Civil Procedure.

50. Compliance and Ethics Oversight Structure. Adviser shall maintain a compliance and ethics oversight infrastructure having the following characteristics:

a. Adviser shall maintain an appropriate Code of Ethics subcommittee or the equivalent thereof having responsibility for all matters relating to issues arising under the Adviser's Code of Ethics. The Code of Ethics subcommittee shall be comprised of senior representatives of the Adviser's operating businesses and Compliance staff. Adviser shall hold at least quarterly meetings of the Code of Ethics subcommittee to review violations of the Code of Ethics, as well as to consider policy matters relating to the Code of Ethics. The Code of Ethics subcommittee shall report on material issues arising under the Code of Ethics, including all material violations thereof, to the Adviser's Compliance Oversight Committee or the Adviser's senior management. Adviser shall report on material issues arising under the Code of Ethics, including all material violations thereof to a designated representative of the independent Trustees of the open-end U.S.-based retail funds that are currently managed or come to be managed by DAMI or DIMA ("Adviser funds") and with such frequency as the independent Trustees may instruct, and in any event at least quarterly, provided however that any material violation shall be reported promptly.

b. Adviser shall maintain an appropriate Compliance Oversight Committee or the equivalent thereof having overall compliance oversight responsibility of the Adviser. The Compliance Oversight Committee shall be comprised of senior executives of Adviser's operating businesses and Compliance staff. The Compliance Oversight Committee shall review material compliance issues throughout the business of Adviser, endeavor to develop solutions to those issues as they may arise from time to time, and oversee implementation of those solutions. The Compliance Oversight Committee, through its designated representative, shall provide reports on material internal compliance matters to the designated representative of the independent Trustees of the Adviser funds, and with such frequency as the independent Trustees of such funds may instruct, and in any event at least quarterly. Adviser shall also provide to the Audit Committee of Adviser the same reports of the Code of Ethics committee and the Compliance Oversight Committee that it provides to the designated representative of the Independent Trustees of the Adviser funds.

51. Independent Compliance Consultant. Adviser shall retain, within 30 days of the date of entry of this Order, the services of an Independent Compliance Consultant not unacceptable to the staff of the Commission and the independent Trustees of the Adviser funds. The Independent Compliance Consultant's compensation and expenses shall be borne exclusively by Adviser or its affiliates. Adviser shall require that the Independent Compliance Consultant shall conduct a comprehensive review of Adviser's supervisory, compliance, and other policies and procedures designed to prevent and detect breaches of fiduciary duty, breaches

of the Code of Ethics and federal securities law violations by Adviser and its employees. This review shall include, but shall not be limited to, a review of Adviser's market timing controls, a review of the Adviser funds' pricing practices that may make those funds vulnerable to market timing, a review of the Adviser funds' utilization of short term trading fees and other controls for deterring excessive short term trading. Adviser shall cooperate fully with the Independent Compliance Consultant and shall provide the Independent Compliance Consultant with access to its files, books, records, and personnel as reasonably requested for the review.

a. Adviser shall require that, at the conclusion of the review, which in no event shall be more than 120 days after the date of entry of this Order, the Independent Compliance Consultant shall submit a Report to Adviser, the Trustees of the Adviser funds, and the staff of the Commission. The Report shall address the issues described in Paragraph 51 of these undertakings, and shall include a description of the review performed, the conclusions reached, the Independent Compliance Consultant's recommendations for changes in or improvements to policies and procedures of Adviser and the Adviser funds, and a procedure for implementing the recommended changes in or improvements to Adviser's policies and procedures.

b. Adviser shall adopt all recommendations with respect to Adviser contained in the Report of the Independent Compliance Consultant; provided, however, that within 150 days after the date of entry of this Order, Adviser shall in writing advise the Independent Compliance Consultant, the Trustees of the Adviser funds and the staff of the Commission of any recommendations that it considers to be unnecessary or inappropriate. With respect to any recommendation that Adviser considers unnecessary or inappropriate, Adviser need not adopt that recommendation at that time but shall propose in writing an alternative policy, procedure or system designed to achieve the same objective or purpose.

c. As to any recommendation with respect to Adviser's policies and procedures on which Adviser and the Independent Compliance Consultant do not agree, such parties shall attempt in good faith to reach an agreement within 180 days of the date of entry of this Order. In the event Adviser and the Independent Compliance Consultant are unable to agree on an alternative proposal, Adviser will abide by the determinations of the Independent Compliance Consultant; provided, however, that if the Adviser believes it necessary to challenge any such determination of the Independent Compliance Consultant, the Adviser may apply to the Commission for an appropriate modification to this Order.

d. Adviser (i) shall not have the authority to terminate the Independent Compliance Consultant, without the prior written approval of the majority of independent Trustees and the staff of the Commission; (ii) shall

compensate the Independent Compliance Consultant, and persons engaged to assist the Independent Compliance Consultant, for services rendered pursuant to this Order at reasonable and customary rates as negotiated with the Adviser; and, (iii) shall not be in and shall not have an attorney-client relationship with the Independent Compliance Consultant and shall not seek to invoke the attorney-client or any other doctrine or privilege to prevent the Independent Compliance Consultant from transmitting any information, reports, or documents to the Trustees or the Commission.

e. Adviser shall require that the Independent Compliance Consultant, for the period of the engagement and for a period of two years from completion of the engagement, shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with Adviser, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such. Adviser shall require that any firm with which the Independent Compliance Consultant is affiliated in performance of his or her duties under this Order shall not, without prior written consent of the independent Trustees and the staff of the Commission, enter into any employment, consultant, attorney-client, auditing or other professional relationship with Adviser, 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.

52. Periodic Compliance Review. Commencing in 2008 but no later than 2010, Adviser shall undergo a compliance review by a third party, who is not an interested person, as defined in the Investment Company Act, of Adviser. At the conclusion of the review, the third party shall issue a report of its findings and recommendations concerning Adviser's supervisory, compliance, and other policies and procedures designed to prevent and detect breaches of fiduciary duty, breaches of the Code of Ethics and federal securities law violations by Adviser and its employees in connection with their duties and activities on behalf of and related to the Adviser funds. Such report shall be promptly delivered to Adviser's Compliance Oversight Committee and to a designated representative of the independent Board of Trustees of each Adviser fund.

53. Certification. No later than twenty-four months after the date of entry of this Order, the chief executive officer of Adviser shall certify to the Commission in writing that Adviser has fully adopted and complied in all material respects with the undertakings set forth in paragraphs 50 through 52 and with the recommendations of the Independent Compliance Consultant or, in the event of material non-adoption or non-compliance, shall describe such material non-adoption and non-compliance.

54. Recordkeeping. DAMI and DIMA shall preserve for a period not less than six years from the end of the fiscal year last used, the first two years in an easily accessible place, any record of Adviser's compliance with the undertakings set forth in paragraphs 50 through 54 and with the recommendations of the Independent Compliance Consultant.

55. Deadlines. For good cause shown, the Commission's staff may extend any of the procedural dates set forth above.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in the Offer. Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 203(e) of the Advisers Act, DAMI is hereby censured;

B. Pursuant to Section 203(e) of the Advisers Act, DIMA is hereby censured;

C. Pursuant to Section 203(k) of the Advisers Act and Section 9(f) of the Investment Company Act, DAMI and DIMA shall cease and desist from committing or causing any violations and any future violations of Sections 206(1) and 206(2) of the Advisers Act and Section 34(b) of the Investment Company Act.

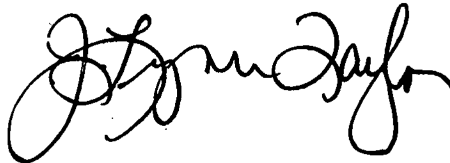
D. DAMI and DIMA shall, jointly and severally, pay $17,200,000 in disgorgement to the Securities and Exchange Commission. Payment shall be deemed satisfied if DAMI and DIMA refund to funds and/or shareholders $17,200,000 in connection with the distribution plan in State of New York v. Deutsche Asset Management, Inc. and Deutsche Investment Management Americas, Inc. filed on December 21, 2006 ("NY State proceeding"). Within 30 days of completion of the distribution plan in the NY State proceeding, but no later than two years after the date of this Order, DAMI and DIMA shall submit an affidavit from the distribution agent in the NY State proceeding indicating that $17.2 million was distributed to those harmed by the market timing in the Kemper and Deutsche funds, which is described in this Order, to Mark K. Schonfeld, Regional Director, Securities and Exchange Commission, Northeast Regional Office, 3 World Financial Center, 4th Floor, New York, New York 10281-1022. For good cause shown, the Commission's staff may extend these procedural dates. If DAMI and DIMA fail to submit the required affidavit, DAMI and DIMA shall pay $17,200,000 in disgorgement to the Securities and Exchange Commission. Such payment shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) wired, hand-delivered, or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22132; and (D) submitted under cover letter that identifies DAMI and DIMA as Respondents in these proceedings, the file number of these proceedings, a copy of which cover letter, wire transfer instruction, money order, or check shall be sent to Mark K. Schonfeld, Regional Director, Securities and Exchange Commission, Northeast Regional Office, 3 World Financial Center, 4th Floor, New York, New York 10281-1022.

D. DAMI and DIMA shall comply with the undertakings set forth in Section III, paragraphs 50 through 54 above.

By the Commission.

Nancy M. Morris

Secretary



By: J. Lynn Taylor
Assistant Secretary

Commissioner Casey Not Participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 54996 / December 21, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12516

In the Matter of JOHN C. FLANDERS, JR., Respondent.	ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTIONS 15(b)(6) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934

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)(6) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against John C. Flanders, Jr. ("Respondent" or "Flanders").

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, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 15(b)(6) and 21C of the Securities Exchange Act of 1934 ("Order"), as set forth below.

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III.

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

1. Flanders, age 37, resides in Glendale, Arizona. He holds Series 7 and 24 securities licenses. Flanders was not a registered broker-dealer, but from at least late 2001 through September 30, 2003, he was associated with a registered broker-dealer. He is not currently associated with a registered broker-dealer.

2. From at least late 2002 through September 30, 2003, Flanders introduced companies to Telvest Communications, Inc. ("Telvest"), which then arranged for the sale of the companies' shares to overseas investors, pursuant to Regulation S, a section of the federal securities laws that permits companies to sell unregistered shares to overseas investors.

3. Pursuant to an agreement with Telvest, Flanders was entitled to receive transaction-based compensation in the form of commissions from Telvest equal to three percent of the proceeds of the Regulation S sales. Based on this agreement, Flanders received approximately $165,000 in transaction-based compensation from Telvest.

4. Flanders' conduct was outside the scope of his association with the broker-dealer. By virtue of his acts and omissions as described above, Flanders was engaged in the business of effecting transactions in securities for the accounts of others. Consequently, Flanders was acting as a "broker" within the meaning of Section 3(a)(4) of the Exchange Act.

5. As a result of the conduct described above, Flanders willfully violated Section 15(a) of the Exchange Act, in that he, directly and indirectly, by the use of mails or the means and instrumentalities of interstate commerce, attempted to induce the purchase or sale of securities (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills), without having registered as a broker in accordance with Section 15(b) 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 Flanders' Offer.

Accordingly, pursuant to Sections 15(b)(6) and 21C of the Exchange Act, it is hereby ORDERED that:

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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.

A. Respondent Flanders cease and desist from committing or causing any violations and any future violations of Section 15(a) of the Exchange Act;

B. Respondent Flanders be, and hereby is, barred from association with any broker or dealer with the right to reapply for association after three (3) years to the appropriate self-regulatory organization, or if there is none, to the Commission;

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;

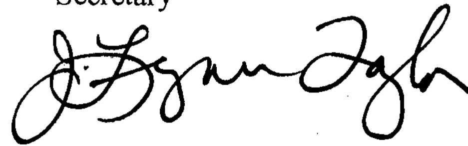
D. Respondent shall, within 10 days of the entry of this Order, pay $165,000 in disgorgement and $17,245 in prejudgment interest to the United States Treasury and that Respondent shall, within 10 days of the entry of this Order, pay a civil money penalty in the amount of $25,000 to the United States Treasury. Such payments shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Flanders as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Charles Stodghill, Division of Enforcement, Securities and Exchange Commission, 100 F Street, NE, Mail Stop 4010-A, Washington, D.C. 20549; and

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

Respondent by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

By the Commission.

Nancy M. Morris
Secretary



By: J. Lynn Taylor
Assistant Secretary

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 54994 / December 21, 2006

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2528 / December 21, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12515

In the Matter of Interstate Bakeries Corporation, Respondent.	ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934

I.

The Securities and Exchange Commission deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Interstate Bakeries Corporation ("Respondent," "IBC," or "the Company").

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 over the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings, Making Findings, and Imposing a Cease-and-Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934 ("Order"), as set forth below.

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III.

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

RESPONDENT

1. Interstate Bakeries Corp. ("IBC"), a Delaware corporation headquartered in Kansas City, Missouri, is one of the nation's largest wholesale bakers and distributors of fresh baked breads and snack cakes, selling Wonder, Dolly Madison, Hostess, and other well-known brands. On September 22, 2004, IBC voluntarily filed a bankruptcy petition seeking relief under chapter 11 of title 11 of the United States Bankruptcy Code, and currently is planning to reorganize.[2]

IBC's common stock was registered with the Commission pursuant to Section 12(b) of the Exchange Act until it was delisted from the NYSE in September 2004, after the Company filed the bankruptcy petition. Since that time, IBC's stock has been deemed registered under Section 12(g). It currently is quoted in the Pink Sheets.

OVERVIEW

2. As described below, IBC violated the record-keeping, internal controls and reporting provisions of the Exchange Act in connection with its financial reporting of its workers' compensation reserves and, consequently, its earnings during the second and third quarters of fiscal 2004.[3] During those periods, IBC's then principal financial officer disregarded the estimates of its future workers' compensation liabilities provided by its insurance consultant, on which IBC historically had relied for this critical piece of its workers' compensation reserve analysis. Instead of recording the $30 to $32 million in additional workers' compensation reserves that IBC's insurance consultant had estimated and confirmed with an independent actuarial firm, the principal financial officer set IBC's quarterly workers' compensation reserve for the fiscal 2004 second and third quarters using obsolete information and estimates derived from a methodology that he had been advised was no longer considered reliable.

3. The principal financial officer, whose quarterly reserve determinations were not reviewed by other IBC personnel, failed to disclose to IBC's accountants, its board, its Audit Committee, its auditor, and the public that IBC had disregarded its consultant's estimates in

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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] *In re Interstate Bakeries Corporation,* Case No. 04-45814-jwv11 (W.D. Mo.).

[3] IBC ends its fiscal year on the Saturday closest to the last day of May. Most of IBC's reporting years contain 52 weeks of operating results, while every fifth or sixth year includes 53 weeks. In addition, each quarter of its fiscal year represents a period of 12 weeks, except the third quarter, which covers 16 weeks, and the fourth quarter of any 53-week year, which covers 13 weeks.

setting the second and third quarter 2004 reserves. As a result, IBC's financial statements contained in its Forms 10-Q for the fiscal second and third quarters 2004 understated the Company's reserves by at least $30 million. Because IBC failed to record the expense necessary to increase the reserve, the Company materially overstated its fiscal second quarter pre-tax income in its Form 10-Q for the period ended November 15, 2003, and its cumulative fiscal third quarter pre-tax income in its Form 10-Q for the period ended March 6, 2004.[4]

BACKGROUND

4. IBC historically has self-insured for its estimated workers' compensation liabilities. As a self-insurer, IBC is required to accrue a reserve for the potential losses associated with its workers' compensation self-insurance program when the loss contingency is probable and the Company can estimate the amount of the loss. *See* Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, ("FAS 5"). The nature of the contingency, the amount of the accrual, and, if appropriate, the possibility of further losses should be disclosed if doing so is necessary to prevent the financial statements from being misleading. Even if the loss contingency is reasonably possible, rather than probable, FAS 5 requires IBC to disclose in its financial statements the possibility of the additional loss, the nature of the loss contingency, and an estimate of the possible loss or range of loss.[5]

5. From at least the mid-1990s through fiscal 2004, IBC's principal financial officer, or *de facto* chief financial officer,[6] set IBC's workers' compensation reserve quarterly relying upon an actuarially-based estimate from the Company's insurance consultant. No one at IBC substantively reviewed the principal financial officer's quarterly workers' compensation reserve determination, or the methodology or rationale for his reserve determination.

6. Toward the end of fiscal 2003, in early May 2003, IBC's insurance consultant advised the principal financial officer that because of recent anomalies in IBC's loss experiences, the insurance consultant's methodology for estimating IBC's future liability for workers' compensation claims potentially was no longer reliable. The insurance consultant further advised that even under this possibly unreliable methodology, IBC likely had a $16 million deficit in its reserve accrual, and that, if other methodologies were used to calculate the reserve, IBC's reserve deficit could be substantially higher.

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4 On December 20, 2006, the Commission filed a district court action against IBC's former principal financial officer seeking a permanent injunction, civil penalties and additional relief. *See* Litigation Rel. No. 19951 (December 20, 2006).

5 A loss is probable if it is likely to occur, and it is reasonably possible if the chance of the loss occurring is more than remote but less than likely. FAS 5, ¶3.

6 Despite financial challenges in fiscal 2003, IBC postponed hiring a new CFO until fiscal 2005 after its former CFO retired in May 2003, in part because a qualified CFO would be expensive and would skew the Company's compensation scale.

7. At the same time, IBC's auditors scrutinized the reserve and developed their own estimates as part of the fiscal 2003 audit. This action ultimately prompted IBC to add $15 million to its workers' compensation reserve in the fourth quarter of fiscal 2003, which brought the total to approximately $103.6 million, or the low end of the range that the auditor had determined was acceptable. In July 2003, IBC announced that it would report $.61 per share earnings in fiscal 2003, down substantially from the prior year's earnings of $1.36 per share, due in part to the workers' compensation reserve increase. IBC's stock price fell more than 10% after the July 14 announcement.

IBC UNDERSTATES ITS WORKERS' COMPENSATION RESERVE

8. In late July or early August 2003, the insurance consultant, in conjunction with discussing its estimate of IBC's workers' compensation liability for the fiscal first quarter 2004, reiterated its concerns about the reliability of the methodology it was using. The report itself continued its reliance on the same methodology, but the insurance consultant again advised IBC's principal financial officer that it was considering changing methodologies, and indicated that if a different methodology was used, IBC's workers' compensation liability could be considerably higher than the then current reserve.

9. In early November 2003, IBC's insurance consultant advised IBC's principal financial officer that, consistent with the concerns it had expressed in the two prior quarterly meetings, it had changed the methodology it used to estimate IBC's workers' compensation reserve. The insurance consultant indicated that it estimated IBC's workers' compensation reserve should be within a range from $134 million to $152.2 million. The low end of this estimate was approximately $32 million higher than IBC's fiscal first quarter 2004 reserve. The principal financial officer did not accept the insurance consultant's report for the quarter, in part because of concerns about the impact of the estimate on IBC. Instead, the insurance consultant and the principal financial officer agreed that the insurance consultant would hire an actuarial firm to substantiate its estimate.

10. By at least early December 2003, the insurance consultant informed the principal financial officer that it had confirmed its new, much higher estimate with an independent actuarial firm. The principal financial officer failed to disclose the insurance consultant's change of methodology, its new, much higher workers' compensation reserve estimate, or the independent confirmation of the consultant's new estimate to IBC accountants, the Company's board, its Audit Committee, or its auditor. As a result, IBC failed to disclose these material facts or contingencies to the investing public in its fiscal second quarter 2004 Form 10-Q or in its second quarter earnings releases, which were filed with the Commission on a Form 8-K.

11. Instead, IBC set its workers' compensation reserve at approximately $101.6 million, or $32 million below the low end of the insurance consultant's estimate range. If, consistent with the consultant's estimate, IBC had recorded a current period expense to increase its reserve by the additional $32 million, the Company's pretax earnings for the period would have been reduced by a corresponding amount. Consequently, IBC reported fiscal second quarter 2004 pretax income of $11.25 million when it should have reported a substantial loss.

12. In early February 2004, during IBC's fiscal third quarter 2004, IBC's insurance consultant, after updating the numbers to reflect the most recent quarter, advised the Company's principal financial officer that its workers' compensation reserve estimate essentially had not changed. Later in February 2004, the insurance consultant provided IBC with a reserve estimate of $137 million. The principal financial officer again failed to disclose the insurance consultant's change of methodology, its new, much higher workers' compensation reserve estimate, or the independent confirmation of the consultant's new estimate to IBC's accountants, its board, its Audit Committee, or its auditor. As a result, IBC again failed to disclose these material facts or contingencies to the investing public in its fiscal third quarter 2004 Form 10-Q or in its third quarter earnings releases, filed on Form 8-K.

13. IBC instead set the third quarter fiscal 2004 workers' compensation reserve at $107 million, approximately $30 million below the low end of the most recent estimate provided by its insurance consultant. As a result, IBC materially understated its workers' compensation reserve, and the company reported pre-tax income of $15,394,000 for the 40 weeks ended March 6, 2004, when it should have reported a substantial loss.

14. During the fiscal second and third quarters of 2004, IBC was close to violating its debt covenants, and likely would have violated those covenants had it used its insurance consultant's workers' compensation reserve estimate in setting its reserve for those periods.

15. In early May 2004, IBC's principal financial officer advised IBC's Audit Committee that management was reviewing the workers' compensation reserve for a possible year-end charge in the fourth quarter, without disclosing the potential magnitude of the issue. In late May 2004, IBC management advised the board, the Audit Committee, and IBC's auditor of the workers' compensation reserve issue and the magnitude of the anticipated reserve increase. Upon learning this information, the IBC board reacted by directing disclosure of the issue to the public and commencing an internal investigation, first by company counsel and then by the Audit Committee, as advised by independent counsel. On June 3, 2004, IBC announced that it had increased its workers' compensation reserve during fiscal 2004 with a charge to pretax income of approximately $40 million, and that it was reviewing whether all or part of the charge related to earlier quarters, thus necessitating a restatement of fiscal 2004 quarterly results of operations.

16. IBC has failed to timely file Forms 10-K for fiscal 2004, 2005, and 2006, and has failed to timely file Forms 10-Q for each of its fiscal 2005 and fiscal 2006 quarters.

VIOLATIONS

17. As a result of the conduct described above, IBC violated 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. Section 13(a) of the Exchange Act requires issuers to file periodic reports with the Commission containing such information as the Commission prescribes by rule. Exchange Act Rules 13a-1 and 13a-13 require issuers to file annual and quarterly reports, respectively, and Rule 13a-11 requires issuers to file current reports. Under Exchange Act Rule 12b-20, such

reports must contain, in addition to disclosures expressly required by statute and rule, such other information as is necessary to ensure that the statements made are not materially misleading under the circumstances. Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act require issuers to make and keep books, records and accounts which, in reasonable detail, accurately and fairly reflect the transactions and disposition of the assets of the issuer and to maintain an adequate system of internal controls, respectively.

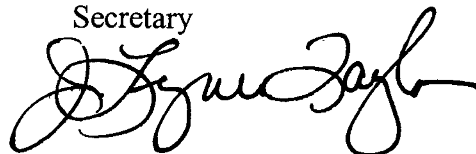
IV.

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

Accordingly, it is hereby ORDERED that Respondent IBC cease and desist from committing or causing any violations and any future violations of Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder.

By the Commission.

Nancy M. Morris
Secretary



By: J. Lynn Taylor
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION
Washington D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 54991 / December 21, 2006

INVESTMENT ADVISERS ACT OF 1940
Rel. No. 2574 / December 21, 2006

Admin. Proc. File No. 3-11972

In the Matter of

PHILIP A. LEHMAN
c/o William B. Fecher, Esq.
Statman, Harris, Siegel & Eyrich, LLC
2900 Chemed Center
255 East Fifth Street
Cincinnati, OH 45202-2912

ORDER DENYING MOTION FOR RECONSIDERATION

I.

On October 27, 2006, we issued an opinion finding that Philip A. Lehman, former president and sole shareholder of a registered broker-dealer and investment adviser, violated the antifraud provisions of federal securities laws (the "October 27, 2006 Opinion"). 1/ Lehman now seeks reconsideration of the portion of the opinion that found that he had not demonstrated an inability to pay the $55,000 penalty we imposed. As discussed below, Lehman's motion affords no basis for reconsideration of the October 27, 2006 Opinion.

II.

We review Lehman's motion to reconsider under Rule 470 of our Rules of Practice. 2/ Rule 470 permits us to reconsider our decisions in exceptional cases. 3/ This extraordinary

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1/ Philip A. Lehman, Securities Exchange Act Rel. No. 54660 (Oct. 27, 2006), __ SEC Docket __.

2/ 17 C.F.R. § 201.470.

3/ Reuben D. Peters, Order Denying Motion for Reconsideration, Exchange Act Rel. No. 51237 (Feb. 22, 2005), 84 SEC Docket 3497, 3498 (citing the comment to Rule 470).

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remedy is intended to correct manifest errors of law or fact or to permit the presentation of new or newly-discovered evidence. 4/

The October 27, 2006 Opinion found that Lehman engaged in a fraudulent scheme that purported to make high-yield, riskless-principal investments. The October 27, 2006 Opinion also found that it was in the public interest to bar Lehman from association with any broker, dealer, or investment adviser and to impose a $55,000 civil money penalty. Lehman claimed an inability to pay the penalty. Based on the record evidence, however, our opinion concluded that Lehman had not demonstrated an inability to pay. Our opinion also held that even if Lehman had demonstrated an inability to pay, his recidivism and our view that his misconduct was egregious warranted no reduction or waiver of the penalty.

The October 27, 2006 Opinion found that Lehman is a member of Cundiff Investments LLC ("Cundiff"), a limited liability company that owns two properties on North Main Street in Dayton, Ohio ("Cundiff Properties"). The opinion also found that, although the record was unclear as to whether Lehman was the sole member of Cundiff during the period at issue, he did not indicate at any time during the proceeding that any of the values associated with Cundiff did not accurately reflect his ownership interest. In his request for reconsideration, Lehman claims that we erred in determining that the net value of the Cundiff Properties should be considered at $170,400.25. Lehman also claims that the Commission improperly "used Respondent's failure to list the Cundiff Properties in his Sworn Financial Statements as grounds to reject his testimony as to the value of certain other assets (the Lexington Properties and the Byers Note) as being uncredible."

A. The October 27, 2006 Opinion found that the value of the Cundiff Properties should be considered at $170,400.25 based on the figures set forth in evidence that the opinion determined to be adequate and credible. That evidence includes (1) an undated local county property summary that lists the combined tax-assessed value of the Cundiff Properties as an asset worth $655,690 and (2) two promissory notes, each entered into by Cundiff on April 1, 2002, that are secured by mortgages granting the lender a security interest in the Cundiff Properties and whose original principal amounts equal a liability worth ($485,289.75). Lehman challenges this finding, and, in support, seeks to adduce additional evidence in the form of a summons, dated August 24, 2006, accompanied by a foreclosure complaint, dated August 23, 2006, that names Cundiff as a defendant. This complaint seeks judgment against Cundiff in the sums of $2,299,600.47 and $1,007,082.89 in connection with Cundiff's alleged default on the mortgage payments associated with each of the two promissory notes. Lehman argues that this evidence demonstrates that the Cundiff Properties "have negative equity in excess of $3,000,000.00," and that, "[t]herefore, there is no equity in the Cundiff Properties which could be used to satisfy the assessed civil penalty."

4/ See id. (citing KPMG Peat Marwick LLP, Order Denying Motion for Reconsideration, 55 S.E.C. 1, 3 n.7 (2001)).

This is not new evidence that appropriately may be submitted as part of a motion for reconsideration. 5/ Rather, it is evidence that was available to Lehman before the October 27, 2006 Opinion issued, but that Lehman presented to us only after our opinion issued. We will not adduce, or incorporate into our opinion, this new evidence, which comes too late. There are fairness as well as efficiency concerns that would be implicated were we to accept the material at this point. 6/ For example, counsel for the Division of Enforcement has not had the opportunity to address the contents of the summons and foreclosure complaint.

Even if we did grant the motion to adduce, the evidence is inconsequential. The summons and foreclosure complaint provide no basis to conclude that the Cundiff Properties have negative equity. Lehman has not provided any indication as to whether any determination has been made with respect to the status of the complaint (e.g., whether Lehman is contesting the case or whether a judgment has been rendered). Nor is there any indication that the plaintiffs filing the complaint have the right to recover against Lehman personally in the event that a foreclosure sale of the Cundiff Properties does not satisfy the judgment amount. A lack of personal liability would reduce the impact of the Cundiff Properties on Lehman's net worth to zero, not a negative amount. The October 27, 2006 Opinion found that Lehman's net worth is at least $274,007.25 based, in part, on the finding that the net value of the Cundiff Properties should be considered at $170,400.25. Subtraction of the net value of the Cundiff Properties from Lehman's net worth would leave a net worth of $103,607. This amount still substantially exceeds the amount of the penalty.

5/ See Feeley & Willcox Asset Mgmt. Corp., Order Denying Motion for Reconsideration, Securities Act Rel. No. 8303 (Oct. 9, 2003), 81 SEC Docket 919, 924-925 & n.18 ("On a motion for reconsideration, we accept, as do the federal courts, only that evidence the movant could not have known about or adduced before entry of the order subject to the motion for reconsideration. See, e.g., Caisse Nationale de Credit Agricole v. CBI Industries, Inc., 90 F.3d 1264, 1269 (7th Cir. 1996) (moving party must establish that evidence was not only newly discovered or unknown to it, but also that it could not have been reasonably discovered and produced during pendency of matter); see also 12 James Wm. Moore et al., Moore's Federal Practice § 59.30[4] (3d ed. 2000), cited in Carroll v. Nakatani, 342 F.3d 934 (9th Cir. 2003) (specifying federal practice with respect to acceptance of newly discovered evidence on motion for reconsideration).").

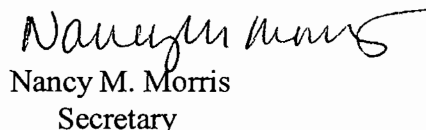
6/ Id. at 925 & n.21 (citing Rule 470(b), which requires that no responses to a motion for reconsideration shall be filed unless requested by the Commission, and noting that had respondents submitted the material before the Commission concluded deliberations, Division counsel would have been afforded the opportunity to address the admissibility and significance of the proffered information).

In any event, the October 27, 2006 Opinion found that Lehman's recidivism and the egregiousness of his misconduct warranted no reduction in the amount of the penalty even if he had demonstrated an inability to pay. 7/ Thus, even if we accept Lehman's assertions about the negative value of Cundiff, such assertions provide no basis for reconsideration.

B. Lehman argues that his failure to list the Cundiff Properties in his 2005 sworn financial statement "should not have been used as a basis to reject Respondent's testimony" regarding the value of the Lexington Avenue Properties and the Byers Note. 8/ The October 27, 2006 Opinion makes no such attribution to Lehman's failure to include the Cundiff Properties in his 2005 sworn financial statement. The October 27, 2006 Opinion did consider and reject Lehman's argument that his testimony, standing alone, was sufficient to establish the value of the Lexington Avenue Properties and the Byers Note. Our opinion found that Lehman's testimony about the value of the Lexington Avenue Properties and the Byers Note was contradicted by adequate, credible evidence, some of which Lehman himself provided. To the extent that Lehman's argument could be construed as an attempt to re-argue the credibility of his testimony regarding the value of the Lexington Avenue Properties and the Byers Note, it is well established that a respondent may not use motions for reconsideration to reiterate arguments previously made. 9/

Accordingly, IT IS ORDERED that the motion for reconsideration filed by Philip A. Lehman be, and it hereby is, DENIED.

By the Commission.



Nancy M. Morris
Secretary

7/ Philip A. Lehman, __ SEC Docket at __.

8/ The October 27, 2006 Opinion found that Lehman owns two buildings on Lexington Avenue in Dayton, Ohio (the "Lexington Avenue Properties") and that Lehman, doing business as Byers Acquisition Group, Inc. ("Byers"), is the creditor with respect to a promissory note ("Byers Note").

9/ See The Rockies Fund, Inc., Order Denying Motion for Reconsideration, Exchange Act Rel. No. 49788 (June 1, 2004), 82 SEC Docket 3764, 3766 (citing Feeley & Willcox Asset Mngmt. Corp., 81 SEC Docket at 921 & n.8 (quoting KPMG, 55 S.E.C. at 3 n.7)).

SECURITIES AND EXCHANGE COMMISSION

17 CFR PARTS 228 and 229

[RELEASE NOS. 33-8765; 34-55009; FILE NO. S7-03-06]

RIN 3235-AI80

EXECUTIVE COMPENSATION DISCLOSURE

AGENCY: Securities and Exchange Commission.

ACTION: Interim final rules with request for comments.

SUMMARY: The Securities and Exchange Commission is adopting, as interim final rules, amendments to the disclosure requirements for executive and director compensation. The amendments to Item 402 of Regulations S-K and S-B revise Summary Compensation Table and Director Compensation Table disclosure with respect to stock awards and option awards to provide disclosure of the compensation cost of awards over the requisite service period, as described in Financial Accounting Standards Board Statement of Financial Accounting Standards No. 123 (revised 2004) Share-Based Payment (FAS 123R). FAS 123R defines a requisite service period as the period or periods over which an employee is required to provide service in exchange for a share-based payment. The revised disclosure replaces disclosure in the Summary Compensation Table and Director Compensation Table of the aggregate grant date fair value of awards computed in accordance with FAS 123R. The amendments revise the Grants of Plan-Based Awards Table to add a column showing, on an grant-by-grant basis, the full grant date fair value of awards computed in accordance with FAS 123R. The amendments also revise the Grants of Plan-Based Awards Table to include information concerning repriced or materially modified options, stock appreciation rights and similar

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option-like instruments, disclosing the incremental fair value computed as of the repricing or modification date computed in accordance with FAS 123R. The amendments to the Director Compensation Table in Item 402 of Regulation S-K require footnote disclosure corresponding to the new Grants of Plan-Based Awards Table fair value disclosures. The amendments are intended to provide investors with more complete and useful disclosure about executive compensation. Disclosing the compensation cost of stock and option awards over the requisite service period will give investors a better idea of the compensation earned by an executive or director during a particular reporting period, consistent with the principles underlying the financial statement disclosure; and retaining the requirement to disclose the grant date fair value will give investors useful information about the total impact of compensation decisions made by a company in a particular reporting period.

DATES: Effective Date: The amendments are effective [insert date of publication in Federal Register].

Comment Date: As discussed below, we are publishing interim final regulations. We will, however, consider any comments received on or before [insert date 30 days after publication in Federal Register] and will revise the interim final rule amendments to Item 402 of Regulations S-K and S-B if necessary.

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

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/final.shtml); or

- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-03-06 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 Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-03-06. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (http://www.sec.gov/rules/proposed/shtml). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available.

FOR FURTHER INFORMATION CONTACT: David Lynn or Anne Krauskopf, at (202) 551-3500, in the Division of Corporation Finance, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-3010.

SUPPLEMENTARY INFORMATION: We are adopting amendments to Item 402[1] of

[1] 17 CFR 229.402 and 17 CFR 228.402.

Regulations S-K[2] and S-B[3] as interim final rules.

I. Background

On July 26, 2006, we voted to adopt revisions to our rules governing disclosure of executive compensation.[4] We intended these revisions to provide investors with a clearer and more complete picture of compensation to principal executive officers, principal financial officers, the other highest paid executive officers and directors.[5]

Two significant features of the amended disclosure rules were revisions to the Summary Compensation Table[6] and adoption of a new Grants of Plan-Based Awards Table.[7] Among other things, we revised the Summary Compensation Table to include a new "Total" column[8] that aggregates the total dollar value of each form of compensation quantified in the other columns. We also adopted a Director Compensation Table,[9] modeled on the revised Summary Compensation Table.

Under these rules, in order to calculate a total dollar amount of compensation in the Summary Compensation Table for a particular fiscal year, a dollar value for all equity awards – rather than the number of securities underlying an equity award – must be

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2 17 CFR 229.10 et seq.

3 17 CFR 228.10 et seq.

4 Executive Compensation and Related Person Disclosure, Release No. 33-8732A (Aug. 29, 2006) [71 FR 53158] (the "2006 Executive Compensation Release"). These revisions became effective on November 7, 2006.

5 The discussion that follows focuses on amendments to Item 402 of Regulation S-K, with references to differences from Item 402 of Regulation S-B where appropriate.

6 Item 402(c) of Regulation S-K, which presents information for each of the company's last three completed fiscal years, and Item 402(b) of Regulation S-B, which presents information for each of a small business issuer's last two completed fiscal years.

7 Item 402(d) of Regulation S-K.

8 Item 402(c)(2)(x) of Regulation S-K and Item 402(b)(2)(x) of Regulation S-B.

9 Item 402(k) of Regulation S-K and Item 402(f) of Regulation S-B. Each of these tables presents information for the last completed fiscal year.

disclosed. We required this valuation to be based on the grant date fair value of the awards determined pursuant to FAS 123R. In particular, for both the Stock Awards and Option Awards columns,[10] we amended the rules to require disclosure of the aggregate grant date fair value of the awards computed in accordance with FAS 123R.[11] This approach provided for Summary Compensation Table and Director Compensation Table disclosure of these awards, consistent with the timing of option and stock awards disclosure that had applied in the Summary Compensation Table since 1992.[12]

The comments we received regarding the dollar amount for Stock Awards and Option Awards in the Summary Compensation Table reflected differing views. Some commenters expressed support for requiring companies to report the full grant date fair value in the fiscal year of the award because it would provide a more complete representation of compensation and would be more consistent with the purpose of executive compensation disclosure.[13] Others stated that we should require Summary

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[10] Items 402(c)(2)(v) and (vi) of Regulation S-K and Items 402(b)(2)(v) and (vi) of Regulation S-B require these columns in the Summary Compensation Table. Items 402(k)(2)(iii) and (iv) of Regulation S-K and Items 402(f)(2)(iii) and (iv) of Regulation S-B require these columns in the Director Compensation Table.

[11] 2006 Executive Compensation Release at Section II.C.1.c.i.

[12] See Executive Compensation Disclosure, Release No. 33-6962 (Oct. 16, 1992) [57 FR 48126] (the "1992 Release"). Before the amendments adopted in the 2006 Executive Compensation Release, the Summary Compensation Table had required disclosure of the sum of the number of securities underlying stock options granted (including options that subsequently have been transferred), with or without tandem stock appreciation rights (SARs), and the number of free-standing SARs. The Summary Compensation Table also had required disclosure of the dollar value (net of any consideration paid by the named executive officer) of any award of restricted stock, calculated by multiplying the closing market price of the company's unrestricted stock on the date of grant by the number of shares awarded. Alternatively, restricted stock awards subject to performance-based vesting conditions could have been reported as long-term incentive plan (LTIP) awards in the separate Long-Term Incentive Plan Awards table, with vesting later reported in the Summary Compensation Table LTIP Payouts column.

[13] See, for example, letters from California Public Employees' Retirement System; CFA Centre for Financial Market Integrity, dated April 13, 2006; Connecticut Retirement Plans and Trust Funds, dated April 10, 2006; Leo J. Burns; Governance for Owners USA, Inc.; Laborers International Union of North America; Nancy Lucke Ludgus; jointly, California Public Employees' Retirement System, California State Teachers' Retirement System, Co-operative Insurance Society – UK,

Compensation Table disclosure of the proportionate amount of an award's total fair value that is recognized in the company's financial statements for the fiscal year.[14] Some of these commenters expressed concerns that disclosing the full grant date fair value would overstate compensation earned related to service rendered for the year, and might confuse the discussion and analysis of compensation policies and practices.[15] Others stated that requiring immediate reporting of the full grant date fair value would not necessarily reflect the cost to the company or the benefit to the named executive officer or director, and that the actual amounts earned later could be substantially different.[16] For example, a performance-based stock award might never be earned, yet the entire grant date fair value of the award is required to be reported in the Summary Compensation Table in the fiscal year of grant.[17] Some commenters expressed concern regarding inconsistency with the

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F&C Asset Management – UK, Illinois State Board of Investment, London Pensions Fund Authority – UK, New York State Common Retirement Fund, New York City Pension Funds, Ontario Teachers' Pension Plan, PGGM Investments – Netherlands, Public Sector and Commonwealth Super (PSS/CSS) – Australia, RAILPEN Investments – UK, State Board of Administration (SBA) of Florida, Stichting Pensioenfonds ABP – Netherlands, UniSuper Limited – Australia, and Universities Superannuation Scheme – UK; State Board of Administration (SBA) of Florida; Teamsters Local 671 Health Services and Insurance Plan; Southwestern Pennsylvania and Western Maryland Area Teamsters and Employers Pension Fund; United Church Foundation, Inc.; Washington State Investment Board; and Western PA Teamsters & Employers Welfare Fund.

14 See, for example, letters from the SEC Regulations Committee of the American Institute of Certified Public Accountants ("AICPA"); Baker, Donelson, Bearman, Caldwell & Berkowitz, P.C.; Chamber of Commerce of the United States of America ("Chamber of Commerce"); Computer Sciences Corporation; Deloitte & Touche LLP ("Deloitte"); Ernst & Young LLP ("E&Y"); Fenwick & West LLP ("Fenwick"); Foley & Lardner LLP ("Foley"); HR Policy Association; American Bar Association, Joint Committee on Employee Benefits; and KPMG LLP ("KPMG").

15 See letters from Chamber of Commerce and E&Y.

16 See letters from Foley (noting that awards would be forfeited if the executive terminates employment before expiration of the vesting period) and WorldatWork.

17 See letter from Compass Bancshares, Inc.

presentation of non-equity incentive plan compensation,[18] which is reported when earned.[19]

Commenters also suggested that providing compensation disclosure that is consistent with the company's financial statements would make it easier for analysts and investors to analyze compensation for top executives.[20] One commenter noted particularly that the Financial Accounting Standards Board engaged in a thorough and extensive process before concluding that financial statements should reflect the compensation cost of the award proportionately over the vesting period.[21] Another commenter stated that the accounting rules shape decision-making on executive compensation.[22] Regarding identification of the most highly compensated executive officers, one commenter noted that reporting full grant date fair value would cause wide year-to-year swings in reported compensation when in fact the executive is earning a consistent level of compensation, and cause inconsistencies in the identification of named executive officers from year-to-year.[23]

Our comprehensive revisions also adopted the Grants of Plan-Based Awards Table to supplement and complement Summary Compensation Table disclosure of stock and option awards by disclosing, among other things, the number of shares of stock or

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18 See, for example, letters from The Corporate & Securities Law Committee and the Employment & Labor Law Committee of the Association of Corporate Counsel; Amalgamated Bank Long-View Funds; BDO Seidman, LLP ("BDO Seidman"); Council of Institutional Investors, dated March 29, 2006; IUE-CWA Pension Fund and 401(k) Plan; and Mercer Human Resources Consulting.

19 Item 402(c)(2)(vii) of Regulation S-K and Item 402(b)(2)(vii) of Regulation S-B.

20 See letters from AICPA; Chamber of Commerce; Deloitte; EY; and KPMG.

21 See letter from Fenwick.

22 See letter from Steven Hall & Partners. If this is the case, we would anticipate that this influence may be discussed in the Compensation Discussion and Analysis. See Item 402(b)(2)(xii) of Regulation S-K.

23 See letter from Fenwick.

units comprising or underlying the award. This supplemental table shows the terms of grants, including estimated future payouts for both equity incentive plans and non-equity incentive plans,[24] with separate disclosure for each grant.

II. Discussion

Under FAS 123R, while the compensation cost is initially measured based on the grant date fair value of an award, it is generally recognized for financial reporting purposes over the period in which the employee is required to provide service in exchange for the award (generally the vesting period). When and where to disclose this compensation cost as executive compensation disclosure requires a careful balancing. In the 2006 Executive Compensation Release, we chose to require disclosure of the full grant date fair value as compensation when the grant is made. As we explained, on balance we chose that approach for the purpose of executive compensation disclosure for a variety of reasons, including that it informs investors of current actions regarding plan awards, and emphasizes the importance of the compensation committee's compensation decisions for the most recent fiscal year.

We recognize, however, that no one approach to disclosure of stock and option awards addresses all of the issues regarding disclosure of these forms of compensation. Upon further consideration, we have concluded that a combination of disclosure of the compensation cost associated with equity awards as that cost is recognized in the financial statements in the Summary Compensation Table, combined with disclosure of the grant date fair value of those awards on an grant-by-grant basis in the Grants of Plan-Based Awards Table, would provide a fuller and more useful picture of executive

[24] Equity incentive plan and non-equity incentive plan are both defined in Item 402(a)(6)(iii) of Regulation S-K and Item 402(a)(5)(iii) of Regulation S-B.

compensation than our recently adopted rules. Thus, we now adopt, as interim final rules, amendments that implement an approach to Summary Compensation Table disclosure of equity awards that provides disclosure of compensation cost of those awards over the requisite service period, as described in FAS 123R. Adopting the amendments as interim final rules – before issuers are required to comply with the recently adopted amendments – will avoid presentation of executive compensation disclosure in the first year that would be different in later years. Measuring compensation in this manner should provide investors with a clearer view of the annual compensation earned by executives and the annual compensation costs to a company, consistent with the timing of financial statement reporting. Measuring compensation in this manner also should eliminate the potential for distortion in identifying named executive officers based on a measure that reflects the full grant date fair value of awards, such as when a single large grant that will be earned by services to be performed over multiple years changes the composition of the named executive officers in the Summary Compensation Table.

In addition, we are revising the Grants of Plan-Based Awards Table to add a column showing the full grant date fair value of each award granted, computed in accordance with FAS 123R. This will provide investors a more complete perspective of the compensation decisions made with respect to the last completed fiscal year, and facilitate Compensation Discussion and Analysis disclosure of the company's policies and decisions regarding compensation awarded to, earned by, or paid to the named executive officers.[25] As a result of the amendments, investors will have more disclosure

[25] The Compensation Discussion and Analysis section is required by Item 402(b) of Regulation S-K. Instruction 2 to Item 402(b) provides, among other things, that the Compensation Discussion and Analysis should be of the information contained in the tables and otherwise disclosed pursuant to Item 402 of Regulation S-K.

and ultimately a more complete picture of a company's compensation decisions. We believe that this approach will better fulfill the Commission's objective of informing investors of current actions regarding plan awards and compensation decisions, and that this disclosure ultimately will be easier for companies to prepare and investors to understand.

A. Summary Compensation Table

Under the amendments we adopt today as interim final rules, the dollar amount of compensation cost recognized over the requisite service period, as described in FAS 123R, will be the amount reported in the Stock Awards and Option Awards columns in the Summary Compensation Table.[26] Compensation cost will include both the amounts recorded as compensation expense in the income statement for the fiscal year as well as any amounts earned by an executive that have been capitalized on the balance sheet for the fiscal year. This amount will include compensation cost recognized in the financial statements with respect to awards granted in previous fiscal years and the subject fiscal year. The amendments revise the corresponding columns in the Director Compensation Table in the same way.[27]

We also amend the related instruction calling for a footnote disclosing all assumptions made in the valuation by reference to a discussion of those assumptions in the company's financial statements, footnotes to the financial statements, or discussion in Management's Discussion and Analysis,[28] and providing that the referenced sections are deemed part of the Item 402 disclosure, to also require footnote disclosure of awards that

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[26] Items 402(c)(2)(v) and (vi) of Regulation S-K and Items 402(b)(2)(v) and (vi) of Regulation S-B.

[27] Items 402(k)(2)(iii) and (iv) of Regulation S-K and Items 402(f)(2)(iii) and (iv) of Regulation S-B.

[28] Item 303 of Regulation S-K [17 CFR 229.303].

are forfeited.[29] Since the amendments correlate Summary Compensation Table disclosure of stock and option awards to the dollar amount recognized for financial statement purposes with respect to the fiscal year, the other related instruction, limiting the amount reported with respect to a repriced option or SAR to the FAS 123R incremental fair value,[30] is rescinded. As discussed below,[31] this information and the full grant date fair value disclosure formerly disclosed in the Summary Compensation Table is moved to the Grants of Plan-Based Awards Table, where it is required on a grant-by-grant basis.

We also revise the instruction to the Summary Compensation Table Salary and Bonus columns regarding salary or bonus forgone at the election of a named executive officer in favor of receiving a non-cash form of compensation.[32] Reporting such forgone amounts in the Stock Awards or Option Awards columns after salary or bonus is earned is inconsistent with the original terms of the award that would have compensated the named executive officer in cash. Accordingly, the revised instruction requires the forgone amount to be reported in the Salary or Bonus column, with footnote disclosure of

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29 Former Instruction 1 to Item 402(c)(2)(v) and (vi) of Regulation S-K and former Instruction 1 to Item 402(b)(2)(v) and (vi) of Regulation S-B. Each of these instructions is redesignated as the Instruction to the respective Item.

30 Former Instruction 2 to Item 402(c)(2)(v) and (vi) of Regulation S-K and former Instruction 2 to Item 402(b)(2)(v) and (vi) of Regulation S-B. With respect to the Director Compensation Table, we correspondingly amend the Instruction to Item 402(k) of Regulation S-K and the Instruction to Item 402(f) of Regulation S-B to reflect this rescission. We also make a technical correcting amendment to the Instruction to Item 402(k) of Regulation S-K so that it also applies Instructions 1 and 5 to Item 402(c)(2)(ix). These two instructions regarding the All Other Compensation column address the treatment of non-equity incentive plan awards and earnings and earnings on stock and options, and accrued amounts under termination or change in control plans or arrangements, respectively.

31 See Section II.B.

32 Instruction 2 to Item 402(c)(2)(iii) and (iv) of Regulation S-K and Instruction 2 to Item 402(b)(2)(iii) and (iv) of Regulation S-B. Compensation that is within the scope of FAS 123R, and hence reportable in the Stock Awards or Option Awards columns, is specified by Paragraph 4 of FAS 123R.

the receipt of non-cash compensation that refers to the Grants of Plan-Based Awards Table where the stock, option or non-equity incentive plan award elected is reported.

Under FAS 123R, the classification of an award as an equity or liability award is an important aspect of the accounting because the classification will affect the measurement of compensation cost recognized in each financial statement reporting period. Awards with cash-based settlement, certain repurchase features, or other features that do not result in an employee bearing the risks and rewards normally associated with share ownership for a specified period of time are classified as liability awards under FAS 123R. For an award classified as an equity award under FAS 123R, the compensation cost recognized is fixed for a particular award and, absent modification of the award, is not revised with subsequent changes in market prices or other assumptions used for purposes of the valuation. In contrast, liability awards are initially measured at fair value on the grant date, but for purposes of recognition in the financial statements are then re-measured at each financial statement reporting date through the date the awards are settled under FAS 123R. Under the amendments to the Summary Compensation Table and Director Compensation Table, these re-measurements of liability awards will be reflected in executive compensation disclosure, providing a more comprehensive measure of liability awards over time.

FAS 123R requires a company to aggregate individuals receiving awards into relatively homogenous groups, for example, executives and non-executives, with respect to exercise and post-vesting employment termination behaviors for the purpose of determining expected term assumption used for computing the grant date fair value. The rules we adopt today as interim final rules, like the recently adopted amendments, are not

intended to change the method used to value employee stock options for purposes of FAS 123R or to affect the judgments as to reasonable groupings for purposes of determining the expected term assumption required by FAS 123R. Where a company uses more than one group, the measurement of grant date fair value for purposes of Item 402 will be derived using the expected term assumption for the group that includes the named executive officers (or the group that includes directors for purposes of the Director Compensation Table).

In determining the amount recognized, FAS 123R requires a company to estimate at the grant date the number of awards that ultimately will be earned. Those estimates are revised each period as awards vest or are forfeited. The interim final rules that we adopt today are not intended to change the method a company uses to estimate forfeitures under FAS 123R. However, under the amendments, the compensation cost disclosed for Item 402 purposes will not include an estimate of forfeitures related to service-based vesting conditions. Compensation cost for awards containing service-based vesting conditions[33] will be disclosed assuming that a named executive officer will perform the requisite service to vest in the award. If the named executive officer fails to perform the requisite service and forfeits the award, the amount of compensation cost previously disclosed in the Summary Compensation Table will be deducted in the period during which the award is forfeited.[34]

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[33] As defined in Appendix E of FAS 123R, a service condition is "a condition affecting the vesting, exercisability, exercise price, or other pertinent factors used in determining the fair value of an award that depends solely on an employee rendering service to the employer for the requisite service period. A condition that results in the acceleration of vesting in the event of an employee's death, disability, or termination without cause is a service condition."

[34] This approach to forfeitures was suggested in the letter from BDO Seidman.

Under the interim final rules, compensation cost for awards containing a performance-based vesting condition[35] will be disclosed in the Summary Compensation Table only if it is probable that the performance condition will be achieved. If the achievement of the performance condition is not probable at the grant date but becomes probable in a subsequent period, the proportionate amount of compensation cost based on service previously rendered will be disclosed in the Summary Compensation Table during the period in which achievement of the performance condition becomes probable. Likewise, if the achievement of a performance condition was previously considered probable but in a later period is no longer considered probable, the amount of compensation cost previously disclosed in the Summary Compensation Table will be reversed during the period in which it is determined that achievement of the performance condition is no longer probable.[36]

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35 As defined in Appendix E of FAS 123R, a performance condition is "a condition affecting the vesting, exercisability, exercise price or other pertinent factors used in determining the fair value of an award that relates to both (a) an employee's rendering service for a specified (either explicitly or implicitly) period of time and (b) achieving a specified performance target that is defined solely by reference to the employer's own operations (or activities). Attaining a specified growth rate in return on assets, obtaining regulatory approval to market a specified product, selling shares in an initial public offering or other financing event, and a change in control are examples of performance conditions for purposes of this Statement. A performance target also may be defined by reference to the same performance measure of another entity or group of entities. For example, attaining a growth rate in earnings per share that exceeds the average growth rate in earnings per share of other entities in the same industry is a performance condition for purposes of this Statement. A performance target might pertain either to the performance of the enterprise as a whole or to some part of the enterprise, such as a division or an individual employee."

36 Disclosing stock and option awards as they are recognized for financial statement reporting purposes may not mirror the timing of disclosure of non-equity incentive plan compensation. Because there is not one clearly required or accepted standard for measuring the value at grant date of non-equity incentive plan awards that reflects the applicable performance contingencies, as there is for equity-based awards under FAS 123R, we have not included such a value in the Summary Compensation Table disclosure. Instead, non-equity incentive plan compensation is disclosed in the Summary Compensation Table in the year when the relevant specified performance criteria are satisfied and the compensation earned, whether or not payment is actually made to the named executive officer in that year. See Item 402(c)(2)(vii) of Regulation S-K, Item 402(b)(2)(vii) of Regulation S-B and 2006 Executive Compensation Release at Section II.C.1.c.ii..

In summary, if an award with service or performance-based conditions ultimately vests, the amount cumulatively recognized in the Summary Compensation Table over a period of years should equal 100% of the grant date fair value of the equity award or the total fair value at the date of settlement for a liability award. The amount cumulatively reported in the Summary Compensation Table for awards with service or performance-based conditions that do not vest will be zero. On this basis, the amount cumulatively reported for equity awards with graded vesting will equal 100% of the grant date fair value of the portion of the award that vests. For example, if 20% of an award to the principal executive officer vests in each of the five years following the grant and the principal executive officer leaves the company after the fourth year of service, 80% of the award's grant date fair value will be reported cumulatively in the Summary Compensation Table over those four years of service.[37]

In some cases, correlating disclosure in the Stock Awards and Option Awards columns to the financial statement recognition timing could result in a negative number. For example, a negative number would result if the value of awards forfeited in a fiscal year by a named executive officer exceeds the value of other awards recognized in the Summary Compensation Table for that same named executive officer. Such a negative number will be disclosed in the relevant column and affect the calculation of "total" for purposes of determining who is a named executive officer. In addition, there could be instances when compensation cost is recognized in the financial statements under FAS 123R in the year before the award is granted. This occurs when an employee is rendering services in exchange for an award, but a grant has not occurred because the terms of the

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37 This example of graded vesting assumes an award with service-based vesting conditions only, where the company has elected the straight line attribution method pursuant to paragraph 42 of

award have not yet been finalized. There also could be instances where a grant has been made, but compensation cost is not recognized in the financial statements. This occurs when an award has a performance condition that is not considered at the date of grant to be probable to vest.[38]

Under FAS 123R, an award granted to a retirement eligible employee who is entitled to retain the award at retirement generally is not considered to have a substantive service requirement. This is because the employee can keep the benefit of the award without performing services, regardless of the stated vesting terms. In this circumstance, the full grant date fair value of the award is recognized in the company's financial statements in the year of grant. Thus, the interim final rules do not effect significant change from the former requirements for computing Stock Awards and Option Awards disclosure for retirement eligible executives.

The amendments do not revise the instruction regarding the determination of the most highly compensated executive officers for purposes of identifying named executive officers other than the principal executive officer and principal financial officer.[39] This determination will continue to be based on total compensation, reduced by the sum of the increase in pension values and nonqualified deferred compensation above-market or preferential earnings reported in column (h) of the Summary Compensation Table, subject to a $100,000 threshold. However, the amendments to the Stock Awards and

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FAS 123R.

38 Footnote 25 of FAS 123R provides that whether vesting is probable for this purpose is determined based on the standard set forth in Financial Accounting Standards Board Statement of Financial Accounting Standards No. 5 Accounting for Contingencies (FAS 5), at paragraph 3, which defines probable as "the future event or events are likely to occur."

39 Instruction 1 to Item 402(a)(3) of Regulation S-K and Instruction 1 to Item 402(a)(2) of Regulation S-B.

Option Awards disclosure may reduce potential fluctuations in total compensation resulting from year-to-year differences in equity awards, as a commenter suggested.[40] Consequently, a company's identification of named executive officers may be more consistent from year-to-year, facilitating investors' ability to track year-to-year changes in compensation for the same persons.

B. Grant of Plan-Based Awards Table

Under the interim final rules, the grant date fair value information with respect to equity awards to named executive officers is moved to the Grants of Plan-Based Awards Table and expanded to include grant-by-grant information. As described above, this should provide investors a more complete perspective of the compensation decisions made with respect to the last completed fiscal year and facilitate Compensation Discussion and Analysis disclosure of the company's policies and decisions regarding named executive officers' compensation.[41]

The amendments revise the Grants of Plan-Based Awards Table to add column (l), showing the full grant date fair value of each equity award, computed in accordance with FAS 123R.[42] Presenting this information on a grant-by-grant basis is consistent with the presentation of other information in the Grants of Plan-Based Awards Table: This

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40 See letter from Fenwick.

41 See general discussion in Section II above.

42 Item 402(d)(2)(viii) of Regulation S-K. Disclosing the value of the equity award in this table resembles the approach taken in the Option/SAR Grants Table previously required by Item 402(c) of Regulation S-K as adopted in the 1992 Release. That table required disclosure of either (a) the present value of the grant at grant date under any option pricing model, or (b) the potential realizable value of each option or freestanding SAR grant assuming annualized appreciation rates of 5% and 10%, and 0% for awards where the exercise or base price was below the market price of the underlying security at the date of grant. In their comment letters, AICPA, E&Y and KPMG recommended presenting full grant date fair value in a supplemental table. In light of our previous decision to report the full grant date fair value in the Summary Compensation Table, we did not follow this recommendation in the 2006 Executive Compensation Release.

presentation should continue to provide investors a clear picture of the value of options when granted, including in-the-money awards.[43] The table will continue to disclose the number of shares underlying an award and other details regarding the award.[44] To conform the presentation for directors, we amend the Director Compensation Table in Item 402 of Regulation S-K to require footnote disclosure of the grant date fair value of each equity award computed in accordance with FAS 123R.[45] Under the amendments, grant date fair value information is not required regarding equity awards to named executive officers or directors of companies covered by Item 402 of Regulation S-B, which does not include a Grants of Plan-Based Awards Table.[46] This differential treatment of small business issuers is consistent with other aspects of Item 402 of Regulation S-B, which in general recognizes that that the executive compensation arrangements of small business issuers typically are less complex than those of other public companies and that satisfying disclosure requirements applicable to other public companies may impose unwarranted burdens on small business issuers.[47]

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43 As noted in the 2006 Executive Compensation Release at Section II.C.1.c.i, disclosing grant date fair value will give investors a clearer picture of the value of any in-the-money awards.

44 Item 402(c)(2)(ix)(G) of Regulation S-K and Item 402(b)(2)(ix)(G) of Regulation S-B require disclosure in the Summary Compensation Table All Other Compensation column of the dollar value of any dividends or other earnings paid on stock or option awards when those amounts were not factored in the grant date fair value for the stock or option award. Item 402(k)(2)(vii)(I) of Regulation S-K and Item 402(f)(2)(vii)(I) of Regulation S-B require corresponding disclosure in the Director Compensation Table. These Items are amended to reflect that the grant date fair value no longer is required to be reported in the Stock Awards or Option Awards columns, and in the case of Regulation S-K, must be reported in the Grants of Plan-Based Awards Table with respect to named executive officers.

45 Instruction to Item 402(k)(2)(iii) and (iv).

46 Instead, Item 402(c) of Regulation S-B requires narrative disclosure to the Summary Compensation Table. Item 402(c)(4) includes among the examples of material factors necessary to an understanding of the Summary Compensation Table for which narrative disclosure should be provided the material terms of each grant, including but not limited to the date of exercisability, any conditions to exercisability, any tandem feature, any reload feature, any tax-reimbursement feature, and any provision that could cause the exercise price to be lowered.

47 See 2006 Executive Compensation Release at Section II.D.1.

The interim final rules further amend the Grants of Plan-Based Awards Table to include information concerning repriced or materially modified options, stock appreciation rights and similar option-like instruments, disclosing the incremental fair value, computed as of the repricing or modification date in accordance with FAS 123R.[48] Consistent with the presentation of other information in the Grants of Plan-Based Awards Table, this disclosure will be made on a grant-by-grant basis. The Director Compensation Table in Item 402 of Regulation S-K also is amended to require footnote disclosure of the same information.[49] Consistent with FAS 123R, this disclosure does not apply to any modification that equalizes the fair value of an award before and after the modification, such as a modification made pursuant to an antidilution provision that requires adjustment in the event of a recapitalization or similar transaction equally affecting all holders of the class of securities underlying the options or SARs. Similarly, this disclosure does not apply to a repricing that occurs through a pre-existing formula or mechanism in the terms of the plan or award that results in the periodic adjustment of the option or SAR exercise or base price, as the adjustment feature would have been reflected

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48 Instruction 7 to Item 402(d) of Regulation S-K. Disclosure of repriced awards was proposed for the Grants of All Other Equity Awards Table, on which the Grants of Plan-Based Awards Table is based in part. Executive Compensation and Related Party Disclosure, Release No. 33-8655 (Jan. 27, 2006) [71 FR 6542] at Section II.B.2.b. In light of previously adopting Summary Compensation Table disclosure of the FAS 123R incremental fair value of these awards, we did not adopt disclosure of these awards in the Grants of Plan-Based Awards Table in the 2006 Executive Compensation Release. See the 2006 Executive Compensation Release at Section II.C.2.

49 Instruction to Item 402(k)(2)(iii) and (iv).

in the grant date fair value of the award.[50] As described in the 2006 Executive Compensation Release, disclosure also will be provided in the Compensation Discussion and Analysis and the narrative disclosures for the Summary Compensation Table and Grants of Plan-Based Awards Table,[51] as appropriate, regarding awards granted in connection with repricing transactions.[52]

III. Administrative Law Matters and Request for Comments

The Administrative Procedure Act generally requires an agency to publish notice of a proposed rulemaking in the Federal Register.[53] This requirement does not apply, however, if the agency "for good cause finds . . . that notice and public procedure are impracticable, unnecessary, or contrary to the public interest."[54]

The Commission, for good cause, finds that notice and solicitation of comment regarding the amendments to Item 402 of Regulations S-K and S-B is impracticable, unnecessary and contrary to the public interest. First, the subject matter of the amendments already was subject to extensive public comment in connection with the 2006 Executive Compensation Release, and the Commission has considered those comments thoroughly in adopting these interim final rules.

Second, compliance with the Item 402 amendments adopted in the 2006 Executive Compensation Release is required for proxy and information statements filed on or after December 15, 2006 that are required to include Item 402 disclosure for fiscal

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[50] Instruction 7 to Item 402(d) and Instruction to Item 402(k)(2)(iii) and (iv), which conform to Instruction 1 to Item 402(e)(1).

[51] Item 402(e)(1)(ii) of Regulation S-K and Item 402(c)(2) of Regulation S-B.

[52] 2006 Executive Compensation Release at Section II.C.3.a.

[53] See 5 U.S.C. §553(b).

[54] Id.

years ending on or after December 15, 2006, and for Forms 10-K and 10-KSB for fiscal years ending on or after December 15, 2006.[55] This compliance schedule affects all public companies with a calendar year fiscal year that are required to file proxy or information statements, which we estimate to number approximately 12,190, excluding investment companies. Submitting the amendments to notice and further opportunity for public comment would generate considerable uncertainty regarding the executive compensation disclosure standards to apply as these companies prepare their proxy statements. Given that the amendments affect not only the calculation of total compensation for each named executive officer, but also the identification of the named executive officers (other than the principal executive officer and principal financial officer) based on highest total compensation, such uncertainty could impose extensive burdens and costs. In effect, submitting the amendments to notice and further opportunity for public comment could compel calendar year-end companies to prepare two different sets of executive compensation disclosures because they would not know which version of Item 402 ultimately would apply on the date the proxy or information statement must be filed.

Adopting the amendments as interim final rules also will substantially benefit investors by minimizing any inconsistency between the measure used for disclosure in the Summary Compensation Table of Stock Awards and Option Awards in the first year of compliance and the measure used in later years. Avoiding such potential inconsistency will facilitate year-to-year comparability of the compensation disclosed for individual named executive officers and directors.

[55] 2006 Executive Compensation Release at Section VII.

The Administrative Procedure Act also generally requires that an agency publish an adopted rule in the Federal Register 30 days before it becomes effective.[56] This requirement, however, does not apply if the agency finds good cause for making the rule effective sooner.[57] For the same reasons as it is waiving notice and comment, the Commission finds good cause to make the amendments effective as interim final rules upon publication of this release in the Federal Register.[58] The compliance dates for the interim final rules will be the same as the compliance dates for the amendments to Item 402 of Regulations S-K and S-B that were adopted in the 2006 Executive Compensation Release.[59]

Although the Commission is dispensing with prior notice of proposed rulemaking, the Commission is interested in receiving written comments on the interim final rules within 30 days after publication of this release in the Federal Register. The Commission will consider those comments and make changes to the amendments if necessary.

- Do the amendments result in disclosure that is easier or more difficult for investors to understand? Do the amendments facilitate or complicate company compliance? For example, does presenting the compensation costs of stock and option awards over the requisite service period, as described in FAS 123R, for each individual named executive officer increase compliance costs?

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[56] See 5 U.S.C. §553(d).

[57] Id.

[58] This finding also satisfies the requirements of 5 U.S.C. §808(2), allowing the rules to become immediately effective notwithstanding the requirements of 5 U.S.C. §801 (if a Federal agency finds that notice and public comment are "impractical, unnecessary, or contrary to the public interest," a rule "shall take effect at such time as the Federal agency promulgating the rule determines.")

[59] See 2006 Executive Compensation Release at Section VII.

- Does correlating the Summary Compensation Table and Director Compensation Table disclosure to the recognition of the compensation cost of stock and option awards over the requisite service period, as described in FAS 123R, with full grant date fair value disclosure for named executive officers and directors of non-small business issuers only, provide investors with a clearer and more useful presentation of compensation for the subject fiscal year than disclosure of aggregate grant date fair value in the Summary and Director Compensation Tables? Are there other approaches that would provide a better presentation of compensation?
- Should footnote or narrative disclosure be required to identify the remeasurement of liability awards? If so, what level of detail should we require?
- Under the interim final rules, the compensation cost disclosed for Summary Compensation Table and Director Compensation Table purposes does not include an estimate of forfeitures related to service-based vesting conditions. Is this deviation from FAS 123R needed to present meaningful executive compensation disclosure? If not, why not? Does this deviation make it easier or harder for companies to prepare the disclosure and for investors to understand it?
- Correlating disclosure in the Stock Awards and Option Awards columns to an approach that provides disclosure of compensation cost of those awards over the requisite service period could result in a negative number. In this circumstance, the negative number will be disclosed and will affect the calculation of "total" for purposes of determining who is a named executive officer. Instead, should the same approach be followed as for disclosure of the aggregate change in actuarial

present value of the named executive officer's accumulated benefit under all defined benefit and actuarial plans, where a negative number is disclosed in a footnote but not reflected in the applicable column and not subtracted for purposes of computing the total?[60]

- Does applying a recognition-based measure for Summary Compensation Table disclosure of equity awards result in any circumstances where, in disclosing a named executive officer's potential payments upon termination or change-in-control,[61] there would be a disclosure gap regarding the remaining value of outstanding awards (as adjusted for any acceleration of vesting) that has not yet been recognized?
- Does spreading out disclosure of equity award compensation over the period that the cost is recognized for financial reporting purposes result in less variability in the amount of total compensation reported from year-to-year?
- If the amendments result in fewer year-to-year fluctuations in the list of named executive officers, will such increased consistency result in more meaningful disclosure to investors?
- The interim final rules revise Summary Compensation Table disclosure of salary or bonus forgone at the election of a named executive officer under which stock, equity-based or other forms of non-cash compensation have instead been received by the named executive officer to require this compensation to be disclosed in the salary or bonus column, as applicable. Should this compensation be disclosed this way? Are there any other items of disclosure that should be revised in light of

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60 Instruction 3 to Item 402(c)(2)(viii) of Regulation S-K.

adopting a recognition-based approach to Summary Compensation Table and Director Compensation Table disclosure of equity-based compensation?

- Will Grants of Plan-Based Awards Table disclosure of the grant date fair value on a grant-by-grant basis improve investors' understanding of the value of awards, including in-the-money grants?
- For companies subject to Item 402 of Regulation S-K, is footnote disclosure in the Director Compensation Table of the grant date fair value of each equity award necessary to investors' understanding of director compensation?
- Under the interim final rules, disclosure of the full grant date fair value of equity awards and disclosure of the incremental fair value for repriced or materially modified awards no longer will be required for named executive officers and directors of small business issuers. Are these results appropriate? Should this disclosure also be required, on either an aggregate or grant-by-grant basis by Regulation S-B companies, either as a footnote or in the narrative disclosure to the Summary Compensation Table?[62] As a footnote or in narrative disclosure to the Director Compensation Table?[63]
- In circumstances where compensation cost with respect to an award is first recognized in the financial statements in the year before the award is granted, should disclosure in the Grants of Plan-Based Awards Table also be required in the year before the award is granted to eliminate potential inconsistency between

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61 This disclosure is required by Item 402(j) of Regulation S-K and Item 402(e) of Regulation S-B.

62 Item 402(c) of Regulation S-B.

63 Item 402(f)(3) of Regulation S-B.

these tables? What modifications would be required to reflect that the terms of the award have not yet been finalized?

- Should footnote or narrative disclosure be required to identify in the Grants of Plan-Based Awards Table and the Regulation S-B narrative disclosure to the Summary Compensation Table equity awards with performance conditions that are not considered probable of achievement and therefore are not reflected in the Summary Compensation Table disclosure? If so, what level of detail should we require?

IV. Transition Guidance

Because FAS 123R became effective for companies in 2006, it did not apply to stock and option awards that were granted in earlier years. Consequently, we are providing transition guidance for application of the Summary Compensation Table and Director Compensation Table amendments to disclosure of awards that were granted before 2006, including both equity awards that are not yet vested and liability awards that are not yet settled.[64] In this regard, we are requiring companies to utilize the FAS 123R modified prospective transition method[65] for Item 402 disclosure purposes, without regard to whether they have adopted that method for financial statement reporting purposes.[66] Under the modified prospective transition method, a proportionate share of the grant date fair value determined under Financial Accounting Standards Board

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64 Under the amendments, the adjustments to update the cumulative compensation costs recognized for certain awards that a company might have in the year that FAS 123R initially is adopted will not be included in the Summary Compensation Table disclosure for that year.

65 Under the modified prospective transition method in FAS 123R, the accounting for new awards and awards that are modified, repurchased or cancelled after the standard's effective date must apply the provisions of FAS 123R.

Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation, of equity awards that are outstanding at the date FAS 123R was adopted will be recognized in the financial statements over those awards' remaining vesting periods, if any. Liability awards that are outstanding at the date FAS 123R was adopted will be recognized in the financial statements until those awards are settled, based on the fair values of those awards at each financial statement reporting period under FAS 123R as well as the portion of the awards that have vested. The same approach will apply for presentation of the corresponding information in the Summary Compensation Table and Director Compensation Table for fiscal 2006 and later fiscal years.

V. Paperwork Reduction Act

A. Background

The interim final rules contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995.[67] We are submitting these to the Office of Management and Budget for review and approval in accordance with the Paperwork Reduction Act[68] The titles for the collection of information are:[69]

(1) "Regulation S-B" (OMB Control No. 3235-0417)

(2) "Regulation S-K" (OMB Control No. 3235-0071);

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66 Consequently, for companies that have not adopted the modified prospective transition method for financial statement reporting, the tabular compensation disclosure may not match financial statement disclosure during the transition period.

67 44 U.S.C. 3501 et seq.

68 44 U.S.C. 3507(d) and 5 CFR 1320.11.

69 The paperwork burden from Regulation S-K is imposed through the forms that are subject to the requirements in those Regulations and is reflected in the analysis of those forms. To avoid a Paperwork Reduction Act inventory reflecting duplicative burdens, for administrative convenience we estimate the burdens imposed by Regulation S-K to be a total of one hour.

(3) "Form SB-2"[70] (OMB Control No. 3235-0418);

(4) "Form S-1"[71] (OMB Control No. 3235-0065);

(5) "Form S-4"[72] (OMB Control Number 3235-0324);

(6) "Form S-11"[73] (OMB Control Number 3235-0067);

(7) "Regulation 14A[74] and Schedule 14A"[75] (OMB Control Number 3235-0059);

(8) "Regulation 14C[76] and Schedule 14C"[77] (OMB Control Number 3235-0057);

(9) "Form 10"[78] (OMB Control No. 3235-0064);

(10) "Form 10-SB"[79] (OMB Control No. 3235-0419)

(11) "Form 10-K"[80] (OMB Control No. 3235-0063);

(12) "Form 10-KSB"[81] (OMB Control No. 3235-0420); and

(13) "Form N-2"[82] (OMB Control No. 3235-0026).

We adopted all of the existing regulations and forms pursuant to the Securities Act of 1933 ("Securities Act")[83] and the Securities Exchange Act of 1934 ("Exchange

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70 17 CFR 239.10.

71 17 CFR 239.11.

72 17 CFR 239.25.

73 17 CFR 239.18.

74 17 CFR 240.14a-1 et seq.

75 17 CFR 240.14a-101.

76 17 CFR 240.14c-1 et seq.

77 17 CFR 240.14c-101.

78 17 CFR 249.210.

79 17 CFR 249.210b.

80 17 CFR 249.310.

81 17 CFR 249.310b.

82 17 CFR 239.14 and 274.11a-1.

83 15 U.S.C. 77a et seq.

Act"),[84] except for Form N-2, which we adopted pursuant to the Securities Act and the Investment Company Act of 1940 ("Investment Company Act").[85] These regulations and forms set forth the disclosure requirements for annual[86] and current reports, registration statements, proxy statements and information statements that are prepared by issuers to provide investors with the information they need to make informed investment decisions in registered offerings and in secondary market transactions, as well as informed voting decisions in the case of proxy statements.

The amendments adopted as interim final rules are intended to provide investors a fuller and more useful picture of executive compensation. In particular, they are intended to provide a more complete perspective of the compensation decisions made with respect to the last completed fiscal year, facilitate Compensation Discussion and Analysis disclosure of the company's policies and decisions regarding named executive officers' compensation, and provide investors with a clearer view of the annual compensation earned by executives and directors and the annual compensation costs to a company consistent with the timing of financial statement reporting.

The hours and costs associated with preparing disclosure, filing forms, and retaining records constitute reporting and cost burdens imposed by the collection of information. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

The information collection requirements related to annual and current reports, registration statements, proxy statements and information statements are mandatory.

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[84] 15 U.S.C. 78a et seq.

[85] 15 U.S.C. 80a-1 et seq.

[86] The pertinent annual reports are those filed on Form 10-K and Form 10-KSB.

However, the information collection requirements relating exclusively to proxy and information statements will apply only to issuers subject to the proxy rules. There is no mandatory retention period for the information disclosed, and the information disclosed will be made publicly available on the EDGAR filing system.

B. Summary of Information Collections

The amendments will affect existing disclosure burdens for affected filings as follows:

- The dollar value reported in the Stock Awards and Option Awards columns of the Summary Compensation Table and Director Compensation Table is revised to disclose the compensation cost of those awards over the requisite service period, as described in FAS 123R, but will not reflect the estimate for forfeitures related to service-based vesting used for financial statement reporting purposes;
- The Stock Awards and Option Awards columns of the Summary Compensation Table and Director Compensation Table are revised to require footnote disclosure of forfeitures during the last completed fiscal year;
- The Grants of Plan-Based Awards Table is revised to require disclosure of the grant date fair value of each individual equity award, computed in accordance with FAS 123R, and the Item 402 of Regulation S-K Director Compensation Table is revised to require footnote disclosure of the same information; and
- The Grants of Plan-Based Awards Table is revised to require disclosure of any option or SAR that was repriced or otherwise materially modified during the last completed fiscal year, including the incremental fair value, computed as of the repricing or modification date in accordance with FAS 123R, and the Item 402 of

Regulation S-K Director Compensation Table is revised to require footnote disclosure of the same incremental fair value information.

C. Paperwork Reduction Act Burden Estimates

For purposes of the Paperwork Reduction Act, we estimate no annual incremental increase in the paperwork burden for companies to comply with our amended collection of information requirements. We base this estimate on the fact that the revised approach is substantially the same as the approach companies already apply when complying with financial reporting requirements, most of the information that will be required to be disclosed will be collected to comply with financial reporting requirements, and any necessary modifications will not impose additional burdens compared to the burdens associated with applying the currently required disclosure. We also base this estimate on the likelihood that the revised approach will make companies' identification of named executive officers more consistent from year-to-year, thereby possibly reducing the burden of tracking the compensation of all executive officers in order to determine which executive officers are the most highly compensated.

D. Request for Comment

We invite comment on this estimate and its assumptions. We request comment in order to: (a) evaluate whether the collections of information are necessary for the proper performance of our functions, including whether the information will have practical utility; (b) evaluate the accuracy of our estimate of the burden of the collections of information; (c) determine whether there are ways to enhance the quality, utility and clarity of the information to be collected; and (d) evaluate whether there are ways to minimize the burden of the collections of information on those who respond, including

through the use of automated collection techniques or other forms of information technology.[87]

VI. Cost-Benefit Analysis

A. Background

We are adopting, as interim final rules, amendments to our rules governing disclosure of executive compensation. The amendments adopted as interim final rules are intended to provide investors a fuller and more useful picture of executive compensation. In particular, they are intended to provide a more complete perspective of the compensation decisions made with respect to the last completed fiscal year, facilitate Compensation Discussion and Analysis disclosure of the company's policies and decisions regarding named executive officers' compensation, and provide investors with a clearer view of the annual compensation earned by executives and directors and the annual compensation costs to a company consistent with the timing of financial statement reporting.

B. Summary of Amendments

Under the amendments adopted as interim final rules, a measure based on the dollar amount recognized for financial statement reporting purposes with respect to the fiscal year in accordance with FAS 123R will become the measure for reporting in the Stock Awards and Option Awards columns in the Summary Compensation Table and the Director Compensation Table. However, this measure does not include an estimate of forfeitures related to service-based vesting conditions, and the amendments require footnote disclosure of awards forfeited during the last completed fiscal year. The new

[87] Comments are requested pursuant to 44 U.S.C. 3506(c)(2)(B).

measure, which is included in total compensation disclosed in the Summary Compensation Table, could affect the determination of most highly compensated executive officers for purposes of identifying named executive officers other than the principal executive officer and principal financial officer.

Under the interim final rules, the Grants of Plan-Based Awards Table is amended to add a column showing the grant date fair value of each equity award computed in accordance with FAS 123R, and information for repriced options, stock appreciation rights and similar option-like instruments, including the incremental fair value computed as of the repricing or modification date in accordance with FAS 123R. The interim final rules also amend the Director Compensation Table in Item 402 of Regulation S-K to provide footnote disclosure of the same grant date fair value and incremental fair value information.

C. Benefits

Basing Stock and Options Award disclosure in the Summary Compensation Table and Director Compensation Table on the amount recognized for financial statement purposes, as required by the interim final rules, will provide investors with a fuller and more useful picture of executive compensation. Measuring compensation in a manner more consistent with FAS 123R recognition will provide investors with a clearer view of the annual compensation costs to a company. The amended presentation in some circumstances will reduce the possibility of overstating compensation related to service rendered for the year that could result from disclosing the full grant date fair value, particularly with respect to liability awards, which are subject to remeasurement, and will better reflect the possibility that some awards may be forfeited. Potentially reducing the

variability in the identity of named executive officers from year-to-year may result in compensation disclosure that is more meaningful to investors due to the ability to track year-to-year changes in the same executive's compensation.

For companies subject to Item 402 of Regulation S-K, grant date fair value information is moved to the Grants of Plan-Based Awards Table, where it is presented on a more comprehensible grant-by-grant basis. This should provide investors a more complete perspective of the compensation decisions made with respect to the last completed fiscal year and facilitate Compensation Discussion and Analysis disclosure of the company's policies and decisions regarding named executive officers' compensation. Amending the Director Compensation Table in Item 402 of Regulation S-K to provide footnote disclosure of the same grant date fair value and incremental fair value information also will present this information on a more comprehensible grant-by-grant basis. Conforming Summary Compensation Table disclosure of equity-based awards to the timing mandated for the company's financial statements, together with the fair value disclosure in the Grants of Plan-Based Awards Table, will provide more disclosure, potentially making it easier for investors and analysts to analyze compensation for top executives.

Although difficult to quantify, disclosure under the amendments will benefit investors in terms of the transparency, completeness and accessibility of executive compensation disclosure. Making Summary Compensation Table and Director Compensation Table disclosure of stock and option awards more comparable to the approach used for financial accounting recognition purposes will make executive compensation disclosure more transparent by providing investors a clearer picture of

annual compensation costs. Moving grant date fair value information to the Grants of Plan-Based Awards Table, where it is presented on a more comprehensive grant-by-grant basis, and requiring the same disclosure in a footnote to the Director Compensation Table, makes this disclosure more complete and accessible for investors in companies that report under Item 402 of Regulation S-K. To the extent that the amendments facilitate Compensation Discussion and Analysis disclosure of the company's policies and decisions regarding named executive officers' compensation, investors will obtain a more complete perspective of the compensation decisions made with respect to the last completed fiscal year.

D. Costs

In our view, the amendments to the executive compensation disclosure rules adopted as interim final rules do not significantly increase the costs of complying with the Commission's rules. In order to implement the amendments, companies will need to incur costs to revise their disclosure controls. However, we believe that these costs will be incurred principally on a transitional basis as companies and their advisors determine how best to compile and report information in response to the amended disclosure requirements. We base this view on the fact that the amended approach for Summary Compensation Table and Director Compensation Table disclosure is substantially the same as the approach companies already apply when complying with financial reporting requirements, most of the information that will be required to be disclosed will have been collected to comply with financial reporting requirements, and any necessary modifications will impose minimal additional costs compared to the costs associated with applying the formerly required disclosure. We also base this view on the likelihood that

the amended approach will make companies' identification of named executive officers more consistent from year-to-year, thereby possibly reducing the costs of tracking the compensation of all executive officers in order to determine which executive officers are the most highly compensated.

The amendments also may generate costs if they affect the compensation practices of companies or executives' preferences with respect to executive compensation. Under the amendments, the Item 402 of Regulation S-B Summary Compensation Table and Director Compensation Table no longer will provide the full grant date fair value of equity awards to named executive officers. Similarly, neither of these tables will provide disclosure of the incremental fair value of awards that are repriced or materially modified. To the extent that the loss of this information will reduce the value of executive compensation disclosure to investors, the amendments could impose costs on investors.

E. Request for Comment

- We solicit quantitative data to assist our assessment of the benefits and costs of the revised disclosure requirements.
- What, if any, additional work and costs are involved in collecting the information necessary to comply with the amendments? What are the types of costs, and in what amounts? In what way can the amendments be modified to mitigate the costs?
- Does identification of named executive officers based on the portion of equity compensation earned during the fiscal year result in more meaningful

identification of named executive officers than under the former method based on the aggregate grant date fair value of awards?

- Will the interim final rules have an effect on companies' choice of compensation packages, or executives' preferences with respect to equity awards?
- Assuming the interim final rules are retained, what are the costs in the first year of compliance versus subsequent years?
- We solicit comments on the degree to which companies already collect the information that the amendments will require to be disclosed.

VII. Consideration of Burden on Competition and Promotion of Efficiency, Competition and Capital Formation

Exchange Act Section 23(a)(2)[88] requires us, when adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition. In addition, Section 23(a)(2) prohibits us from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. Furthermore, Securities Act Section 2(b),[89] Exchange Act Section 3(f)[90] and Investment Company Act Section 2(c)[91] require us, when engaging in rulemaking where we are required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

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88 15 U.S.C. 78w(a)(2).

89 15 U.S.C. 77b(b).

90 15 U.S.C. 78c(f).

91 15 U.S.C. 80a-2(c).

We have also discussed other impacts of the amendments adopted as interim final rules in our Cost-Benefit, Paperwork Reduction Act and Final Regulatory Flexibility Act Analyses. The amendments to Regulations S-K and S-B are intended to make executive compensation disclosure more consistent with financial statement disclosure, which should promote efficiency. The amendments should enhance investors' understanding of how corporate resources are used, and enable shareholders to better evaluate the actions of the board of directors and executive officers in fulfilling their responsibilities. In particular, measuring executive and director compensation in a manner more consistent with financial accounting recognition, along with disclosure of the grant date fair value of equity awards on a grant-by-grant basis, should provide investors with a fuller and more useful picture of executive compensation. This would include a clearer view of a company's compensation decisions and the annual compensation costs to a company.

The amendments may have the effect of reducing the likelihood of inconsistencies in the identity of named executive officers from year-to-year. To this extent, the number of executives for whom competitors could potentially gain insights with respect to a company's executive compensation practices through the required disclosure over a period of years may be reduced. However, we do not expect the incremental effect of the amendments overall to affect competition materially.

In adopting the amendments, we have considered their effect on capital formation and believe that the amendments will have little effect on capital formation.

We request comment on whether the amendments will promote efficiency, competition, and capital formation or have an impact or burden on competition.

Commenters are requested to provide empirical data and other factual support for their views, if possible.

VIII. Final Regulatory Flexibility Act Analysis

This Final Regulatory Flexibility Act Analysis has been prepared in accordance with 5 U.S.C. 603. It relates to revisions to the rules and forms under the Securities Act and Exchange Act, adopted as interim final rules, that will provide investors with a presentation of compensation for the fiscal year that is more comparable to the approach used for financial accounting purposes.

A. Need for the Amendments

Since the enactment of the Securities Act and the Exchange Act, the Commission has on a number of occasions explored the best methods for communicating clear, concise and meaningful material information about executive and director compensation. Recently, the Commission adopted comprehensive amendments to improve the clarity and completeness of executive compensation disclosure.[92] The interim final rules principally modify two aspects of those comprehensive amendments: modifying the timing of reporting option and stock awards in the Summary Compensation Table and Director Compensation Table so that it is more comparable to financial accounting recognition; and, in Item 402 of Regulation S-K, requiring Grants of Plan-Based Awards Table reporting of the full grant date fair value of equity awards and information regarding option, SAR and similar option-like awards that are repriced or materially modified during the fiscal year, and Director Compensation Table footnote disclosure of the same information. The overall goal of the amendments is to increase the transparency

[92] See the 2006 Executive Compensation Release.

and completeness of executive compensation disclosure by providing investors a fuller and more useful picture of executive compensation. In particular, they are intended to provide a more complete perspective of the compensation decisions made with respect to the last completed fiscal year, facilitate Compensation Discussion and Analysis disclosure of the company's policies and decisions regarding named executive officers' compensation, and provide investors with a clearer view of the annual compensation earned by executives and directors and the annual compensation costs to a company consistent with the timing of financial statement reporting.

B. Significant Issues Raised by Public Comment

As summarized in Section I above, several commenters expressed the view that Summary Compensation Table disclosure of equity awards should be presented on a basis that is generally consistent with financial statement reporting. We have taken these comments into account in adopting the amendments that would apply to small entities.

C. Small Entities Subject to the Amendments

For purposes of the Regulatory Flexibility Act, Securities Act Rule 157[93] and Exchange Act Rule 0-10(a)[94] define an issuer to be a "small business" or "small organization" for purposes of the Regulatory Flexibility Act if it had total assets of $5 million or less on the last day of its most recent fiscal year. These are the types of entities that we refer to as small entities in this section. We believe that the amendments will affect small entities that are operating companies. We estimate that there are approximately 2,500 issuers, other than investment companies, that may be considered

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[93] 17 CFR 230.157.

[94] 17 CFR 240.0-10(a).

small entities. Under Rule 0-10 under the Investment Company Act,[95] 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. We believe that the amendments will affect small entities that are investment companies. Specifically, we believe that the amendments will affect small entities that are business development companies.[96] We estimate that there are 53 business development companies that qualify as small entities.

D. Reporting, Recordkeeping, and Other Compliance Requirements

We note that small business issuers,[97] which is a broader category of issuers than small entities, in certain circumstances may provide the executive compensation disclosure specified in Item 402 of Regulation S-B, rather than the corresponding disclosure specified in Item 402 of Regulation S-K.

The amendments adopted as interim final rules will affect small business issuers as follows:

- The dollar value reported in the Stock Awards and Option Awards columns of the Summary Compensation Table and Director Compensation Table is revised to disclose the compensation cost of those awards over the requisite service period, as described in FAS 123R, but will not reflect the estimate for forfeitures related to service-based vesting used for financial statement reporting purposes; and

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95 17 CFR 270.0-10.

96 Business development companies are a category of closed-end investment companies that are not required to register under the Investment Company Act. 15 U.S.C. §80a-2(a)(48).

97 Item 10 of Regulation S-B (17 CFR 228.10) defines a small business issuer as a registrant that has revenues of less than $25 million, is a U.S. or Canadian issuer, is not an investment company, and has a public float of less than $25 million. Also, if it is a majority owned subsidiary, the parent corporation also must be a small business issuer.

- The Stock Awards and Option Awards columns of the Summary Compensation Table and Director Compensation Table are revised to require footnote disclosure of forfeitures during the last completed fiscal year.

Because Item 402 of Regulation S-B does not include the Grants of Plan-Based Awards Table, the amendments to Item 402 of Regulation S-B do not include the following disclosures that are required for named executive officers and directors by the amendments to Item 402 of Regulation S-K:

- Disclosure of the grant date fair value of each individual equity award, computed in accordance with FAS 123R; and
- Disclosure of the incremental fair value, computed as of the repricing or modification date in accordance with FAS 123R, of any option or SAR that was repriced or otherwise materially modified during the last completed fiscal year.

As a result, the amendments to Item 402 of Regulation S-B do not result in the same level of incremental increase in costs or burdens to small businesses as do the amendments to Item 402 of Regulation S-K.

E. Agency Action to Minimize Effect on Small Entities

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish the stated objectives, while minimizing any significant adverse impact on small entities. In connection with the amendments, we considered the following alternatives:

1. establishing different compliance or reporting requirements which take into account the resources available to smaller entities;

2. the clarification, consolidation or simplification of disclosure for small entities;

3. use of performance standards rather than design standards; and

4. exempting smaller entities from coverage of the disclosure requirements, or any part thereof.

We have considered different changes to our rules and forms to achieve our regulatory objectives, and where possible, have taken steps to minimize the effect of the rules on smaller entities. The amendments are unlikely to have a significant impact on smaller entities because their principal effect is to make Summary Compensation Table and Director Compensation Table disclosure of stock and option awards more comparable to the financial statement presentation of those compensation items. The amendments do not affect the abbreviated format of the Regulation S-B Summary Compensation Table, which requires disclosure with respect to the principal executive officer and two most highly compensated executive officers for the small business issuer's last two completed fiscal years. Because Item 402 of Regulation S-B does not include a Grants of Plan-Based Awards Table, the amendments to that table do not apply.

F. General Request for Comments

We solicit written comments regarding this analysis. We request comment on whether the amendments adopted as interim final rules could have an effect that we have not considered. We request that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of the impact.

IX. Statutory Authority and Text of the Amendments

We are adopting rule amendments pursuant to Sections 3(b), 6, 7, 10, and 19(a) of the Securities Act, as amended, Sections 12, 13, 14, 15(d) and 23(a) of the Exchange Act, as amended, Section 38 of the Investment Company Act, and Section 3(a) of the Sarbanes-Oxley Act of 2002.

List of Subjects

17 CFR Part 228

Reporting and recordkeeping requirements, Securities, Small businesses.

17 CFR Part 229

Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

PART 228 – INTEGRATED DISCLOSURE SYSTEM FOR SMALL BUSINESS ISSUERS

1. The authority citation for part 228 continues to read in part as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77jjj, 77nnn, 77sss, 78l, 78m, 78n, 78o, 78u-5, 78w, 78ll, 78mm, 80a-8, 80a-29, 80a-30, 80a-37, 80b-11, and 7201 et seq.; and 18 U.S.C. 1350.

* * * * *

2. Section 228.402 is amended by revising Instruction 2 to Item 402(b)(2)(iii) and (iv), paragraphs (b)(2)(v), (b)(2)(vi) and the Instructions to paragraphs

(b)(2)(v) and (b)(2)(vi), paragraph (b)(2)(ix)(G), paragraphs (f)(2)(iii), (f)(2)(iv) and (f)(2)(vii)(I), and Instruction to Item 402(f) to read as follows:

§228.402 (Item 402) Executive compensation.

* * * * *

(b) * * *

(2) * * *

Instructions to Item 402(b)(2)(iii) and (iv).

* * * * *

2. Small business issuers shall include in the salary column (column (c)) or bonus column (column (d)) any amount of salary or bonus forgone at the election of a named executive officer under which stock, equity-based or other forms of non-cash compensation instead have been received by the named executive officer. However, the receipt of any such form of non-cash compensation instead of salary or bonus must be disclosed in a footnote added to the salary or bonus column and, where applicable, referring to the narrative disclosure to the Summary Compensation Table (required by paragraph (c) of this Item) where the material terms of the stock, option or non-equity incentive plan award elected by the named executive officer are reported.

(v) For awards of stock, the dollar amount recognized for financial statement reporting purposes with respect to the fiscal year in accordance with FAS 123R (column (e));

(vi) For awards of options, with or without tandem SARs, the dollar amount recognized for financial statement reporting purposes with respect to the fiscal year in accordance with FAS 123R (column (f));

Instruction to Item 402(b)(2)(v) and (vi). For awards reported in columns (e) and (f), disregard the estimate of forfeitures related to service-based vesting conditions. Include a footnote describing all forfeitures during the year, and disclosing all assumptions made in the valuation. Disclose assumptions made in the valuation by reference to a discussion of those assumptions in the registrant's financial statements, footnotes to the financial statements, or discussion in the Management's Discussion and Analysis. The sections so referenced are deemed part of the disclosure provided pursuant to this Item.

* * * * *

(ix) * * *

(G) The dollar value of any dividends or other earnings paid on stock or option awards, when those amounts were not factored into the grant date fair value for the stock or option award; and

* * * * *

(f) * * *

(2) * * *

(iii) For awards of stock, the dollar amount recognized for financial statement reporting purposes with respect to the fiscal year in accordance with FAS 123R (column (c));

(iv) For awards of stock options, with or without tandem SARs, the dollar amount recognized for financial statement reporting purposes with respect to the fiscal year in accordance with FAS 123R (column (d));

* * * * *

(vii) * * *

(I) The dollar value of any dividends or other earnings paid on stock or option awards, when those amounts were not factored into the grant date fair value for the stock or option award; and

* * * * *

Instruction to Item 402(f).

In addition to the Instruction to paragraph (f)(2)(vii) of this Item, the following apply equally to paragraph (f) of this Item: Instructions 2 and 4 to paragraph (b) of this Item; the Instructions to paragraphs (b)(2)(iii) and (iv) of this Item; the Instruction to paragraphs (b)(2)(v) and (vi) of this Item; the Instructions to paragraph (b)(2)(vii) of this Item; the Instruction to paragraph (b)(2)(viii) of this Item; the Instructions to paragraph (b)(2)(ix) of this Item; and paragraph (c)(7) of this Item. These Instructions apply to the columns in the Director Compensation Table that are analogous to the columns in the Summary Compensation Table to which they refer and to disclosures under paragraph (f) of this Item that correspond to analogous disclosures provided for in paragraph (b) of this Item to which they refer.

* * * * *

PART 229 – STANDARD INSTRUCTIONS FOR FILING FORMS UNDER SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934 AND ENERGY POLICY AND CONSERVATION ACT OF 1975 – REGULATION S-K

3. The general authority citation for part 229 is revised to read in part as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77iii, 77jjj, 77nnn, 77sss, 78c, 78i, 78j, 78l, 78m,

78n, 78o, 78u-5, 78w, 78ll, 78mm, 80a-8, 80a-9, 80a-20, 80a-29, 80a-30, 80a-31(c), 80a-37, 80a-38, 80a-39, 80b-11, and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

4. Section 229.402 is amended by revising Instruction 2 to Item 402(c)(2)(iii) and (iv), paragraphs (c)(2)(v) and (c)(2)(vi), the Instructions to paragraphs (c)(2)(v) and (c)(2)(vi), and paragraph (c)(2)(ix)(G), revising the Grants of Plan-Based Awards Table in paragraph (d)(1), removing "and" at the end of paragraph (d)(2)(vi), removing the period at the end of paragraph (d)(2)(vii) and adding "and" in its place, adding paragraph (d)(2)(viii) and Instruction 7 to Item 402(d), revising paragraphs (k)(2)(iii), (k)(2)(iv), the Instruction to paragraphs (k)(2)(iii) and (iv), and revising paragraph (k)(2)(vii)(I) and Instruction to Item 402(k), to read as follows:

§229.402 (Item 402) Executive compensation.

* * * * *

(c) * * *

(2) * * *

Instructions to Item 402(c)(2)(iii) and (iv).

* * * * *

2. Registrants shall include in the salary column (column (c)) or bonus column (column (d)) any amount of salary or bonus forgone at the election of a named executive officer under which stock, equity-based or other forms of non-cash compensation instead have been received by the named executive officer. However, the receipt of any such form of non-cash compensation instead of salary or bonus must be disclosed in a footnote

added to the salary or bonus column and, where applicable, referring to the Grants of Plan-Based Awards Table (required by paragraph (d) of this Item) where the stock, option or non-equity incentive plan award elected by the named executive officer is reported.

(v) For awards of stock, the dollar amount recognized for financial statement reporting purposes with respect to the fiscal year in accordance with FAS 123R (column (e));

(vi) For awards of options, with or without tandem SARs, the dollar amount recognized for financial statement reporting purposes with respect to the fiscal year in accordance with FAS 123R (column (f));

Instruction to Item 402(c)(2)(v) and (vi). For awards reported in columns (e) and (f), disregard the estimate of forfeitures related to service-based vesting conditions. Include a footnote describing all forfeitures during the year, and disclosing all assumptions made in the valuation. Disclose assumptions made in the valuation by reference to a discussion of those assumptions in the registrant's financial statements, footnotes to the financial statements, or discussion in the Management's Discussion and Analysis. The sections so referenced are deemed part of the disclosure provided pursuant to this Item.

* * * * *

(ix) * * *

(G) The dollar value of any dividends or other earnings paid on stock or option awards, when those amounts were not factored into the grant date fair value required to

be reported for the stock or option award in column (l) of the Grants of Plan-Based Awards Table required by paragraph (d)(2)(viii) of this Item; and

* * * * *

(d) * * *

GRANTS OF PLAN-BASED AWARDS

Name	Grant Date	Estimated Future Payouts Under Non-Equity Incentive Plan Awards			Estimated Future Payouts Under Equity Incentive Plan Awards			All Other Stock Awards: Number of Shares of Stock or Units (#)	All Other Option Awards: Number of Securities Under-lying Options (#)	Exercise or Base Price of Option Awards ($/Sh)	Grant Date Fair Value of Stock and Option Awards
		Thresh-old ($)	Target ($)	Maxi-mum ($)	Thresh-old (#)	Target (#)	Maxi-mum (#)				
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)	(k)	(l)
PEO											
PFO											
A											
B											
C											

(2) * * *

(viii) The grant date fair value of each equity award computed in accordance with FAS 123R (column (l)). If at any time during the last completed fiscal year, the registrant has adjusted or amended the exercise or base price of options, SARs or similar option-like instruments previously awarded to a named executive officer, whether through amendment, cancellation or replacement grants, or any other means ("repriced"), or otherwise has materially modified such awards, the incremental fair value, computed as

of the repricing or modification date in accordance with FAS 123R, with respect to that repriced or modified award, shall be reported.

Instructions to Item 402(d).

* * * * *

7. Options, SARs and similar option-like instruments granted in connection with a repricing transaction or other material modification shall be reported in this Table. However, the disclosure required by this Table does not apply to any repricing that occurs through a pre-existing formula or mechanism in the plan or award that results in the periodic adjustment of the option or SAR exercise or base price, an antidilution provision in a plan or award, or a recapitalization or similar transaction equally affecting all holders of the class of securities underlying the options or SARs.

* * * * *

(k) * * *

(2) * * *

(iii) For awards of stock, the dollar amount recognized for financial statement reporting purposes with respect to the fiscal year in accordance with FAS 123R (column (c));

(iv) For awards of stock options, with or without tandem SARs, the dollar amount recognized for financial statement reporting purposes with respect to the fiscal year in accordance with FAS 123R (column (d));

Instruction to Item 402(k)(2)(iii) and (iv).

For each director, disclose by footnote to the appropriate column: the grant date fair value of each equity award computed in accordance with FAS 123R; for each option,

SAR or similar option like instrument for which the registrant has adjusted or amended the exercise or base price during the last completed fiscal year, whether through amendment, cancellation or replacement grants, or any other means ("repriced"), or otherwise has materially modified such awards, the incremental fair value, computed as of the repricing or modification date in accordance with FAS 123R; and the aggregate number of stock awards and the aggregate number of option awards outstanding at fiscal year end. However, the disclosure required by this Instruction does not apply to any repricing that occurs through a pre-existing formula or mechanism in the plan or award that results in the periodic adjustment of the option or SAR exercise or base price, an antidilution provision in a plan or award, or a recapitalization or similar transaction equally affecting all holders of the class of securities underlying the options or SARs.

* * * * *

(vii) * * *

(I) The dollar value of any dividends or other earnings paid on stock or option awards, when those amounts were not factored into the grant date fair value for the stock or option award; and

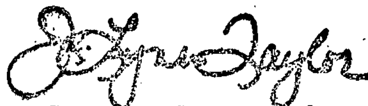
* * * * *

<u>Instruction to Item 402(k)</u>.

In addition to the Instruction to paragraphs 402(k)(2)(iii) and (iv) and the Instructions to paragraph (k)(2)(vii) of this Item, the following apply equally to paragraph (k) of this Item: Instructions 2 and 4 to paragraph (c) of this Item; Instructions to paragraphs (c)(2)(iii) and (iv) of this Item; the Instruction to paragraphs (c)(2)(v) and (vi) of this Item; Instructions to paragraph (c)(2)(vii) of this Item; Instructions to paragraph

(c)(2)(viii) of this Item; and Instructions 1 and 5 to paragraph (c)(2)(ix) of this Item. These Instructions apply to the columns in the Director Compensation Table that are analogous to the columns in the Summary Compensation Table to which they refer and to disclosures under paragraph (k) of this Item that correspond to analogous disclosures provided for in paragraph (c) of this Item to which they refer.

* * * * *



By: J. Lynn Taylor
Assistant Secretary

By the Commission.

J. Lynn Taylor
Assistant Secretary

Dated: December 22, 2006

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 200, 232, 240 and 249

[RELEASE NO. 34-55005; INTERNATIONAL SERIES RELEASE NO. 1300;

FILE NO. S7-12-05]

RIN 3235-AJ38

TERMINATION OF A FOREIGN PRIVATE ISSUER'S REGISTRATION OF A CLASS OF SECURITIES UNDER SECTION 12(g) AND DUTY TO FILE REPORTS UNDER SECTION 13(a) OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

AGENCY: Securities and Exchange Commission.

ACTION: Reproposed rule.

SUMMARY: We are reproposing amendments to the rules that govern when a foreign private issuer may terminate the registration of a class of equity securities under section 12(g) of the Securities Exchange Act of 1934 ("Exchange Act") and the corresponding duty to file reports required under section 13(a) of the Exchange Act, and when it may cease its reporting obligations regarding a class of equity or debt securities under section 15(d) of the Exchange Act. Under the current rules, a foreign private issuer may find it difficult to terminate its Exchange Act registration and reporting obligations despite the fact that there is relatively little interest in the issuer's U.S.-registered securities among United States investors. Moreover, currently a foreign private issuer can only suspend, and cannot terminate, a duty to report arising under section 15(d) of the Exchange Act. Reproposed Exchange Act Rule 12h-6 would permit the termination of Exchange Act reporting regarding a class of equity securities under either section 12(g) or section 15(d) of the Exchange Act by a foreign private issuer that meets a quantitative

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benchmark designed to measure relative U.S. market interest for that class of securities, which does not depend on a head count of the issuer's U.S. security holders. The reproposed benchmark would require the comparison of the average daily trading volume of an issuer's securities in the United States with that in its primary trading market. Because the Commission did not fully address this approach when it originally proposed Rule 12h-6, and because of other proposed changes to Rule 12h-6 not fully discussed in the original rule proposal, we are reproposing Rule 12h-6 and the accompanying rule amendments. These rule amendments would seek to provide U.S. investors with ready access through the Internet on an ongoing basis to material information about a foreign private issuer of equity securities that is required by its home country after it has exited the Exchange Act reporting system.

DATES: Comments must be received on or before [insert date 30 days after publication in the Federal Register.] Given the advanced stage of this rulemaking initiative, the Commission anticipates taking further action as expeditiously as possible after the end of the comment period. It therefore strongly encourages the public to submit their comments within the prescribed comment period. Comments received after that point cannot be assured of full consideration by the Commission.

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

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml); or

- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-12-05 on the subject line; or

- Use the Federal eRulemaking Portal (http://www.regulations.gov). Follow the instructions for submitting comments.

Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-9303.

All submissions should refer to File Number S7-12-05. 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, 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: Elliot Staffin, Special Counsel, at (202) 551-3450, in the Office of International Corporate Finance, Division of Corporation Finance, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-3628.

SUPPLEMENTARY INFORMATION: We are reproposing amendments to Commission Rule 30-1,[1] Rule 101[2] of Regulation S-T,[3] and Rules 12g3-2, 12g-4 and

[1] 17 CFR 200.30-1.

[2] 17 CFR 232.101.

[3] 17 CFR 232.10 et seq.

12h-3[4] under the Exchange Act,[5] and reproposing new Rule 12h-6[6] and Form 15F[7] under the Exchange Act.

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[4] 17 CFR 240.12g3-2, 240.12g-4 and 240.12h-3.

[5] 15 U.S.C. 78a et. seq.

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I. EXECUTIVE SUMMARY AND BACKGROUND

A. Introduction

On December 23, 2005, the Commission issued proposed amendments to its current rules governing when a foreign private issuer[8] may exit the Exchange Act reporting regime.[9] The Commission proposed these rule amendments out of concern that, due to several trends, including the increased internationalization of the U.S. securities markets in recent decades, it has become difficult for a foreign private issuer to exit the Exchange Act reporting system even when there is relatively little U.S. investor interest in its U.S.-registered securities.[10]

We recognized that U.S. investors benefit from the investment opportunities provided by foreign private issuers registering their securities with the Commission and listing and publicly offering those securities in the United States. However, because of the burdens and uncertainties associated with terminating registration and reporting under the Exchange Act, the current exit process may serve as a disincentive to foreign private issuers accessing the U.S. public capital markets. In order to remove this disincentive, we proposed to amend the current Exchange Act exit rules for foreign private issuers.

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[8] As defined in Rule 3b-4(c) (17 CFR 240.3b-4(c)), a foreign private issuer is a corporation or other organization incorporated or organized in a foreign country that either has 50 percent or less of its outstanding voting securities held of record by United States residents or, if more than 50 percent of its voting securities are held by U.S. residents, about which none of the following are true:

(1) a majority of its executive officers or directors are U.S. citizens or residents;
(2) more than 50 percent of its assets are located in the United States; and
(3) the issuer's business is administered principally in the United States.

[9] Release No. 34-53020 (December 23, 2005), 70 FR 77688 (December 30, 2005) (Original Proposing Release).

[10] See Original Proposing Release, 70 FR at 77689-77690.

We received over 50 letters commenting on the proposed rule amendments.[11] While most of the commenters supported the purpose and general framework of the proposed rulemaking, many expressed concern that the rule proposals would unduly restrict a significant portion of U.S.-registered foreign private issuers from terminating their Exchange Act registration and reporting obligations. We have carefully considered commenters' suggestions regarding the rule proposals, and have incorporated many of them into the rules that we are reproposing today.

A number of commenters have noted that many non-U.S. securities markets impose relatively few restrictions on the ability of a foreign issuer to delist from those markets and to terminate all reporting and other compliance obligations in those markets.[12] In the United States, foreign companies are generally able to delist their securities from exchanges without significant restrictions.[13] However, although a foreign private issuer is able to delist its securities from U.S. exchanges, it may continue to have reporting obligations under the Exchange Act.

The rules we are reproposing today are intended to provide foreign private issuers with methods by which they can exit the U.S. public securities markets without significant burdens when U.S. market interest in the issuers' securities is relatively low. For foreign registrants of equity securities, that method would be based on a comparison

[11] These comments are available on the Commission's Web site at http://www.sec.gov/rules/proposed/s71205.shtml and in the Commission's Public Reference Room in its Washington, DC headquarters.

[12] See, for example, the letter, dated February 9, 2004, from the Association Francaise Des Entreprises Privees (AFEP) and other European industry group representatives.

[13] See, for example, Exchange Act Rule 12d2-2 (17 CFR 240.12d2-2) and section 806.02 of the New York Stock Exchange (NYSE) Listed Company Manual.

of the average daily trading volume of its class of securities in the United States with that in its primary trading market.[14] Although we expressed some reservation about relying solely on trading volume data as the basis for measuring U.S. regulatory interest in the Proposing Release, in light of the comments received, we are reconsidering our position. We believe that a standard based on trading volume may in fact be superior to the originally proposed standard, which was based primarily on a comparison of an issuer's U.S. public float with its worldwide public float, because it is a direct measure of the issuer's nexus with the U.S. market, and because trading volume data is easier to obtain than public float or record holder data. In applying an exit standard based on trading volume data for the U.S. and an issuer's primary trading market, issuers will face reduced costs when determining whether they can terminate their registration and reporting obligations under the Exchange Act, compared to the earlier proposed measures that would have required an issuer to assess the U.S. residence of its security holders.

We believe the reproposed rules appropriately provide meaningful protection of U.S. investors by permitting the termination of Exchange Act registration and reporting only by foreign registrants in whose U.S. registered securities relative U.S. market interest is low. We believe the proposed conditions governing eligibility to use the trading volume-based measure, along with the other proposed conditions concerning prior Exchange Act reporting, the prohibition against recent registered U.S. offerings, and required foreign listing should further serve to protect U.S. investors.

[14] As discussed in greater detail in Part II.A. of this release, a foreign private issuer would be eligible to deregister a class of equity securities under reproposed Rule 12h-6 if the average daily trading volume in the United States was no greater than 5% of its average daily trading volume in its primary trading market over a recent 12-month period.

We believe the reproposed rules will provide foreign private issuers, regardless of size, with the meaningful option of terminating their Exchange Act reporting obligations when, after electing to access the U.S. public capital markets, they find that there is relatively little U.S. investor interest in their U.S.-registered securities. As a result, foreign private issuers should be more willing initially to register their securities with the Commission, to the benefit of U.S. investors who will have more investment choices.

B. Overview of the Current Exchange Act Exit Rules

Exchange Act Rule 12g-4 currently governs whether an issuer may terminate its registration of a class of securities under section 12(g) of the Exchange Act[15] and its corresponding section 13(a) reporting obligations.[16] Under this rule, a foreign private issuer may seek termination of its registration of a class of securities under section 12(g) by certifying in Form 15[17] that the subject class of securities is held of record by less than 300 residents in the United States or by less than 500 U.S. residents when the issuer's total assets have not exceeded $10 million on the last day of each of the issuer's most recent three fiscal years.[18] To determine the number of U.S. resident shareholders under

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[15] This statutory section only applies to equity securities. See Exchange Act Section 12(g)(1) [15 U.S.C. 78l (g)(1)]. An issuer may register a class of equity securities under section 12(g) either voluntarily or because it had 500 or more security holders of record and more than $10 million in total assets and, if a foreign private issuer, more than 300 shareholders resident in the United States on the last day of its most recently completed fiscal year. See Exchange Act Rules 12g-1 (17 CFR 12g-1) and 12g3-2(a) (17 CFR 240.12g3-2(a)). However, a foreign private issuer may avoid an Exchange Act registration obligation under section 12(g) by establishing the exemption under Exchange Act Rule 12g3-2(b) (17 CFR 240.12g3-2(b)).

[16] 15 U.S.C. 78m(a).

[17] 17 CFR 249.323.

[18] Exchange Act Rule 12g-4(a)(2) (17 CFR 240.12g-4(a)(2)). Alternatively, a foreign private issuer may seek to terminate its section 12(g) registration under the Rule 12g-4 provision that applies to any issuer, whether domestic or foreign. Under this provision, an issuer must certify on Form 15 that its class of equity securities is held of record on a worldwide basis by less than 300

this rule, a foreign private issuer must use the method of counting provided under Exchange Act Rule 12g3-2(a).[19] This method requires looking through the record ownership of brokers, dealers, banks, depositaries or other nominees on a worldwide basis and counting the number of separate accounts of customers resident in the United States for which the securities are held.[20] Under this rule, issuers are required to make inquiries of all nominees, wherever located and wherever in the chain of ownership, for the purpose of assessing the number of U.S. resident holders.

Rule 12h-3[21] is the Exchange Act rule governing when an issuer may suspend its reporting obligations under section 15(d).[22] While Rule 12h-3's standards are substantially similar to those under Rule 12g-4,[23] there are two important differences. First, an issuer may generally not suspend its section 15(d) reporting obligations until it has filed one Exchange Act annual report after the offering in question. Second, an issuer cannot terminate its reporting obligations under section 15(d) but can only suspend those

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persons or by less than 500 persons when the issuer's total assets have not exceeded $10 million on the last day of each of the issuer's most recent three fiscal years. Exchange Act Rule 12g-4(a)(1) (17 CFR 240.12g-4(a)(1)).

[19] 17 CFR 240.12g3-2(a).

[20] See 17 CFR 240.12g3-2(a)(1).

[21] 17 CFR 240.12h-3.

[22] The effectiveness of a registration statement under the Securities Act of 1933 (Securities Act) triggers Section 15(d) reporting obligations. That section provides that an issuer cannot suspend its reporting obligations unless the subject class of securities is held of record by less than 300 persons at the beginning of a fiscal year other than the year in which the Securities Act registration statement became effective.

[23] See, in particular, Rule 12h-3(b)(2) (17 CFR 240.12h-3(b)(2)). This provision imposes not only the same record holder standards as under Rule 12g-4 but also the same counting method required under Rule 12g3-2(a).

obligations.[24] Therefore, for as long as the subject class of securities is outstanding, a foreign private issuer must also determine at the end of each fiscal year whether the number of U.S. resident security holders or total number of record holders has increased enough to trigger anew its section 15(d) reporting obligations.

An issuer may be subject to Exchange Act reporting obligations under more than one statutory section or rule. While an issuer is deemed to have only one active set of reporting obligations, when an issuer attempts to exit the Exchange Act reporting system, it must consider whether there are any dormant or suspended reporting obligations that would preclude the issuer from ceasing its Exchange Act reporting.

For example, an issuer may have active section 13(a) reporting obligations because it has a class of equity or debt securities listed on a national securities exchange and registered with the Commission under section 12(b) of the Exchange Act.[25] When attempting to exit the Exchange Act reporting system, the registrant not only must take steps to effect its delisting from the national securities exchange,[26] but also must consider whether it has any dormant or suspended reporting obligations under section 12(g) or 15(d)[27] that will become operative once its section 12(b) registration

[24] Exchange Act Rule 12h-3(e) (17 CFR 240.12h-3(e)).

[25] 15 U.S.C. 78l(b).

[26] To effect the delisting and subsequent termination of an issuer's registration of a class of securities under section 12(b), the national securities exchange or issuer must file a Form 25 (17 CFR 249.25) with the Commission pursuant to Exchange Act Rule 12d2-2 (17 CFR 240.12d2-2). We have adopted amendments to our rules and Form 25 to streamline the procedures for removing from listing, and withdrawing from registration, securities under section 12(b). See Release No. 34-52029 (July 14, 2005), 70 FR 42456 (July 22, 2005).

[27] A registrant may have section 12(g) reporting obligations following its termination of registration of a class of equity securities under section 12(b): (1) if it initially registered the class of securities under section 12(g) before listing the securities on a national securities exchange; or (2) under Exchange Act Rule 12g-2 (17 CFR 240.12g-2). That rule provides that any class of

ceases.[28]

C. Concerns Regarding the Current Exchange Act Exit Rules

It has been almost four decades since the Commission first adopted the "300 U.S. resident shareholder" standard as the benchmark for determining both when a foreign private issuer must register a class of equity securities under section 12(g) and when it may terminate that registration.[29] Moreover, it has been over two decades since the Commission adopted Form 15 under Rules 12g-4 and 12h-3.[30] Since then, market globalization, advances in information technology, the increased use of American Depositary Receipt ("ADR")[31] facilities by foreign companies to sell and list their

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securities that would have been required to be registered under section 12(g), except for the fact that it was listed and registered on a national securities exchange, is deemed to be registered under section 12(g) upon the termination of registration under section 12(b) as long as the class of securities are not exempt from registration under section 12 and are held of record by 300 or more persons. Exchange Act section 15(d) automatically suspends the duty to file reports under that section regarding securities registered under an effective Securities Act registration statement once the issuer has registered the class of securities under section 12 of the Exchange Act.

[28] Because compliance with Rule 12d2-2 does not depend on the number of an issuer's record holders, termination of registration under section 12(b) does not raise the same concerns for an issuer as under section 12(g) or 15(d). As is currently the case, under the rule amendments reproposed today, a foreign private issuer that has a class of securities registered under section 12(b) will have to comply with Rule 12d2-2 before it can effect termination of registration under section 12(g) or termination of its reporting obligations under section 13(a) or section 15(d). Moreover, as under the current Exchange Act exit regime, a foreign private issuer will have to file a post-effective amendment to terminate the registration of any unsold securities under an existing Securities Act registration statement before it can terminate its registration and reporting under Rule 12h-6.

[29] See Release No. 34-8066 (April 28, 1967).

[30] See Release No. 34-20784 (March 22, 1984), 49 FR 12688 (March 30, 1984).

[31] An ADR is a negotiable instrument that represents an ownership interest in a specified number of securities, which the securities holder has deposited with a designated bank depositary. Use of an ADR facility makes it easier for a U.S. resident to collect dividends in U.S. dollars. Moreover, because the clearance and settlement process for ADRs generally is the same for securities of domestic companies that are traded in U.S. markets, a U.S. holder of an ADR is able to hold securities of a foreign company that trades, clears and settles within automated U.S. systems and

securities in the United States, and other factors have increased significantly the number of foreign companies that have engaged in cross-border securities activities and sought listings in U.S. securities markets, as well as increased the amount of U.S. investor interest in the securities of foreign companies.

Representatives of foreign companies and foreign industry associations have voiced their concerns that the "300 U.S. resident shareholder" standard has become outdated and too easily exceeded by a foreign company that may have engaged in very little recent selling activity in the United States.[32] These representatives have further criticized the exit rules' reliance on the number of U.S. resident shareholders because, with the advent of book-entry recording,[33] it is difficult and costly to arrive at an accurate count of a foreign company's U.S. resident shareholders. These representatives have also been critical of Rule 12h-3 because it merely suspends rather than terminates a company's section 15(d) reporting obligations. As such, years after filing a Form 15, a foreign company may find that it has once again exceeded the 300 U.S. resident shareholder threshold, and thereupon again become subject to section 15(d) reporting duties, without regard to its U.S. market activity.[34]

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within U.S. time periods.

[32] See, for example, the letter from AFEP.

[33] The last three decades have seen the development of a U.S. clearance and settlement system that relies on electronic book-entry to settle securities transactions and transfer ownership rather than one dependent on the use of paper certificates. For an overview of this development, see Release No. 33-8398 (March 11, 2004), 69 FR 12922 (March 18, 2004), the text surrounding n. 104. This movement to electronic book-entry clearance and settlement systems has taken place on a global basis as well, as both developed and developing securities markets have sought to improve efficiency.

[34] Similarly, as some commenters have noted, after terminating its registration regarding a class of securities under section 12(g), with little or no effort on its part, a foreign private issuer may discover at the end of a subsequent fiscal year that it once again has more than 300 U.S. resident

Finally, these representatives have objected to our current rule, which does not permit a foreign private issuer to obtain the Exchange Act Rule 12g3-2(b) exemption[35] if, during the previous 18 months, it has had a class of securities registered under section 12 or a reporting obligation, suspended or active, under section 15(d) of the Exchange Act.[36]

D. The Originally Proposed Rule Amendments

In light of the changes to U.S. capital markets caused primarily by market globalization and advances in information technology, the Commission proposed to amend the rules allowing a foreign private issuer to exit the Exchange Act registration and reporting regime. We proposed to amend Rules 12g-4 and 12h-3 to eliminate the provisions that primarily condition a foreign private issuer's eligibility to cease its Exchange Act reporting obligations on whether the number of its U.S. resident security holders has fallen below the 300 or 500 person threshold. In their place, we proposed new Exchange Act Rule 12h-6 that would permit a foreign private issuer that meets the conditions discussed below to terminate:

- its registration of a class of equity securities under section 12(g) and its resulting section 13(a) reporting obligations; and

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shareholders and, therefore, must register the class of securities anew under that section of the Exchange Act.

[35] Rule 12g3-2(b) provides an exemption from registration under section 12(g) with respect to a foreign private issuer that submits to the Commission, on a current basis, the home country materials required by the rule.

[36] Exchange Act Rule 12g3-2(d)(1) (17 CFR 12g3-2(d)(1)). This exception to the Rule 12g3-2(b) exemption does not apply to registered Securities Act offerings filed by Canadian companies on certain Multijurisdictional Disclosure System ("MJDS") forms. The Rule 12g3-2(b) exemption is also not available for a foreign private issuer's securities issued to acquire by merger or similar transaction an issuer that had securities registered under section 12 or a reporting obligation, suspended or active, under section 15(d), except for a transaction registered on specified MJDS forms. See Exchange Act Rule 12g3-2(d)(2) (17 CFR 240.12g3-2(d)(2)).

- its section 15(d) reporting obligations regarding a class of equity or debt securities.

Under proposed Rule 12h-6, a foreign private issuer would have been eligible to terminate its Exchange Act reporting obligations regarding a class of equity securities if it met one of a set of alternative benchmarks, not based on a record holder count, and which depended on whether the issuer was a well-known seasoned issuer ("WKSI").[37] As proposed, a foreign private issuer could have terminated its Exchange Act registration and reporting obligations:

- if a WKSI, as long as the U.S. average daily trading volume ("ADTV") of the subject class of securities had been no greater than 5 percent of the ADTV of that class of securities in its primary trading market during a recent 12 month period, and U.S. residents held no more than 10 percent of the issuer's worldwide public float as of a specified date; or
- if a WKSI with greater than 5 percent U.S. ADTV, or if a non-WKSI, regardless of U.S. trading volume, U.S. residents held no more than 5 percent of the issuer's worldwide public float as of a specified date.[38]

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[37] For purposes of proposed Rule 12h-6, a "well-known seasoned issuer" would have meant a well-known seasoned issuer as defined in Securities Act Rule 405 (17 CFR 230.405), which would have required the worldwide market value of an issuer's outstanding voting and non-voting common equity held by non-affiliates to be $700 million or more.

[38] If a foreign private issuer was unable to meet one of these proposed benchmarks, but satisfied the other conditions of the rule, it could still have terminated its Exchange Act registration and reporting obligations regarding a class of equity securities as long as that class of securities was held of record by less than 300 persons on a worldwide basis or less than 300 persons resident in the United States as of a specified date. Proposed Rule 12h-6 also included a similar "300 U.S. resident or worldwide holder" standard for debt securities issuers.

Proposed Rule 12h-6 also would have imposed the following conditions on a foreign private issuer before it could terminate its registration and reporting obligations regarding a class of equity securities:

- the issuer must have been an Exchange Act reporting company for the past two years, have filed or furnished all reports required for this period, and have filed at least two annual reports under section 13(a);
- the issuer's securities must not have been sold in the United States in either a registered or unregistered offering under the Securities Act during the preceding 12 months except for a few specified exempt securities or exempt transactions; and
- for the preceding two years, the issuer must have maintained a listing of the subject class of securities on an exchange in its home country, as defined in Form 20-F,[39] which constituted the primary trading market for the securities.

Finally, we also proposed to:

- streamline the counting method used to determine an issuer's U.S. public float or the number of its U.S. shareholders by permitting the look-through to be limited to the United States, the issuer's jurisdication, and, if different, the jurisdiction of its primary trading market;
- permit issuers to rely on the assistance of an independent information services provider when calculating the number of their U.S. resident holders; and

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[39] 17 CFR 249.220f. Form 20-F General Instruction F defines "home country" as the jurisdiction in which the issuer is legally organized, incorporated or established and, if different, the jurisdiction where it has its principal listing.

- permit issuers to establish the Rule 12g3-2(b) exemption for a class of equity securities that was the subject of a Form 15F immediately upon termination of Exchange Act reporting, so long as the issuer publishes its home country materials electronically.

E. Principal Comments Regarding the Proposed Rule Amendments

We received 54 comment letters in response to our proposals. These letters represented the views of over 80 distinct entities, including business and legal associations, foreign companies, depositary banks, stock exchanges and market operators, financial advisory and accounting firms, law firms, foreign governments, and academia. While most commenters supported the purpose and overall structure of the rule proposals, many also believed that the proposed rule amendments would be, like the existing rules, unnecessarily restrictive.

We received the most comments concerning the proposed quantitative benchmarks that would enable a foreign private issuer of equity securities to exit the Exchange Act reporting regime regardless of the number of its U.S. resident shareholders. Numerous commenters urged the Commission to increase significantly the proposed benchmarks based on the calculation of the percentage of an issuer's worldwide public float held by U.S. residents. Several commenters also urged the Commission to adopt the same quantitative standards for smaller companies as for well-known seasoned issuers. Many commenters also suggested the adoption of a rule provision that would permit an issuer to exclude certain holders, such as qualified institutional buyers

("QIBs"),[40] from its U.S. public float percentage determination, as an alternative to adopting significantly raised quantitative benchmarks. Numerous commenters further favored significantly raising the alternative record holder threshold for equity securities issuers and the record holder standard for debt securities issuers.

Other issues raised by commenters included their request:

- to extend termination of Exchange Act reporting under Rule 12h-6 to prior Form 15 filers whose termination of registration or suspension of reporting became effective before the effective date of the new rule;
- to require a shorter prior reporting period for some or all classes of issuers;
- to permit an issuer that has succeeded to the Exchange Act reporting obligations of an acquired company under Exchange Act Rule 12g-3[41] or Rule 15d-5[42] to take into account the reporting history of the acquired company for the purpose of meeting the prior reporting condition under Rule 12h-6;
- to exclude unregistered offerings from the one year dormancy condition;
- to permit an issuer to meet the listing condition requirement if at least 55 percent of the trading volume of the subject class of securities occurs in the aggregate in more than one non-U.S. market;

[40] A QIB is an entity specified under Securities Act Rule 144A (17 CFR 230.144A) that in the aggregate owns at least $100 million in securities of issuers that are not affiliated with the entity.

[41] 17 CFR 240.12g-3.

[42] 17 CFR 240.15d-5.

- to increase the 300 record holder standard, which is included in both the alternative record holder provision for equity securities issuers and the provision for debt securities issuers;
- to extend the Exchange Act Rule 12g3-2(b) exemption to prior Form 15 filers even if 18 months has not elapsed;
- to extend the Rule 12g3-2(b) exemption to successor issuers;
- to permit all issuers having the Rule 12g3-2(b) exemption to publish electronically on their web sites their home country documents; and
- to amend Exchange Act Rule 12g3-2(a), which governs when a foreign private issuer enters the Exchange Act registration and reporting regime under section 12(g), so as to conform that rule to the amended exit thresholds under Rule 12h-6.

F. Summary of the Reproposed Rule Amendments

We have addressed many of the commenters' concerns in the rules that we are reproposing today. Major revisions to the proposed rules include:

- revising the quantitative benchmark provision for an issuer of equity securities by:
    - applying the same quantitative benchmark, which does not require a head count of security holders, to any issuer of equity securities, regardless of size;
    - permitting an issuer to terminate its Exchange Act registration and reporting obligations regarding a class of equity securities, assuming it meets all the other conditions of Rule 12h-6, if the U.S. ADTV of the subject class of

securities has been no greater than 5 percent of the ADTV of that class of securities in the issuer's primary trading market during a recent 12 month period, regardless of the size of its U.S. public float;

- requiring an issuer to wait 12 months before filing its Form 15F[43] in reliance on the trading volume standard if the issuer has delisted its class of equity securities from a national securities exchange or automated inter-dealer quotation system in the United States,[44] and, at the time of delisting, the U.S. ADTV of the subject class of securities exceeded 5 percent of the ADTV of that class of securities in the issuer's primary trading market for the preceding 12 months; and
- further requiring an issuer to wait 12 months before filing its Form 15F in reliance on the trading volume standard if the issuer has terminated an American Depositary Receipts (ADR) facility;

- shortening the prior reporting period required for an issuer of equity securities so that, under the reproposed rules, an issuer must have at least one year of Exchange Act reporting, must be current in reporting obligations for that period, and have filed at least one Exchange Act annual report;

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[43] Like current Rules 12g-4 and 12h-3, which require the filing of Form 15, reproposed Rule 12h-6 would require the filing of a form--Form 15F--by which an issuer would certify that it meets the conditions for ceasing its Exchange Act reporting obligations.

[44] Neither the OTC Bulletin Board operated by the NASD nor the market operated by the Pink Sheets LLC are deemed to be automated inter-dealer quotation systems. See Release 33-6862 (April 23, 1999), n.22.

- permitting an issuer of equity securities during the one year dormancy period to sell unregistered securities exempted under the Securities Act, including securities sold in section 4(2) private placements,[45] pursuant to Securities Act Rule 144A,[46] under section 3(a)(10) schemes of arrangement,[47] and pursuant to Securities Act Rules 801 and 802;[48]
- expanding the types of registered offerings that are excluded from the dormancy condition's prohibition against the sale of registered securities, so that, in addition to permitting registered securities sold to its employees or by selling shareholders in a non-underwritten offering, an issuer may issue registered securities upon the exercise of outstanding rights that have been granted pro rata to all security holders, pursuant to a dividend or interest reinvestment plan, or upon the conversion of outstanding convertible securities;
- revising the proposed home country listing condition for an issuer of equity securities by:
  - shortening the minimum period of required non-U.S. listing to one year;
  - permitting an issuer to have maintained that listing in a foreign jurisdiction that, either singly or together with one other foreign jurisdiction, constitutes the primary trading market for the issuer's subject class of

[45] 15 U.S.C. 77d(2).

[46] 17 CFR 230.144A.

[47] 15 U.S.C. 77c(a)(10).

[48] 17 CFR 230.801 and 230.802.

securities;

- revising the definition of "primary trading market" to mean that at least 55 percent of the trading in the foreign private issuer's subject class of securities took place in, on or through the facilities of a securities market or markets in no more than two foreign jurisdictions; and
- requiring that, if an issuer aggregates the trading of its securities in two foreign jurisdictions for the purpose of Rule 12h-6, the trading market for the issuer's securities in at least one of the two foreign jurisdictions must be larger than the U.S. trading market for the issuer's securities;

- revising the proposed counting method to apply only to an issuer's determination of its U.S. resident holders under the reproposed 300 record holder standard for equity and debt securities issuers, and to provide that an issuer that aggregates the trading volume of its securities in two foreign jurisdictions for the purpose of meeting the listing condition under Rule 12h-6 would have to look through nominee accounts in both foreign jurisdictions, which comprise its primary trading market, as well as in the United States and in its jurisdiction of incorporation if different from the two jurisdictions that comprise its primary trading market;
- revising the proposed scope of Rule 12h-6 to extend termination of Exchange Act reporting to a successor issuer that meets specified conditions;
- revising the proposed scope of Rule 12h-6 to extend termination of Exchange Act reporting to a foreign private issuer that filed a Form 15 and thereafter suspended or terminated its Exchange Act reporting obligations

before the effective date of Rule 12h-6, as long as:

- since the effective date of its termination or suspension of reporting under Form 15, the issuer has not engaged in any transaction or triggered any threshold that, under the current rules, would require it to resume or assume anew Exchange Act reporting obligations;
- the issuer files a Form 15F; and
- if its Form 15 applied to a class of equity securities, the issuer has satisfied Rule 12h-6's "primary trading market" listing condition for that class of securities;

- extending the Rule 12g3-2(b) exemption to a foreign private issuer, including a successor issuer, immediately upon its termination of reporting under Rule 12h-6;
- extending the Rule 12g3-2(b) exemption to a foreign private issuer that previously filed a Form 15, and thereafter terminated or suspended its Exchange Act reporting obligations regarding a class of equity securities before the effective date of Rule 12h-6, immediately upon the effectiveness of its termination of reporting under Rule 12h-6; and
- permitting a non-reporting company that has received or will receive the Rule 12g3-2(b) exemption, upon application to the Commission and not pursuant to Rule 12h-6, to publish its "ongoing" home country documents required under Rule 12g3-2(b)(1)(iii)[49] on its Internet Web site rather than submitting them in paper to the Commission.

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[49] 17 CFR 240.12g3-2(b)(1)(iii).

We are reproposing other proposed provisions with little to no change. These provisions include:

- the alternative record holder provision for equity issuers and the provision for debt securities issuers, both of which retain the current 300 record holder standard, as proposed;
- the provision permitting an issuer of equity or debt securities to rely on the assistance of an independent information services provider when calculating the number of its U.S. resident security holders;
- the requirement that a foreign private issuer publish a notice, such as a press release, which announces its intention to terminate its Exchange Act reporting obligations, except that instead of the proposed requirement that the notice be published at least 15 business days before the filing of the Form 15F, we are reproposing to require that an issuer publish the notice before or at the time of filing of the Form 15F;
- the automatic suspension of an issuer's Exchange Act reporting obligations upon the filing of its Form 15F followed by a 90 day waiting period at the end of which, assuming the Commission has no objections, the suspension becomes a termination of reporting;
- the form and content of Form 15F, except that we have modified proposed Form 15F to conform to the changes to the proposed rule amendments that we are reproposing today; and
- the electronic furnishing of home country information on the Internet Web site of an issuer that has obtained the Rule 12g3-2(b) exemption upon the

termination of its Exchange Act reporting obligations under Rule 12h-6.

We believe the rules we are reproposing today are consistent with the protection of U.S. investors. These rules would establish a new benchmark that reflects the balancing of potential benefits to U.S. investors, in the form of increased investment opportunities in foreign private companies listing in the United States, and the potential loss of the full protections of the Exchange Act for U.S. investors in foreign private issuers that elect to terminate their Exchange Act registration and reporting under reproposed Rule 12h-6. Compared to the current exit rules, the reproposed rule amendments would establish a more clearly defined process with more appropriate benchmarks by which a foreign private issuer can terminate its Exchange Act reporting obligations if, after a period of time, U.S. market interest is not significant relative to non-U.S. market interest. As a result, we believe foreign private issuers should be more willing initially to register their securities with the Commission, to the benefit of investors.

At the same time, we believe the conditions that determine a foreign private issuer's eligibility to terminate its Exchange Act registration and reporting under reproposed Rule 12h-6 will serve to protect U.S. investors. For example, the prior reporting condition is intended to provide investors with at least one complete year's worth of Exchange Act reports, including an annual report, upon which they can base their investment decisions about a particular foreign registrant before it exits the Exchange Act reporting system. The dormancy condition is designed to deter a foreign private issuer's promotion of U.S. investor interest through recent registered capital-raising before exiting our reporting system. The foreign listing condition and U.S.

trading volume benchmark support our view that, before a foreign private issuer may terminate its Exchange Act reporting obligations under Rule 12h-6, it must be subject to an ongoing disclosure and financial reporting regime, and have a significant market following, in its home market. The condition restricting the ability of an issuer to rely on the trading volume standard under specified circumstances should deter an issuer from excluding U.S. investors, particularly retail investors, from investing in their securities when U.S. market interest is still significant. The immediate availability of the exemption under Rule 12g3-2(b) would foster access by U.S. investors to ongoing home country information about an issuer after it terminates its Exchange Act registration and reporting under Rule 12h-6. Finally, the conditions relating to the filing of Form 15F and the publication of a press release or other notice would promote transparency in the exit process.

II. DISCUSSION

A. Conditions For Equity Securities Issuers

1. Quantitative Benchmarks

a. Non-Record Holder Benchmark

As reproposed, Rule 12h-6 would enable a foreign private issuer, regardless of size, to qualify for termination of its Exchange Act reporting by meeting a quantitative benchmark provision that does not depend on the number of its U.S. record holders or the percentage of its securities held by those holders. Specifically, an issuer would be able to terminate its Exchange Act registration and reporting obligations regarding a class of equity securities, assuming it meets the other conditions of Rule 12h-6, if the ADTV of the subject class of equity securities in the United States has been 5 percent or less of the

ADTV of that class of securities in the issuer's primary trading market during a recent 12-month period.[50]

Although numerous commenters supported the adoption of a quantitative benchmark that is not based on the number of an issuer's U.S. shareholders, many commenters expressed concern that, based on their projections, too few existing reporting foreign private issuers would be eligible to terminate their Exchange Act registration and reporting obligations under the proposed benchmarks.[51] The proposed benchmarks were based either on a combination of U.S. public float and trading volume criteria or solely on U.S. public float data. According to these commenters, the proposed rules, if adopted, would continue to discourage foreign companies from entering U.S. public capital markets.[52]

While many commenters supported significantly increasing the proposed U.S. shareholder standard to a 25 percent threshold,[53] there was less agreement on whether a particular class of security holders should be included when making the U.S. public float

[50] Reproposed Rule 12h-6(a)(4)(i). When calculating its U.S. ADTV, an issuer would have to take into account all U.S. trading of its subject securities, whether occurring on a registered national securities exchange or elsewhere, as reported through the U.S. transaction reporting plan. It would then divide its U.S. ADTV by the ADTV in the one or two jurisdictions that comprise its primary trading market. For a discussion of how an issuer would make its primary trading market determination under reproposed Rule 12h-6, see Part II.A.4. of this release.

[51] See, for example, the letter of Sullivan & Cromwell.

[52] See, for example, the letter, dated February 28, 2006, of Cleary Gottlieb Steen & Hamilton LLP ("Cleary Gottlieb letter").

[53] See the letter from the European Commission, the letter, dated February 28, 2006, from the European Association for Listed Companies and other designated associations of publicly traded European companies ("EALIC"), and the letters from the American Bar Association, Section of Business Law ("ABA (Business)"), Linklaters, Cleary Gottlieb, and Cravath, Swaine and Moore ("Cravath").

determination. Some commenters suggested the possible exclusion of a number of classes of investors, such as qualified institutional buyers ("QIBs"), the top five or ten U.S. shareholders of an issuer's equity securities, and U.S. shareholders owning more than a specified amount (for example, $10 million) of an issuer's equity securities.[54] Others supported the inclusion of all U.S. investors, regardless of type.[55]

Another commenter supported a quantitative benchmark based solely on trading volume criteria because that would best indicate the impact of U.S. deregistration on the broader market for the foreign issuer's securities.[56] Although we initially did not propose such an approach, after reconsideration, we now believe that a new quantitative benchmark based solely on trading volume may more efficiently further the purposes of this rulemaking.

One advantage to a benchmark based solely on trading volume is that it is a fairly direct measure of U.S. market interest in a foreign private issuer's securities at a particular time. Another factor in favor of a trading volume only benchmark is that trading volume data for the U.S. and an issuer's primary market is easier to obtain and confirm than is the data required for a U.S. public float or record holder determination. As commenters have noted, it is difficult for a reporting foreign private issuer to determine accurately the specific identities of its U.S. investors.[57] A public float benchmark would require such a

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[54] See, for example, the letters from the European Commission, EALIC and Cleary Gottlieb.

[55] See the letters from the New York Stock Exchange and Galileo Global Advisors.

[56] See the letter from Fried, Frank, Harris, Shriver & Jacobson. Earlier letters from EALIC and Cleary Gottlieb, dated February 9, 2004, suggested a similar approach.

[57] See, for example, the letter, dated March 18, 2005, from Cleary Gottlieb.

determination to varying degrees, particularly if classes of investors are excluded. As a result, the reproposed benchmark, based solely on trading volume, should result in reduced costs to issuers in determining whether they can terminate their Exchange Act reporting obligations.

Various markets may measure and report trading volume differently. For example, dealer interpositioning in dealer markets may result in a higher reported volume in securities transactions. In our other rules that use ADTV as a measure, however, we have not found it necessary or appropriate to make distinctions based on the type of market on which a security is traded for purposes of determining ADTV.[58] Nonetheless, as noted below, we seek comment as to whether Rule 12h-6 should take into account in some fashion the fact that ADTV may not be measured uniformly across trading markets.

Reproposed Rule 12h-6 does not mandate or expressly specify acceptable information sources for determining ADTV. This is consistent with other rules that use ADTV as a measure.[59] Issuers should have flexibility in determining the ADTV of their securities in the appropriate markets from information that is generally widely available from a number of reliable sources. Nonetheless, as noted below, we seek comment as to whether Rule 12h-6 should specify one or more acceptable sources of ADTV information.

As originally proposed, Rule 12h-6 would have established different deregistration thresholds for well-known seasned issuers ("WKSIs"). Many commenters opposed having different standards for WKSIs and smaller companies. Those

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[58] See Regulation M, 17 CFR 242.100-105, and Release No. 33-7375 (December 20, 1996).

[59] See, for example, the definition of ADTV in Regulation M at 17 CFR 242.100.

commenters maintained that smaller companies should benefit from the full range of options available to WKSIs under the new rule since the costs of Exchange Act reporting generally are disproportionately greater for smaller companies than for larger companies.[60] These comments have persuaded us to propose the same trading volume standard for smaller issuers as for larger issuers. Having the same benchmark for any foreign private issuer of equity securities, regardless of size, should add increased flexibility and simplification to the Exchange Act deregistration regime.[61] Moreover, setting the percentage of U.S. trading volume at a low level, at 5% of trading volume in the primary market, would serve to protect U.S. investors.

i. One Year Ineligibility Period After Delisting

Because the principal quantitative measure under proposed Rule 12h-6 would be based on a comparison of the trading volume in the United States and in one or two foreign markets of a foreign private issuer's equity securities, the rule should be structured so as not to create an incentive for a foreign private issuer to delist its securities from a U.S. exchange for the purpose of decreasing its U.S. trading volume. Indeed, as one commenter suggested, if we were to adopt a measure based solely on trading volume, a foreign private issuer that delisted its securities from a U.S. exchange

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[60] See the letters from the European Commission, PricewaterhouseCoopers and Cleary Gottlieb.

[61] In the Proposing Release, in support of separate standards for WKSIs and non-WKSIs, we noted that there typically is a greater flow of information about a WKSI, both from the issuer and its analysts, than about a smaller company, and that this flow of information is more likely to continue after the WKSI's termination of reporting. After considering the numerous comments opposing a rule based on WKSI status, we are of the view that, the proposed rules, if adopted, could well discourage smaller foreign companies from entering U.S. public capital markets, to the detriment of U.S. investors. In addition, we note that both smaller and larger companies will have to publish their material home country documents on their Internet Web sites as a condition to maintaining the Rule 12g3-2(b) exemption received upon termination of reporting under Rule 12h-6.

before its trading volume fell below the applicable percentage should not be eligible to terminate its registration under such a standard.[62]

Companies should not be unnecessarily restricted in choosing the markets in which they wish their securities to trade. As a result, we do not believe that delisting from a U.S. exchange should result in a bar against a foreign private issuer from using the reproposed rule. Nonetheless, we share the concern about a possible negative impact stemming from a measure based solely on trading volume. In addition, by requiring companies to remain registered and reporting under the Exchange Act for a period of time after delisting when, before delisting, the company had a relatively active U.S. market for its securities, U.S. investors will have access to information prepared in accordance with the Commission's financial reporting and disclosure requirements for a period of time during which, most likely, the U.S. market will be diminishing.

To address these concerns, we are proposing, as a condition to the use of the trading volume standard of Rule 12h-6 and corresponding eligibility to file Form 15F, that if a foreign private issuer has had its equity securities delisted from a registered national securities exchange or automated inter-dealer quotation system within one year before filing the Form 15F, it must have satisfied the trading volume percentage as of the date of delisting, and as measured over the 12 months preceding the date of delisting. Under this proposed condition:

- a listed foreign private issuer that satisfied the trading volume condition would be able to delist from its stock exchange and terminate its Exchange Act registration and reporting obligations concurrently; and

[62] See the letter, dated February 9, 2004, from Cleary Gottlieb.

- a listed foreign private issuer that did not satisfy the trading volume condition would be able to delist but would not be eligible to file a Form 15F and terminate its Exchange Act registration and reporting obligations until one year after the date of delisting, assuming that, at the date of filing its Form 15F, its U.S. ADTV for the recent 12 month period subsequent to its delisting did not exceed 5% of the ADTV in the issuer's primary trading market.[63]

ii. One Year Ineligibility Period After Termination of ADR Facility

Many foreign issuers have their securities trade in the United States in the form of American Depositary Receipts ("ADRs"). It appears that the current rules relating to termination of Exchange Act reporting by foreign private issuers may, as an unintended consequence, encourage foreign private issuers to terminate their ADR facilities as they seek to have fewer than 300 U.S. resident holders of their securities.[64] When an issuer terminates its ADR facility, the holders of ADRs generally have the option to make arrangements to hold the underlying securities directly. However, if holders are unable or unwilling to make these arrangements, or to pay the costs associated with these arrangements, the holders will have their investment cashed out, that is, the underlying securities will generally be sold into the home market and the net proceeds (after

[63] Proposed Note 1 to paragraph (a)(4) of reproposed Rule 12h-6. An issuer that failed to meet the trading volume standard at the date of delisting would have to meet the trading volume standard one year later when filing its Form 15F. If, notwithstanding its delisting, an active U.S. over-the-counter market in the company's securities continued, the company would not be eligible to use proposed Rule 12h-6 and file a Form 15F in reliance on the trading volume benchmark.

[64] One ADR depositary bank commented that it has recently been involved in at least a dozen ADR facility terminations for this purpose, which have eliminated thousands of U.S. retail holders. See the letter from the Bank of New York.

deducting fees and expenses of the selling broker and the depositary bank) remitted to the former ADR holders.

We believe foreign issuers should be encouraged to maintain their ADR facilities, even when they delist from a U.S. market and terminate their Exchange Act reporting obligations. After a foreign issuer delists and deregisters, its ADRs should continue to be able to be traded in the over-the-counter market in the United States. The termination of ADR facilities has a detrimental impact on holders, imposing fees and other charges on investors and, when investors are cashed out, subjecting investors to unplanned tax consequences. In addition, the termination of ADR facilities will effectively limit the ability of many U.S. investors to purchase the securities of the subject foreign company.

To address these concerns, we are proposing, as a condition to the use of Rule 12h-6 and eligibility to file Form 15F in reliance on the trading volume provision, that a foreign private issuer shall not have terminated any sponsored ADR facility within the 12 month period before filing the Form 15F.

Comment Solicited

We solicit comment on the proposed trading volume benchmark and on the proposed conditions restricting its use:

- Is the proposed trading volume benchmark an appropriate measure of the relative U.S. market interest in a foreign private issuer's securities?
- We assume that U.S. trading volume numbers reflect U.S. investor interest and U.S. resident trading activity in a security. We request data on the accuracy of these assumptions.

- Would the proposed trading volume benchmark provide adequate U.S. investor protection, particularly of retail investors?
- Would the proposed trading volume benchmark affect the OTC trading in the securities of foreign issuers? If so, how so? Would investors in those OTC securities be adquately protected by the proposed trading volume benchmark?
- Is the proposed trading volume benchmark preferable to the originally proposed benchmarks that were based either, if a WKSI, on a combination of trading volume and public float criteria, or solely on public float criteria?
- If the proposed trading volume threshold is preferable, is the threshold set at the appropriate level (5%)? Should it be set, instead, at a lower level, for example, 3% or 1%, or a higher level, for example, 7% or 10%?[65]
- Should the proposed trading volume benchmark require the measurement of the issuer's ADTV over a recent 12 month period, as proposed? Should it be measured over a shorter period, say, 6 months, 3 months, or two months, or over a longer period, for example, 18 months or 24 months? Would a longer or shorter period be more or less susceptible to manipulation or other distorting effects regarding certain transactions?
- Should the proposed trading volume benchmark require an issuer to measure U.S. trading volume as a percentage of its worldwide trading volume, rather than as a percentage of the trading volume in its primary market, as proposed? If so, should an issuer only have to obtain trading volume data from foreign

[65] We encourage commenters to provide appropriate economic support for any suggested change in the reproposed trading volume benchmark.

jurisdictions in which it has listed its securities in addition to the United States? If the proposed benchmark should measure U.S. trading volume as a percentage of worldwide trading volume, should we reduce the threshold, for example, to 3% or 1%, to take account that some issuers many be listed or traded in several markets?

- Are there difficulties associated with determining trading volume in the United States or foreign markets for purposes of reproposed Rule 12h-6? How should the rule deal with any such difficulties?
- Should the U.S. ADTV component of the proposed trading volume benchmark include all U.S. trading in the subject class of securities, whether listed or over-the-counter, as proposed?
- Should the proposed trading volume benchmark require an issuer to obtain trading volume data from particular sources? Should the reproposed rule instead provide safe harbor procedures regarding sources that an issuer may use, but would not be required to use, to obtain trading volume data? If so, what are those procedures or sources?
- Should the proposed trading volume benchmark require an issuer to account for differences in calculating trading volume between different types of markets? If so, how should such differences be taken into account?
- Should one trading volume standard apply to all issuers, regardless of size, as proposed? Should we instead adopt different trading volume standards depending, for example, on the size of the issuer's U.S. public float?

- Would it be more appropriate to adopt an absolute trading volume measure that would require an issuer's U.S. trading volume not to have exceeded a specified amount for a 12 month period? If so, what should be the specified amount? What factors should determine that amount?
- Would the proposed trading volume benchmark create any unanticipated incentives in foreign private issuers that are undesirable? For example, is there a potential for manipulation in the calculation of average trading volume under reproposed Rule 12h-6? If so, how should we address it?
- What are the approximate costs that an issuer is expected to incur when determining whether it meets the proposed trading volume threshold? Are these costs lower or higher than the costs that an issuer would incur under the originally proposed benchmarks?
- Should we adopt the originally proposed benchmarks instead?
- Should we instead adopt a benchmark or benchmarks that use public float criteria, with or without a trading volume component, but that are set at a higher level than the originally proposed public float benchmarks? For example, should we adopt a standard that permits deregistration if an issuer's U.S. public float is no greater than 15%, 20%, or 25% of its worldwide public float? Should the issuer's status as a WKSI be a factor?
- Is it appropriate to require an issuer to wait one year before being eligible to rely on Rule 12h-6's trading volume standard after delisting its securities from a U.S. stock market when, at the time of the delisting, the issuer did not satisfy the trading volume condition, as proposed?

- If so, should we adopt a one year ineligibility period, as proposed? Should the period be more than one year, for example, 15, 18 or 24 months? Should it be shorter than one year, for example, six or nine months?
- Should we apply the proposed one year ineligibility period relating to delisting to issuers that delisted before the effective date of Rule 12h-6? If not, what type of relief should be provided to those issuers?
- Is it appropriate to require an issuer to wait one year before being eligible to use proposed Rule 12h-6 after terminating its ADR facility?
- If so, should we adopt a one year ineligibility period, as proposed? Should the period be more than one year, for example, 15, 18 or 24 months? Should it be shorter than one year, for example, six or nine months?
- Should the one year ineligibility condition apply only when, at the date of termination of its ADR facility, the ADTV of the issuer's U.S. market exceeded 5% of the ADTV in its primary trading market for the preceding 12 months?
- Should we adopt a condition requiring an issuer to maintain a sponsored ADR facility for a certain period of time following its deregistration under Rule 12h-6? If so, should the period be six months, more than six months, for example, three months, or longer than six months, for example, a year following deregistration?
- Should we apply the proposed condition relating to the termination of an ADR facility to issuers that terminated their ADR facilities before the effective date of Rule 12h-6? If not, what type of relief should be provided to those issuers?

b. Alternative 300 Holder Condition

As an alternative to the proposed trading volume benchmark provision, reproposed Rule 12h-6 would permit a foreign private issuer to terminate its Exchange Act reporting obligations regarding a class of equity securities if it has less than 300 record holders on a worldwide basis or who are U.S. residents as long as the issuer meets the rule's other conditions.[66] The purpose of this alternative 300 holder condition is to enable an issuer to terminate its Exchange Act reporting obligations if it cannot satisfy the new trading volume benchmark but does meet the current 300 holder standard. Otherwise, an issuer could find itself worse off under Rule 12h-6 than under the current exit rules.[67]

While numerous commenters supported having an alternative record holder condition, most requested that the Commission significantly raise the 300 holder threshold.[68] Many supported an increase to 3,000 while others requested an increase to 500 or 1,000. Some commenters also requested that the Commission raise the record holder "entrance" threshold in Rule 12g3-2(a) to conform to any record holder increase in the new exit rule.

We are not proposing to increase the 300 holder threshold for foreign private issuers either in the exit or entrance rules at this time. We understand that, due to the

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[66] Proposed Rule 12h-6(a)(4)(ii).

[67] The reproposed alternative record holder condition is substantially the same as the proposed condition. We did not originally propose, and we are not now proposing, a similar 500 record holder condition, although one exists in the current rules for a small issuer with total assets that have not exceeded $10 million for its most recent three fiscal years. Based on current experience, we believe foreign private issuers seldom use the current standard.

[68] See, for example, the letters from Cleary Gottlieb and Linklaters.

increased internationalization of the U.S. securities markets in recent decades, the 300 holder standard may not reflect current market conditions and, therefore, may require updating. However, the principal purpose for retaining the 300 holder provision is to preclude disadvantaging those companies that could terminate their Exchange Act reporting obligations under the current exit rules but not under the proposed trading volume condition. In addition, since domestic registrants are subject to a substantially similar record holder standard, we believe any change would be more appropriately considered as part of a comprehensive evaluation of the record holder provisions in both the Exchange Act entrance and exit rules for both domestic and foreign registrants.[69]

Comment Solicited

We solicit comment on the reproposed alternative 300 holder condition:

- Would it be appropriate to adopt a 300 holder standard as an alternative to the proposed trading volume standard, as reproposed?
- Should we require an issuer to wait one year after terminating its ADR facility or after delisting before being eligible to rely on the 300 holder condition, as we have proposed for the trading volume standard?
- Does the adoption of the proposed trading volume benchmark obviate the need to increase the 300 holder standard under reproposed Rule 12h-6?

[69] In this regard, we note that the Advisory Committee on Smaller Public Companies has made recommendations relating to Exchange Act registration and termination of registration. See the Final Report of the Advisory Committee on Smaller Public Companies, dated April 23, 2006, which is available at http://www.sec.gov/ info/ smallbus/acspc/acspc-finalreport.pdf.

2. Prior Exchange Act Reporting Condition

We are reproposing a prior Exchange Act reporting condition that a foreign private issuer must meet before it can terminate its section 12(g) registration or its section 15(d) reporting obligations regarding a class of equity securities under Rule 12h-6.[70] This condition would require an issuer of equity securities to have had reporting obligations under section 13(a) or section 15(d) of the Exchange Act for at least the 12 months preceding the filing of Form 15F, to have filed or furnished all reports required for this period, and to have filed at least one annual report pursuant to section 13(a) of the Exchange Act. The purpose of this prior Exchange Act reporting condition is to provide investors in U.S. securities markets with a minimum period of time to make investment decisions regarding a foreign private issuer's securities based on the information provided in an Exchange Act annual report and the interim home country materials furnished in English under cover of Form 6-K.[71]

Originally proposed Rule 12h-6 would have required a foreign private issuer to have had Exchange Act reporting obligations for the two years preceding the filing of its Form 15F and to have filed at least two Exchange Act annual reports before it could terminate its Exchange Act reporting obligations regarding a class of equity securities. Several commenters objected to this two year reporting condition on the grounds that it would impose a stricter reporting requirement than is the case under the current exit

[70] Reproposed Rule 12h-6(a)(1).

[71] Under cover of a Form 6-K (17 CFR 249.306), a foreign private issuer is required to furnish in English a copy of any document that it publishes or is required to publish under the laws of its home country or the requirements of its local exchange or that it has distributed to shareholders, and which is material to an investment decision.

rules.[72] Some noted that section 15(d) and Rule 12h-3 only require at a minimum the filing of one Exchange Act annual report. Others stated that there is no mandatory minimum reporting requirement under section 12(g) and Rule 12g-4.[73]

Still other commenters opposed a prior reporting condition that required an issuer to have furnished all Form 6-K reports required during the applicable period. Those commenters stated that this requirement would make the rule unavailable if a foreign private issuer did not submit a single required Form 6-K report during the period because it was unsure of the underlying home country document's materiality.[74]

In order to prevent the rule from imposing a significantly greater burden on a foreign private issuer than the current exit regime, we propose to reduce the required prior reporting period to at least 12 months and require only one Exchange Act annual report. However, the reproposed rule would also require a foreign private issuer to have submitted all Form 6-Ks required during the 12 months preceding the filing of its Form 15F in order to be eligible to terminate its reporting obligations regarding a class of equity securities. This requirement would help ensure that a U.S. investor is able to access through EDGAR[75] and in English all material interim information about a foreign private issuer as required by its home country. We believe this investor protection concern outweighs any difficulty that a foreign private issuer may experience when determining whether a particular home country document is material, particularly since a

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[72] See the letters from Simpson Thacher & Bartlett and the New York State Bar Association.

[73] See the letter from Skadden, Arps, Slate, Meagher & Flom.

[74] See the letter from Cleary Gottlieb.

[75] EDGAR is the Commission's Electronic Data Gathering, Analysis and Retrieval System.

foreign private issuer must routinely make materiality judgments under existing Exchange Act reporting requirements.

From a practical point of view, the proposed 12-month prior reporting requirement should not be problematic since, based on current experience, most foreign companies that register securities with the Commission, including solely under Exchange Act section 12(g), stay in the U.S. market for at least a year and file at least one Exchange Act annual report.[76] Moreover, the prior reporting condition would require that a foreign private issuer must be current in its reporting obligations, not that it must have timely filed all reports required during the 12 month period. In the event that an issuer determines that it should have filed a Form 6-K during this period, it can do so before it files its Form 15F.[77]

Comment Solicited

We solicit comment on the reproposed prior Exchange Act reporting condition:

- Is it appropriate to require, as a condition of deregistration under Rule 12h-6, that an issuer have been an Exchange Act reporting company for at least the 12 months prior to the filing of its Form 15F, and to have filed or submitted all Exchange Act reports, including one annual report, for that period, as reproposed?

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[76] See the letter from PricewaterhouseCoopers, which, when maintaining that a two-year reporting period was unnecessary, stated its belief that "companies would not generally incur the cost to become an SEC registrant if they intended to deregister within a two-year period." See also Commission staff's annual review of foreign private issuers that are Exchange Act reporting companies at the end of each calendar year ("International Registered and Reporting Companies" Reports), which are available at the Commission's Internet Web site at http://www.sec.gov/divisions/corpfin/internatl/companies.shtml.

[77] See Part II.D.1. of this release for a discussion of the application of reproposed Rule 12h-6, including its prior reporting condition, to successor issuers.

- Should this time period be longer in order to provide U.S. investors with a history of Exchange Act reports, including financial reports?
- If a foreign private issuer seeking to deregister has not timely filed its reports, should any adopted rule require a period of time to elapse within which the issuer would have to be both current and timely before it could file its Form 15F to cease its Exchange Act reporting obligations? If so, should the required period be one month or a period longer or shorter than one month?

3. The One Year Dormancy Condition

As reproposed, a foreign private issuer would also have to comply with a one year dormancy condition before it could terminate its Exchange Act registration and reporting obligations regarding a class of equity securities under Rule 12h-6.[78] As reproposed, Rule 12h-6 would prohibit sales of a foreign private issuer's securities in the United States in a registered offering under the Securities Act during the 12 months preceding the filing of its Form 15F other than securities issued:

- to the issuer's employees;
- by selling security holders in non-underwritten offerings;
- upon the exercise of outstanding rights granted by the issuer if the rights are granted pro rata to all existing security holders of the class of the issuer's securities to which the rights attach;
- pursuant to a dividend or interest reinvestment plan; or

[78] Reproposed Rule 12h-6(a)(2).

- upon the conversion of outstanding convertible securities or upon the exercise of outstanding transferable warrants issued by the issuer.

The primary purpose of the dormancy condition's prohibition of registered offerings is to preclude a foreign private issuer from exiting the Exchange Act reporting system shortly after it has engaged in U.S. capital raising.

As originally proposed, Rule 12h-6 would have excepted from the dormancy condition's prohibition of sales of an issuer's registered securities in the United States only securities sold to an issuer's employees and those sold by selling security holders in non-underwritten offerings. The reproposed rule retains these exceptions because, as we noted in the Original Proposing Release, these sales are not undertaken primarily for capital-raising purposes or for the benefit of the issuer. The reproposed rule continues to prohibit sales of an issuer's securities by its selling security holders in an underwritten registered offering, despite some commenters who opposed this prohibition,[79] because there is a greater likelihood of issuer involvement in a U.S. underwritten offering than in a non-underwritten offering of selling security holders.

At the suggestion of some commenters, we propose to add three additional exceptions to the dormancy condition's prohibition of sales of an issuer's registered securities:[80] the issuance of registered securities pursuant to pro rata rights offerings, dividend or interest reinvestment plans, and the conversion of outstanding convertible securities. These transactions may occur for reasons unrelated to capital raising or for the benefit of the issuer, for example, to benefit current security holders or for the

[79] See the letter from Cravath.

[80] See the letter from ABA (Business).

convenience of investors. However, the reproposed rule also provides that these exceptions do not apply to securities issued pursuant to a standby underwritten offering or other similar arrangement in the United States. This limitation is consistent with the Commission's previous treatment of these three types of registered offerings.[81]

As originally proposed, Rule 12h-6 would also have precluded a foreign private issuer from engaging in unregistered offerings in the United States during the dormancy period, other than those involving securities sold to its employees, securities exempt from registration under section 3 of the Securities Act[82] (except section 3(a)(10)) and obligations having a maturity at the time of issuance of less than nine months and exempted under section 4(2) of the Securities Act. We proposed to prohibit unregistered offerings, such as private placements, under the dormancy condition in order to prevent a foreign company that has actively engaged in U.S. capital raising efforts and sold securities to U.S. investors relatively recently from exiting the Exchange Act reporting regime under Rule 12h-6 on the grounds that the U.S. securities markets no longer represent as viable an option for capital raising. In addition, we believed that proscribing only registered offerings could act as a disincentive to a foreign private issuer to conduct a registered offering in the United States.

Numerous commenters urged the Commission to exclude unregistered offerings from the one year dormancy condition on the grounds that an issuer that has engaged in exempted offerings, such as Rule 144A or section 4(2) private placements, has not taken advantage of its status as a reporting company since both reporting and non-reporting

[81] Instruction 2 to Item 8 of Form 20-F imposes a similar limitation.

[82] 15 U.S.C. 77c.

companies may engage in those exempted offerings, and since, without a contractual undertaking, purchasers in those offerings are not entitled to the full protections of the U.S. federal securities laws.[83] Many commenters also warned that, unless the Commission excluded from the dormancy requirement exempted unregistered offerings, such as rights offerings exempt under Securities Act Rule 801 or exchange offers exempt under Securities Act Rule 802, foreign private issuers would systematically exclude U.S. investors from these offerings,[84] thereby running counter to the Commission's stated goal of encouraging foreign companies to include U.S. holders in these offerings on an equal basis with foreign security holders when it adopted the cross-border transaction safe harbors of Securities Act Rules 801 and 802 and the Tier 1 tender offer rules.[85]

Several commenters specifically opposed including schemes of arrangement exempted under Securities Act section 3(a)(10) within the scope of the dormancy condition. Those commenters noted that many schemes of arrangement are undertaken for non-capital raising purposes, for example, to effect a redomicile or reorganization for tax purposes.[86] Others believed that prohibiting only registered offerings under the dormancy condition would only marginally encourage issuers to engage in unregistered offerings instead of registered ones, if at all.[87]

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[83] See, for example, the letters from Cravath, the New York State Bar, and Skadden Arps.

[84] See, for example, the letter from Linklaters.

[85] See Release No. 33-7759 (October 26, 1999), 64 FR 61382 (November 10, 1999).

[86] See, for example, the letter from Cleary Gottlieb.

[87] See the letter from Linklaters.

These comments have persuaded us that adoption of the originally proposed dormancy condition could well drive many private placement financings and other unregistered offerings by foreign companies offshore, to the detriment of U.S. investors and U.S. broker-dealers, since many companies might prefer to finance outside the United States under Regulation S than inside the United States, for example, under section 4(2) and Rule 144A, in order to avoid triggering the dormancy condition. Therefore, we are reproposing a dormancy condition that is significantly less restrictive in scope than the proposed condition. The reproposed rule would permit the unregistered sale of securities that are exempted under the Securities Act. The permitted category of securities would include sales pursuant to section 4(2), Regulation D, Rule 144A, Rules 801 and 802, and exempt securities under section 3, including section 3(a)(10) of the Securities Act.

At the request of several commenters, the reproposed rule would include the definition of "employee" under Form S-8[88] for the purpose of applying the dormancy condition under Rule 12h-6.[89] That definition includes any employee, director, general partner, certain trustees, certain insurance agents, and former employees as well as executors, administrators or beneficiaries of the estates of deceased employees, and a family member of an employee who has received shares through a gift or domestic relations order.[90] Otherwise, a narrow interpretation of the term "employee" could result

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[88] 17 CFR 239.16b. Form S-8 is the form used by an Exchange Act reporting company to register securities for issuance to its employees or those of its subsidiaries or parent under an employee benefit plan.

[89] See, for example, the letter from ABA (Business).

[90] See General Instruction A.1 to Form S-8.

in an issuer being disqualified from terminating its Exchange Act registration and reporting obligations under Rule 12h-6 because it engaged in a sale of securities during the dormancy period to an employee's family member or other relationship permitted under Form S-8 but not explicitly allowed under the new rule.

Comment Solicited

We solicit comment on the reproposed dormancy condition:

- Would it be appropriate to adopt the dormancy condition, as reproposed?
- Is the reproposed amount of time required for the dormancy condition too long or too short?
- Are the reproposed exceptions to the dormancy condition appropriate?
- Are certain transactions we initially proposed to exempt from the dormancy condition, when a public float standard was proposed, no longer appropriate for exemption? For example, is there a risk that foreign private issuers would issue securities to U.S. investors or employees who would then sell them in registered secondary offerings before deregistration?

4. Foreign Listing Condition

As reproposed, Rule 12h-6 would require that, with respect to equity securities, for at least the 12 months preceding the filing of its Form 15F, a foreign private issuer must have maintained a listing of the subject class of securities on an exchange in a foreign jurisdiction, which, either singly or together with one other foreign jurisdiction, constitutes the primary trading market for the issuer's subject class of securities.[91] The

[91] Reproposed Rule 12h-6(a)(3) (17 CFR 240.12h-6(a)(3)).

reproposed rule defines "primary trading market" to mean that at least 55 percent of the trading in the foreign private issuer's subject class of securities took place in, on or through the facilities of a securities market or markets in no more than two foreign jurisdictions during a recent 12-month period.[92] That definition further provides that if an issuer aggregates the trading of its securities in two foreign jurisdictions for the purpose of Rule 12h-6, the trading market for the issuer's securities in at least one of the two foreign jurisdictions must be larger than the U.S. trading market for the issuer's securities.[93]

The purpose of this foreign listing condition is to help assure that there is a non-U.S. jurisdiction that principally regulates and oversees the issuance and trading of the issuer's securities and the issuer's disclosure obligations to investors. This listing condition makes more likely the availability of a set of non-U.S. securities disclosure documents to which a U.S. investor may turn for material information when making investment decisions about the issuer's securities following the termination of its disclosure obligations under Rule 12h-6. If the United States was the sole or principal market for the foreign private issuer's securities, then the Commission would have a greater regulatory interest in continuing to subject the foreign company to the Exchange Act reporting regime.

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[92] Reproposed Rule 12h-6 defines "recent 12-month period" to mean a 12-calendar month period that ended no more than 60 days before the filing date of the Form 15F. Rule 12h-6(e)(7).

[93] Rule 12h-6(e)(6). As proposed and as adopted, measurement under this condition is by reference to average daily trading volume (ADTV) as reported by the relevant market. Although the proposing release noted that there are differences concerning how various markets measure and report trading volume (for example, dealer markets versus auction markets), no commenter addressed this point.

As originally proposed, Rule 12h-6 would have required a foreign private issuer of equity securities to have maintained a listing of the subject class of securities for the preceding two years on an exchange in its home country. As originally proposed, "home country" would have had the same meaning as under Form 20-F, which defines "home country" as the jurisdiction in which the issuer is legally organized, incorporated or established and, if different, the jurisdiction where it has its principal listing. Originally proposed Rule 12h-6 would further have required that a foreign private issuer's home country constitute its primary trading market. We proposed to define the term "primary trading market" to mean that at least 55 percent of the trading in the foreign private issuer's securities took place in, on or through the facilities of a securities market in a single foreign country during a recent 12 month period.

We received a variety of comments on this home country listing condition. Although most commenters agreed in principle with a prior non-U.S. listing condition, several commenters expressed concern that many foreign private issuers would not be able to meet the "55 percent trading in a single non-U.S. market" threshold of the primary trading market definition.[94] Those commenters urged the Commission to adopt a prior listing condition that would permit an issuer to meet the 55 percent or greater trading threshold by aggregating its trading in more than one non-U.S. market.

Some commenters expressed concern that the proposed prior non-U.S. listing period was too long.[95] Other commenters noted that some foreign private issuers have

[94] See, for example, the letter from Cravath. However, commenters did not provide data or other specific information in this area.

[95] See the letter from Ziegler, Ziegler & Associates.

their principal trading market in a jurisdiction that is different than its place of incorporation or principal listing.[96] For example, some companies are incorporated in Switzerland and listed on the Swiss Exchange (SWX), but are primarily traded on virt-x, a cross-border electronic trading platform based in London that is regulated by the United Kingdom's Financial Services Authority. Those companies would not meet the proposed home country listing condition because their primary trading market is in the United Kingdom, and not in their jurisdiction of incorporation or principal listing.

In response to commenters' concerns, we are shortening the reproposed foreign listing period to one year from the originally proposed two years. This change is consistent with our similar revision of the proposed prior reporting condition. We also propose to permit an issuer to aggregate its trading over two non-U.S. markets for the purpose of meeting the foreign listing condition in order to address the concerns of issuers that have substantial trading markets in more than one country. Finally, we are proposing a "foreign listing" condition rather than a "home country" listing condition in order to accommodate issuers that have their primary trading market in jurisdictions other than their place of incorporation or principal listing. These proposed revisions should increase the flexibility of the new rule for many foreign private issuers.

At the same time, the reproposed foreign listing condition should serve to protect the interests of U.S. investors by requiring that at least 55 percent of the ADTV of the company's subject class of securities must have occurred through the facilities of no more than two foreign jurisdictions, and that, if an issuer does aggregate the ADTV of its subject class of securities over two non-U.S. jurisdictions, at least one of the two foreign

[96] See the letter from the Swiss Exchange.

markets must be larger than the U.S. market for the subject class of securities.[97] These proposed requirements should increase the likelihood that the principal pricing determinants for a foreign private issuer's securities are located outside the United States and that the issuer is subject to an overseas regulator with principal authority for regulating the issuance and trading of the issuer' securities and the issuer's disclosure to investors.[98] Consequently, for an issuer meeting these requirements, there should be less interruption in the flow of material information about the issuer once it exits the Exchange Act reporting system, to the benefit of U.S. investors.

As reproposed, Rule 12h-6 would require issuers to determine that the primary trading market for their equity securities is outside the United States and, if it is, that the trading volume of their securities in the United States does not exceed the threshold under the rule. In addition, as noted above, the condition relating to primary trading market would help assure that a foreign private issuer would be subject to the disclosure and other requirements of a foreign regulatory authority. The evolution of market structures could raise a number of issues in this area. Non-U.S., private non-exchange trading markets may develop in the future whose listed or traded issuers may not be subject to the same regulatory treatment by foreign securities regulators as listed companies today. Also, securities markets, which historically have been organized and regulated along

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[97] For the purpose of the reproposed primary trading market determination, an issuer would first measure the ADTV of its listed securities aggregated over one or two foreign jurisdictions. It would then divide this amount by its worldwide ADTV. This denominator would include the ADTV only for those foreign jurisdictions in which the issuer has listed the subject class of securities as well as its U.S. ADTV. Its U.S. ADTV would include all securities of the subject class, whether listed or unlisted.

[98] This "primary trading market" requirement would also help ensure that an issuer's foreign listing represents a significant trading market for its equity securities rather than a listing on a non-trading market such as the Luxembourg Stock Exchange.

national lines, and their listed companies, which also have been largely regulated by national securities regulatory authorities, may in the future become more transnational. The schemes of regulation for these markets and companies may change in response to these continued developments.

Comment Solicited

We solicit comment on the reproposed foreign listing condition:

- Would it be appropriate to adopt the foreign listing condition, as reproposed?
- Should the foreign listing condition be longer or shorter than the reproposed condition?
- Is the reproposed definition of primary trading market appropriate? Should we instead require an issuer's primary trading market to consist of one single foreign country, as initially proposed, rather than two foreign countries, as reproposed? Should we instead permit an issuer to aggregate the trading in its securities over three or more foreign jurisdictions as long as the trading volume in one of those jurisdictions is greater than its U.S. trading volume?
- Should the reproposed definition require that more than or less than 55% of an issuer's trading occur in the primary trading market?
- For purposes of the reproposed primary trading market determination, will issuers have difficulty making the necessary calculations? If so, what are these difficulties and how might they be addressed in the rule?
- Should the worldwide foreign trading component in the denominator of the primary trading market calculation include all foreign markets in which an

issuer's securities are traded, including unlisted or over-the-counter trading, rather than only for foreign listed markets, as reproposed?

- Should the denominator of the primary trading market calculation include only the foreign jurisdictions in the numerator plus U.S. ADTV?
- Should the U.S. ADTV component in the denominator of the primary trading market calculation include only listed securities rather than all U.S. traded securities, whether listed or unlisted, as reproposed?
- Will issuers have difficulty obtaining ADTV information for trading in the United States, in their primary trading market, or elsewhere?
- In the United States, issuers should be able to obtain information through the U.S. transaction reporting plan. Do other markets or jurisdictions have similar trade reporting arrangements? Is additional guidance from the Commission necessary in this area, or will issuers be able to make reasonable judgments?
- Should the proposed rule provide additional flexibility for the development of trans-national trading markets? If so, what types of provisions would be appropriate to address these types of markets?

B. Debt Securities Provision

As reproposed, Rule 12h-6 would enable a foreign private issuer to terminate its Exchange Act reporting obligations regarding a class of debt securities as long as the issuer has filed or furnished all reports required under Exchange Act section 13(a) or section 15(d), including at least one Exchange Act annual report, and has its class of debt securities held of record by less than 300 holders either on a worldwide basis or who are

U.S. residents.[99] This provision reflects the minimum reporting requirement and current 300 holder standard under section 15(d) and Rule 12h-3.

The reproposed debt securities provision is substantially similar to the originally proposed provision.[100] We did not originally propose, and we are not here proposing, a provision comparable to Rule 12h-3's 500 record holder threshold for debt securities issuers because we believe most foreign private issuers that are debt securities registrants would likely exceed the $10 million asset threshold that accompanies the 500 record holder standard.[101]

A few commenters requested that the Commission increase the debt securities record holder threshold to as much as 1,000. We have decided against proposing to increase the debt securities threshold at this time for the same reasons that we also are not proposing to increase the record holder threshold for equity securities issuers as part of this rulemaking.

Comment Solicited

We solicit comment on the reproposed debt securities record holder condition:

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[99] Reproposed Rule 12h-6(b).

[100] We have made one technical revision to the originally proposed debt securities provision. An issuer that has listed a class of debt securities on an exchange and registered the class under section 12(b), without also registering those securities under the Securities Act, would have reporting obligations under section 13(a), not section 15(d) of the Exchange Act. Yet the originally proposed debt securities provision only referred to section 15(d) obligations. In order to permit the termination of registration and reporting under Rule 12h-6 by listed debt issuers, we have revised the reporting condition to state that an issuer must have filed or furnished all reports required under Exchange Act section 13(a) or section 15(d). A listed debt issuer must have terminated its listing and section 12(b) registration pursuant to Rule 12d-2 before it could effect its termination of reporting under Rule 12h-6.

[101] None of the commenters requested that we incorporate the 500 record holder and $10 million asset standard into proposed Rule 12h-6's debt securities provision or into the alternative record holder condition for equity securities.

- Would it be appropriate to adopt the debt securities record holder condition, as reproposed?

C. Revised Counting Method

As originally proposed, Rule 12h-6 would have permitted an issuer to use a modified version of the "look through" counting method under Rule 12g3-2(a) when determining the percentage of a foreign private issuer's outstanding equity shares held by its non-affiliates on a worldwide basis that are held by U.S. residents or the number of U.S. residents holding a foreign private issuer's equity or debt securities. Instead of having to look through the accounts of brokers, banks and other nominees on a worldwide basis to determine the number of its U.S. resident holders, as is required under the current rules, an issuer could limit its inquiry to brokers, banks and other nominees located in the United States, the issuer's jurisdiction of incorporation, legal organization or establishment and, if different, the jurisidiction of its primary trading market.[102] This revised counting method is substantially similar to the counting method that the Commission adopted under the exemptive rules for cross-border rights offerings, exchange offers and business combinations, as well as under the definition of foreign private issuer.

The reproposed counting method is substantially the same as originally proposed, except for two revisions. Since reproposed Rule 12h-6 would eliminate the public float benchmark, the reproposed counting method would apply only to an issuer of equity securities proceeding under the alternative 300 holder provision, or to a debt securities issuer that must meet the 300 holder standard. In addition, as reproposed, Rule 12h-6

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[102] Reproposed Rule 12h-6(d).

would provide that an issuer that aggregates the trading volume of its securities in two foreign jurisdictions for the purpose of meeting the rule's listing condition will have to look through nominee accounts in both foreign jurisdictions, which comprise its primary trading market, and in the United States as well as in its jurisdiction of incorporation, if different from the two jurisdictions that comprise its primary trading market.

As part of the counting method provision, we are reproposing a presumption that we previously adopted under the cross-border rules and definition of foreign private issuer.[103] This presumption is that, if, after reasonable inquiry, an issuer is unable without unreasonable effort to obtain information about the amount of securities held by nominees for the accounts of customers resident in the United States, it may assume that the customers are the residents of the jurisdiction in which the nominee has its principal place of business.

Some commenters stated that, while this presumption is useful when determining the percentage of an issuer's worldwide public float that is held by U.S. residents, it is not much help when an issuer must calculate the actual number of its U.S. resident holders for the purpose of either the alternative record holder condition for equity issuers or the debt securities provision. Those commenters urged the Commission to adopt a presumption that would enable an issuer to count each nominee as one shareholder located in the nominee's principal place of business when the issuer is unable without unreasonable effort to obtain information about the nominee's customer accounts.

[103] See Securities Act Rule 800(h)(4) (17 CFR 230.800(h)(4)) and Instruction B to Exchange Act Rule 3b-4(c)(1) (17 CFR 240.3b-4(c)(1)).

We did not adopt the suggested presumption when we adopted the counting method for the rule defining the term "foreign private issuer,"[104] and we decline to propose it as part of this rulemaking. Based on our experience with that definitional rule, we are not persuaded that issuers are unable without undue burden to apply the current standard using the adopted presumption.

Some foreign jurisdictions have laws that provide an established and enforceable means for a public company to obtain information about its shareholders. We solicited comment regarding whether we should permit an issuer to rely on information obtained through these foreign statutory or code provisions when calculating the percentage of its worldwide public float held by U.S. residents or the number of its U.S. resident equity or debt holders. We received only two comment letters regarding this issue.[105]

Reproposed Rule 12h-6 does not provide that a foreign private issuer may rely solely on specified foreign statutory or code provisions. However, as part of its inquiry regarding whether it meets any of the quantitative benchmarks under Rule 12h-6, an issuer may refer to shareholder information obtained pursuant to those foreign statutory or code provisions to the extent that this shareholder information is reasonably reliable and accurate and furthers the purpose of the inquiry.

Comment Solicited

We solicit comment on the reproposed counting method provison:

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[104] See Release No. 34-41936 (September 28, 1999), 64 FR 53900 (October 5, 1999).

[105] Both commenters stated that they had successfully relied on section 212 of the United Kingdom Companies Act to obtain information about an issuer's shareholders. One of the commenters also cited Article L. 228-2 of the French Commercial Code as an established and reliable means for a company to obtain shareholder information.

- Would it be appropriate to adopt the counting method provision, as reproposed?
- How should issuers' experiences with applying the counting method under the cross-border rules and definition of foreign private issuer inform our decision whether to adopt the reproposed counting method?
- The reproposed counting method would limit the current required worldwide search for nominees of U.S. holders to the U.S., the jurisdiction of incorporation or organization, and possibly the primary trading market. Are these limits appropriate? If not, should the search be further limited or expanded?

D. Expanded Scope of Rule 12h-6

In response to comments on the appropriate scope of Rule 12h-6, we propose to expand the rule in two respects. First, we propose to provide that an issuer that has succeeded to the Exchange Act reporting obligations of an acquired company may terminate those reporting obligations under Rule 12h-6 as long as it satisfies specified conditions. Second, we propose to extend the application of Rule 12h-6 to a foreign private issuer that previously filed a Form 15 and effected its termination of registration or suspension of reporting under the current exit rules before the effective date of Rule 12h-6, subject to conditions.

1. Application of Rule 12h-6 to Successor Issuers

In the Original Proposing Release, we requested comment on the prior Exchange Act reporting condition. Several commenters expressed their concern that, as proposed, an issuer that has succeeded to the Exchange Act reporting obligations of an acquired

company pursuant to Rule 12g-3 or 15d-5[106] may not be able to terminate its reporting obligations under Rule 12h-6 because of the proposed rule's reporting condition, although the successor issuer satisfies the rule's other requirements. In order to address this concern, reproposed Rule 12h-6 specifically provides that, following a merger, consolidation, exchange of securities, acquisition of assets or otherwise, a foreign private issuer that has succeeded to the reporting obligations under Exchange Act section 13(a) of another issuer pursuant to Rule 12g-3, or to the reporting obligations of another issuer under Exchange Act section 15(d) pursuant to Rule 15d-5, may file a Form 15F to terminate those reporting obligations if, regarding a class of equity securities, the successor issuer meets Rule 12h-6's prior reporting, foreign listing, and quantitative benchmark conditions.[107] Regarding a class of debt securities, the successor issuer must meet the conditions under Rule 12h-6(b), including the revised reporting condition. Reproposed Rule 12h-6 then provides that, when determining whether it meets the prior reporting condition under either the equity or debt securities provision of the final rule, a successor issuer may take into account the reporting history of the issuer whose reporting obligations it has assumed pursuant to Rule 12g-3 or 15d-5.[108]

This successor issuer provision would enable a non-Exchange Act reporting foreign private issuer that acquires a reporting foreign private issuer in a transaction exempt under the Securities Act, for example, under Rule 802 or section 3(a)(10), to qualify immediately for termination of its Exchange Act reporting obligations under

[106] 17 CFR 240.12g-3 and 240.15d-5.

[107] Reproposed Rule 12h-6(c)(1).

[108] Reproposed Rule 12h-6(c)(2).

Rule 12h-6, without having to file an Exchange Act annual report, as long as the successor issuer meets the rule's listing and quantitative benchmark conditions, and the acquired company's reporting history fulfills Rule 12h-6's prior reporting condition. Since the successor issuer would have assumed the acquired company's Exchange Act reporting obligations, we believe that it is appropriate that the issuer succeed to the acquired company's reporting history for the purpose of Rule 12h-6.

However, if a previously non-Exchange Act reporting foreign private issuer acquires an Exchange Act reporting company by consummating an exchange offer, merger or other business combination registered under the Securities Act, most likely on a Form F-4 registration statement, the acquiror would have to fulfill Rule 12h-6's prior reporting condition without reference to the acquired company's reporting history. Since the acquiror would have triggered its own section 15(d) reporting obligations upon the effectiveness of its Securities Act registration statement, it would have to meet Rule 12h-6's full reporting condition like any other section 15(d) reporting company before it could terminate its reporting obligations under the new rule.

Comment Solicited

We solicit comment on the proposed expanded scope of Rule 12h-6 with respect to successor issuers:

- Should an issuer be permitted to terminate its Exchange Act reporting obligations under Rule 12h-6 if, following a merger, acquisition or other similar transaction in which it has succeeded to Exchange Act reporting obligations pursuant to Rule 12g-3, it meets Rule 12h-6's foreign listing and

quantitative benchmark requirements, and the acquired company's reporting history fulfills Rule 12h-6's prior reporting condition, as proposed?

- Should we require that the Exchange Act reporting target company have satisfied the trading volume or 300 record holder benchmark just prior to completing one of the above transactions before a successor issuer may proceed under Rule 12h-6?
- Should there be limitations placed on a successor issuer's eligibility to use Rule 12h-6? If so, what what are those limitations?

2. Application of Rule 12h-6 to Prior Form 15 Filers

As originally proposed, Rule 12h-6 would have applied only to reporting foreign private issuers that have not yet filed a Form 15 to cease their Exchange Act reporting obligations. In response to our request for comments concerning the scope of proposed Rule 12h-6 and on the current exemptive scheme for foreign private issuers,[109] numerous commenters urged the Commission to expand the scope of Rule 12h-6 by extending it to foreign private issuers that have previously filed a Form 15 and thereby already terminated or suspended their Exchange Act reporting obligations under the current exit rules.[110]

We agree with those commenters who stated that foreign private issuers should not be denied the benefits of the new exit regime simply because they met the requirements for ceasing their Exchange Act reporting obligations under the current rules

[109] See Release No. 34-53020 at pp. 20 and 69-70.

[110] See the letters from the European Commission, Cleary Gottlieb and Makinson Cowell.

and followed the only exit procedure available to them.[111] We see no meaningful distinction between an issuer that would qualify for termination of Exchange Act reporting under the alternative record holder provision of Rule 12h-6 and a Form 15 filer that has already met the record holder requirements under Rule 12g-4 or Rule 12h-3 but, under the proposed rule amendments, would continue to have to count its U.S. shareholders annually in order to determine whether it has renewed or assumed anew Exchange Act reporting obligations.

Accordingly, as reproposed, Rule 12h-6 would extend termination of Exchange Act reporting to a foreign private issuer that, before the effective date of Rule 12h-6, has already effected the suspension or termination of its Exchange Act reporting obligations after filing a Form 15. Since these filers have already met a quantitative standard under the current exit rules, they would not have to meet any other quantitative benchmark under Rule 12h-6. They also would not have to satisfy the prior reporting or dormancy provisions since they would already be non-reporting entities.

However, a prior Form 15 filer would have to meet the following conditions in order to obtain the benefits of Rule 12h-6:

- the issuer must currently not be required to register a class of securities under section 12(g) or be required to file reports under section 15(d);
- the issuer must file a Form 15F; and

[111] These benefits include termination of Exchange Act reporting regarding a subject class of securities and the immediate availability of the Rule 12g3-2(b) exemption upon the termination of reporting.

- if its Form 15 applied to a class of equity securities, for at least the 12 months before the filing of its Form 15F, the issuer must have maintained a listing of the subject class of equity securities on an exchange in a foreign jurisdiction, which, either singly or together with another foreign jurisdiction, constitutes the primary trading market for the issuer's class of subject securities.

As with any other foreign private issuer of equity securities that elects to terminate its reporting obligations under Rule 12h-6, the purpose of the proposed listing condition is to help ensure that the prior Form 15 filer is subject to a foreign regulator and a non-U.S. body of regulation governing the trading of the issuer's securities and its disclosure obligations to its shareholders. This listing condition makes more likely the availability of a set of home country securities documents to which a U.S. investor may turn for material information when making investment decisions about the issuer's securities following the termination of its disclosure obligations under Rule 12h-6.

The purpose of the proposed Form 15F filing requirement is to notify investors and alert the Commission that the prior Form 15 filer is claiming the benefits of Rule 12h-6, to have the issuer certify that it meets the conditions of the new rule, and to provide the issuer's Internet Web site address.[112]

Comment Solicited

We solicit comment on the proposed expanded scope of Rule 12h-6 with respect to prior Form 15 filers:

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[112] A prior Form 15 filer would have to furnish its home country documents, required under Rule 12g3-2(b), on the Internet the same as any other Form 15F filer. See Part II.H., below.

- Is it appropriate to permit an issuer that, before the effective date of Rule 12h-6, has terminated or suspended its Exchange Act reporting obligations by filing a Form 15, to obtain the benefits of termination under Rule 12h-6, as proposed?
- Are the proposed requirements that a prior Form 15 filer must meet in order to be eligible to proceed under Rule 12h-6 appropriate? Are there any other eligibility requirements that we should add?

E. Public Notice Requirement

We are reproposing a public notice requirement as a condition to termination of reporting under Rule 12h-6, except for prior Form 15 filers.[113] Pursuant to this requirement, an issuer of equity or debt securities or a successor issuer would have to publish, either before or on the date that it files its Form 15F, a notice in the United States that discloses its intent to terminate its section 13(a) or 15(d) reporting obligations. The issuer would have to publish the notice, such as a press release, through a means reasonably designed to provide broad dissemination of the information to the public in the United States. The issuer also would be required to submit a copy of the notice, either under cover of a Form 6-K before or at the time of filing of the Form 15F, or as an exhibit to the Form 15F. The primary purpose of this reproposed notice provision is to alert U.S. investors who have purchased the issuer's securities about the issuer's intended exit from the Exchange Act registration and reporting system.

The reproposed notice provision is substantially similar to the originally proposed notice requirement, except that, under the earlier proposed provision, the issuer would have had to publish the notice at least 15 business days before it files its Form 15F. At

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[113] Reproposed Rule 12h-6(g).

the suggestion of commenters, we have revised the notice provision simply to require an issuer to publish the notice before or on the date of filing of its Form 15F. We agree that a fixed, prior Form 15F notice requirement would be of little benefit to investors and would only serve to prolong the termination process.

The reproposed notice requirement would not apply to a prior Form 15 filer that files a Form 15F to terminate its registration and reporting obligations under Rule 12h-6(h). Since a prior Form 15 filer would already have ceased its Exchange Act reporting obligations, investors would gain little from the publishing of such a notice.

Comment Solicited

We solicit comment on the reproposed notice requirement:

- Would it be appropriate to adopt the notice requirement, as reproposed?
- Should we require an issuer to mail a copy of the notice to each of its U.S. investors in addition to, or in lieu of, publishing the notice through a press release or other publicly disseminated means?

F. Form 15F

Like our current exit rules, reproposed Rule 12h-6 would require a foreign private issuer to file electronically on EDGAR a form certifying that it meets the requirements for ceasing its Exchange Act reporting obligations. By signing and filing new Form 15F, a foreign private issuer would be certifying that:

- it meets all of the conditions for termination of Exchange Act reporting specified in Rule 12h-6; and
- there are no classes of securities other than those that are the subject of the Form 15F regarding which the issuer has Exchange Act reporting obligations.

Unlike current Form 15, reproposed Form 15F would require a foreign private issuer to provide disclosure regarding several items in order to provide investors with information regarding an issuer's decision to terminate its Exchange Act reporting obligations. The information would also assist Commission staff in monitoring the use of Rule 12h-6.

Most commenters that addressed the originally proposed Form 15F generally agreed with its form and content. Accordingly, the reproposed Form 15F is substantially similar to the earlier proposed Form 15F. Like the originally proposed form, the reproposed Form 15F would solicit information regarding:

- an issuer's Exchange Act reporting history;
- when it last sold registered securities in the United States other than those excluded from consideration under Rule 12h-6;
- the primary trading market for an issuer's equity securities that is the subject of its Form 15F;
- trading volume data for an issuer's equity securities in the United States and in its primary trading market, if applicable;
- the number of an issuer's equity or debt securities record holders, if applicable; and
- the classes of equity and debt securities, if any, that are the subject of the Form 15F.

In addition, we have revised the proposed form to conform to the changes to the originally proposed Rule 12h-6, as reproposed today. These revisions include adding items to acquire material information concerning a Form 15F filer:

- that is a successor issuer;
- that is a prior Form 15 filer;
- that has a primary trading market composed of two foreign jurisdictions; and
- that may have delisted or terminated an ADR facility prior to filing the Form 15F.

As with Form 15, and as originally proposed, filing of the reproposed Form 15F would immediately suspend an issuer's Exchange Act reporting obligations regarding the subject class of securities and commence a 90-day waiting period. If, at the end of this 90-day period, the Commission has not objected to the filing, the suspension would automatically become a termination of registration and reporting. If the Commission denies the Form 15F or the issuer withdraws it, within 60 days of the date of the denial or withdrawal, the issuer would be required to file or submit all reports that would have been required had it not filed the Form 15F.[114]

Some commenters requested that we shorten the 90 day period to 60 days or lengthen the time in which an issuer must file or submit Exchange Act reports upon withdrawal of its Form 15F. We are not proposing to do so because the reproposed time periods are based on those established under Form 15 and the current exit rules, which we believe have proven adequate.

After filing the reproposed Form 15F, an issuer would have no continuing obligation to make inquiries or perform other work concerning the information contained in the Form 15F, including its assessment of trading volume or ownership of its securities. However, the reproposed Form 15F would require an issuer to undertake to

[114] Reproposed Rule 12h-6(f).

withdraw its Form 15F before the date of effectiveness if it has actual knowledge of information that causes it reasonably to believe that, at the date of filing the Form 15F:

- the average daily trading volume of its subject class of securities in the United States during a recent 12-month period exceeded 5 percent of the average daily trading volume of that class of securities in the issuer's primary trading market during the same period, if proceeding under Rule 12h-6(a)(4)(i);
- its subject class of securities was held of record by 300 or more United States residents or 300 or more persons worldwide, if proceeding under Rule 12h-6(a)(4)(ii) or Rule 12h-6(b); or
- it otherwise no longer qualified for termination of its Exchange Act reporting obligations under Rule 12h-6.

While this reproposed undertaking is substantially similar to the originally proposed undertaking, in response to commenters, we have added the phrase "at the date of filing" to clarify that an issuer would not be required to withdraw a Form 15F due to changes in its trading volume or share ownership occurring after the date of filing.[115]

Comment Solicited

We solicit comment on the reproposed Form 15F filing requirement:

- Would it be appropriate to adopt the Form 15F filing requirement, as reproposed?

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[115] We also are reproposing amendments to the rules governing the Commission's delegated authority to permit staff of the Division of Corporation Finance to accelerate the effectiveness of an issuer's termination of registration and reporting under Rule 12h-6 before the 90th day at the issuer's request. The issuer must make this request in writing and file it on EDGAR. Nevertheless, Division of Corporation Finance staff may submit requests to accelerate the effectiveness of an issuer's termination of registration and reporting pursuant to Rule 12h-6 to the Commission for consideration, as appropriate. As we noted in the Original Proposing Release, there is currently a similar delegation relating to Form 15, which is rarely used.

- Are there any items that should be added to the Form 15F? Are there any reproposed items that should be removed?

G. Amended Rules 12g-4 and 12h-3

Although similar to the current 300 record holder standard, reproposed Rule 12h-6's alternative threshold record holder condition and its debt securities provision would offer advantages compared to the current exit rules. As reproposed, Rule 12h-6's revised counting method would limit the jurisdictions in which a foreign private issuer must search for records of its U.S. resident holders. Moreover, reproposed Rule 12h-6 would enable a foreign private issuer to terminate, rather than merely suspend, its section 15(d) reporting obligations regarding a class of equity or debt securities. In addition, under reproposed Rule 12h-6, a foreign private issuer would be able to claim the benefits of the Rule 12g3-2(b) exemption immediately upon the effectiveness of its termination of reporting regarding a class of equity securities under section 12(g) or 15(d). In each instance, once its termination of reporting becomes effective under Rule 12h-6, an issuer would no longer have to concern itself with whether the number of its U.S. resident or worldwide holders of the class of subject securities has risen above the statutory or regulatory threshold.

Given these advantages, we believe that, following the adoption of reproposed Rule 12h-6, few, if any, foreign private issuers would elect to proceed under the provisions of Rule 12g-4 or Rule 12h-3 that allow a foreign private issuer to terminate its registration of a class of securities under section 12(g) or suspend the duty to file reports under section 15(d) if the class of securities is held by less than 300 U.S. residents or by 500 U.S. residents and the issuer has had total assets not exceeding $10 million on the

last day of each of its most recent three fiscal years.[116] Accordingly, we are reproposing the amendments to eliminate these provisions in Rules 12g-4 and 12h-3, as originally proposed.

Comment Solicited

We solicit comment on the reproposed amendments to Rules 12g-4 and 12h-3:

- Would it be appropriate to adopt the amendment to the current exit rules, as reproposed?

H. Amendment Regarding the Rule 12g3-2(b) Exemption

We are reproposing, substantially as originally proposed, an amendment to Exchange Act Rule 12g3-2[117] that would apply the exemption under Exchange Act Rule 12g3-2(b) immediately to an issuer of equity securities upon the effectiveness of its termination of reporting under Rule 12h-6.[118] As a condition to the immediate application of the Rule 12g3-2(b) exemption upon its termination of reporting under Rule 12h-6, an issuer would have to publish subsequently in English material home country documents required under Rule 12g3-2(b)(1)(iii) on its web site or through an electronic information delivery system generally available to the public in its primary

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[116] See Exchange Act Rules 12g-4(a)(2) and 12h-3(b)(2).

[117] Reproposed Rule 12g3-2(e).

[118] Currently, foreign private issuers that registered a class of securities under section 12 must wait at least 18 months following their termination of reporting before they would be eligible to apply for the Rule 12g3-2(b) exemption. In addition, foreign private issuers with an active or suspended reporting obligation under section 15(d) have thus far not been eligible to claim the Rule 12g3-2(b) exemption. See Rule 12g3-2(d)(1) (17 CFR 240.12g3-2(d)(1)), which currently excepts from the 18 month requirement issuers that have filed Securities Act registration statements using the Multijurisdictional Disclosure Act (MJDS) forms.

trading market.[119]

The purpose of this condition is to provide U.S. investors with access to material information about an issuer of equity securities following its termination of reporting pursuant to Rule 12h-6.[120] In addition, an issuer would be able to maintain a sponsored ADR facility with respect to its securities.[121] This condition also would facilitate resales of that issuer's securities to qualified institutional buyers under Rule 144A.[122] Moreover, having a foreign private issuer's key home country documents posted in English on its web site would assist U.S. investors who are interested in trading the issuer's securities in its primary securities market.[123]

The reproposed extension of Rule 12g3-2(b) would apply both to a class of equity securities formerly registered under section 12(g) and one that formerly gave rise to section 15(d) reporting obligations, as originally proposed. The Rule 12g3-2(b) exemption received under reproposed Rule 12g3-2(e) would remain in effect for as long

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[119] Reproposed Rule 12g3-2(e)(2).

[120] Any post-termination trading of a foreign private issuer's securities in the United States would have to occur through over-the-counter markets such as that maintained by the Pink Sheets, LLC since, as of April, 1998, the NASD and the Commission have required a foreign private issuer to register a class of securities under Exchange Act section 12 before its securities could be traded through the electronic over-the-counter bulletin board administered by Nasdaq. See, for example, NASD Notice to Members (January 1998).

[121] In order to establish an ADR facility, an issuer must register the ADRs on Form F-6 (17 CFR 239.36) under the Securities Act. The eligibility criteria for the use of Form F-6 include the requirement that the issuer have a reporting obligation under Exchange Act section 13(a) or have established the exemption under Rule 12g3-2(b).

[122] See Securities Act Rule 144A(d)(4) (17 CFR 230.144A(d)(4)).

[123] Brokers currently are exempt from complying with certain information obligations under Exchange Act Rule 15c2-11 (17 CFR 240.15c2-11) when a foreign company has established and maintains the Rule 12g3-2(b) exemption. See Release No. 34-41110 (February 25,1999), 64 FR 11124 (March 8, 1999).

as the foreign private issuer satisfies the rule's electronic publication conditions or until the issuer registers a new class of securities under section 12 or incurs section 15(d) reporting obligations by filing a new Securities Act registration statement, which has become effective.[124]

Some commenters have suggested that we make the application of the Rule 12g3-2(b) exemption optional rather than automatic upon the termination of reporting under Rule 12h-6. We decline to do so as part of the reproposed rule amendments because we do not believe that such an amendment would be in the best interests of U.S. investors. Enabling an issuer to claim the exemption immediately upon termination of reporting under Rule 12h-6, rather than upon application or notice to the Commission at some later date, should foster the prompt publishing of that issuer's material home country documents on its Internet Web site, to the benefit of investors.[125]

1. Extension of the Rule 12g3-2(b) Exemption Under Reproposed Rule 12g3-2(e)

As reproposed, because Rule 12g3-2(e) applies to any issuer that has terminated its reporting under Rule 12h-6, the rule amendment would effectively extend the Rule 12g3-2(b) exemption to:

- a foreign private issuer of equity securities immediately upon its termination of reporting pursuant to Rule 12h-6(a);
- a successor issuer immediately upon its termination of reporting pursuant to Rule 12h-6(c); and

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[124] See Reproposed Rule 12g3-2(e)(3).

[125] An issuer that does not want to claim the Rule 12g3-2(b) exemption immediately following its deregistration under Rule 12h-6 could abstain from posting its home country documents on its Web site at that time.

- a prior Form 15 filer immediately upon its termination of reporting pursuant to Rule 12h-6(h).

Currently Rule 12g3-2(d)(2) precludes extending the Rule 12g3-2(b) exemption to a foreign private issuer, other than a Canadian issuer using the MJDS forms, that has issued securities in a merger or other similar transaction to acquire a company that has registered a class of securities under section 12 or has a reporting obligation under section 15(d). As reproposed, we would amend Rule 12g3-2(d)(2) effectively to extend the Rule 12g3-2(b) exemption to a successor issuer that has terminated its Exchange Act reporting obligations under Rule 12h-6(c). Since we have proposed to permit a successor issuer to rely on its predecessor's reporting history for the purpose of Rule 12h-6, we believe the issuer should also benefit from claiming the Rule 12g3-2(b) exemption immediately upon the effectiveness of its Form 15F.

We also propose to extend the Rule 12g3-2(b) amendment immediately upon the termination of reporting pursuant to Rule 12h-6(h) to a foreign private issuer that, before the effective date of Rule 12h-6, terminated its registration or suspended its reporting obligations regarding a class of equity securities after filing a Form 15. This is consistent with our proposed expansion of the scope of Rule 12h-6 to encompass prior Form 15 filers. Without this change, a prior Form 15 filer would find itself subject to the 18 month waiting period that currently exists under Rule 12g3-2(d), although the issuer qualified for termination of reporting under Rule 12h-6(h).

We further propose to permit a foreign private issuer that filed a Form 15F solely to terminate its reporting obligations regarding a class of debt securities to apply for the Rule 12g3-2(b) exemption for a class of equity securities any time after the effectiveness

of its termination of reporting regarding the class of debt securities.[126] Since we are reproposing to abolish the 18 month "waiting period" for equity securities issuers that have terminated their Exchange Act reporting obligations pursuant to Rule 12h-6, it would serve no useful purpose to impose this waiting period on a debt securities issuer that has terminated its reporting obligations regarding a class of debt securities under Rule 12h-6 and, sometime thereafter, determines that it will need the Rule 12g3-2(b) exemption for a class of equity securities.

However, contrary to the suggestions of some commenters, we are not proposing to permit a debt securities issuer to claim the Rule 12g3-2(b) exemption immediately upon the effectiveness of termination of its debt securities under Rule 12h-6 on the possibility that, at some future date, it may require the exemption for a class of equity securities. When that date arrives, the issuer may submit an application for the Rule 12g3-2(b) exemption, which will provide the Commission with current information about the outstanding class of equity securities, including U.S. ownership information.

Comment Solicited

We solicit comment on the reproposed amendments to Rule 12g3-2:

- Would it be appropriate to extend the Rule 12g3-2(b) amendment to an issuer immediately upon the effectiveness of its termination of Exchange Act reporting obligations under Rule 12h-6, as reproposed?
- Would it be appropriate to extend the Rule 12g3-2(b) amendment to successor issuers and prior Form 15 filers that are eligible to file a Form 15F under

[126] Reproposed Rule 12g3-2(e)(4).

Rule 12h-6, as reproposed?

- What are the estimated annual costs of electronically publishing the material home country documents required by Rule 12g3-2(b), as proposed?

2. Electronic Publishing of Home Country Documents

Currently foreign companies claim the Rule 12g3-2(b) exemption by submitting to the Commission on an ongoing basis the material required by the rule. This material may only be submitted in paper format.[127] Because paper submissions are more difficult to access, we are reproposing Rule 12g3-2(e), which relies on electronic access to a foreign company's home country securities documents, although not through the Commission's electronic database.

As part of the condition requiring an issuer to publish its home country documents required under Rule 12g3-2(b)(1)(iii) on its Internet Web site or through an electronic information delivery system generally available to the public in its primary trading market, reproposed Rule 12g3-2(e) would require an issuer to publish English translations of the following documents on its web site:

- its annual report, including or accompanied by annual financial statements;
- interim reports that include financial statements;
- press releases; and

[127] A non-Exchange Act reporting issuer that has successfully filed an application for the Rule 12g3-2(b) exemption must currently furnish its home country documents in paper because the application is analogous to one submitted for an exemption under Exchange Act section 12(h). See Regulation S-T Rule 101(c)(16) (17 CFR 232.101(c)(16)). Although the Commission's EDGAR database contains an entry signifying the receipt of paper documents, materials received in paper are not accessible through the EDGAR system.

- all other communications and documents distributed directly to security holders of each class of securities to which the exemption relates.[128]

Reproposed Rule 12g3-2(e) would further require a foreign private issuer of equity securities to disclose in the Form 15F the address of its Internet Web site or that of the electronic information delivery system in its primary trading market on which it will publish the information required under Rule 12g3-2(b)(1)(iii).[129] The purpose of this requirement is to alert investors and the Commission regarding where investors and others may find the company's home country documents should a problem arise concerning the Internet location of those documents.

Currently non-reporting issuers that seek the Rule 12g3-2(b) exemption must submit their letter application for the exemption and their home country documents to the Commission in paper. We agree with the commenters who stated that the same primary reason for requiring an issuer to publish its home country documents on its Internet Web site after it terminates its reporting obligations under Rule 12h-6 applies equally to current Rule 12g3-2(b) exempt companies and the non-reporting companies that eventually will apply for the exemption. In each case, the electronic posting of an issuer's home country documents would increase an investor's ability to access those documents.

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[128] Reproposed Note 1 to Rule 12g3-2(e). Rule 12g3-2(b) requires an exempt issuer to submit substantially the same categories of home country documents as a reporting issuer must furnish to the Commission under cover of Form 6-K. Moreover, both Rule 12g3-2(b) and Form 6-K state that only material information need be furnished under the rule and form. See Rule 12g3-2(b)(3) (17 CFR 240.12g3-2(b)(3)) and General Instruction B to Form 6-K.

[129] Note 3 to reproposed Rule 12g3-2(e). An issuer would not have to update the Form 15F to reflect a change in that address.

Therefore, we propose to amend Rule 12g3-2 to permit a foreign private issuer that, upon application to the Commission and not after filing Form 15F, has obtained or will obtain the Rule 12g3-2(b) exemption to publish its home country documents that it is required to furnish on a continuous basis under Rule 12g3-2(b)(1)(iii) on its Internet Web site or through an electronic information delivery system generally available to the public in its primary trading market.[130] As a condition to this electronic posting, an issuer that wishes to use this procedure would have to comply with the English translation requirements of reproposed Rule 12g3-2(e). It also would have to provide the Commission with the address of its Internet Web site or that of the electronic information delivery system in its primary trading market in its application for the Rule 12g3-2(b) exemption or in an amendment to that application.

Because currently the Commission does not have an established means for a non-reporting company to submit electronically to the Commission its initial documents under Rule 12g3-2(b)(1)(i) and (ii),[131] an applicant would have to continue to submit its letter application and the home country documents submitted in support of its initial application to the Commission in paper.[132] Commenters provided several suggestions in response to our request for comments relating to the operation of Rule 12g3-2(b) in general. We will consider these suggestions in future rulemaking, as appropriate.

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[130] Reproposed Rule 12g3-2(f).

[131] 17 CFR 240.12g3-2(b)(1)(i) and (ii).

[132] As under current practice, the applicant should send these initial materials to the Commission's Office of International Corporate Finance in the Division of Corporation Finance.

Some commenters suggested that the Commission impose a specific time limit, for example 3 years, governing how long an issuer must keep its home country documents on its Internet Web site. We decline to propose a specific time limit primarily because different types of home country documents may require different periods of electronic posting. While an issuer would be required to post electronically a home country document for a reasonable period of time, what constitutes a reasonable period would depend on the nature and purpose of the home country document. At a minimum, we suggest companies provide Web site access to their home country reports for at least a 12 month period.

We solicit comment on the reproposed electronic publishing requirement:

- Is it appropriate to require an issuer, which has claimed the Rule 12g3-2(b) exemption immediately upon the effectiveness of its termination of Exchange Act reporting obligations under Rule 12h-6, to publish in English its material home country documents required by Rule 12g3-2(b) on its Internet web site or through an electronic information delivery system generally available to the public in its primary trading market, as reproposed?
- Is it appropriate to permit an issuer that has obtained the Rule 12g3-2(b) exemption upon application to the Commission, and not under reproposed Rule 12h-6, to publish in English its material home country documents required by Rule 12g3-2(b) on its Internet web site or through an electronic information delivery system generally available to the public in its primary trading market, as reproposed?

General Request for Comments

We solicit comment on reproposed Rule 12h-6, reproposed Form 15F, reproposed amendments to Rules 12g-4, 12h-3, and 12g3-2, as well as to all other aspects of the reproposed rule amendments. Here and throughout the release, when we solicit comment, we are interested in hearing from all interested parties, including members and representatives of the investing public, representatives of foreign companies and foreign industry groups, representatives of broker-dealers, domestic issuers, and other participants in U.S. securities markets. We are further interested in learning from all parties what aspects of the rule reproposal they deem essential, what aspects they believe are preferred but not essential, and what aspects they believe should be modified. We also would like to know whether there are any facts or considerations not discussed in the comment letters submitted in response to the Original Proposing Release that, in your opinion, make adoption of reproposed Rule 12h-6 and the accompanying reproposed rule amendments inappropriate? We are still interested in commenters' views on the questions posed in the Original Proposing Release, as we are still considering those questions in light of the reproposal. Due to the advanced stage of this rulemaking, we intend to act expeditiously on the reproposed rules, so we encourage you to submit your comments promptly.

III. PAPERWORK REDUCTION ACT ANALYSIS

The reproposed rule amendments contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[133] The titles of the affected collection of informations are Form 20-F (OMB Control No.

[133] 44 U.S.C. 3501 et seq.

3235-0288), Form 40-F (OMB Control No. 3235-0381), Form 6-K (OMB Control No. 3235-0116), new Form 15F, and submissions under Exchange Act Rule 12g3-2 (OMB Control No. 3235-0119).[134] An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information such as Form 20-F or new Form 15F unless it displays a currently valid OMB control number. Compliance with the disclosure requirements of new Form 15F and new Rule 12h-6, which will affect the above collections of information, is mandatory.

Form 20-F sets forth the disclosure requirements for a foreign private issuer's annual report and registration statement under the Exchange Act as well as many of the disclosure requirements for a foreign private issuer's registration statements under the Securities Act. We adopted Form 20-F pursuant to the Exchange Act and the Securities Act in order to provide investors with information about foreign private issuers that have registered securities with the Commission.

Form 40-F sets forth the disclosure requirements regarding the annual report and registration statement under the Exchange Act for a Canadian issuer that is qualified to use the Multijurisdictional Disclosure System ("MJDS"). We adopted Form 40-F pursuant to the Exchange Act in order to permit qualified Canadian issuers to prepare their Exchange Act annual reports and registration statements based primarily in accordance with Canadian requirements.

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[134] A limited number of foreign private issuers file annual reports on Form 10-K (17 CFR 249.310) and a limited number of foreign private issuers file annual reports on Form 10-KSB (17 CFR 249.310b). In voluntarily electing to file periodic reports using domestic issuer forms, these issuers seem to have closely aligned themselves with the U.S. market. Accordingly, for the purpose of the Paperwork Reduction Act Analysis, these issuers do not appear likely to terminate their Exchange Act registration under new Rule 12h-6, and we have assumed that none of these companies will seek to use Rule 12h-6. Foreign private issuers that file periodic reports using domestic issuer forms will be eligible, nonetheless, to use Rule 12h-6.

Form 6-K is used by a foreign private issuer to report material information that it:

- makes or is required to make public under the laws of the jurisdiction of its incorporation, domicile or organization (its "home country");
- files or is required to file with its home country stock exchange that is made public by that exchange; or
- distributes or is required to distribute to its security holders.

A foreign private issuer may attach annual reports to security holders, statutory reports, press releases and other documents as exhibits or attachments to the Form 6-K. We adopted Form 6-K under the Exchange Act in order to keep investors informed on an ongoing basis about foreign private issuers that have registered securities with the Commission.

As reproposed, new Form 15F is the form that a foreign private issuer would have to file when terminating its Exchange Act reporting obligations under new Exchange Act Rule 12h-6. Form 15F would require a filer to disclose information that would help investors understand the foreign private issuer's decision to terminate its Exchange Act reporting obligations and assist Commission staff in assessing whether the Form 15F filer is eligible to terminate its Exchange Act reporting obligations pursuant to Rule 12h-6.

Exchange Act Rule 12g3-2 is an exemptive rule that, under paragraph (b) of that rule, provides an exemption from Exchange Act section 12(g) registration for a foreign private issuer that, in addition to satisfying other requirements, submits copies of its material home country documents to the Commission on an ongoing basis. We adopted paragraph (b) of Rule 12g3-2 in order to provide information for U.S. investors concerning foreign private issuers with limited securities trading in U.S. capital markets.

The hours and costs associated with preparing, filing and sending Forms 20-F, 40-F, 6-K and 15F, and making submissions under Exchange Act Rule 12g3-2(b) constitute reporting and cost burdens imposed by those collections of information. We based our estimates of the effects that the reproposed rule amendments would have on those collections of information primarily on our review of the most recently completed PRA submissions for Forms 20-F, 40-F, and 6-K, and for submissions under Rule 12g3-2(b), on the particular requirements for those forms and submissions, and on relevant information, for example, concerning comparative trading volume for numerous filers of those forms.

Reproposed Rule 12h-6 would permit a foreign private issuer to terminate its Exchange Act reporting obligations, including the obligation to file an annual report on Form 20-F or 40-F and the obligation to submit interim Form 6-K reports, after filing a Form 15F. Reproposed Rule 12h-6 and the accompanying rule amendments would also enable a foreign private issuer to claim the Rule 12g3-2(b) exemption immediately upon the effectiveness of its termination of reporting pursuant to the reproposed, new exit rule, and to publish copies of its home country documents required by Rule 12g3-2(b) on its Internet Web site instead of submitting them in paper to the Commission. We have based the annual burden and cost estimates of the adopted rule amendments on Forms 20-F, 40-F, 6-K and 15F, and on the home country submissions required under Rule 12g3-2(b), on the following estimates and assumptions:

- a foreign private issuer incurs or will incur 25% of the annual burden required to produce each Form 20-F or 40-F report or Form 15F;
- outside firms, including legal counsel, accountants and other advisors, incur or

will incur 75% of the burden required to produce each Form 20-F or 40-F report or Form 15F at an average cost of $400 per hour;

- a foreign private issuer incurs or will incur 75% of the annual burden required to produce each Form 6-K report and Rule 12g3-2(b) submission, not including English translation work, and 25% of the annual burden required to perform the English translation work for Form 6-K reports and Rule 12g3-2(b) submissions; and
- outside firms, including legal counsel, accountants and other advisors, incur or will incur 25% of the burden required to produce each Form 6-K report and Rule 12g3-2(b) submission, not including English translation work, at an average cost of $400 per hour, and 75% of the annual burden resulting from the English translation work for Form 6-K reports and Rule 12g3-2(b) submissions, at an average cost of $125 per hour.[135]

As was the case with the originally proposed rule amendments, the estimated effects of the reproposed rule amendments reflect the initial phase-in period of the Exchange Act termination process under new Rule 12h-6 and Form 15F during the first year of use. We expect that most of these estimated effects would occur on a one-time, rather than a recurring, basis. While we expect that some issuers would terminate their Exchange Act reporting under Rule 12h-6 and file Form 15F in subsequent years, we do not expect the resulting burdens and costs to be of the same magnitude as the burdens and

[135] We relied on most of these estimates and assumptions for the proposed rulemaking. However, at the original proposing stage, we used an estimated hourly rate of $300 for work performed by an outside firm, not including English translation work. We recently increased the estimated outside firm rate to $400/hour after consulting with several private law firms. We have used the $400/hour rate for outside firms in this reproposing rulemaking.

costs currently expected during the first year. Moreover, we expect that, over time the number of foreign private issuers that are encouraged to enter the Exchange Act reporting system as a result of the reproposed rule amendments would increase so that, on an annual basis, the number of foreign companies entering the Exchange Act reporting regime would exceed the number exiting that regime.

We published a notice requesting comment on the collection of information requirements in the Original Proposing Release and submitted these requirements to the Office of Management and Budget ("OMB") for review in accordance with the PRA.[136] OMB subsequently approved the proposed requirements without change. As discussed in Part II above, we received several comment letters regarding the proposed rule amendments, although none addressed their estimated effects on the collection of information requirements. We have revised proposed Rule 12h-6 and the accompanying proposed rule amendments in response to these comments. Because of these changes, we have revised the estimated reporting and cost burdens of the reproposed rule amendments, as discussed below.

A. Form 20-F

During the first year of effectiveness of reproposed Rule 12h-6, we estimate that as many as 25% of Form 20-F filers could terminate their Exchange Act reporting obligations under the new rule, compared to the 15% previously estimated under the earlier, proposed rule amendments.[137] However, we continue to believe that Rule 12h-6

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[136] 44 U.S.C. 3507(d) and 5 CFR 1320.11.

[137] This estimate has increased due to a number of revisions to the proposed rule, which should enable more foreign private issuers to qualify for termination of Exchange Act reporting under reproposed Rule 12h-6 than under the proposed rule. A review by the Commission's Office of Economic Analysis of trading volume data on a sample of foreign Exchange Act reporting

would encourage some foreign companies to enter the Exchange Act registration and reporting regime for the first time. Consequently, during the first effective year of Rule 12h-6, the number of Form 20-F annual reports filed could increase by 5%, leading to a net decrease of 20% for Form 20-Fs filed over this same period. This net decrease would cause:

- the number of Form 20-Fs filed to decrease to 880, which is 110 less than the 990 estimated under the originally proposed rule;[138]
- the total number of burden hours required to produce Form 20-F[139] to decrease to 2,314,400 total hours, which is 289,300 hours less than the decrease to 2,603,700 total hours estimated under the originally proposed rule;[140]
- the total number of burden hours required by foreign private issuers to produce Form 20-F to decrease to 578,600 total hours, which is 72,325 hours less than the decrease to 650,925 total hours estimated under the orginally proposed rule;[141] and

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companies that filed Form 20-F during 2004 suggests that approximately 30% of filers would meet the U.S. trading volume threshold of the reproposed rule. That percentage may vary by region.

[138] 1,100 Form 20-Fs filed annually (prior to this rulemaking) x .20 = 220; 1,100 - 220 = 880 Form 20-Fs filed annually.

[139] As in the Original Proposing Release, we estimate that a foreign private issuer requires on average 2,630 hours to produce each Form 20-F.

[140] 880 Form 20-Fs filed annually x 2,630 hours per Form 20-F = 2,314,400 hours.

[141] 880 Form 20-Fs x 2,630 hours per Form 20-F x .25 = 578,600 hours. Thus, we estimate that, during the first year of effectiveness of Rule 12h-6, foreign private issuers could incur a reduction of 144,650 hours in the number of burden hours required to produce Form 20-F. 220 Form 20-Fs x 2,630 hrs x .25 = 144,650 hours. Using an estimated hourly rate of $175 for in-house work, foreign private issuers could incur Form 20-F cost savings of $25,313,750 during Rule 12h-6's first year of effectiveness. 144,650 hrs. x $175/hr. = $25,313,750.

- the cost incurred by outside firms to produce Form 20-F to total $694,320,000, [142] which is $108,487,500 more than the $585,832,500 estimated under the originally proposed rule.[143]

B. Form 40-F

During the first year of effectiveness of reproposed Rule 12h-6, we estimate that as many as 10% of Form 40-F filers could terminate their Exchange Act reporting obligations under the new rule, which is the same percentage previously estimated under the originally proposed rule amendments.[144] However, the reproposed rule could encourage some foreign companies to enter the Exchange Act registration and reporting regime for the first time, including some that would be eligible to use the MJDS forms, including the Form 40-F annual report. Consequently, over this same period, the number of Form 40-F annual reports filed could increase by approximately 3%, resulting in a net decrease of 7% for Form 40-Fs filed over this same period.[145] This net decrease would

[142] 880 Form 20-Fs x 2,630 hours x .75 x $400/hour = $694,320,000. The $108,487,500 increase reflects the increase in the estimated outside firm hourly rate from $300 to $400.

[143] We further estimate cost savings of $173,580,000 regarding outside firms' production of Form 20-Fs during Rule 12h-6's first year of effectiveness. 220 Form 20-Fs x 2,630 hrs. x .75 x $400/hr. = $173,580,000. Thus, during the first year of its effectiveness, Rule 12h-6 could result in total estimated Form 20-F cost savings of $198,893,750. $25,313,750 + $173,580,000 = $198,893,750.

[144] We do not expect the expanded scope of reproposed Rule 12h-6 to have as great an effect on MJDS filers as other foreign reporting companies since, typically, the percentage of an MJDS filer's shares held by U.S. residents and the U.S. trading volume relating to those shares is significant. Moreover, because of their close proximity to U.S. capital markets, we believe MJDS filers are less likely to seek to terminate their Exchange Act reporting obligations than other foreign private issuers. Accordingly, based on current experience, we expect no more than 10% of Form 40-F filers would terminate their Exchange Act reporting obligations under reproposed Rule 12h-6.

[145] This is the same percentage previously estimated under the originally proposed rule amendments.

cause:

- the number of Form 40-Fs filed to total 125;[146]
- the number of burden hours required to produce Form 40-F[147] to total 53,375 total hours;[148]
- the number of burden hours required by foreign private issuers to produce Form 40-F to total 13,344 hours;[149] and
- the cost incurred by outside firms to produce Form 40-F to total $16,012,500, which is $4,003,125[150] more than the $12,009,375 estimated under the originally proposed rule.[151]

C. Form 6-K

During the first year of effectiveness of reproposed Rule 12h-6, we estimate that

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[146] 134 Form 40-Fs filed annually (prior to this rulemaking) x .07 = 9; 134 - 9 = 125 Form 40-Fs filed annually.

[147] As in the Original Proposing Release, we estimate that it takes 427 hours on average to produce a Form 40-F report.

[148] 125 Form 40-Fs filed annually x 427 hours per Form 40-F = 53,375 hours.

[149] 125 Form 40-Fs filed annually x 427 hours per Form 40-F x .25 = 13,344 hours. Thus, we estimate that, during the first year of effectiveness of reproposed Rule 12h-6, foreign private issuers could incur a reduction of 961 hours in the number of burden hours required to produce Form 40-F. 9 Form 40-Fs x 427 hrs. x .25 x = 961 hrs. This could result in estimated Form 40-F cost savings for foreign private issuers of $168,175. 961 hrs. x $175/hr. = $168,175.

[150] The $4,003,125 increase results from an increase in the estimated outside firm hourly rate from $300 to $400.

[151] 125 Form 40-Fs filed annually x 427 hours per Form 40-F x .75 x $400/hour = $16,012,500. This estimate corresponds to estimated cost savings of $1,152,900 in connection with outside firms' production of Form 40-F during reproposed Rule 12h-6's first year of effectiveness. 9 x 427 hrs. x .75 x $400/hr. = $1,152,900. Thus, during the first year of its effectiveness, Rule 12h-6 could result in estimated total Form 40-F cost savings of $168,175 + $1,152,900 = $1,321,075.

as many as 23% of foreign private issuers that furnish Form 6-K reports could terminate their Exchange Act reporting obligations under the new rule,[152] compared to the 14% previously estimated under the originally proposed rule amendments. However, the reproposed rule could encourage some foreign companies to enter the Exchange Act registration and reporting regime for the first time, including those that would furnish Form 6-K reports. Consequently, over this same period, the number of Form 6-K reports furnished could increase by as much as 5%,[153] resulting in a net decrease of 18% for Form 6-Ks furnished over this same period. This net decrease would cause:

- the number of Form 6-K reports furnished to decrease to 12,022, which is 1,320 less than the 13,342 estimated under the originally proposed rule;[154]
- the total number of burden hours required to produce the Form 6-Ks[155] to decrease to 104,591 total hours,[156] which is 12,054 hours less than the decrease to 116,645 total hours estimated under the originally proposed rule;
- the total number of burden hours required by foreign private issuers to produce

[152] This estimate is based on the estimated number of Form 20-F and Form 40-F filers that are expected to terminate their Exchange Act reporting obligations under reproposed Rule 12h-6. 1,100 Form 20-Fs x .25 = 275; 134 Form 40-Fs x .10 = 13; 288 = .23 x 1,234.

[153] This estimate is based on the estimated number of foreign private issuers that are expected to enter the Exchange Act reporting regime and file Form 20-Fs or Form 40-Fs as a result of this reproposed rulemaking during the first year of effectiveness. 1,100 Form 20-Fs x .05 = 55; 134 Form 40-Fs x .03 = 4; 59 = .05 x 1,234.

[154] 14,661 Form 6-K reports x .18 = 2,639; 14,661-2,639 = 12,022 Form 6-K reports.

[155] In the Original Proposing Release, we estimated that, prior to this rulemaking, it took a total of 127,197 annual burden hours to produce the 14,661 Form 6-Ks, or approximately 8.7 hours per Form 6-K (for work performed by foreign private issuers and outside firms). We continue to use this 8.7 hour estimate for the reproposed rule amendments.

[156] 12,022 Form 6-K reports x 8.7 hours = 104,591 hours.

Form 6-K[157] to decrease to 65,369 hours,[158] which is 17,572 hours less than the decrease to 82,941 total hours estimated under the originally proposed rule;[159] and

- the cost incurred by outside firms to produce Form 6-K to total $10,295,775,[160] which is $2,078,475 more than the $8,217,300 estimated under the originally proposed rule.[161]

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[157] In the Original Proposing Release, we estimated that the amount of time required to translate foreign language materials into English constitutes approximately 8% of the total hours required to produce Form 6-K. We have revised this estimate to 25% based on updated information provided by financial printer representatives.

[158] 104,591 hours x .25 = 26,148 hours for English translation work; 104,591 hours - 26,148 hours = 78,443 hours for non-English translation work; 78,443 hours x .75 = 58,832 hours for non-English translation work performed by foreign private issuers; 26,148 hours x .25 = 6,537 hours of English translation work performed by foreign private issuers; 58,832 hours + 6,537 hours = 65,369 total hours for Form 6-K work performed by foreign private issuers, or 5.4 hours for foreign private issuer work per Form 6-K.

[159] We further estimate that, during the first year of effectiveness of reproposed Rule 12h-6, foreign private issuers could incur a reduction of 14,349 hours in the number of burden hours required to produce Form 6-K. 2,639 Form 6-Ks x 8.7 hours = 22,959 hours; 22,959 hours x .25 = 5,740 hours of English translation work; 5,740 hours x .25 = 1,435 hours of English translation work for foreign private issuers; 22,959 x .75 = 17,219 hours of non-English translation work; 17,219 x .75 = 12,914 hours of non-English translation work for foreign private issuers; 1,435 + 12,914 = 14,349 hours. This could result in estimated Form 6-K cost savings of $2,511,075 for foreign private issuers during the first year of reproposed Rule 12h-6's effectiveness. 14,349 hrs. x $175/hr. = $2,511,075.

[160] 78,443 hours x .25 = 19,611 hours x $400/hour = $7,844,400 for non-translation work; 26,148 hours x .75 = 19,611 hours x $125/hour = $2,451,375 for English translation work; $7,844,400 + $2,451,375 = $10,295,775 for total work performed by outside firms. The $2,078,475 increase reflects the increase in the estimated outside firm hourly rate from $300 to $400.and the increase in the estimated outside firm rate for English translation work from $75 to $125/hour based on current information provided by financial printer representatives.

[161] This estimate corresponds to estimated cost savings of $2,260,025 in connection with outside firms' production of Form 6-K during Rule 12h-6's first year of effectiveness. 5,740 hrs. x .75 x $125/hour = $538,125 for English translation work; 17,219 x .25 x $400/hour = $1,721,900 for non-English translation work. $538,125 + $1,721,900 = $2,260,025 in Form 6-K cost savings for outside firms. Thus, Rule 12h-6 could result in total estimated Form 6-K cost savings of $4,771,100. $2,511,075 + $2,260,025 = $4,771,100.

D. **Form 15F**

During the first year of effectiveness of reproposed Rule 12h-6, we estimate that as many as 351 foreign private issuers[162] could file a Form 15F to terminate their Exchange Act reporting obligations compared to the 178 previously estimated under the originally proposed rule amendments. This increase in the estimated number of Form 15F filers could cause:

- the number of burden hours required to produce Form 15F[163] to total 10,530 hours,[164] which is 5,190 hours more than the 5,340 hours estimated under the originally proposed rule amendments;
- foreign private issuers to incur a total of 2,633 hours to produce Form 15F,[165] which is 1,298 hours more than the 1,335 hours estimated under the originally proposed rule amendments; and

[162] We derived this estimate from the number of Form 20-F filers (275) and Form 40-F filers (13) estimated to elect to terminate their Exchange Act reporting obligations under reproposed Rule 12h-6 during the first year of the rule's effectiveness. We then added to this sum (288) the number of prior Form 15 filers (63) estimated to file a Form 15F during the first year of reproposed Rule 12h-6's effectiveness in order to make their Form 15 termination or suspension of reporting obligations . The latter number is based on the approximate number of foreign private issuers that filed a Form 15 from 2003 through the present.

[163] In the Original Proposing Release, we estimated that the production of each Form 15F would require 30 hours. Although we have revised some aspects of the originally proposed Form 15F, we do not believe these changes are significant enough to affect materially this 30 hour estimate. Therefore, we continue to use this estimate for the reproposed rule amendments.

[164] 351 Form 15Fs x 30 = 10,530 hours.

[165] 10,530 hours x .25 = 2,633 hours. This could result in estimated Form 15F costs for foreign private issuers of $460,775 during reproposed Rule 12h-6's first year of effectiveness. 2,633 hrs. x $175 = $460,775.

- outside firms to incur a total cost of $3,159,200 to produce Form 15F,[166] which is $1,174,700 more than the $1,984,500 estimated under the originally proposed rule amendments.[167]

E. Rule 12g3-2(b) Submissions

We estimate that 685 foreign private issuers currently have obtained the Rule 12g3-2(b) exemption.[168] In addition, we estimate that each Rule 12g3-2(b) exempt issuer currently makes 12 Rule 12g3-2(b) submissions per year for a total of 8,220 Rule 12g3-2(b) submissions. We further estimate that it takes a total of 32,880 annual burden hours, or 4 annual burden hours per submission (for work performed by foreign private issuers and outside firms), to produce the 8,220 Rule 12g3-2(b) submissions.[169]

During the first year of effectiveness of reproposed Rule 12h-6, we estimate that as many as 351 foreign private issuers could claim the Rule 12g3-2(b) exemption immediately upon the effectiveness of their termination of reporting under reproposed

[166] 10,530 hours x .75 = 7,898 hours; 7,898 hours x $400/hour = $3,159,200. The $3,159,200 increase reflects the increase in the number of estimated Form 15F filers and the increase in the estimated outside firm hourly rate from $300 to $400.

[167] Thus, reproposed Rule 12h-6 could result in total estimated Form 15F costs of $3,619,975 during its first year of effectiveness. $460,775 + $3,159,200 = $3,619,975.

[168] This estimate is based on Commission staff's most recent annual review of the number of current Rule 12g3-2(b) exempt companies, which will be available soon on our Internet Web site at http://www.sec.gov/divisions/corpfin.shtml.

[169] These estimates represent an adjustment of 31,080 hours from the 1,800 total hours previously reported for Rule 12g3-2(b) submissions. As part of this rulemaking, we have re-evaluated the number of foreign private issuers that currently claim the Rule 12g3-2(b) exemption, the number of Rule 12g3-2(b) submissions made by them, and the number of burden hours required for their production, in addition to assessing the effects on Rule 12g3-2(b) submissions expected to result from adoption of the final rule amendments. We believe these estimates more accurately reflect the current burden hours required for the collections of information submitted under Rule 12g3-2(b).

Rule 12h-6.[170] This increase in the number of Rule 12g3-2(b) exempt issuers would cause:

- the number of issuers claiming the Rule 12g3-2(b) exemption to total 1,036;
- the number of Rule 12g3-2(b) submissions made annually to total 12,432;
- the number of annual burden hours required to produce these Rule 12g3-2(b) submissions to total 49,728 hours;
- foreign private issuers to incur a total of 31,080 annual burden hours to produce these Rule 12g3-2(b) submissions, or 2.5 annual burden hours per submission;[171] and
- outside firms to incur a total cost of $4,909,275[172] to produce the

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[170] This amount includes the estimated 288 Form 20-F and 40-F filers expected to terminate their Exchange Act reporting obligations under reproposed Rule 12h-6 as well as the estimated 63 prior Form 15 filers expected to file a Form 15F to make their prior termination or suspension of reporting under Rule 12h-6.

[171] Because the home country document submission requirement under Rule 12g3-2(b) is similar to the home country document submission requirement under Form 6-K, we have used the same assumptions regarding the English and non-English translation work required under Rule 12g3-2(b) that we adopted for Form 6-K submissions. Accordingly: 49,728 hours x .25 = 12,432 total annual burden hours for English translation work; 49,728 - 12,432 = 37,296 total annual burden hours required for non-English translation work; 37,296 hours x .75 = 27,972 total annual burden hours incurred by foreign private issuers for non-English translation work; 12,432 hours x .25 = 3,108 total annual hours incurred by foreign private issuers for English translation work; 27,972 + 3,108 = 31,080 total annual burden hours incurred by foreign private issuers for Rule 12g3-2(b) submissions, or 2.5 annual burden hours per submission. Of the 31,080 hours, 10,530 hours would result from adoption of the reproposed rules and 20,550 hours represents an adjustment from the previous PRA estimates for Rule 12g3-2 submissions.

[172] 49,728 hours x .25 = 12,432 hours for English translation work; 12,432 hours x .75 = 9,324 hours; 9,324 hours x $125 = $1,165,500 for English translation work; 49,728 hours - 12,432 hours = 37,296 hours for non-English translation work; 37,296 hours x .25 = 9,324 hours; 9,324 hours x $400 = $3,729,600 for non-English translation work; $1,165,500 + $3,729,600 = $4,895,100 for total work performed by outside firms. Of that total amount, $1,658,475 would result from adoption of the reproposed rules and $3,236,625 constitutes an adjustment from the previous PRA estimates for Rule 12g3-2 submissions.

Rule 12g3- 2(b) submissions.[173]

Comment Solicited

We solicit comment on the expected effects of reproposed Rule 12h-6 and the accompanying reproposed rule amendments on Form 20-F, Form 40-F, Form 6-K and Rule 12g3-2(b) submissions and on the expected effects of reproposed Form 15F under the PRA. In particular, we solicit comment on:

- the extent to which foreign private issuers would respond to reproposed Rule 12h-6 by electing to file Form 15F to terminate their registration and reporting in the U.S.;
- how many foreign private issuers would join the Exchange Act registration and reporting regime for the first time as a result of the reproposed rule;
- how accurate are our burden hour and cost estimates for Forms 20-F, 40-F, and 6-K, and Rule 12g3-2(b) submissions expected to result from the reproposed rule amendments;
- how accurate are our burden hour and cost estimates for reproposed Form 15F; and
- whether most of the effects of reproposed Rule 12h-6 would occur during the

[173] We further estimate that reproposed Rule 12h-6 and the accompanying rule amendments could result in total estimated Rule 12g3-2(b) costs of $3,501,225 during the first year of their effectiveness. 351 issuers x 12 submissions/issuer x 2.5 hrs./submission = 10,530 hours; 10,530 hours x $175/hr. = $1,842,750 in Rule 12g3-2(b) submission costs for foreign private issuers. For outside firm costs: 351 issuers x 12 submissions/issuer x 4 hrs./submission = 16,848 hours; 16,848 x .25 = 4,212 hours of English translation work; 4,212 x .75 x $125 = $394,875 of English translation costs for outside firms. 16,848 hours x .75 = 12,636 hours of non-English translation work; 12,636 x .25 x $400 = $1,263,600 of non-English translation costs for outside firms. $394,875 + $1,263,600 = $1,658,475 in total Rule 12g3-2(b) submission costs for outside firms. $1,842,750 + $1,658,475 = $3,501,225 in total estimated Rule 12g3-2(b) costs.

first year, as expected, or over a longer period, for example, during the first two or three years.

We further solicit comment in order to:

- evaluate whether the reproposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility;
- determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected;
- evaluate whether there are ways to minimize the burden of the collections of information on those who respond, including through the use of automated collection techniques or other forms of information technology; and
- evaluate whether the reproposed rule amendments will have any effects on any other collections of information not previously identified in this section.

Any member of the public may direct to us any comments concerning these burden and cost estimates and any suggestions for reducing the burdens and costs. Persons who desire to submit comments on the collections of information requirements should direct their comments to the OMB, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and send a copy of the comments to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-9303, with reference to File No. S7-12-05. Requests for materials submitted to the OMB by us with regard to these collections of information should be in writing, refer to File No. S7-12-05, and be submitted to the Securities and Exchange Commission, Records Management, Office of

Filings and Information Services, 100 F Street, NE, Washington, DC 20549. Because the OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, your comments are best assured of having their full effect if the OMB receives them within 30 days of publication.

IV. COST-BENEFIT ANALYSIS

A. Expected Benefits

Reproposed Rule 12h-6 and the accompanying rule amendments would benefit U.S. investors to the extent that they remove a possible disincentive for foreign companies that are not currently Exchange Act reporting companies to register their equity and debt securities with the Commission. In response to foreign companies' concerns about Exchange Act reporting and other obligations, these rules would fine-tune the criteria by which a foreign company may terminate those obligations. In so doing, the reproposed rule amendments should over time remove an impediment to foreign company access and participation in U.S. public capital markets while still providing U.S. investors with the protections afforded by our Exchange Act reporting regime.

The reproposed rule amendments should remove a disincentive for foreign firms to enter our Exchange Act reporting regime by lowering the cost of exiting from that regime. Investors are expected to benefit from the amendments by being able to purchase shares in foreign firms that have been registered with the Commission and that, therefore, provide a high level of investor protection. In addition, U.S. investors may incur lower transaction costs when trading a foreign company's shares on a U.S. exchange relative to a foreign exchange.

To remove a disincentive for foreign companies to enter U.S. public capital markets, the reproposed rule amendments would benefit U.S. investors by enabling a foreign Exchange Act reporting company to lower its costs of compliance in connection with Exchange Act deregistration. This reduction in the cost of compliance would directly benefit both foreign companies and their investors, including those resident in the United States.

The reproposed rule amendments would result in foreign private issuers incurring lower costs of Exchange Act compliance in four possible ways. First, rather than require a foreign private issuer to determine the number of its U.S.holders, as is the case under the current exit rules, reproposed Rule 12h-6 would enable a foreign private issuer to rely solely on trading volume data regarding its securities in the United States and its primary trading market when determining whether it may terminate its Exchange Act reporting obligations. Because trading volume data is more easily obtainable than information regarding its U.S. shareholders, the reproposed rule should lower the costs of Exchange Act termination for foreign private issuers.

Second, reproposed Rule 12h-6 would allow a foreign firm to terminate its Exchange Act reporting obligations regarding a class of equity securities and immediately obtain the Rule 12g3-2(b) exemption. Accordingly, such a terminating foreign private issuer would be able to avoid the costs associated with continued annual verification that its number of holders of record remains below 300.

Third, the reproposed rule would permit an issuer to rely on the assistance of an independent information services provider when determining whether it falls below the 300 U.S. holder standard. The option to hire an independent information services

provider may be a more efficient and cost-effective mechanism to make that determination. Moreover, a foreign company may save costs when assessing its eligibility to terminate its registration and reporting under the 300 record holder provision of reproposed Rule 12h-6, since the rule would limit the number of jurisdictions in which a foreign private issuer must search for the amount of securities represented by accounts of customers resident in the United States held by brokers, dealers, banks and other nominees. The current rules require a foreign private issuer to conduct a worldwide search for such U.S. customer accounts.

Fourth, once having terminated its reporting obligations under reproposed Rule 12h-6, a foreign company would no longer be required to incur costs associated with producing an Exchange Act annual report or interim Form 6-K reports.[174] Based on estimates and assumptions used for the purpose of the Paperwork Reduction Act, these estimated cost savings could total approximately $200,000,000 for the first year of reproposed Rule 12h-6's effectiveness.[175]

B. Expected Costs

Investors could incur costs from the reproposed rule amendments to the extent that currently registered foreign companies respond to the rule changes by terminating their Exchange Act registration and reporting obligations with respect to their equity and

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[174] We recognize that, as a result of terminating their Exchange Act reporting obligations under reproposed Rule 12h-6, foreign firms may accrue other cost savings that are not specifically quantified in this section. One such example is an investment in an internal control system in order to comply with the Sarbanes-Oxley Act.

[175] As discussed in Part III of this release, for the first year of reproposed Rule 12h-6's effectiveness, estimated cost savings in connection with Forms 20-F, 40-F and 6-K could amount to, respectively, $198,893,750, $1,321,075, and $4,771,100, for a total of $204,985,925.

debt securities. If Exchange Act disclosure requirements provide more information or protection to U.S. or other investors than is provided in an issuer's primary trading market, then all investors, both U.S. and foreign, may suffer the costs of losing that information and protection upon Exchange Act termination.[176] If this is the case, the announcement that a foreign firm is terminating its Exchange Act reporting may result in a loss of share value and the incurrence by investors of higher costs from trading in the firm's equity and debt securities.

There are costs associated with the filing of reproposed Form 15F, which is a requirement for a foreign private issuer that terminates its Exchange Act registration and reporting under Rule 12h-6.[177] A foreign private issuer will also incur costs in connection with having to post on its Internet Web site in English its material home country documents required to maintain the Rule 12g3-2(b) exemption that it will have received upon the effectiveness of its termination of reporting under reproposed Rule 12h-6.[178]

We expect that reproposed Rule 12h-6 would enable some foreign registrants to avoid other recent U.S. regulation, such as the Sarbanes-Oxley Act.[179] Investors would

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[176] Conversely, in countries that have similar regulatory regimes and levels of investor protection, the impact of U.S. deregistration may be mitigated.

[177] As discussed in Part III of this release, based on estimates and assumptions adopted for the purpose of the Paperwork Reduction Act, these costs could total $3,619,975 during the first year of the reproposed form's use.

[178] As discussed in Part III of this release, based on estimates and assumptions adopted for the Paperwork Reduction Act, these resulting Rule 12g3-2(b) costs could amount to $3,501,225.

[179] 15 U.S.C. 7201 et seq.

lose the benefits afforded by the Sarbanes-Oxley Act to the extent a current foreign registrant is not fully subject to that Act.

Some U.S. investors might seek to trade in the equity securities of a foreign company following its termination of Exchange Act reporting under reproposed Rule 12h-6. U.S. investors seeking to trade the former reporting company's securities in the U.S. may be forced to trade in over-the-counter markets such as the one administered by Pink Sheets, LLC, which could result in higher transaction costs than if the foreign company had continued to have a class of securities registered with the Commission.

U.S. investors seeking to trade the former reporting company's securities in its primary trading market also could incur additional costs. For example, U.S. investors who held the securities in the form of ADRs could incur costs associated with the depositary's conversion of the ADRs into ordinary shares.[180] Moreover, some U.S. investors could incur costs associated with finding and contracting with a new broker-dealer who is able to trade in the foreign reporting company's primary trading market. U.S. investors may face additional costs due to the cost of currency conversion and higher transaction costs trading the securities in a foreign market.

Some investors who wish to make investment decisions regarding former Exchange Act reporting foreign companies also may incur costs to the extent that the

[180] A foreign company may terminate its ADR facility whether or not it is an Exchange Act registrant, and reproposed Rule 12h-6 does not require the termination of ADR facilities. In fact, by granting foreign private issuers the Rule 12g3-2(b) exemption immediately upon their termination of reporting with regard to a class of equity securities, Rule 12h-6 would enable foreign private issuers to retain their ADR facilities as unlisted facilities following their termination of reporting under Rule 12h-6. As reproposed, Rule 12h-6 would require an issuer that has terminated a sponsored ADR facility to wait a year before it may file a Form 15F in reliance on the trading volume provision of reproposed Rule 12h-6.

information provided by such companies pursuant to any home country regulations is different from that which currently is required under the Exchange Act. Such investors could incur costs associated with hiring an attorney or investment adviser, to the extent that they have not already done so, to explain the material differences, if any, between a foreign company's home country reporting requirements, as reflected in its home country annual report posted on its Internet Web site, and Exchange Act reporting requirements.

Comment Solicited

We solicit comment on the costs and benefits to U.S. and other investors, foreign private issuers, and others who may be affected by reproposed Rule12h-6, reproposed Form 15F and the associated reproposed rule amendments. We request your views on the costs and benefits described above as well as on any other costs and benefits that could result from adoption of the reproposed rules. We also request data to quantify the costs and value of the benefits identified. In particular, we solicit comment on:

- the number of current foreign private issuers that are expected to terminate their Exchange Act registration and reporting as a result of reproposed Rule 12h-6 and the accompanying reproposed rule amendments and the timing of such termination;
- the number of prospective foreign companies that are expected to join the Exchange Act reporting regime as a result of the reproposed rules and the timing of such intial registration and reporting; and
- how investors would be affected both directly and indirectly from the rule proposals, as discussed in this section.

V. CONSIDERATION OF IMPACT ON THE ECONOMY, BURDEN ON COMPETITION AND PROMOTION OF EFFICIENCY, COMPETITION AND CAPITAL FORMATION ANALYSIS

When adopting rules under the Exchange Act, Section 23(a)(2) of the Exchange Act[181] requires us to consider the impact that any new rule would have on competition. Section 23(a)(2) also prohibits us from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. Furthermore, when engaging in rulemaking that requires us to consider or determine whether an action is necessary or appropriate in the public interest, Section 3(f) of the Exchange Act[182] requires the Commission to consider whether the action will promote efficiency, competition and capital formation.

In the Original Proposing Release, we considered proposed Rule 12h-6 and the accompanying proposed rule amendments in light of the standards set forth in the above statutory sections. We solicited comment on whether, if adopted, proposed Rule 12h-6 and the other proposed rule amendments would result in any anti-competitive effects or promote efficiency, competition and capital formation. We further encouraged commenters to provide empirical data or other facts to support their views on any anti-competitive effects or any burdens on efficiency, competition or capital formation that might result from adoption of proposed Rule 12h-6 and the other proposed rule amendments.

Although most commenters did not submit any empirical data to support their views, many commenters maintained that proposed Rule 12h-6 would not achieve its

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[181] 15 U.S.C. 78w(a)(2).

[182] 15 U.S.C. 78c(f).

intended purpose--to facilitate the exit from the Exchange Act reporting system of a foreign private issuer in which there is relatively little U.S. market interest and thereby remove a disincentive for other foreign companies to join that system. According to these commenters, because a significant number of foreign reporting companies would not benefit from the proposed new rules, other foreign companies would avoid registering their securities with the Commission out of concern that once an issuer became an Exchange Act reporting company, it would remain one indefinitely. Consequently, according to these commenters, contrary to the Commission's intention, the rule proposals would not promote competition and capital formation by foreign private issuers in the U.S. securities markets.

In response to these concerns, we have revised the rule proposals in several respects, including proposing a provision that would enable a foreign registrant to terminate its Exchange Act reporting obligations based solely on trading volume data, which should be more easily obtainable than information regarding the number of a foreign registrant's U.S. holders or the percentage of shares held by such holders. We believe the reproposed rule amendments will provide a foreign reporting company with a more efficient option of exiting the Exchange Act reporting system when U.S. investor interest has become relatively scarce. In so doing, reproposed Rule 12h-6 and the other reproposed rule amendments should encourage foreign private issuers to register their equity and debt securities with the Commission by reassuring foreign private issuers that, should interest in the U.S. market for their securities decline sufficiently, they may exit the Exchange Act reporting system with little difficulty.

By providing increased flexibility for foreign private issuers regarding our Exchange Act reporting system, the reproposed rule amendments should encourage foreign companies to participate in U.S. capital markets as Exchange Act reporting companies to the benefit of investors. In so doing, the reproposed rule amendments should foster increased competition between domestic and foreign firms for investors in U.S. capital markets.

Moreover, by requiring a foreign private issuer that has terminated its Exchange Act reporting under reproposed Rule 12h-6 to publish its home country documents required under Exchange Act Rule 12g3-2(b) in English on its Internet web site or through an electronic information delivery system that is generally available to the public in its primary trading market, the reproposed rules would help ensure that U.S. investors continue to have ready access to material information in English about the foreign private issuer.[183] Thus, reproposed Rule 12h-6 and the accompanying rule amendments should foster increased efficiency in the trading of the issuer's securities for U.S. investors following the issuer's termination of Exchange Act reporting.

Comment Solicited

We solicit comment on whether the reproposed rules would impose a burden on competition or whether they would promote efficiency, competition and capital formation. Commenters are requested to provide empirical data and other factual support for their views if possible.

[183] Similarly, by expanding the scope of proposed Rule 12h-6 to permit prior Form 15 filers to terminate their Exchange Act reporting obligations under the reproposed, new exit rule and claim the Rule 12g3-2(b) exemption immediately upon such termination, the reproposed rules would help promote the availability of material home country information in English about those issuers for U.S. investors.

VI. REGULATORY FLEXIBILITY ACT CERTIFICATION

The Securities and Exchange Commission hereby certifies, pursuant to 5 U.S.C. 605(b), that reproposed Rule 12h-6 and reproposed Form 15F under the Exchange Act, the reproposed amendments to Rules 12g3-2, 12g-4 and 12h-3 under the Exchange Act, and the reproposed amendments to Rule 30-1 of its Delegation of Authority rules and Rule 101 of Regulation S-T, if adopted, would not have a significant economic impact on a substantial number of small entities for purposes of the Regulatory Flexibility Act. The reason for this certification is as follows.

Reproposed Rule 12h-6, reproposed Form 15F and the accompanying reproposed rule amendments would permit the termination of Exchange Act reporting by a foreign private issuer regarding a class of equity securities under either Exchange Act section 12(g) or section 15(d) for which U.S. markets show relatively little interest. The reproposed rules would further permit a foreign private issuer that seeks termination of reporting regarding a class of equity or debt securities to also terminate its section 15(d) reporting obligations regarding a class of debt securities as long as it meets conditions similar to those currently required for suspending reporting obligations under section 15(d). The reproposed rule amendments would also automatically extend the Exchange Act Rule 12g3-2(b) exemption to a foreign private issuer that has terminated its Exchange Act reporting obligations with regard to a class of equity securities pursuant to reproposed Rule 12h-6 on the condition that it publish material information required by its home country in English on its Internet web site or through an electronic information delivery system that is generally available to the public in its primary trading market. The reproposed rule amendments would similarly extend an electronic

publishing option to a foreign private issuer that has obtained the Rule12g3-2(b) exemption upon application and not under Rule 12h-6.

Because reproposed Rule 12h-6 and the accompanying reproposed rule amendments would only apply to foreign private issuers, they would directly affect only foreign companies and not domestic companies. Similarly, reproposed Form 15F would only affect foreign companies since only foreign private issuers would be permitted to use this form.

Based on an analysis of the language and legislative history of the Regulatory Flexibility Act, Congress did not intend that the Act apply to foreign issuers. Accordingly, the entities directly affected by the reproposed rule and form amendments will fall outside the scope of the Act. For this reason, reproposed Exchange Act Rule 12h-6, reproposed Form 15F, and the accompanying reproposed rule amendments should not have a significant economic impact on a substantial number of small entities.

We encourage written comments regarding this certification. We request in particular that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of the impact.

VII. STATUTORY BASIS AND TEXT OF PROPOSED RULE AMENDMENTS

We are reproposing the amendments to Rule 30-1 of Part 200, Rule 101 of Regulation S-T, and Exchange Act Rules 12g3-2, 12g-4 and 12h-3, new Exchange Act Rule 12h-6 and new Exchange Act Form 15F under the authority in sections 6, 7, 10 and

19 of the Securities Act[184] and sections 3(b), 12, 13, 23 and 36 of the Exchange Act.[185]

List of Subjects

17 CFR Part 200

Administrative practice and procedure, Authority delegations (Government agencies).

17 CFR Parts 232, 240 and 249

Reporting and recordkeeping requirements, Securities.

TEXT OF PROPOSED RULE AMENDMENTS

For the reasons set out in the preamble, we propose to amend Title 17, Chapter II of the Code of Federal Regulations as follows.

PART 200 - ORGANIZATION; CONDUCT AND ETHICS; AND INFORMATION AND REQUESTS

1. The general authority citation for Part 200 is revised to read as follows:

Authority: 15 U.S.C. 77s, 77o, 77sss, 78d, 78d-1, 78d-2, 78w, 78ll(d), 78mm, 80a-37, 80b-11, and 7202, unless otherwise noted.

* * * * *

2. Amend §200.30-1 by adding paragraph (e)(17) to read as follows:

§200.30-1 Delegation of authority to Director of Division of Corporation Finance.

* * * * *

(e) * * *

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[184] 15 U.S.C. 77f, 77g, 77j, and 77s.

[185] 15 U.S.C. 78c, 78l, 78m, 78w, and 78mm.

(17) At the request of a foreign private issuer, pursuant to Rule 12h-6 (§240.12h-6 of this chapter), to accelerate the termination of the registration of a class of securities under section 12(g) of the Act (15 U.S.C. 78l(g)) or the duty to file reports under section 13(a) of the Act (15 U.S.C. 78m(a)) or section 15(d) of the Act (15 U.S.C. 78o(d)).

* * * * *

PART 232 - REGULATION S-T - GENERAL RULES AND REGULATIONS FOR ELECTRONIC FILINGS

3. The general authority citation for Part 232 is revised to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a), 77sss(a), 78c(b), 78l, 78m, 78n, 78o(d), 78w(a), 78ll(d), 80a-8, 80a-29, 80a-30, 80a-37, and 7201 et seq.; and 18 U.S.C. 1350.

* * * * *

4. Amend §232.101 by:

a. Removing the word "and" at the end of paragraph (a)(1)(x);

b. Removing the period and adding "; and" at the end of paragraph (a)(1)(xi); and

c. Adding paragraph (a)(1)(xii).

The addition reads as follows:

§232.101 Mandated electronic submissions and exceptions.

(a) * * *

(1) * * *

(xii) Forms 15 and 15F (§249.323 and §249.324 of this chapter).

* * * * *

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

5. The general authority citation for Part 240 is revised to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

6. Amend §240.12g3-2 by revising paragraphs (d)(1) and (d)(2) and adding paragraphs (e) and (f) to read as follows:

§240.12g3-2 Exemptions for American depositary receipts and certain foreign securities.

* * * * *

(d) * * *

(1) Securities of a foreign private issuer that has or has had during the prior eighteen months any securities registered under section 12 of the Act or a reporting obligation (suspended or active) under section 15(d) of the Act (other than arising solely by virtue of the use of Form F-7, F-8, F-9, F-10 or F-80), except as provided by paragraph (e) of this section;

(2) Securities of a foreign private issuer issued in a transaction (other than a transaction registered on Form F-8, F-9, F-10 or F-80) to acquire by merger, consolidation, exchange of securities or acquisition of assets, another issuer that had securities registered under section 12 of the Act or a reporting obligation (suspended or

active) under section 15(d) of the Act, except as provided by paragraph (e) of this section; and

* * * * *

(e)(1) A foreign private issuer that has filed a Form 15F (§249.324 of this chapter) pursuant to §240.12h-6 shall receive the exemption provided by paragraph (b) of this section for a class of equity securities immediately upon the effectiveness of the termination of registration of that class of securities under section 12(g) of the Act (15 U.S.C. 78l(g)) or the termination of the duty to file reports regarding that class of securities under section 15(d) of the Act (15 U.S.C. 78o(d)), or both.

(2) Notwithstanding any provision of §240.12g3-2(b), in order to satisfy the conditions of the §240.12g3-2(b) exemption received under this paragraph, the issuer shall publish in English the information required under paragraph (b)(1)(iii) of this section on its Internet Web site or through an electronic information delivery system generally available to the public in its primary trading market, rather than furnish that information to the Commission.

(3) The §240.12g3-2(b) exemption received under this paragraph will remain in effect for as long as the foreign private issuer satisfies the electronic publication condition of paragraph (e)(2) of this section or until the issuer registers a class of securities under section 12 of the Act or incurs reporting obligations under section 15(d) of the Act.

(4) Notwithstanding the time period specified in §240.12g3-2(d)(1), a foreign private issuer that filed a Form 15F solely with respect to a class of debt securities under section 15(d) of the Act (15 U.S.C. 78o(d)) may apply for the exemption provided by

paragraph (b) of this section for a class of equity securities at any time following the effectiveness of its termination of reporting regarding the class of debt securities.

Notes to Paragraph (e): 1. In order to maintain the §240.12g3-2(b) exemption obtained under this paragraph, at a minimum, a foreign private issuer shall electronically publish English translations of the following documents required to be furnished under paragraph (b)(1)(iii) of this section if in a foreign language:

a. Its annual report, including or accompanied by annual financial statements;

b. Interim reports that include financial statements;

c. Press releases; and

d. All other communications and documents distributed directly to security holders of each class of securities to which the exemption relates.

2. As used in paragraph (e)(2) of this section, primary trading market has the same meaning as under §240.12h-6(e).

3. A foreign private issuer that filed a Form 15F regarding a class of equity securities shall disclose in the Form 15F the address of its Internet Web site or that of the electronic information delivery system in its primary trading market on which it will publish the information required under paragraph (b)(1)(iii) of this section. An issuer need not update the Form 15F to reflect a change in that address.

4. A foreign private issuer that filed a Form 15F solely with respect to a class of debt securities must provide the Commission with the address of its Internet Web site or that of the electronic information delivery system in its primary trading market when it applies for the exemption under §240.12g3-2(b) regarding a class of equity securities.

(f)(1) A foreign private issuer that, upon application to the Commission and not after filing a Form 15F, has obtained or will obtain the exemption under §240.12g3-2(b), may publish the information required under paragraph (b)(1)(iii) of this section on its Internet Web site or through an electronic information delivery system generally available to the public in its primary trading market, rather than furnish that information to the Commission, as long as it complies with the English translation requirements provided in paragraph (e) of this section.

(2) Before a foreign private issuer may publish information electronically pursuant to this paragraph, it must provide the Commission with the address of its Internet Web site or that of the electronic information delivery system in its primary trading market in its application for the exemption under §240.12g3-2(b) or in an amendment to that application.

7. Amend §240.12g-4 by:

a. Removing the authority citations following the section; and

b. Revising paragraph (a) to read as follows:

§240.12g-4 Certifications of termination of registration under section 12(g).

(a) Termination of registration of a class of securities under section 12(g) of the Act (15 U.S.C. 78l(g)) shall take effect 90 days, or such shorter period as the Commission may determine, after the issuer certifies to the Commission on Form 15 (17 CFR 249.323) that the class of securities is held of record by:

(1) Less than 300 persons; or

(2) Less than 500 persons, where the total assets of the issuer have not exceeded $10 million on the last day of each of the issuer's most recent three fiscal years.

* * * * *

8. Amend §240.12h-3 by:

a. Removing the authority citations following the section;

b. Adding the word "and" at the end of paragraph (b)(1)(ii);

c. Removing paragraph (b)(2), including the undesignated paragraph;

d. Redesignating paragraph (b)(3) as (b)(2);

e. Revising the cite "paragraphs (b)(1)(ii) and (2)(ii)" to read "paragraph (b)(1)(ii)" in paragraph (c); and

f. Revising the phrase "criteria (i) and (ii) in either paragraph (b)(1) or (2)" to read "either criteria (i) or (ii) of paragraph (b)(1)" in paragraph (d).

9. Add §240.12h-6 to read as follows:

§240.12h-6 Certification by a foreign private issuer regarding the termination of registration of a class of securities under section 12(g) or the duty to file reports under section 13(a) or section 15(d).

(a) A foreign private issuer may terminate the registration of a class of securities under section 12(g) of the Act (15 U.S.C. 78l(g)) or terminate the obligation under section 15(d) of the Act (15 U.S.C. 78o(d)) to file or furnish reports required by section 13(a) of the Act (15 U.S.C. 78m(a)), or both, with respect to a class of equity securities, after certifying to the Commission on Form 15F (17 CFR 249.324) that:

(1) The foreign private issuer has had reporting obligations under section 13(a) or section 15(d) of the Act for at least the 12 months preceding the filing of the Form 15F, has filed or furnished all reports required for this period, and has filed at least one annual report pursuant to section 13(a) of the Act;

(2) The foreign private issuer's securities have not been sold in the United States in a registered offering under the Securities Act of 1933 (15 U.S.C. 77a et seq.) during the 12 months preceding the filing of the Form 15F, other than securities issued:

(i) To the issuer's employees;

(ii) By selling security holders in non-underwritten offerings;

(iii) Upon the exercise of outstanding rights granted by the issuer if the rights are granted pro rata to all existing security holders of the class of the issuer's securities to which the rights attach;

(iv) Pursuant to a dividend or interest reinvestment plan; or

(v) Upon the conversion of outstanding convertible securities or upon the exercise of outstanding transferable warrants issued by the issuer;

Note to Paragraph (a)(2): The exceptions in paragraphs (a)(2)(iii)-(v) do not apply to securities issued pursuant to a standby underwritten offering or other similar arrangement in the United States;

(3) The foreign private issuer has maintained a listing of the subject class of securities for at least the 12 months preceding the filing of the Form 15F on an exchange in a foreign jurisdiction that, either singly or together with the trading of the same class of the issuer' s securities in another foreign jurisdiction, constitutes the primary trading market for those securities; and

(4)(i) The average daily trading volume of the subject class of securities in the United States during a recent 12-month period has been no greater than 5 percent of the average daily trading volume of that class of securities in the issuer's primary trading market during the same period; or

(ii) On a date within 120 days before the filing date of the Form 15F, a foreign private issuer's subject class of equity securities is either held of record by:

(A) Less than 300 persons on a worldwide basis; or

(B) Less than 300 persons resident in the United States.

Notes to Paragraph (a)(4):

1. If an issuer has delisted a class of equity securities from a national securities exchange or inter-dealer quotation system in the United States, and at the time of delisting, the average daily trading volume of that class of securities in the United States exceeded 5 percent of the average daily trading volume of that class of securities in the issuer's primary trading market threshold for the preceding 12 months, the issuer must wait at least 12 months before it may file a Form 15F to terminate its section 13(a) or 15(d) reporting obligations in reliance on paragraph (a)(4)(i).

2. An issuer that has terminated a sponsored American Depositary Receipts facility must wait 12 months before it may file a Form 15F to terminate its section 13(a) or 15(d) reporting obligations in reliance on paragraph (a)(4)(i).

(b) A foreign private issuer may terminate its duty to file or furnish reports pursuant to section 13(a) or section 15(d) of the Act with respect to a class of debt securities after certifying to the Commission on Form 15F that:

(1) The foreign private issuer has filed or furnished all reports required by section 13(a) or section 15(d) of the Act, including at least one annual report pursuant to section 13(a) of the Act; and

(2) On a date within 120 days before the filing date of the Form 15F, the class of debt securities is either held of record by:

(i) Less than 300 persons on a worldwide basis; or

(ii) Less than 300 persons resident in the United States.

(c)(1) Following a merger, consolidation, exchange of securities, acquisition of assets or otherwise, a foreign private issuer that has succeeded to the reporting obligations under section 13(a) of the Act of another issuer pursuant to §240.12g-3, or to the reporting obligations of another issuer under section 15(d) of the Act pursuant to §240.15d-5, may file a Form 15F to terminate those reporting obligations if:

(i) Regarding a class of equity securities, the successor issuer meets the conditions under paragraphs (a)(1), (a)(3) and (a)(4) of this section; or

(ii) Regarding a class of debt securities, the successor issuer meets the conditions under paragraph (b) of this section.

(2) When determining whether it meets the prior reporting requirement under paragraph (a)(1) or paragraph (b)(1) of this section, a successor issuer may take into account the reporting history of the issuer whose reporting obligations it has assumed pursuant to §240.12g-3 or §240.15d-5.

(d) Counting method. When determining under this section the number of United States residents holding a foreign private issuer's equity or debt securities:

(1)(i) Use the method for calculating record ownership §240.12g3-2(a), except that you may limit your inquiry regarding the amount of securities represented by accounts of customers resident in the United States to brokers, dealers, banks and other nominees located in:

(A) The United States;

(B) The foreign private issuer's jurisdiction of incorporation, legal organization or establishment; and

(C) The foreign private issuer's primary trading market, if different from the issuer's jurisdiction of incorporation, legal organization or establishment.

(ii) If you aggregate the trading volume of the issuer's securities in two foreign jurisdictions for the purpose of complying with paragraph (a)(3) of this section, you must include both of those foreign jurisdictions when conducting your inquiry under paragraph (d)(1)(i) of this section.

(2) If, after reasonable inquiry, you are unable without unreasonable effort to obtain information about the amount of securities represented by accounts of customers resident in the United States, for purposes of this section, you may assume that the customers are the residents of the jurisdiction in which the nominee has its principal place of business.

(3) You must count securities as owned by United States holders when publicly filed reports of beneficial ownership or information that is otherwise provided to you indicates that the securities are held by United States residents.

(4) When calculating under this section the number of your United States resident security holders, you may rely in good faith on the assistance of an independent information services provider that in the regular course of its business assists issuers in determining the number of, and collecting other information concerning, their security holders.

(e) Definitions. For the purpose of this section:

(1) Debt security means any security other than an equity security as defined under §240.3a11-1, including non-participatory preferred stock, which is defined as non-convertible capital stock, the holders of which are entitled to a preference in payment of dividends and in distribution of assets on liquidation, dissolution, or winding up of the issuer, but are not entitled to participate in residual earnings or assets of the issuer.

(2) Employee has the same meaning as the definition of employee provided in Form S-8 (§239.16b).

(3) Equity security has the same meaning as under §240.3a11-1.

(4) Foreign private issuer has the same meaning as under §240.3b-4.

(5) Primary trading market means that:

(i) At least 55 percent of the trading in a foreign private issuer's class of securities that is the subject of Form 15F took place in, on or through the facilities of a securities market in a single foreign jurisdiction or in no more than two foreign jurisdictions during a recent 12-month period; and

(ii) If a foreign private issuer aggregates the trading of its subject class of securities in two foreign jurisdictions for the purpose of this section, the trading market for the issuer's securities in at least one of the two foreign jurisdictions must be larger than the United States trading market for the same class of the issuer's securities.

(6) Recent 12-month period means a 12-calendar-month period that ended no more than 60 days before the filing date of the Form 15F.

(f)(1) Suspension of a foreign private issuer's duty to file reports under section 13(a) or section 15(d) of the Act shall occur immediately upon filing the Form 15F with the Commission if filing pursuant to paragraph (a), (b) or (c) of this

section. If there are no objections from the Commission, 90 days, or such shorter period as the Commission may determine, after the issuer has filed its Form 15F, the effectiveness of any of the following shall occur:

(i) The termination of registration of a class of securities under section 12(g); and

(ii) The termination of a foreign private issuer's duty to file reports under section 13(a) or section 15(d) of the Act.

(2) If the Form 15F is subsequently withdrawn or denied, the issuer shall, within 60 days after the date of the withdrawal or denial, file with or submit to the Commission all reports that would have been required had the issuer not filed the Form 15F.

(g) As a condition to termination of reporting under paragraph (a), (b) or (c) of this section, a foreign private issuer must, either before or on the date that it files its Form 15F, publish a notice in the United States that discloses its intent to terminate its reporting obligations under section 13(a) or section 15(d) of the Act or both. The issuer must publish the notice through a means reasonably designed to provide broad dissemination of the information to the public in the United States. The issuer must also submit a copy of the notice to the Commission, either under cover of a Form 6-K (17 CFR 249.306) before or at the time of filing of the Form 15F, or as an exhibit to the Form 15F.

(h)(1) A foreign private issuer that, before the effective date of this section, terminated the registration of a class of securities under section 12(g) of the Act or suspended its reporting obligations regarding a class of equity or debt securities under section 15(d) of the Act may file a Form 15F in order to:

(i) Terminate under this section the registration of a class of equity securities that was the subject of a Form 15 (§249.323 of this chapter) filed by the issuer pursuant to §240.12g-4; or

(ii) Terminate its reporting obligations under section 15(d) of the Act, which had been suspended by the terms of that section or by the issuer's filing of a Form 15 pursuant to §240.12h-3, regarding a class of equity or debt securities.

(2) In order to be eligible to file a Form 15F under this paragraph:

(i) an issuer must currently not be required to register a class of securities under section 12(g) of the Act or be required to file reports under section 15(d) of the Act; and

(ii) If a foreign private issuer terminated the registration of a class of securities pursuant to §240.12g-4 or suspended its reporting obligations pursuant to §240.12h-3 or section 15(d) of the Act regarding a class of equity securities, for at least the 12 months before the filing of its Form 15F, the issuer must have maintained a listing of the subject class of equity securities on an exchange in a foreign jurisdiction that, either singly or together with one other foreign jurisdiction, constitutes the primary trading market for the issuer's class of equity securities.

(3)(i) If the Commission does not object, 90 days after the filing of a Form 15F under this paragraph, or such shorter period as the Commission may determine, the effectiveness of any of the following shall occur:

(A) The termination under this section of the registration of a class of equity securities, which was the subject of a Form 15 filed pursuant to §240.12g-4, and the duty to file reports required by section 13(a) of the Act regarding that class of securities; or

(B) The termination of a foreign private issuer's reporting obligations under section 15(d) of the Act, which had previously been suspended by the terms of that section or by the issuer's filing of a Form 15 pursuant to §240.12h-3, regarding a class of equity or debt securities.

(ii) If the Form 15F is subsequently withdrawn or denied, the foreign private issuer shall, within 60 days after the date of the withdrawal or denial, file with or submit to the Commission all reports that would have been required had the issuer not filed the Form 15F.

PART 249 - FORMS, SECURITIES EXCHANGE ACT OF 1934

10. The authority citation for Part 249 continues to read in part as follows:

Authority: 15 U.S.C. 78a et seq. and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

11. Add §249.324 to read as follows:

§249.324 Form 15F, certification by a foreign private issuer regarding the termination of registration of a class of securities under section 12(g) or the duty to file reports under section 13(a) or section 15(d).

This form shall be filed by a foreign private issuer to disclose and certify the information on the basis of which it meets the requirements specified in Rule 12h-6 (§240.12h-6 of this chapter) to terminate the registration of a class of securities under section 12(g) of the Act (15 U.S.C. 78l(g)) or the duty to file reports under section 13(a) of the Act (15 U.S.C. 78m(a)) or section 15(d) of the Act (15 U.S.C. 78(o)(d)). In each instance, unless the Commission objects, termination occurs 90 days, or such shorter time as the Commission may direct, after the filing of Form 15F.

12. Add Form 15F (referenced in §249.324) to read as follows:

(Note: The text of Form 15F will not appear in the Code of Federal Regulations.)

OMB APPROVAL
OMB Number: 3235-0621
Expires:
Estimated average burden hours per response. . .30.0

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 15F

CERTIFICATION OF A FOREIGN PRIVATE ISSUER'S TERMINATION OF REGISTRATION OF A CLASS OF SECURITIES UNDER SECTION 12(g) OF THE SECURITIES EXCHANGE ACT OF 1934 OR ITS TERMINATION OF THE DUTY TO FILE REPORTS UNDER SECTION 13(a) OR SECTION 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission File Number ______________

____

(Exact name of registrant as specified in its charter)

____

(Address, including zip code, and telephone number, including area code, of registrant's principal executive offices)

____

(Title of each class of securities covered by this Form)

Place an X in the appropriate box(es) to indicate the provision(s) relied upon to terminate the duty to file reports under the Securities Exchange Act of 1934:

Rule 12h-6(a) ☐ Rule 12h-6(c) ☐

Rule 12h-6(b) ☐ Rule 12h-6(h) ☐

GENERAL INSTRUCTIONS

A. Who May Use Form 15F and When

1. A foreign private issuer may file Form 15F, pursuant to Rule 12h-6(a) (17 CFR 240.12h-6(a)) under the Securities Exchange Act of 1934 ("Exchange Act"), when seeking to terminate:

- the registration of a class of securities under section 12(g) of the Exchange Act and the corresponding duty to file or furnish reports required by section 13(a) of the Exchange Act; or
- the obligation under section 15(d) of the Exchange Act to file or furnish reports required by section 13(a) of the Act regarding a class of equity securities; or
- both.

2. A foreign private issuer may file Form 15F, pursuant to Rule 12h-6(b) (17 CFR 240.12h-6(b)), when seeking to terminate its reporting obligations under section 13(a) or section 15(d) of the Exchange Act regarding a class of debt securities.

3. A foreign private issuer may file Form 15F, pursuant to Rule 12h-6(c) (17 CFR 240.12h-6(c)), when seeking to terminate reporting obligations under section 13(a) or section 15(d) of the Exchange Act to which it has succeeded pursuant to Rule 12g-3 (17 CFR 240.12g-3) or Rule 15d-5 (17 CFR 240.15d-5).

4. A foreign private issuer may file Form 15F, pursuant to Rule 12h-6(h) (17 CFR 240.12h-6(h)), if, before the effective date of Rule 12h-6, it terminated the

registration of a class of securities under section 12(g) of the Act, or suspended its reporting obligations regarding a class of equity or debt securities under section 15(d) of the Act, in order to:

- terminate under Rule 12h-6 the registration of a class of equity securities that was the subject of a Form 15 (§249.323 of this chapter) filed by the issuer pursuant to §240.12g-4; or
- terminate its reporting obligations under section 15(d) of the Act, which had been suspended by the terms of that section or by the issuer's filing of a Form 15 pursuant to §240.12h-3, regarding a class of equity or debt securities.

B. Certification Effected by Filing Form 15F

By completing and signing this Form, the issuer certifies that:

- it meets all of the conditions for termination of Exchange Act reporting specified in Rule 12h-6 (17 CFR 240.12h-6); and
- there are no classes of securities other than those that are the subject of this Form 15F regarding which the issuer has Exchange Act reporting obligations.

C. Effective Date

For an issuer filing Form 15F under Rule 12h-6(a), (b) or (c), the duty to file any reports required under section 13(a) of the Exchange Act will be suspended immediately upon filing the Form 15F. If there are no objections from the Commission, 90 days, or within a shorter period as the Commission may determine, after the issuer has filed its Form 15F, there shall take effect:

- the termination of registration of a class of securities under section 12(g) of the Act;

- the termination of the issuer's duty to file or submit reports under section 13(a) or section 15(d) of the Act; or
- both.

For an issuer that has already terminated its registration of a class of equity securities pursuant to Rule 12g-4 or suspended its reporting obligations under section 15(d) or Rule 12h-3, the effectiveness of its termination of section 12(g) registration under Rule 12h-6 and the corresponding duty to file reports required by section 13(a) of the Act, or the termination of its previously suspended reporting obligations under section 15(d) of the Act, shall also occur 90 days after the issuer has filed its Form 15F under Rule 12h-6(h), or within a shorter period as the Commission may determine, if there are no objections from the Commission.

Regardless of the particular Rule 12h-6 provision under which it is filing the Form 15F, an issuer that seeks an effective date sooner than 90 days after the filing of its Form 15F must submit its request to the Commission in writing.

D. Other Filing Requirements

You must file Form 15F and related materials, including correspondence, in electronic format via our Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system in accordance with the EDGAR rules set forth in Regulation S-T (17 CFR Part 232). The Form 15F and related materials must be in the English language as required by Regulation S-T Rule 306 (17 CFR 232.306). You must provide the signature required for Form 15F in accordance with Regulation S-T Rule 302 (17 CFR 232.302). If you have technical questions about EDGAR, call the EDGAR Filer Support Office at (202) 551-8900. If you have questions about the EDGAR rules, call

the Office of EDGAR and Information Analysis at (202) 551-3610.

If the Form 15F is subsequently withdrawn or denied, you must, within 60 days after the date of the withdrawal or denial, file with or submit to the Commission all reports that would have been required had you not filed the Form 15F. See Rule 12h-6(f)(2) (17 CFR 240.12h-6(f)(2)) and Rule 12h-6(h)(3)(ii) (17 CFR 240.12h-6(h)(3)(ii)).

E. Rule 12g3-2(b) Exemption

Regardless of the particular Rule 12h-6 provision under which it is proceeding, a foreign private issuer that has filed a Form 15F regarding a class of equity securities shall receive the exemption under Rule 12g3-2(b) (17 CFR 240.12g3-2(b)) for the subject class of equity securities immediately upon the effective date of its termination of registration and reporting under Rule 12h-6. Refer to Rule 12g3-2(e) or (f) (17 CFR 240.12g3-2(e) or (f)) for the conditions that a foreign private issuer must meet in order to maintain the Rule 12g3-2(b) exemption following its termination of Exchange Act registration and reporting.

PART I

The purpose of this part is to assist the Commission in assessing whether you meet the requirements for terminating your Exchange Act reporting under Rule 12h-6. If, pursuant to Rule 12h-6, there is an item that does not apply to you, mark that item as inapplicable.

Item 1. Exchange Act Reporting History

A. State when you first incurred the duty to file reports under section 13(a) or section 15(d) of the Exchange Act.

B. State whether you have filed or submitted all reports required under Exchange Act section 13(a) or section 15(d) and corresponding Commission rules for the 12 months preceding the filing of this form, and whether you have filed at least one annual report under section 13(a).

Instruction to Item 1.

If you are a successor issuer that has filed this Form 15F pursuant to Rule 12h-6(c), and are relying on the reporting history of the issuer to which you have succeeded under Rule 12g-3 (17 CFR 12g-3) or Rule 15d-5 (17 CFR 240.15d-5), identify that issuer and provide the information required by this section for that issuer.

Item 2. Recent United States Market Activity

State when your securities were last sold in the United States in a registered offering under the Securities Act of 1933 (15 U.S.C. 77a et seq.) ("Securities Act").

Instructions to Item 2.

1. Do not include registered offerings involving the issuance of securities:

    a. to your employees, as that term is defined in Form S-8 (17 CFR 239.16b);

    b. by selling security holders in non-underwritten offerings;

    c. upon the exercise of outstanding rights granted by the issuer if the rights are granted pro rata to all existing security holders of the class of the issuer's securities to which the rights attach;

    d. pursuant to a dividend or interest reinvestment plan; or

    e. upon the conversion of outstanding convertible securities or upon the exercise of outstanding transferable warrants issued by the issuer.

However, you must include registered offerings described in paragraphs (c) through (e) of this instruction if undertaken pursuant to a standby underwritten offering or other similar arrangement in the United States.

2. If you have registered equity securities on a shelf or other Securities Act registration statement under which securities remain unsold, disclose the last sale of securities under that registration statement. If no sale has occurred during the preceding 12 months, disclose whether you have filed a post-effective amendment to terminate the registration of unsold securities under that registration statement.

Item 3. Primary Trading Market

A. Identify the exchange outside the United States, and the foreign jurisdiction in which that exchange is located, on which you have maintained a listing of the class of securities that is the subject of this Form.

B. Provide the date of initial listing on that foreign exchange. In addition, disclose whether you have maintained a listing of the subject class of securities on that foreign exchange for at least the 12 months preceding the filing of this Form.

C. Disclose the percentage of trading in the subject class of securities that occurred in the jurisdiction of your foreign listing as of a recent 12-month period.

Instruction to Item 3.

When responding to this item, refer to the definition of "primary trading market" in Rule 12h-6(e) (17 CFR 240.12h-6(e)). In accordance with that definition, if your primary trading market consists of two foreign jurisdictions, provide the information required by this section for each foreign jurisdiction. In addition, disclose whether the trading market for your securities in at least one of those two foreign jurisdictions is

larger than the trading market for your securities in the United States as of the same recent 12-month period. Disclose the first and last days of that recent 12-month period.

Item 4. Comparative Trading Volume Data

If relying on Rule 12h-6(a)(4)(i) (17 CFR 240.12h-6(a)(4)(i)), provide the following information:

A. Identify the first and last days of the recent 12-month period used to meet the requirements of that rule provision.

B. For the same recent 12-month period, disclose the average daily trading volume of the class of securities that is the subject of this Form both in the United States and in your primary trading market.

C. For the recent 12-month period, disclose the average daily trading volume of the subject class of securities in the United States as a percentage of the average daily trading volume for that class of securities in your primary trading market.

D. Disclose whether you have delisted the subject class of securities from a national securities exchange or inter-dealer quotation system in the United States. If so, provide the date of delisting, and, as of that date, disclose the average daily trading volume of the subject class of securities in the United States as a percentage of the average daily trading volume for that class of securities in your primary trading market for the preceding 12-month period.

E. Disclose whether you have terminated a sponsored American depositary receipt (ADR) facility regarding the class of subject securities. If so, provide the date of the ADR facility termination.

Instructions to Item 4.

1. "Recent 12-month period" means a 12-calendar-month period that ended no more than 60 days before the filing date of this form, as defined under Rule 12h-6(e). You may disclose the comparative trading volume data in response to this item in tabular format and attached as an exhibit to this Form.

2. An issuer is ineligible to rely on paragraph (a)(4)(i) of Rule 12h-6 if, as of the date of delisting, the average daily trading volume of the subject class of securities in the United States exceeded 5 percent of the average daily trading volume of that class of securities in the issuer's primary trading market, as measured over the preceding 12 months, and 12 months has not elapsed from the date of delisting.

3. An issuer is ineligible to rely on paragraph (a)(4)(i) of Rule 12h-6 if it has terminated a sponsored ADR facility and 12 months has not elapsed from the date of termination.

Item 5. Alternative Record Holder Information

If relying on Rule 12h-6(a)(4)(ii) (17 CFR 240.12h-6(a)(4)(ii)):

Disclose the number of record holders of the subject class of equity securities on a worldwide basis or who are United States residents at a date within 120 days before filing this Form. Disclose the date used for the purpose of Item 5.

Item 6. Debt Securities

If relying on Rule 12h-6(b) (17 CFR 240.12h-6(b)):

Disclose the number of record holders of your debt securities either on a worldwide basis or who are United States residents at a date within 120 days before the date of filing of this Form. Disclose the date used for the purpose of Item 6.

Instructions to Items 5 and 6.

1. When determining the number of record holders of your equity or debt securities who are United States residents, refer to Rule 12h-6(d) (17 CFR 240.12h-6(d)) for the appropriate counting method.

2. If you have relied upon the assistance of an independent information services provider to determine the number of your United States equity or debt securities holders, identify this party in your response.

Item 7. Notice Requirement

If filing Form 15F pursuant to Rule 12h-6(a), (b) or (c):

A. Disclose the date of publication of the notice, required by Rule 12h-6(g) (17 CFR 240.12h-6(g)), disclosing your intent to terminate your duty to file reports under section 13(a) or 15(d) of the Exchange Act or both.

B. Identify the means, such as publication in a particular newspaper, used to disseminate the notice in the United States.

Instruction to Item 7.

If you have submitted a copy of the notice under cover of a Form 6-K (17 CFR 249.306), disclose the submission date of the Form 6-K. If not, attach a copy of the notice as an exhibit to this Form. See Rule 12h-6(g).

Item 8. Prior Form 15 Filers

If relying on Rule 12h-6(h):

A. Disclose whether, before the effective date of Rule 12h-6, you filed a Form 15 (17 CFR 249.323) to terminate the registration of a class of equity securities pursuant to Rule 12g-4 (17 CFR 240.12g-4) or to suspend your reporting obligations under

section 15(d) of the Act regarding a class of equity or debt securities pursuant to Rule 12h-3 (17 CFR 240.12h-3). If so, disclose the date that you filed the Form 15. If you suspended your reporting obligations by the terms of section 15(d), disclose the effective date of that suspension as well as the date that you filed a Form 15 to notify the Commission of that suspension pursuant to Rule 15d-6 (17 CFR 240.15d-6).

B. Disclose whether, since the effectiveness of your termination of registration pursuant to Rule 12g-4, or of your suspension of reporting pursuant to Rule 12h-3 or section 15(d) of the Exchange Act, your reporting obligations under section 13(a) or section 15(d) of the Exchange Act have remained terminated or suspended.

C. If you terminated the registration of a class of equity securities pursuant to Rule 12g-4 or suspended your reporting obligations regarding a class of equity securities pursuant to Rule 12h-3 or section 15(d) of the Exchange Act, provide the disclosure required by Item 3 of this Form, "Primary Trading Market."

PART II

Item 9. Rule 12g3-2(b) Exemption

Disclose the address of your Internet Web site or of the electronic information delivery system in your primary trading market on which you will publish the information required under Rule 12g3-2(b)(1)(iii) (17 CFR 240.12g3-2(b)(1)(iii)).

Instruction to Item 9.

Refer to Note 1 to Rule 12g3-2(e) for instructions regarding providing English translations of documents published pursuant to Rule 12g3-2(b)(1)(iii) (17 CFR 240.12g3-2(b)(1)(iii).

PART III

Item 10. Exhibits

List the exhibits attached to this Form.

Instruction to Item 10.

In addition to exhibits specifically mentioned on this Form, you may attach as an exhibit any document providing information that is material to your eligibility to terminate your reporting obligations under Exchange Act Rule 12h-6. You should refer to any relevant exhibit when responding to the items on this Form.

Item 11. Undertakings

Furnish the following undertaking:

The undersigned issuer hereby undertakes to withdraw this Form 15F if, at any time before the effectiveness of its termination of reporting under Rule 12h-6, it has actual knowledge of information that causes it reasonably to believe that, at the time of filing the Form 15F:

(1) The average daily trading volume of its subject class of securities in the United States during a recent 12-month period exceeded 5 percent of the average daily trading volume of that class of securities in the issuer's primary trading market during the same period, if proceeding under Rule 12h-6(a)(4)(i);

(2) Its subject class of securities was held of record by 300 or more United States residents or 300 or more persons worldwide, if proceeding under Rule 12h-6(a)(4)(ii) or Rule 12h-6(b); or

(3) It otherwise no longer qualified for termination of its Exchange Act reporting

obligations under Rule 12h-6.

Instruction to Item 11.

After filing this Form, an issuer has no continuing obligation to make inquiries or perform other work concerning the information contained in this Form, including its assessment of trading volume or ownership of its securities in the United States.

Signature

Pursuant to the requirements of the Securities Exchange Act of 1934, [name of registrant as specified in charter] has duly authorized the undersigned person to sign on its behalf this certification on Form 15F. In so doing, [name of registrant as specified in charter] certifies that, as represented on this Form, it has complied with all of the conditions set forth in Rule 12h-6 for terminating its registration under section 12(g) of the Exchange Act, or its duty to file reports under section 13(a) or section 15(d) of the Exchange Act, or both.

By : ______________________

Title: ______________________

Date: ______________________

Florence E. Harmon

By the Commission.

Florence E. Harmon
Deputy Secretary

Dated: December 22, 2006

UNITED STATES OF AMERICA

Before the
Securities and Exchange Commission
December 27, 2006

Securities Exchange Act of 1934
Release No. 55011/December 27, 2006

	)	**CORRECTED**
In the Matter of	)	
NetCoalition	)	**Order Granting Petition for**
400 N. Capitol St.	)	**Review and Scheduling**
Washington, DC 20001	)	**Filing of Statements**
	)	

Pursuant to Rule 431[1] of the Rules of Practice, the petition of NetCoalition for review of the staff's action in approving by delegated authority File No. SR-NYSEArca-2006-21[2] is granted.

It is ORDERED, pursuant to Rule 431 that any party or other person may file a statement in support of or in opposition to the action made by delegated authority on or before January 17, 2007, and

It is FURTHER ORDERED that the stay in effect shall be continued.

By the Commission.

Nancy M. Morris

Nancy M. Morris
Secretary

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1 17 CFR 201.431.

2 See Securities Exchange Act Release No. 54597 (Oct. 12, 2006), 71 FR 62029 (Oct. 20, 2006).

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UNITED STATES OF AMERICA
BEFORE THE
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT COMPANY ACT OF 1940
Release No. 27611/December 27, 2006

In the Matter of
Delaware Investments Dividend and Income Fund, Inc.
and
Delaware Investments Global Dividend and Income Fund, Inc.

3400 One Commerce Road
Philadelphia, PA 19103-7098

(812-12420)

ORDER UNDER SECTION 38(a) OF THE INVESTMENT COMPANY ACT OF 1940 ("ACT") RESCINDING A PRIOR ORDER

On September 1, 2006, the Commission issued a notice (Investment Company Act Release No. 27475) of its intention to rescind, on its own motion pursuant to section 38(a) of the Act, a prior order of the Commission issued to Delaware Investments Dividend and Income Fund, Inc. and Delaware Investments Global Dividend and Income Fund, Inc. under section 6(c) of the Act granting an exemption from section 19(b) of the Act and rule 19b-1 under the Act (Investment Company Act Release No. 25524 (April 15, 2002)) (the "Prior Order").

The notice gave interested persons an opportunity to request a hearing and stated that an order rescinding the Prior Order would be issued unless a hearing was ordered. No request for a hearing has been filed.

Accordingly,

IT IS ORDERED, pursuant to section 38(a) of the Act, that the Prior Order be, and hereby is, rescinded.

By the Commission.

Nancy Morris
Secretary

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

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SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 230 and 275

[Release No. 33-8766; IA-2576; File No. S7-25-06]

RIN 3235-AJ67

Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Commission is today proposing new rules designed to provide additional investor protections that would affect pooled investment vehicles, including hedge funds. First, the Commission is proposing a rule that would prohibit advisers to pooled investment vehicles from making false or misleading statements or otherwise defrauding investors or prospective investors in those pooled investment vehicles. Second, the Commission is proposing two rules that would revise the definition of accredited investor as it relates to natural persons. The latter rules would apply solely to the offer and sale of interests in certain privately offered investment pools specified in the rules.

DATES: Comments should be received on or before March 9, 2007.

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

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-25-06 on the subject line; or

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- Use the Federal eRulemaking Portal (http://www.regulations.gov). Follow the instructions for submitting comments.

Paper comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-25-06. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (http://www.sec.gov/rules/proposed.shtml). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: With respect to proposed rule 206(4)-8, Jennifer Sawin, Senior Special Counsel, or Daniel Kahl, Branch Chief, at 202-551-6787, and with respect to proposed rules 216 and 509, Elizabeth G. Osterman, Assistant Chief Counsel, or Tara R. Buckley, Senior Counsel, at 202-551-6825, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-5041.

SUPPLEMENTARY INFORMATION: The Commission is requesting comment on proposed new rule 206(4)-8 under the Investment Advisers Act of 1940 ("Advisers Act"),[1] and proposed new rules 216 and 509 under the Securities Act of 1933 ("Securities Act").[2]

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[1] 15 U.S.C. 80b. Unless otherwise noted, when we refer to the Advisers Act, or any paragraph of the Advisers Act, we are referring to 15 U.S.C. 80b of the United States Code, at which the Advisers Act is codified.

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I. INTRODUCTION

In the past few years, the Commission has been examining a variety of issues relating to hedge funds and other pooled investment vehicles with a view to strengthening protections for investors.[3] We are now proposing to address two areas of particular concern. First, we are proposing to adopt a new antifraud rule under the Advisers Act that would clarify, in light of a

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[2] 15 U.S.C. 77. Unless otherwise noted, when we refer to the Securities Act, or any paragraph of the Securities Act, we are referring to 15 U.S.C. 77 of the United States Code, at which the Securities Act is codified.

[3] See, e.g., Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission, available at http://www.sec.gov/spotlight/hedgefunds.htm ("2003 Staff Study").

recent court decision,[4] the Commission's ability to bring enforcement actions under the Advisers Act against investment advisers who defraud investors or prospective investors in a hedge fund or other pooled investment vehicle.

Second, we are proposing a rule that would revise the requirements for determining whether an individual is eligible to invest in certain pooled investment vehicles. We are concerned that the definition of "accredited investor," which certain privately offered investment pools ("private pools") use in determining whether an individual is eligible to invest in the pool, may not provide sufficient protections for investors. We are therefore proposing to define a new category of accredited investor called "accredited natural person," which is designed to help ensure that investors in these types of funds are capable of evaluating and bearing the risks of their investments.

Consistent with the purposes of the Advisers Act and the Securities Act, we believe these two proposals have the potential to enhance substantially the protections for investors and potential investors in hedge funds and other similar funds.

II. ANTIFRAUD PROVISIONS OF THE ADVISERS ACT

The Advisers Act is intended to protect investors whose assets are managed by investment advisers in pools as well as those who rely on advisers to manage their individual portfolios or to otherwise provide them with investment advice.[5] Advisers to pooled investment

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4 Goldstein v. Securities and Exchange Commission, 451 F.3d 873 (D.C. Cir. 2006) ("Goldstein").

5 Section 201 (Findings) of the Advisers Act states "that investment advisers are of national concern, in that, among other things ... the foregoing transactions occur in such volume as substantially to affect interstate commerce, national securities exchanges, and other securities markets, the national banking system, and the national economy."

vehicles that invest in securities, including unregistered pools, are "investment advisers" under the Advisers Act.[6]

The Advisers Act gives the Commission broad authority to protect against fraud by these investment advisers. Section 206(1) of the Advisers Act makes it unlawful for any adviser to "employ any device, scheme, or artifice to defraud any client or prospective client," and section 206(2) makes it unlawful for any adviser to "engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." Section 206(4) of the Advisers Act provides that it is unlawful for investment advisers to "engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative" and that "[t]he Commission shall, for purposes of [paragraph 206(4)] by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices and courses of business as are fraudulent, deceptive, or manipulative."[7]

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[6] Section 202(a)(11) of the Advisers Act defines an investment adviser as "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 . . .". Sections 202(a)(11)(A)-(F) identify several types of persons who are excepted from this definition, even though they may give advice about securities; exceptions are available to certain banks, accountants, lawyers, teachers, engineers, broker-dealers, publishers and ratings agencies. See also Abrahamson v. Fleschner, 568 F.2d 862, 871 (2d Cir. 1977), cert. denied, 436 U.S. 913 (1978), overruled on other grounds by Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979) ("Transamerica"); SEC v. Saltzman, 127 F. Supp. 2d 660, 669 (E.D. Pa. 2000); SEC v. Michael W. Berger, Manhattan Investment Fund, Ltd., and Manhattan Capital Management, Inc., 244 F. Supp. 2d 180, 192 (S.D.N.Y. 2001).

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

Recently, an opinion by the Court of Appeals for the D.C. Circuit created uncertainties regarding obligations that investment advisers to pools have to the pools' investors.[8] The court, in Goldstein v. SEC, vacated a rule we adopted in 2004 that required certain hedge fund advisers to register under the Advisers Act.[9] In addressing the scope of the exemption from registration in section 203(b)(3) of the Advisers Act and the meaning of "client" as used in that section, the court expressed the view that, for purposes of sections 206(1) and (2), the "client" of an investment adviser managing a pool is the pool itself, not the investors in the pool.[10] As a result, the opinion created some uncertainty regarding the application of sections 206(1) and 206(2) of the Advisers Act in certain cases where investors in a pool are defrauded by an investment adviser.

The Goldstein decision did not, however, call into question the Commission's authority to adopt rules under section 206(4) of the Advisers Act to protect investors in pooled investment vehicles. Section 206(4) is broader in scope and not limited to conduct aimed at clients or

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almost the identical wording of section 15(c)(2) of the Securities Exchange Act of 1934 in regard to brokers and dealers."). The Supreme Court, in United States v. O'Hagan, interpreted nearly identical language in section 14(e) of the Securities Exchange Act of 1934 [15 U.S.C. 78n(e)] ("Exchange Act") as providing the Commission with authority to adopt rules that are "definitional and prophylactic" and that may prohibit acts that are "not themselves fraudulent ... if the prohibition is 'reasonably designed to prevent ... acts and practices [that] are fraudulent.'" United States v. O'Hagan, 521 U.S. 642, at 667, 673 (1997). The wording of the rulemaking authority in section 206(4) remains substantially similar to that of section 14(e) and section 15(c)(2) of the Exchange Act.

[8] Prior to the issuance of this opinion, we brought enforcement actions against hedge fund advisers alleging false or misleading statements to investors under sections 206(1) and (2) of the Advisers Act. See, e.g., SEC v. Kirk S. Wright, International Management Associates, LLC, et al., Litigation Release No. 19581 (Feb. 28, 2006); SEC v. Wood River Capital Management, LLC, et al., Litigation Release No. 19428 (Oct. 13, 2005) ("Wood River"); SEC v. Samuel Israel III; Daniel E. Marino; Bayou Management, LLC; Bayou Accredited Fund, LLC; Bayou Affiliates Fund, LLC; Bayou No Leverage Fund, LLC; and Bayou Superfund, LLC, Litigation Release No. 19406 (Sept. 29, 2005) ("Bayou"); SEC v. Beacon Hill Asset Management LLC, et al., Litigation Release No. 18745A (June 16, 2004).

[9] Goldstein, supra note 4.

[10] Id.

prospective clients. This section permits us to adopt rules proscribing fraudulent conduct that is potentially harmful to the growing number of investors who directly or indirectly invest in hedge funds and other types of pooled investment vehicles. Our commitment to protect the interests of those investors is no less than those to whom the adviser directly provides investment advice.

Accordingly, today we are using our authority under section 206(4) to propose, as a means reasonably designed to prevent fraud, a new rule under the Advisers Act that would prohibit advisers to investment companies and other pooled investment vehicles from (i) making false or misleading statements to investors in those pools, or (ii) otherwise defrauding them. We would enforce the rule through administrative and civil actions against advisers under section 206(4) of the Advisers Act.

A. Scope of Proposed Rule 206(4)-8

1. Investors and Prospective Investors.

Section 206(4), unlike sections 206(1) and (2), is not limited to conduct aimed at clients or prospective clients.[11] Proposed rule 206(4)-8 would address the uncertainty created by the Goldstein decision regarding conduct aimed at investors by prohibiting advisers from (i) making false or misleading statements to investors in pooled investment vehicles, or (ii) otherwise defrauding these investors.

Sections 206(1) and (2) of the Act make unlawful fraud by advisers to both clients and prospective clients. For similar policy reasons, rule 206(4)-8 would also prohibit false or misleading statements made to, or other fraud on, prospective investors in pooled investment

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[11] See Goldstein, supra note 4, at note 6. See also United States v. Elliott, 62 F.3d 1304, 1311 (11th Cir. 1995).

vehicles.[12] Thus, the rule would prohibit false or misleading statements made, for example, to existing investors in account statements as well as to prospective investors in private placement memoranda, offering circulars, or responses to "requests for proposals."

We request comment on this aspect of the proposed rule.

2. Unregistered Advisers.

The proposed rule would apply to any investment adviser to a pooled investment vehicle, including advisers that are not registered or required to be registered under the Advisers Act.[13] Many of our enforcement cases against advisers to pools have been against advisers that are not registered under the Advisers Act, and we believe it is critical that we continue to be in a position to bring actions against unregistered advisers that manage pools and that defraud investors in those pools.

While section 206 applies to all investment advisers,[14] our other antifraud rules adopted under section 206 apply only to advisers registered or required to be registered under the Advisers Act.[15] In 1996, Congress enacted the National Securities Markets Improvements Act ("NSMIA"), which delegated to state securities authorities responsibility for regulating smaller

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12 The effect of "prospective clients" in section 206(1) and (2) is to make unlawful fraudulent behavior that an adviser uses in an attempt to draw in new clients. Similarly, we are including "prospective investors" in the proposed rule for the same underlying policy reasons – that false or misleading statements and other frauds by advisers are no less objectionable when made to prospective investors than when made to persons who have already invested in the pool.

13 Proposed rule 206(4)-8 does not address the question of whether a person is an investment adviser and thus subject to the Act, including the antifraud provisions.

14 See, e.g., SEC v. K.L. Group, LLC, et al., Litigation Release No. 19117 (Mar. 3, 2005) ("KL Group"); SEC v. Barry Alan Bingham and Bingham Capital Management, Litigation Release No. 19345 (Aug. 23, 2005); SEC v. Conrad P. Seghers and James R. Dickey, Litigation Release No. 18749 (June 17, 2004); SEC v. Ryan J. Fontaine and Simpleton Holdings Corporation a/k/a Signature Investments Hedge Fund, Litigation Release No. 17864 (Nov. 26, 2002); SEC v. Edward Thomas Jung, et al., Litigation Release No. 17417 (Mar. 15, 2002).

15 See rules 206(4)-1 through 7 under the Advisers Act [17 CFR 275.206(4)-1 through 7].

advisers (which would no longer register with us).[16] Although Congress intended that we continue to apply our general antifraud authority under section 206 to state-registered advisers,[17] we decided not to apply the prophylactic provisions of our rules under section 206(4) to advisers not registered (or required to be registered) with us because we concluded that these matters had become more appropriately issues for state regulators. Accordingly, in 1997, we amended the rules we had adopted under section 206(4) to limit their application to advisers registered or required to be registered with us,[18] and our more recently adopted rules under section 206(4) have also been limited in scope to advisers registered or required to be registered with us.[19] We believe, however, that it may be appropriate to apply proposed rule 206(4)-8 to all investment advisers because the rule is designed broadly to define the making of materially false or misleading statements as a fraudulent, deceptive or manipulative practice, and to prohibit other practices that defraud or deceive pool investors, rather than designed to prohibit a specific practice.

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[16] Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified in scattered sections of the U.S. Code). NSMIA generally allocated regulatory authority to state securities authorities for advisers that did not manage a registered investment company and that had less than $25 million of assets under management. Section 203A of the Advisers Act prohibits these smaller advisers from registering with the Commission.

[17] See S. Rep. No. 293, 104th Cong., 2d Sess. 3-4 (1996) ("1996 Senate Report") at 4 ("Both the Commission and the states will be able to continue bringing antifraud actions against investment advisers regardless of whether the investment adviser is registered with the state or the SEC."). The Commission has brought such actions against state-registered advisers. See, e.g., In the Matter of James William Fuller, Investment Advisers Act Release No. 1842 (Oct. 4, 1999).

[18] See Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 1633 (May 15, 1997) [62 FR 28112 (May 22, 1997)].

[19] See Proxy Voting by Investment Advisers, Investment Advisers Act Release No. 2106 (Jan. 31, 2003) [68 FR 6585 (Feb. 7, 2003)]; Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204 (Dec. 17, 2003) [68 FR 74713 (Dec. 24, 2003)].

We request comment on this aspect of the proposed rule. Commenters who believe certain advisers to pools should not be subject to the rule should please explain in detail which advisers should be exempt, and why such an exemption would be appropriate.

3. Pooled Investment Vehicles.

The proposed rule would not distinguish among types of pooled investment vehicles and is designed to protect investors both in investment companies and in pools that are excluded from the definition of investment company under section 3(a) of the Investment Company Act of 1940 ("Company Act")[20] by reason of either section 3(c)(1) or 3(c)(7) of the Company Act.[21] We believe that most of the pooled investment vehicles privately offered to investors are organized under one or the other of these two provisions.

Like section 206, the new antifraud rule would apply to all advisers regardless of the investment strategy they employ, or the structure of the type of pooled investment vehicle they manage. As a result, the rule would apply to investment advisers subject to section 206 of the Advisers Act with respect to all pooled investment vehicles that they advise, such as hedge funds, private equity funds, venture capital funds, and other types of privately offered pools that

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[20] 15 U.S.C. 80a. Unless otherwise noted, when we refer to the Company Act, or any paragraph of the Company Act, we are referring to 15 U.S.C. 80a of the United States Code, at which the Company Act is codified.

[21] Company Act section 3(c)(1) or (7). Section 3(c)(1) excludes from the definition of investment company an issuer the securities (other than short-term paper) of which are beneficially owned by not more than 100 persons and that is not making or proposing to make a public offering of its securities. Section 3(c)(7) excludes from the definition of investment company an issuer the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are "qualified purchasers" and that is not making or proposing to make a public offering of its securities. "Qualified purchaser" is defined in section 2(a)(51) of the Company Act generally to include a natural person (or a company owned by two or more related natural persons) who owns not less than $5,000,000 in investments; a person, acting for its own account or accounts of other qualified purchasers, who owns and invests on a discretionary basis, not less than $25,000,000; and a trust whose trustee, and each of its settlors, is a qualified purchaser.

invest in securities, as well as investment companies that are offered to the public.[22] Defrauding investors in any of these pools is equally unacceptable.

We request comment on the scope of the proposed rule. We are proposing to include only investment companies and companies that qualify for the exclusions provided by sections 3(c)(1) and 3(c)(7) of the Company Act, but request comment on whether the rule should apply to companies excluded from the definition of investment company by other provisions in section 3(c) of the Company Act. Commenters suggesting we broaden the scope of the proposed rule should please indicate which types of companies should be included and why. Conversely, commenters favoring limiting the application of the rule so as to exclude certain pools, as we are proposing to do in the Securities Act rules we propose in this Release,[23] should please explain to us how we should draw distinctions among pools in this regard, and why those distinctions are appropriate.

B. Prohibition on False or Misleading Statements

Under proposed rule 206(4)-8(a)(1), it would constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of section 206(4) for any investment adviser to a pooled investment vehicle to make any untrue statement of a material fact to any investor or prospective investor in the pooled investment vehicle, or to omit to state a material fact necessary in order to make the statements made to any investor or prospective investor in the pooled investment vehicle, in the light of the circumstances under which they

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[22] We have brought enforcement actions under the Advisers Act against advisers to these types of funds. See, e.g., In the Matter of Thayer Capital Partners, et al., Investment Advisers Act Release No. 2276 (Aug. 12, 2004) (private equity fund); SEC v. Michael A. Liberty, et al., Litigation Release No. 19601 (Mar. 8, 2006) (venture capital fund); In the Matter of Askin Capital Management, L.P and David J. Askin, Investment Advisers Act Release No. 1492 (May 23, 1995).

[23] See Section III.B.4 of this Release.

were made, not misleading.[24] This wording, which is similar to that in many of our antifraud laws and rules,[25] prohibits false or misleading statements of material facts by investment advisers.

Unlike rule 10b-5 under the Exchange Act and other rules that focus on securities transactions, rule 206(4)-8 would not be limited to fraud in connection with the purchase and sale of a security.[26] Accordingly, proposed rule 206(4)-8(a)(1) would prohibit advisers to pooled investment vehicles from making any materially false or misleading statements to investors in the pool regardless of whether the pool is offering, selling, or redeeming securities. Unlike violations of rule 10b-5, the Commission would not need to demonstrate that an adviser violating rule 206(4)-8 acted with scienter.[27] There would be no private cause of action against an adviser under the proposed rule.[28]

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24 Proposed rule 206(4)-8(a)(1).

25 See, e.g., sections 12 and 17 of the Securities Act; section 14 of the Exchange Act [15 U.S.C. 78n]; section 34 of the Company Act; rules 156, 159, and 610 under the Securities Act [17 CFR 230.156, 230.159, 230.610]; rules 10b-5, 13e-3, 13e-4, and 15c1-2 under the Exchange Act [17 CFR 240.10b-5, 240.13e-3, 240.13e-4, 240.15c1-2]; and rule 17j-1 under the Company Act [17 CFR 270.17j-1]). In addition, section 34(b) of the Company Act uses similar wording with respect to documents filed or transmitted pursuant to the Company Act; we believe that, as a general matter, most advisers that advise registered investment companies will, to a large extent, communicate with investors and prospective investors in those funds through documents that are already subject to section 34(b).

26 Under the proposed rule, we could bring enforcement actions even when the facts of the case did not involve the offer, purchase or sale of a security. We have, however, brought a number of enforcement actions involving pools alleging violations of section 10(b) of the Exchange Act [15 U.S.C. 78j(b)], rule 10b-5 under the Exchange Act [17 CFR 240.10b-5], and section 17(a) of the Securities Act, when the alleged frauds were "in connection with the purchase or sale of a security," or allegedly involved the "offer or sale" of a security. See, e.g., SEC v. Sharon E. Vaughn and Directors Financial Group, Ltd., Litigation Release No. 19589 (Mar. 3, 2006); SEC v. HMC International, LLC., et al., Litigation Release No. 19508 (Dec. 21, 2005); In the Matter of Maxwell Investments, LLC, Gary J. Maxwell, and Bart D. Coon, Investment Advisers Act Release No. 2455 (Dec. 1, 2005); Wood River, supra note 8; Bayou, supra note 8; SEC v. Jon E. Hankins, et al., Litigation Release No. 19283 (June 24, 2005).

27 See SEC v. Steadman, 967 F.2d 636, at 647 (D.C. Cir. 1992). The court in Steadman analogized section 206(4) of the Advisers Act to section 17(a)(3) of the Securities Act, which the Supreme Court had held did not require a finding of scienter, id. (citing Aaron v. SEC, 446 U.S. 680

The effect of this provision of the rule would be to prohibit, for example, materially false or misleading statements regarding investment strategies the pooled investment vehicle will pursue (including strategies the adviser may pursue for the pool in the future), the experience and credentials of the adviser (or its associated persons), the risks associated with an investment in the pool, the performance of the pool or other funds advised by the adviser, the valuation of the pool or investor accounts in it, and practices the adviser follows in the operation of its advisory business such as how the adviser allocates investment opportunities.[29]

We request comment on these provisions of the proposed rule.

C. Prohibition of Other Frauds

We are also using our broad authority under section 206(4) to propose a prohibition against other fraud on investors in pooled investment vehicles by advisers to those pools.

(1980)); the Steadman court concluded that "scienter is not required under section 206(4)." Id. In discussing section 17(a)(3) and its lack of a scienter requirement, the Steadman court observed that, similarly, a violation of section 206(2) of the Advisers Act could rest on a finding of simple negligence. Id. at 643 note 5. For the same reason, the Commission would not need to demonstrate scienter under paragraph (a)(2) of the proposed rule. See Section II.C of this Release for a discussion of paragraph (a)(2).

[28] The Supreme Court has held that "there exists a limited private remedy under the Investment Advisers Act of 1940 to void an investment adviser's contract, but that the Act confers no other private causes of action, legal or equitable." Transamerica, supra note 6, at 24 (footnote omitted). Similarly, paragraph (a)(2) of the proposed rule would not create a new private right of action. See Section II.C of this Release for a discussion of paragraph (a)(2).

[29] We have previously brought enforcement actions alleging these or similar types of frauds. We have brought actions alleging advisers' material misrepresentations or omissions regarding their background or experience. See, e.g., SEC v. EPG Global Private Equity Fund, Litigation Release No. 18577 (Feb. 17, 2004); SEC v. Peter W. Chabot, Chabot Investments, Inc., Sirens Investments, Inc., Sirens Synergy, The Synergy Fund, LLC, Litigation Release No. 18214 (July 3, 2003); SEC v. Ashbury Capital Partners, L.P., Ashbury Capital Management, L.L.C., and Mark Yagalla, Litigation Release No. 16770 (Oct. 17, 2000); SEC v. Michael Batterman, Randall B. Batterman III, and Dynasty Fund, Ltd., et al., Litigation Release No. 16615 (June 30, 2000). We have also brought enforcement actions alleging advisers' misrepresentations of the pool's performance. See, e.g., In the Matter of Evan Misshula, Investment Advisers Act Release No. 2524 (June 21, 2006); Bayou, supra note 8; K.L. Group, supra note 14; In the Matter of Samer M. El Bizri and Bizri Capital Partners, Inc., Investment Advisers Act Release No. 2250 (June 16, 2004).

Proposed rule 206(4)-8(a)(2) would make it a fraudulent, deceptive, or manipulative act, practice, or course of business for any investment adviser to a pooled investment vehicle to "otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle."[30] The language of this provision is drawn from the first sentence of section 206(4) and is designed to apply more broadly to deceptive conduct that may not involve statements.

We request comment on this provision.

D. No Fiduciary Duty Created

Proposed rule 206(4)-8 would not create a fiduciary duty to investors or prospective investors in the pooled investment vehicle not otherwise imposed by law. Nor would the rule alter any duty or obligation an adviser has under the Advisers Act, any other federal law or regulation, or any state law or regulation (including state securities laws) to investors in a pooled investment vehicle it advises.[31]

III. AMENDMENTS TO PRIVATE OFFERING RULES UNDER THE SECURITIES ACT

A. Offer and Sale of Securities Issued by Private Investment Pools

Private offerings of securities issued by investment pools in the United States are made without compliance with the registration and prospectus delivery requirements of section 5 of the Securities Act[32] in reliance on the private offering exemption provided by section 4(2) of the Securities Act or in compliance with certain rules related to that section.

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30 Proposed rule 206(4)-8(a)(2).

31 For example, under the Uniform Limited Partnership Act, advisers who serve as general partners owe fiduciary duties to the limited partners. UNIF. LIMITED PARTNERSHIP ACT § 408 (2001).

32 Section 5 of the Securities Act requires that the offer and sale of an issuer's securities comply with certain registration requirements, unless an exemption from registration is available for that transaction or class of securities.

Section 4(2) exempts from the registration requirements of the Securities Act any "transaction by an issuer not involving a public offering."[33] Before 1982, our rules generally required an issuer seeking to rely on section 4(2) to make a subjective determination that each offeree had sufficient knowledge and experience in financial and business matters to enable that offeree to evaluate the merits of the prospective investment or that such offeree was able to bear the economic risk of the investment.

In part because of a degree of uncertainty as to the availability of the section 4(2) exemption,[34] the Commission adopted Regulation D under the Securities Act in 1982 to establish non-exclusive "safe harbor" criteria for the section 4(2) private offering exemption.[35] Rule 506

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[33] In 1980, Congress enacted section 4(6) of the Securities Act to provide an additional offering exemption. Small Business Investment Incentive Act of 1980, Pub. L. 96-477, §602 (Oct. 21, 1980) (codified at 15 U.S.C. 77d(6)). Section 4(6) provides an issuer exemption for offers and sales of securities to accredited investors if the issuer offers no more than $5 million of securities and does not engage in a general solicitation. At the same time, Congress enacted section 2(a)(15) of the Securities Act. Section 2(a)(15)(i) establishes a statutory definition of the term "accredited investor" used in section 4(6) that includes certain institutions. Section 2(a)(15)(ii) provides the Commission with statutory authority to adopt rules to further define any person (including any natural person) as an accredited investor based on "such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management."

[34] In 1953, in discussing the private offering exemption, the U.S. Supreme Court stated that a private offering is an "offering to those who are shown to be able to fend for themselves" and that the availability of the private offering exemption "turns on the knowledge of the offerees" and is limited to situations in which the offerees have access to the kind of information afforded by registration under section 5 of the Securities Act. SEC v. Ralston Purina Co., 346 U.S. 119, 125, 126-27 (1953).

[35] Securities Act Release No. 6389 (Mar. 8, 1982) [47 FR 11251 (Mar. 16, 1982)] (adopting Regulation D) ("1982 Adopting Release"). Rule 501(a) of Regulation D applies to offerings made under rules 505 and 506 of Regulation D and defines accredited investor to include a number of categories of investors.

As noted, section 4(6) of the Securities Act also provides an exemption for certain offers and sales made to accredited investors. See supra note 33. The definition of accredited investor for purposes of section 4(6) is contained partly in section 2(a)(15)(i) of the Securities Act and partly in rule 215 under that Act. Rule 215 contains the categories of accredited investors adopted by the Commission. Taken together, the accredited investor categories under section 4(6) are the same as under Regulation D. See Defining the Term "Qualified Purchaser" under the Securities Act of 1933, Securities Act Release No. 8041 (Dec. 19, 2001) [66 FR 66839 (Dec. 27, 2001)] ("2001 Proposing Release") (history of accredited investor concept).

of Regulation D is the safe harbor protection that privately offered investment pools typically rely upon in making offers and sales of their securities.[36] An issuer may sell its securities under rule 506 to an unlimited number of "accredited investors"[37] without registration under the Securities Act, unless the issuer is subject to another restriction.[38]

Rule 501(a) of Regulation D defines the term "accredited investor" to include a natural person whose individual net worth, or joint net worth with the person's spouse, exceeds $1,000,000 at the time of the purchase,[39] or whose individual income exceeds $200,000 (or joint income with the person's spouse exceeds $300,000) in each of the two most recent years and who has a reasonable expectation of reaching the same income level in the year of investment.[40] We adopted the $1,000,000 net worth and $200,000 income standards in 1982 based on our view that these tests would provide appropriate and objective standards to meet our goal of ensuring

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36 Most private pools rely on an exclusion from the definition of investment company under the Company Act provided by section 3(c)(1) or section 3(c)(7) of the Company Act, both of which are premised on the absence of a public offering. See supra note 21 (generally discusses such exclusions); 2003 Staff Study, supra note 3 (staff discussion of exclusions and related interpretation of private offering).

37 An issuer making a private offering under rule 506 also may have 35 non-accredited purchasers of its securities provided that each such purchaser has such knowledge and experience in financial and business matters that the purchaser is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description. See rule 506(b)(2). Such non-accredited investors must receive certain disclosure required by Regulation D. See rule 502(b). Section 4(6), section 2(a)(15) and rule 215 do not include this provision.

38 See Company Act section 3(c)(1), supra note 21. Private pools that rely on the exclusion from the definition of investment company provided by section 3(c)(1) of the Company Act ("3(c)(1) Pools") may have no more than 100 beneficial owners, regardless of whether they are accredited investors under rule 501(a). In addition, issuers with more than 499 holders of record generally must register their securities under the Exchange Act. See Exchange Act section 12 [15 U.S.C. 78l] and rule 12g-1 [17 CFR 240.12g-1] under the Exchange Act.

39 Rule 501(a)(5).

40 Rule 501(a)(6).

that only such persons who are capable of evaluating the merits and risks of an investment in private offerings may invest in one.[41]

We recently have taken the opportunity to reconsider the standards we established to qualify persons as accredited investors under the safe harbor provided under Regulation D and our rules for certain small offerings. We note our staff's observation in its 2003 Staff Study that "inflation, along with the sustained growth in wealth and income of the 1990s, has boosted a substantial number of investors past the 'accredited investor' standard."[42] Based on analysis conducted by our Office of Economic Analysis ("OEA"), we also note that the increase in investor wealth is due in part to the increase in the values of personal residences since 1982. Accordingly, many individual investors today may be eligible to make investments in privately offered investment pools as accredited investors that previously may not have qualified as such for those investments. Moreover, private pools have become increasingly complex and involve risks not generally associated with many other issuers of securities.[43] Not only do private pools often use complicated investment strategies, but there is minimal information available about them in the public domain. Accordingly, investors may not have access to the kind of information provided through our system of securities registration and therefore may find it difficult to appreciate the unique risks of these pools, including those with respect to undisclosed conflicts of interest, complex fee structures and the higher risk that may accompany such pools' anticipated returns.

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41 1982 Adopting Release, supra note 35. See also Securities Act Release No. 6758 (Mar. 3, 1988) [53 FR 7866 (Mar. 10, 1988)] (adopting $300,000 joint income standard).

42 2003 Staff Study, supra note 3 at text accompanying note 271.

43 See generally 2003 Staff Study, id.

We note that natural persons may have indirect exposure to private pools as a result of their participation in pension plans and investment in certain pooled investment vehicles that invest in private pools. Such plans and vehicles are generally administered by entities of plan fiduciaries and registered investment professionals. This protection is not present in the case of natural persons who seek to invest in 3(c)(1) Pools outside of the structure of such pension plans and pooled investment vehicles. Moreover, while the existing net worth and income tests provide some investor protection, we believe that additional protections may be appropriate.

The investor protections that we believe may be lacking with respect to 3(c)(1) Pools already exist for private pools that rely on the exclusion from the definition of investment company provided by section 3(c)(7) of the Company Act ("3(c)(7) Pools").[44] Natural persons who invest in such pools are required to own $5 million in certain investments at the time of their investment in the pool.[45] In addition, for a 3(c)(7) Pool to rely on the safe harbor provided by Regulation D, the pool must limit the sale of its securities to qualified purchasers who also meet the definition of accredited investor. Accordingly, 3(c)(7) Pools are subject to a two-step approach that is designed to provide assurance that an investor has a level of knowledge and financial sophistication and the ability to bear the economic risk of the investment in such pools, as demonstrated by the investor's investment experience and also, for natural persons, that person's net worth or income.

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[44] See supra note 21.

[45] Company Act section 2(a)(51)(A). See also note 21 (definition of "qualified purchaser" as it relates to natural persons). See 1996 Senate Report, supra note 17 at 10 ("The qualified purchaser pool reflects the Committee's recognition that financially sophisticated investors are in a position to appreciate the risks associated with investment pools that do not have the Investment Company Act's protections. Generally, these investors can evaluate on their own behalf matters such as the level of a fund's management fees, governance provisions, transactions with affiliates, investment risk, leverage, and redemptions rights.").

We believe that such a two-step approach may provide important, additional investor protections to natural persons who invest in certain 3(c)(1) Pools. Accordingly, as discussed below, the proposed rules governing investments in such pools incorporate that approach.

B. Proposed Rules 509 and 216

For the reasons discussed above, we are proposing two rules under the Securities Act. As proposed, rules 509 and 216 would define a new category of accredited investor ("accredited natural person") that would apply to offers and sales of securities issued by certain 3(c)(1) Pools (defined in the proposed rules as "private investment vehicles") to accredited investors under Regulation D and section 4(6).[46] The term accredited natural person would mean any natural person who meets either the net worth or income test specified in rule 501(a) or rule 215, as applicable, and who owns at least $2.5 million in investments, as defined in the proposed rules. The term would apply for purposes of ascertaining whether a person is an accredited investor at the time of that person's purchase of securities of private investment vehicles. As proposed, the rules would not alter the criteria for investments by natural persons described in rule 501(a)(4) and rule 215(d).

Rule 501(a) generally provides that the term "accredited investor" means a person who is or who the issuer reasonably believes comes within any of the categories specified in the rule. Proposed rule 509(a) incorporates this concept. We note that a similar provision is not included under section 4(6), section 2(a)(15) or rule 215,[47] and therefore proposed rule 216 does not incorporate this concept. We solicit comments on this approach.

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[46] Our proposed definition would be the same for purposes of section 4(6) and Regulation D private offerings. Accordingly, except as noted, we do not discuss the rules separately.

[47] See supra note 37.

Except as modified by the application of the proposed definition of accredited natural person, all other provisions of Regulation D, and sections 4(6) and 2(a)(15) and rule 215, would continue to apply to the offer and sale of securities issued by private investment vehicles. The application of the proposed rules and the definitions used in the proposed rules are discussed more fully below.

1. Application of Proposed Rules to Private Investment Vehicles.

The proposed rules would apply solely to the offer and sale of securities issued by private investment vehicles, as defined in the proposed rules.[48] The proposed rules would not apply to offers and sales of securities issued by private funds not meeting the proposed definition of the term private investment vehicle, including venture capital funds, as defined in the proposed rules and discussed below.[49]

The proposed rules would define the term private investment vehicle to mean an issuer that would be an investment company (as defined in section 3(a) of the Company Act) but for the exclusion provided by section 3(c)(1) of that Act.[50] The proposed rules would apply to private investment vehicles that rely on the safe harbor provisions of Regulation D in connection with the offer and sale of their securities. The proposed rules would also apply to offerings of private investment vehicles made in reliance on section 4(6) of the Securities Act.

We are not including 3(c)(7) Pools within the definition of private investment vehicle because offers and sales of securities issued by 3(c)(7) Pools must be made to qualified purchasers (as that term is defined by section 2(a)(51)(A) of the Company Act) who are also accredited investors under Regulation D. As noted, 3(c)(7) Pools already are subject to investor

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48 Proposed rule 509(a); proposed rule 216(a).

49 <u>See</u> <u>infra</u> section III.B.4.

50 Proposed rule 509(b)(1); proposed rule 216(b)(1).

protections with higher thresholds than the ones that we propose today.[51] Commenters who suggest that we increase the net worth and income amounts specified under Regulation D for natural persons in response to comments solicited below in connection with the proposed definition of accredited natural person, however, are asked to comment on whether, if we adopt such an approach, the net worth and income amounts specified under Regulation D for natural persons should also be increased for 3(c)(7) Pools.

2. Definition of Accredited Natural Person.

As proposed, the term accredited natural person would include any natural person who meets the requirements specified in the current definition of accredited person, as that term relates to natural persons,[52] and would add a requirement that such person also must own (individually, or jointly with the person's spouse) not less than $2.5 million (as adjusted every five years for inflation[53]) in investments at the time of purchase of securities issued by private investment vehicles under Regulation D or section 4(6).[54] The proposed rules would not alter the criteria for investments by natural persons described in rule 501(a)(4) and rule 215(d). The proposed definition is similar in design to the two-step approach for 3(c)(7) Pools.[55] The proposed definition is consistent with our goal of providing an objective and clear standard to use in ascertaining whether a purchaser of a private investment vehicle's securities is likely to have sufficient knowledge and experience in financial and business matters to enable that

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51 See supra notes 44 and 45 and accompanying text.

52 See section 2(a)(15) and rules 215 and 501(a).

53 Proposed rule 509(c)(6); proposed rule 216(c)(6).

54 See discussion of the terms private investment vehicle and investments elsewhere in this release.

55 See supra notes 44 and 45 and accompanying text.

purchaser to evaluate the merits and risks of a prospective investment, or to hire someone who can.

We also are proposing to amend paragraphs (a)(5) and (a)(6) of rule 501 and paragraphs (e) and (f) of rule 215 to provide a cross-reference to our proposed definition of accredited natural person in proposed rule 509 and proposed rule 216, as applicable. Such a cross-reference would alert persons reading rules 501 and 215 to the existence of the proposed rules for sales of securities issued by private investment vehicles.

We solicit comment on whether retaining the existing definition of accredited investor as it relates to natural persons and adding an additional requirement for that term that uses the amount and type of a natural person's investments (individually, or jointly with the person's spouse) is an appropriate standard by which to measure whether that person is likely to have sufficient knowledge and financial sophistication to evaluate the merits of a prospective investment in a private investment vehicle and to bear the economic risk of such an investment.

Solely in the context of investments in private investment vehicles, if we adopt rules using the two-step approach that we propose today, commenters are asked whether we should increase (or decrease) the amounts specified for the net worth and income criteria applicable to natural persons under the Regulation D definition of accredited investor. Commenters are also solicited for their views on whether (and why) we should use a standard based solely on the objective net worth and income tests specified in the existing rules under Regulation D and rule 215 for offers and sales of securities issued by private investment vehicles to natural persons, rather than adding the proposed additional criteria based on investments.[56] In responding to both or either of these requests, we ask commenters to discuss what they believe the appropriate levels

[56] See supra notes 39 and 40 and accompanying text.

for the net worth and income criteria should be, if different than set forth in our accredited investor rules. For example, OEA estimates that the levels used in those rules, adjusted for inflation, would have been approximately $1.9 million (net worth), $388,000 (individual income) and $582,000 (joint income) as of July 1, 2006.[57] Commenters who believe that changing the applicable levels under either the proposed two-step approach or the current definition are requested to suggest alternate levels and to explain why it would be appropriate to use the suggested approach and changed levels. We also request that commenters explain in their response why their suggestions would address our interest in providing an objective and clear standard for ascertaining whether a purchaser of a private investment vehicle's securities is likely to have sufficient knowledge and financial sophistication to enable that purchaser to evaluate the merits of a prospective investment in a private investment vehicle and to bear the economic risk of such an investment.

We have specified $2.5 million for the amount of investments that a person would be required to own under the proposed definition. As proposed, this dollar amount would be adjusted for inflation on April 1, 2012, and every five years thereafter, to reflect any changes in the value of the Personal Consumption Expenditures Chain-Type Price Index (or any successor index thereto), as published by the Department of Commerce, from December 31, 2006.[58] OEA estimates that approximately 1.3% of United States households would qualify for accredited

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57 OEA estimated these levels using the Personal Consumption Expenditures Chain-Type Price Index, as published by the Department of Commerce, available at www.bea.gov.

58 Each adjustment would be rounded to the nearest multiple of $100,000.

We have selected the above-referenced index following discussions with the Federal Reserve Bank and our conclusion that that index is a widely used and broad indicator of inflation in the U.S. economy.

natural person status based on owning $2.5 million in investments.[59] It estimates that in 1982, when Regulation D was adopted, approximately 1.87% of U.S. households qualified for accredited investor status. It further estimates that by 2003 that percentage increased by 350% to approximately 8.47% of households. By incorporating the proposed requirement for $2.5 million of investments owned by the natural person at the time of purchase, that percentage would decrease to 1.3% of households that would qualify for accredited natural person status, a percentage below 1982 levels. We believe that this result is appropriate given the increasing complexity of financial products, in general, and hedge funds, in particular, over the last decade. In addition, we note that the proposed level is less than required for qualified purchasers in 3(c)(7) Pools. We believe that the proposed amount therefore would establish a bright-line standard that addresses our concerns about the increase in individual wealth and income, but that maintains separate requirements for private investment vehicles, 3(c)(7) Pools and investments in all other private offerings.[60] We generally solicit comment on this approach.

In particular, commenters are asked to comment on our proposal to adjust the amount every five years and the methodology that we have used for this purpose in the proposed rules. Should the time period between adjustments be longer or shorter than five years? Is the methodology (calculation based on the proposed index and time period) used in the proposed rules appropriate? Commenters responding to these questions who believe that a different methodology and/or time period would be appropriate for us to use are asked to provide rule text for their suggestion. They also are asked to explain why their suggestion would be more

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59 This estimate was prepared by OEA using data from the 1983 and 2004 Federal Reserve Surveys of Consumer Finance ("Federal Reserve Surveys"). The Federal Reserve Survey is conducted triennially. The 1983 and 2004 Federal Reserve Surveys used year-end 1982 and 2003 values, respectively. More information regarding the Federal Reserve Surveys may be obtained at http://www.federalreserve.gov/pubs/oss/oss2/scfindex.html.

60 See supra note 21.

appropriate. We also request commenters' views on our data. Is there a more appropriate data set to use that would support another amount or is there a more appropriate way to interpret the data that we used?

We also solicit comment on our proposal to use $2.5 million as the level of investments that an accredited natural person must own. Should we use another level that is higher or lower than proposed? For example, as discussed previously, natural persons seeking to invest in 3(c)(7) Pools must own $5 million in investments at the time of purchase. Also, investment advisers may charge a natural person client a performance fee if the adviser reasonably believes that the client has a net worth (together with assets held jointly with the client's spouse) of more than $1.5 million at the time that the client enters into a contract with the adviser.[61] Is one of these levels more appropriate than the proposed $2.5 million? Commenters responding to this request who believe that a different amount would be more appropriate are asked to specify that amount and explain why they believe that it is a more appropriate measure of a natural person's investment experience, financial knowledge and sophistication. Such commenters are asked to suggest rule text reflecting their view.

We note that our proposed rules would not grandfather current accredited investors who would not meet the new accredited natural person standard so that they could make future investments in private investment pools, even those in which they currently are invested. Commenters are asked to comment on whether such a grandfathering provision is necessary and/or appropriate and why.

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[61] See rule 205-3(a) and (d)(1)(i)(A) (performance fee prohibition of the Advisers Act does not apply to qualified clients, defined to include a natural person with more than $1.5 million of net worth (together with assets held jointly with the person's spouse) at the time that the natural person enters into a contract with the adviser).

We also solicit comment on whether employees of private investment vehicles or their investment advisers (collectively "pool employees") should be subject to the same accredited natural person standard. Would applying such a standard to pool employees preclude many of them from investing in such pools? We are aware that many private investment vehicles currently offer and sell their interests to pool employees who do not meet the current accredited investor standard. We note that such private investment vehicles may: (i) rely on rule 506, which allows for 35 non-accredited purchasers, provided that the pool employees meet the condition in rule 506(b)(2)(ii) and receive the information required by rule 502(b); (ii) make an offering pursuant to section 4(2) of the Securities Act; or (iii) rely on rule 701 under the Securities Act, which provides an exemption from registration for offers and sales of securities to certain natural persons pursuant to certain compensatory benefit plans and contracts relating to compensation. We also are aware that many private pools provide equity incentive compensation to pool employees through contractual arrangements in employment agreements not subject to direct regulation under the federal securities laws. For example, a private pool manager may allocate a portion of the pool's interest in the performance fee, or "carry," payable by the pool, to certain of its employees. We request comment on whether any or all of the four different ways that we believe that private pools may compensate pool employees are sufficient to permit pool employees who are not accredited natural persons to receive securities issued by a private investment vehicle. Commenters who believe that they are not are asked to explain why not. We also request comment on whether we should add to the list of accredited natural persons certain "knowledgeable employees," consistent with the concept of "knowledgeable employees" eligible to invest in private investment pools in accordance with rule 3c-5 under the Company Act.[62]

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[62] Under rule 3c-5, knowledgeable employees include executive officers, directors, trustees, general

3. Definition of Investments.

We have based the proposed definition of investments in the proposed rules on the definition of that term set forth in rule 2a51-1 under the Company Act.[63] Including this definition would provide a bright-line standard for ascertaining an investor's status as an accredited natural person.

We have modified the proposed definition of investments to the extent that certain provisions of rule 2a51-1 would not be relevant to a definition that applies solely to natural persons. For example, rule 2a51-1 generally refers to qualified purchaser[64] and section 3(c)(7) Pools. These terms generally are not relevant to the definition of accredited natural person because the proposed definition relates only to natural persons and would not involve investments in 3(c)(7) Pools. We solicit comment on whether we have made appropriate modifications to the term investments for purposes of the proposed definition. If not, commenters are asked to discuss any changes that they believe would be appropriate and why they believe that they would be appropriate.

In addition, the treatment in the proposed rules of investments a natural person may own jointly with a spouse or that are part of a shared community interest is different from the treatment of such investments under rule 2a51-1. Rule 2a51-1 permits all of such investments to be included in the determination of whether a natural person is a qualified purchaser for purposes

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partners and advisory board members of a 3(c)(1) Pool or a 3(c)(7) Pool, and those who serve in similar capacities. The rule also includes certain other employees of the private fund or its management affiliate who participate in investment activities and have performed such functions for at least 12 months.

63 Proposed rule 509(b)(3); proposed rule 216(b)(3).

64 The term "qualified purchaser" includes both institutional investors and natural persons that meet the conditions of section 2(a)(51)(A) of the Company Act.

of section 2(a)(51)(A).[65] We believe that, for purposes of determining whether a natural person, acting on that person's own behalf (and not jointly with a spouse), should be able to qualify as an accredited natural person, a natural person's investments should include only a portion of the amount of any investments owned jointly, or of any investments which ownership is shared, with the person's spouse. Accordingly, the proposed rules provide that the investments of a natural person seeking to make an investment in a private investment vehicle on his or her own behalf may include only 50 percent of: (a) any of such person's investments held jointly with that person's spouse; and (b) any investments in which the natural person shares a community property or similar shared ownership interest with that person's spouse.[66] We believe that including only half of these categories of investments is typical of the division of assets of natural persons and their spouses made for other purposes. Where spouses make a joint investment in a private investment vehicle, the full amount of all of their investments (whether made jointly or separately) may be included for purposes of determining whether each spouse is an accredited natural person. We seek comment on this amount and the approach generally, including the feasibility of implementing it. In addition, the proposed rules would provide that the aggregate amount of investments owned and invested on a discretionary basis by the natural person is the fair market value of such investments.[67] We intend the value of a natural person's investments to be calculated on a per investment basis. We solicit comment on whether this is clear.

As noted previously, one reason for the rise in the net worth of natural persons is the increase in the value of personal residences since 1982. We believe that such an increase should

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65 Rule 2a51-1(g)(2).

66 Proposed rule 509(c)(4); proposed rule 216(c)(4).

67 Proposed rule 509(c)(2); proposed rule 216(c)(2).

not be relevant in evaluating whether an investor may qualify as an accredited investor for purposes of sales under Regulation D or section 4(6) of securities issued by private investment vehicles. Moreover, the value of a person's personal residence or place of business, or real estate held in connection with a trade or business, bears little or no relationship to that person's knowledge and financial sophistication. Accordingly, the proposed definition, like rule 2a51-1 on which it is modeled, would not include, as an investment held for investment purposes, real estate that is used by a natural person or certain family members for personal purposes or as a place of business, or in connection with a trade or business.[68] Is this treatment of real estate appropriate? Commenters who respond to this question are asked to discuss whether they believe that any such real estate should be counted as an investment held for investment purposes under the proposed rules and why. We solicit comment on our concern about the effect of increased housing values on the application of the definition of accredited investor solely in connection with the offer and sale of private investment companies.

We solicit comment on whether our proposed definition of investments captures the universe of relevant investments that should be included for purposes of the proposed definition. Should any investments included in our proposed definition be excluded? Are there any investments that are not reflected in our definition that should be included? Commenters are asked to explain the basis for any exclusion or inclusion that they recommend.

Our proposed definition of "prospective accredited natural person" refers to securities "issued by" a private investment vehicle rather than the reference to securities "of" a 3(c)(7) Pool under the parallel definition in rule 2a51-1 under the Company Act. The use of securities "of" an issuer could be misinterpreted to refer to the portfolio securities held by a private pool and not

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[68] Proposed rule 509(c)(1)(i); proposed rule 216(c)(1)(i).

the securities issued by that pool. Rule 2a51-1 was not meant to be subject to such an interpretation and neither are our proposed rules.

4. Proposed Exclusion for Venture Capital Pools.

The proposed rules specifically would not apply to the offer and sale of securities issued by venture capital funds. As defined in the proposed rules, the term venture capital fund would have the same meaning as the definition of business development company in section 202(a)(22) of the Advisers Act.[69] In the Small Business Investment Incentive Act of 1980, Congress generally modeled the definition of business development company on the capital formation activities of venture capital funds.[70] Both venture capital funds and business development companies provide capital to small businesses. They also often provide managerial assistance to these small businesses.[71] In proposing to exclude the offer and sale of securities issued by

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69 Proposed rule 509(b)(2); proposed rule 216(b)(2). See section 202(a)(22) of the Advisers Act. Section 202(a)(22) defines the term business development company to mean any company which is described in section 2(a)(48) of the Company Act, infra note 72, and which complies with section 55 of the Company Act, except that, in contrast to business development companies under the Company Act, a business development company under the Advisers Act: (i) is prohibited from acquiring any assets (except those described by section 55(a)(1) through (7) of the Company Act which include securities issued by "eligible portfolio companies") unless at least 60 percent of its total assets are invested in assets described by 55(a)(1) through (6) (for purposes of this release "section 55(a) assets") (compared to 70 percent for Company Act business development companies); (ii) does not have to be a closed-end company or be subject to the provisions of sections 55 through 65 of the Company Act; and (iii) may purchase section 55(a) assets from any person. A business development company defined in section 202(a)(22) must offer managerial assistance to companies that are counted against its 60 percent requirement.

The Company Act generally defines eligible portfolio companies to be domestic companies that are not (i) investment companies or (ii) companies that would be investment companies but for the exclusions provided by section 3(c) of the Company Act. Company Act sections 2(a)(46)(A) and (B). See generally Definition of Eligible Portfolio Company under the Investment Company Act of 1940, Company Act Release No. 27538 (Oct. 25, 2006) [71 FR 64086 (Oct. 31, 2006)] (adoption of new definition of the term eligible portfolio company). See also Definition of Eligible Portfolio Company under the Investment Company Act of 1940, Company Act Release No. 27539 (Oct. 25, 2006) [71 FR 64093 (Oct. 31, 2006)] (proposal to include additional domestic, non-financial companies within the definition of the term eligible portfolio company).

70 See H.R. Rep. No. 1341, 96th Cong., 2d Sess. 21 (1980) ("1980 House Report").

71 See id. at 21.

venture capital funds from the application of the proposed definition, therefore, we recognize the benefit that venture capital funds play in the capital formation of small businesses.

We note that the term business development company is also defined in section 2(a)(48) of the Company Act.[72] We solicit comment on whether defining venture capital fund with reference to the definition provided in the Advisers Act is appropriate. Would it be more appropriate to define venture capital fund with reference to the definition provided in the Company Act? Would it be more appropriate to define venture capital funds in terms of their investment objective and strategy (e.g., investing in and developing start-up and early phase businesses)? Alternatively, would it be more appropriate to define private investment vehicles to be 3(c)(1) Pools that do not permit their investors to redeem their interests in the pools within a specified period of time ("holding period")?[73] Would such an approach cause most 3(c)(1) Pools to simply extend their holding periods sufficient to avoid application of the proposed rules? We request comment on how this would affect investors, including those with respect to any possible

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72 See section 2(a)(48) of the Company Act. Section 2(a)(48) defines business development company for purposes of the Company Act as any closed-end company which securities are registered under the Securities Act and: (i) is organized under the laws of, and has its principal place of business in, any State or States; (ii) is operated for the purpose of making investments in section 55(a) assets, see supra note 69, (iii) is prohibited from making any purchases of any assets (except those described by section 55(a)(1) through (7) of the Company Act) unless the value of the company's assets invested in section 55(a) assets at the time of any new purchase constitutes at least 70 percent of the value of its total assets; (iv) offers managerial assistance to issuers of section 55(a) assets that it purchases; and (v) has elected to be subject to the provisions of sections 55 through 65 of the Company Act. In addition, Company Act business development companies are generally required to purchase section 55(a) assets from their issuers or close affiliates.

73 See, e.g., Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333 (Dec. 2, 2004) [69 FR 72054 (Dec. 10, 2004)] (generally defined "private fund" to mean any "company: (i) That would be an investment company under section 3(a) of the . . . Company Act but for the [exclusion] provided from that definition by either section 3(c)(1) or 3(c)(7) of [the Company] Act . . .; (ii) That permits its owners to redeem any portion of their ownership interests within two years of the purchase of such interests; and (iii) Interests in which are or have been offered based on the investment advisory skills, ability or expertise of the investment adviser.").

adverse effect on investors that might result from such extension of holding periods. For example, how would taking such an approach impact natural persons who might have more current needs for assets invested in the pool? If we followed this approach, should we also include a provision that would allow private investment vehicles to redeem securities in the case of emergencies, such as the death or serious illness of an investor, or other unforeseeable events?[74] If we adopted this approach, would two years be appropriate,[75] or would a shorter (e.g., one year) or longer (e.g., four year) holding period be more appropriate?

We particularly solicit the views of commenters on the different types of investments made by venture capital funds, as currently operating in the market, and business development companies, as defined under the Advisers Act.[76] We note that there currently are venture capital funds that invest significantly in offshore markets or other private pools. If we were to adopt a definition of venture capital fund based on either of the statutory definitions of business development company, should we modify that definition to include venture capital funds that invest a significant amount of their assets in foreign securities and other private pools?

We request comment on whether excluding venture capital funds from the application of the proposed rules is appropriate at all. If so, would applying the proposed definition to them affect their ability to raise capital? Are there other policy reasons for excluding venture capital funds? For example, are there aspects of such funds that make them more appropriate investments for less wealthy investors?

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[74] Id.

[75] Id.

[76] See supra note 69.

IV. GENERAL REQUEST FOR COMMENT

The Commission requests comment on the rules proposed in this Release, suggestions for additions to the rules, whether any changes are necessary or appropriate to implement the objectives of our proposed rules and what those changes might be, and comment on other matters that might have an effect on the proposals contained in this Release. For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, the Commission also requests information regarding the potential impact of the proposed rules on the economy on an annual basis. Commenters should provide empirical data to support their views.

V. PAPERWORK REDUCTION ACT

A. Proposed Rule 206(4)-8

The proposed rule, titled 206(4)-8 Pooled Investment Vehicles, would not impose a new "collection of information" within the meaning of the Paperwork Reduction Act of 1995.[77] Proposed rule 206(4)-8 would make it a fraudulent, deceptive, or manipulative act, practice, or course of business for an investment adviser to a pooled investment vehicle to make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made not misleading to any investor or prospective investor in the pooled investment vehicle. The proposed rule would also make it a fraudulent, deceptive or manipulative act, practice, or course of business within the meaning of section 206(4) for any investment adviser to certain pooled investment vehicles to otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle. The proposed rule would not create any filing, reporting, recordkeeping, or disclosure requirements for investment advisers subject to the rule

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[77] 44 U.S.C. 3501 to 3520.

and accordingly there would be no "collection of information" under the Paperwork Reduction Act.

B. Proposed Rules 509 and 216

Certain provisions of proposed rules 509 and 216 contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 [44 U.S.C. 3501 et seq.], and the Commission is submitting the proposed collection 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. The title for the collection of information is "Form D." 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.

Form D (OMB Control No. 3235-0076) was adopted pursuant to sections 2(a)(15), 3(b), 4(2), 19(a) and 19(c)(3) of the Securities Act [15 U.S.C. 77b(15), 77c(b), 77d(2), 77s(a) and 77s(c)(3)].

We recently have taken the opportunity to reconsider the standards we established to qualify persons as accredited investors under the safe harbor provided under Regulation D and our rules for certain small offerings. We note our staff's observation in its 2003 Staff Study that "inflation, along with the sustained growth in wealth and income of the 1990s, has boosted a substantial number of investors past the 'accredited investor' standard."[78] Based on analysis conducted by OEA, we also note that the increase in investor wealth is due in part to the increase in the values of personal residences since 1982. Accordingly, many individual investors today may be eligible to make investments in privately offered investment pools as accredited investors that previously may not have qualified as such for those investments. Moreover, private pools

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[78] 2003 Staff Study, supra note 3 at text accompanying note 271.

have become increasingly complex and involve risks not generally associated with many other issuers of securities.[79] Not only do private pools often use complicated investment strategies, but there is minimal information available about them in the public domain. Accordingly, investors may not have access to the kind of information provided through our system of securities registration and therefore may find it difficult to appreciate the unique risks of these pools, including those with respect to undisclosed conflicts of interest, complex fee structures and the higher risk that may accompany such pools' anticipated returns.

We note that natural persons may have indirect exposure to private pools as a result of their participation in pension plans and investment in certain pooled investment vehicles that invest in private pools. Such plans and vehicles are generally administered by entities of plan fiduciaries and registered investment professionals. This protection is not present in the case of natural persons who seek to invest in 3(c)(1) Pools outside of the structure of such pension plans and pooled investment vehicles. Moreover, while the existing net worth and income tests provide some investor protection, we believe that additional protections may be appropriate.

The investor protections that we believe may be lacking with respect to 3(c)(1) Pools already exist for 3(c)(7) Pools.[80] Natural persons who invest in such pools are required to own $5 million in certain investments at the time of their investment in the pool.[81] In addition, for a 3(c)(7) Pool to rely on the safe harbor provided by Regulation D, the pool must limit the sale of its securities to qualified purchasers who also meet the definition of accredited investor. Accordingly, 3(c)(7) Pools are subject to a two-step approach that is designed to provide assurance that an investor has a level of knowledge and financial sophistication and the ability to

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79 See generally 2003 Staff Study, id.

80 See supra note 21.

81 See supra note 45.

bear the economic risk of the investment in such pools, as demonstrated by the investor's investment experience and also, for natural persons, that person's net worth or income.

We believe that such a two-step approach may provide important, additional investor protections to natural persons who invest in certain 3(c)(1) Pools. Accordingly, the proposed rules governing investments in such pools incorporate that approach.

Form D contains collection of information requirements. The issuers likely to be affected by the proposed rules are companies relying on section 3(c)(1) of the Company Act and filing with the Commission on Form D a notice of sale of securities. Compliance with the notice requirements of Form D is mandatory to the extent that a company elects to make an offering of securities in reliance on an exemption under Regulation D or section 4(6). Responses to the notice requirements are not confidential.

We estimate that if the proposed rules are adopted, the estimated burden for responding to the collection of information in Form D would not increase for most companies because the information required in the form would not change. The number of eligible accredited investors available to invest in issuers relying on section 3(c)(1) of the Company Act and registering with the Commission on Form D, however, would likely decrease. Such a decrease in accredited investors may result in either issuers reducing the number of offerings they make, or increasing the number of non-accredited investors in their pools.[82]

The currently approved collection of information in Form D is 17,500 hours. We estimate that there may be 20 fewer filings as a result of the proposed rules.[83] Accordingly, we

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[82] We note that an issuer electing to use the rule 506 exemption would not be able to sell to more than 35 non-accredited investors. See supra note 37.

[83] In fiscal year 2006, 19,250 filings were submitted to the Commission on Form D. Form D does not contain sufficient information to allow the Commission to determine whether a filer is an operating company, a 3(c)(7) Pool or a 3(c)(1) Pool. Of the 19,250 filings on Form D, we

estimate the proposed rules would reduce the annual aggregate information collection burden under Form D by 20 hours[84] for a total of 17,480 hours.

We request comment on the accuracy of our estimates. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to: (i) evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility; (ii) evaluate the accuracy of the Commission's estimate of burden of the proposed collection of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) evaluate whether there are ways to minimize the burden of the collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons submitting comments on the collection of information requirements should direct the comments to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should send a copy of their comments to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-1090, with reference to File No. S7-25-06. Requests for materials submitted to OMB by the Commission with regard to this collection of information should be in writing, refer to File No. S7-25-06, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filing and Information Services, 100 F Street NE, Washington, DC 20549. OMB is

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estimate that 20%, or 3,850 filings, were made by 3(c)(1) and 3(c)(7) Pools. Of those 3,850 filings, we estimate that 10%, or 385 filings, were made by filers that are 3(c)(1) Pools. Of the filers that are 3(c)(1) Pools, we estimate that 5% might not make new offerings as a result of our proposed rules, resulting in an estimated decrease of 20 filings on Form D.

84 An estimated reduction of 20 filings on Form D at 1 hour each (20 x 1 = 20). We estimate that each filer spends approximately 1 hour in preparing a filing on Form D.

required to make a decision concerning the collection of information between 30 and 60 days after publication of this Release. Consequently, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days after publication of this Release.

VI. COST-BENEFIT ANALYSIS

A. Proposed Rule 206(4)-8

The Commission is sensitive to costs imposed by our rules and the benefits that derive from them, and is considering the costs and benefits of proposed rule 206(4)-8. The proposed rule would make it a fraudulent, deceptive or manipulative act, practice, or course of business within the meaning of section 206(4) for any investment adviser to a pooled investment vehicle to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle. The proposed rule would also make it a fraudulent, deceptive or manipulative act, practice, or course of business within the meaning of section 206(4) for any investment adviser to a pooled investment vehicle to otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle. For the reasons discussed below, we do not believe that the proposed rule would require advisers to incur new or additional costs.

Investment advisers to pooled investment vehicles should not be making untrue statements or omitting material facts or otherwise be engaged in fraud with respect to investors or prospective investors in pooled investment vehicles today, because federal authorities, state authorities and private litigants often can, and do, seek redress from the adviser for the untrue statements or omissions, or other frauds. In most cases, the conduct that the rule would prohibit

is already prohibited by federal securities statutes,[85] other federal statutes (including federal wire fraud statutes),[86] as well as state law.[87]

We recognize that there are costs involved in assuring that communications to investors and prospective investors do not contain untrue or misleading statements and preventing other frauds. Advisers have incurred, and will continue to incur, these costs due to the prohibitions and deterrent effect of the law and rules that would apply under these circumstances. While each of the provisions noted above may have different limitation periods, apply in different factual circumstances, or require the government (or a private litigant) to prove different states of mind than the proposed rule, we believe that the multiple prohibitions against fraud, and the consequences under both criminal and civil law for fraud, should currently cause an adviser to take the precautions it deems necessary to refrain from such conduct.

Furthermore, prior to Goldstein, advisers operated with the understanding that the Advisers Act prohibited the same conduct that would be prohibited by the proposed rule. Accordingly, we do not believe that advisers to pooled investment vehicles would need to take

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85 See, e.g., section 10(b) of the Exchange Act [15 U.S.C. 78j(b)] and section 17(a) of the Securities Act which would apply when the false statements are made "in connection with the purchase or sale of a security" or involve the "offer or sale" of a security, and section 34(b) of the Company Act which makes it unlawful "to make any untrue statement of a material fact in any registration statement, application, report, account, record, or other document filed or transmitted pursuant to [the Company Act] ...".

86 See, e.g., 18 U.S.C. 1341 (Frauds and swindles) and 18 U.S.C. 1343 (Fraud by wire, radio, or television) which make it a criminal offense to use the mails or to communicate by means of wire, having devised a scheme to defraud or for obtaining money or property by means of false or fraudulent pretenses, and 18 U.S.C. 1957 (Engaging in monetary transactions in property derived from specified unlawful activity) which makes it a criminal racketeering offense to engage or attempt to engage in a transaction in criminally derived property of a value greater than $10,000.

87 See, e.g., Metro Communications Corp. BVI v. Advanced Mobilecomm Technologies, et al., 854 A.2d 121,156 (Del. Ch. 2004) (court held that plaintiff-former member of LLC had sufficiently alleged a common law fraud claim based on allegation that series of reports by LLC's managers contained misleading statements; court stated that "[i]n the usual fraud case, the speaking party who is subject to an accusation of fraud is on the opposite side of a commercial transaction from the plaintiff, who alleges that but for the material misstatements or omissions of the speaking party he would not have contracted with the speaking party").

steps or alter their business practices in such a way that would require them to incur new or additional costs as a result of the adoption of the proposed rule.

We also recognize that the proposed rule, if adopted, may cause some advisers to pay more attention to the information they present to better guard against making an untrue or misleading statement to an investor or prospective investor and to reevaluate measures that are intended to prevent fraud. As a consequence, some advisers might seek guidance, legal or otherwise, and more closely review the information that they disseminate to investors and prospective investors and the antifraud related policies and procedures they have implemented. While increased concern about making false statements or committing fraud could be attributable to the new rule, advisers should already be incurring these costs to ensure truthfulness and prevent fraud, regardless of the proposed rule, because of the myriad of laws or regulations that may already apply.

The principal benefit of the rule is that it would clearly enable the Commission to bring enforcement actions under the Advisers Act, if an adviser to a pooled investment vehicle disseminates false or misleading information to investors or prospective investors or otherwise commits fraud with respect to any investor or prospective investor. Our enforcement actions permit us to protect fund investor assets by stopping ongoing frauds,[88] barring persons that have committed certain specified violations or offenses from being associated with an investment adviser,[89] imposing penalties,[90] seeking court orders to protect fund assets,[91] and to order

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88 See section 203(k) (Commission authority to issue cease and desist orders).

89 See section 203(f) (Commission authority to bar a person from being associated with an investment adviser).

90 See section 203(i) (Commission authority to impose civil penalties).

91 See section 209(d) (Commission authority to seek injunctions and restraining orders in federal court).

disgorgement of ill-gotten gains.[92] Moreover, we believe that proposed rule 206(4)-8 would deter advisers to pooled investment vehicles from engaging in fraudulent conduct with respect to investors in those pools and would provide investors with greater confidence when investing in pooled investment vehicles.

We request comment on the assumptions on which we base our preliminary conclusion that advisers that would be subject to the new rule would not incur additional costs if we determined to adopt the rule as proposed. We encourage commenters to discuss any potential costs and benefits that we did not consider in our discussion above. We request commenters to provide analysis and empirical data to support their statements regarding any costs or benefits associated with proposed rule 206(4)-8.

B. Proposed Rules 509 and 216

The Commission is sensitive to the costs and benefits that result from its rules. We recently have taken the opportunity to reconsider the standards we established to qualify persons as accredited investors under the safe harbor provided under Regulation D and our rules for certain small offerings. We note our staff's observation in its 2003 Staff Study that "inflation, along with the sustained growth in wealth and income of the 1990s, has boosted a substantial number of investors past the 'accredited investor' standard."[93] Based on analysis conducted by OEA, we also note that the increase in investor wealth is due in part to the increase in the values of personal residences since 1982. Accordingly, many individual investors today may be eligible to make investments in privately offered investment pools as accredited investors that previously may not have qualified as such for those investments. Moreover, private pools have become increasingly complex and involve risks not generally associated with many other issuers of

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92 See section 203(j) (Commission authority to order disgorgement).

93 2003 Staff Study, supra note 3 at text accompanying note 271.

securities.[94] Not only do private pools often use complicated investment strategies, but there is minimal information available about them in the public domain. Accordingly, investors may not have access to the kind of information provided through our system of securities registration and therefore may find it difficult to appreciate the unique risks of these pools, including those with respect to undisclosed conflicts of interest, complex fee structures and the higher risk that may accompany such pools' anticipated returns.

We note that natural persons may have indirect exposure to private pools as a result of their participation in pension plans and investment in certain pooled investment vehicles that invest in private pools. Such plans and vehicles are generally administered by entities of plan fiduciaries and registered investment professionals. This protection is not present in the case of natural persons who seek to invest in 3(c)(1) Pools outside of the structure of such pension plans and pooled investment vehicles. Moreover, while the existing net worth and income tests provide some investor protection, we believe that additional protections may be appropriate.

The investor protections that we believe may be lacking with respect to 3(c)(1) Pools already exist for 3(c)(7) Pools.[95] Natural persons who invest in such pools are required to own $5 million in certain investments at the time of their investment in the pool.[96] In addition, for a 3(c)(7) Pool to rely on the safe harbor provided by Regulation D, the pool must limit the sale of its securities to qualified purchasers who also meet the definition of accredited investor. Accordingly, 3(c)(7) Pools are subject to a two-step approach that is designed to provide assurance that an investor has a level of knowledge and financial sophistication and the ability to

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94 See generally 2003 Staff Study, id.

95 See supra note 21.

96 See supra note 45.

bear the economic risk of the investment in such pools, as demonstrated by the investor's investment experience and also, for natural persons, that person's net worth or income.

We believe that such a two-step approach may provide important, additional investor protections to natural persons who invest in certain 3(c)(1) Pools. Accordingly, the proposed rules governing investments in such pools incorporate that approach.

We have identified certain costs and benefits that may result from the proposed rules. We encourage commenters to identify, discuss, analyze, and supply relevant data regarding these or any additional costs and benefits.

We believe that the proposed rules would benefit those investors who are currently accredited investors and would meet the proposed accredited natural person standard. The revised eligibility standard may benefit those accredited investors who would meet the definition of accredited natural person by increasing the competition among 3(c)(1) Pools for their investment money. Such competition may result in lower fees. We request comment on the nature and extent of the benefits to investors that would result from increasing the accredited investor standards for natural persons investing in certain 3(c)(1) Pools.

The proposed rules may impose certain costs on affected 3(c)(1) Pools. These costs may include administrative compliance costs, such as the costs related to amending investor questionnaires and other administrative documents and procedures. These costs also could include expenses for computer time, legal and accounting fees, and information technology staff. Under the proposed rules, sponsors of an affected 3(c)(1) Pool would need to prepare and review new administrative documents and procedures, and implement such new procedures, in order to determine if prospective investors in the 3(c)(1) Pool would meet the revised accredited investor standards we propose for natural persons in connection with the offer or sale of securities issued

by those pools. We expect the costs involved in complying with these proposed requirements would be minimal based on our understanding that many sponsors of 3(c)(1) Pools also sponsor 3(c)(7) Pools. We note that to the extent a sponsor of a 3(c)(1) Pool also sponsors a 3(c)(7) Pool that sponsor would already have systems in place and would be familiar with the process of evaluating investor eligibility. We solicit comment on our understanding and conclusion that the costs would be minimal. We also solicit comment on the administrative and legal costs that a sponsor of 3(c)(1) Pools that does not also sponsor 3(c)(7) Pools would incur in setting up and implementing new systems and procedures to evaluate investor eligibility. Commenters who believe that the proposed rules would impose more than minimal costs are solicited to discuss the costs of compliance that the proposed rules would impose. Commenters are asked to explain why they believe that the proposed rules would impose such costs and to quantify the costs of compliance with the proposed rules.

The proposed rules would shrink the pool of accredited investors eligible to invest in 3(c)(1) Pools.[97] Such a decrease in the investor base may increase competition among 3(c)(1) Pools which could lower profits and thereby possibly result in some sponsors of 3(c)(1) Pools not offering new 3(c)(1) Pools or some potential sponsors of such pools not entering the business. While we recognize that there are costs associated with such a decrease in the investor pool and potential new pools, we believe that these costs would be justified by the potential benefits of investor protection, and possibly lower fees resulting from increased competition.

Further, to the extent that a 3(c)(1) Pool has more than 35 investors who do not meet the increased accredited investor standards for natural persons in our proposed rules, the 3(c)(1) Pool would not be able to rely on the exclusion from registration under rule 506 of Regulation D of

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[97] See supra note 59 and accompanying text.

the Securities Act. The 3(c)(1) Pool, however, may still be able to rely on section 4(2) of the Securities Act. We request comment on the number of 3(c)(1) Pools that would be able to rely on section 4(2) of the Securities Act.

The proposed rules may also result in costs to investors. It is possible that the proposed rules could result in a diminishment of the universe of 3(c)(1) Pools available to investors. We believe, however, that such a diminishment, were it to take place, may result in increased competition among 3(c)(1) Pools which, in turn, may result in lower fees for investors.

Our proposed definition may also result in costs to previously accredited investors who would not meet the proposed accredited natural person standards. Since the proposed definition of accredited natural person is not precisely correlated with actual investment sophistication, to the extent that a sophisticated investor would no longer be considered accredited, his or her investment opportunities would decrease. We believe, that to the extent that our proposed definition captures financial sophistication for investors in 3(c)(1) Pools better than the accredited investor definition alone, the benefits would still justify the costs. We request comment on the nature and extent of the costs to private pools and investors that would result from our proposed revisions to the accredited investor standards for natural persons investing in certain 3(c)(1) Pools.

We request comments on all aspects of this cost-benefit analysis, including identification of any additional costs or benefits of the proposed rules. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

VII. REGULATORY FLEXIBILITY ACT ANALYSIS

A. Certification for Proposed Rule 206(4)-8

Section 3(a) of the Regulatory Flexibility Act requires the Commission to undertake an Initial Regulatory Flexibility Analysis of the proposed rule on small entities unless the Commission certifies that the proposed rule, if adopted, would not have a significant economic impact on a substantial number of small entities.[98] Pursuant to section 605(b) of the Regulatory Flexibility Act, the Commission hereby certifies that proposed rule 206(4)-8 would not, if adopted, have a significant economic impact on a substantial number of small entities.[99] Proposed rule 206(4)-8 would make it a fraudulent, deceptive, or manipulative act, practice, or course of business for an investment adviser to a pooled investment vehicle to make any untrue statement of material fact or to omit to state a material fact necessary to make the statements made not misleading to any investor in the pooled investment vehicle. The proposed rule would also make it a fraudulent, deceptive or manipulative act, practice, or course of business within the meaning of section 206(4) for any investment adviser to certain pooled investment vehicles to otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle. The rule is intended to provide the Commission with clear enforcement authority under the Advisers Act for false or misleading statements or other frauds committed by investment advisers with respect to investors in pooled investment vehicles. The conduct the rule would prohibit is already prohibited, in most cases, by laws other than the Advisers Act. As such, we do not believe that the proposed rule would have any economic impact on an investment adviser to a pooled investment vehicle, regardless of whether the investment adviser is a small entity.

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[98] 5 U.S.C. 603(a).

[99] 5 U.S.C. 605(b).

Accordingly, the Commission certifies that proposed rule 206(4)-8 would not have a significant economic impact on a substantial number of small entities.

The Commission encourages written comments regarding this certification. The Commission requests that commenters describe the nature of any impact on small businesses and provide empirical data to support the extent of the impact.

B. Initial Regulatory Flexibility Analysis for Proposed Rules 509 and 216

This Initial Regulatory Flexibility Analysis has been prepared in accordance with 5 U.S.C. 603, and relates to the Commission's proposed rules 509 and 216 under the Securities Act that would revise the definition of accredited investor as it relates to natural persons. These proposed rules would apply solely to the offer and sale of certain privately offered investment pools specified in the rules. The proposed rules are designed to provide assurance that natural persons who invest in 3(c)(1) Pools have a level of knowledge and financial sophistication and the ability to bear the economic risk of the investment in such pools.

1. Reasons for, and Objectives of, Proposed Rules.

We recently have taken the opportunity to reconsider the standards we established to qualify persons as accredited investors under the safe harbor provided under Regulation D and our rules for certain small offerings. We note our staff's observation in its 2003 Staff Study that "inflation, along with the sustained growth in wealth and income of the 1990s, has boosted a substantial number of investors past the 'accredited investor' standard."[100] Based on analysis conducted by OEA, we also note that the increase in investor wealth is due in part to the increase in the values of personal residences since 1982. Accordingly, many individual investors today may be eligible to make investments in privately offered investment pools as accredited investors

[100] 2003 Staff Study, supra note 3 at text accompanying note 271.

that previously may not have qualified as such for those investments. Moreover, private pools have become increasingly complex and involve risks not generally associated with many other issuers of securities.[101] Not only do private pools often use complicated investment strategies, but there is minimal information available about them in the public domain. Accordingly, investors do not have access to the kind of information provided through our system of securities registration and therefore may find it difficult to appreciate the unique risks of these pools, including those with respect to undisclosed conflicts of interest, complex fee structures and the higher risk that may accompany such pools' anticipated returns.

We note that natural persons may have indirect exposure to private pools as a result of their participation in pension plans and investment in certain pooled investment vehicles that invest in private pools. Such plans and vehicles are generally administered by entities of plan fiduciaries and registered investment professionals. This protection is not present in the case of natural persons who seek to invest in 3(c)(1) Pools outside of the structure of such pension plans and pooled investment vehicles. Moreover, while the existing net worth and income tests provide some investor protection, we believe that additional protections may be appropriate.

The investor protections that we believe may be lacking with respect to 3(c)(1) Pools already exist for 3(c)(7) Pools.[102] Natural persons who invest in such pools are required to own $5 million in certain investments at the time of their investment in the pool.[103] In addition, for a 3(c)(7) Pool to rely on the safe harbor provided by Regulation D, the pool must limit the sale of its securities to qualified purchasers who also meet the definition of accredited investor. Accordingly, 3(c)(7) Pools are subject to a two-step approach which is designed to provide

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[101] See generally 2003 Staff Study, id.

[102] See supra note 21.

[103] See supra note 45.

assurance that an investor has a level of knowledge and financial sophistication and the ability to bear the economic risk of the investment in such pools, as demonstrated by the investor's investment experience and also, for natural persons, that person's net worth or income. We believe that such a two-step approach may provide important, additional investor protections to natural persons who invest in certain 3(c)(1) Pools. Accordingly, the proposed rules governing investments in such pools incorporate that approach.

2. Legal Basis.

The Commission is proposing new rules pursuant to authority set forth in sections 2(a)(15), 3(b), and 19(a) of the Securities Act of 1933 [15 U.S.C. 77b(15), 77c(b), and 77s(a)].

3. Small Entities Subject to the Rule.

For purposes of the Regulatory Flexibility Act, an issuer is a "small business" or "small organization" if it has total assets of $5 million or less as of the end of its most recent fiscal year.[104] Approximately 19,250 filings on Form D were made in fiscal year 2006. Of these filings, we estimate that 385 were made by private issuers that are 3(c)(1) Pools.[105] Of those filings made by 3(c)(1) Pools, we estimate that 50%, or 193, of them were made by issuers that are small businesses that would be affected by the proposed rules.[106]

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[104] 17 CFR 230.157.

[105] Form D does not contain sufficient information to allow the Commission to determine the number of filings on Form D that were made by 3(c)(1) Pools. Of the 19,250 filings on Form D, we estimate that 20%, or 3,850 filings, were made by filers that are 3(c)(1) and 3(c)(7) Pools. Of those 3,850 filings, we estimate that 10%, or 385 filings, were made by filers that are 3(c)(1) Pools.

[106] Form D also does not provide the Commission with sufficient information to determine the number of filings on Form D made by small businesses. We, therefore, estimate that 50% of 3(c)(1) Pools are small businesses.

4. Reporting, Recordkeeping, and Other Compliance Requirements.

The proposed rules would require 3(c)(1) Pools to amend their administrative procedures to evaluate whether investors meet the eligibility standards of the proposed rules.

The proposed rules would apply equally to private pools that are small entities and to other private pools. The Commission estimates that the proposed rules may result in some one-time formatting and ongoing costs and burdens that would be imposed on all affected private pools, but which may have a relatively greater impact on smaller firms. These include the costs related to amending investor questionnaires and other administrative documents and procedures, and implementing such procedures. These costs also could include expenses for computer time, legal and accounting fees, and information technology and compliance staff. However, many sponsors of 3(c)(1) Pools also sponsor 3(c)(7) Pools and therefore may already be familiar with the systems necessary to monitor the financial eligibility of investors. Commenters are solicited for their views on the effect the proposed rules would have on small entities.

5. Duplicative, Overlapping or Conflicting Federal Rules.

There are no rules that duplicate, overlap, or conflict with the proposed rules.

6. Significant Alternatives.

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish our stated objective, while minimizing any significant adverse impact on small issuers. In connection with the proposed rules, the Commission considered the following alternatives: (i) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (ii) the clarification, consolidation, or simplification of compliance and reporting requirements under the proposed rules for small

entities; (iii) the use of performance rather than design standards; and (iv) an exemption from coverage of the proposed rules, or any part thereof, for small entities.

With respect to the establishment of special compliance requirements or timetables under the proposals for small entities, we do not presently think this is feasible or appropriate. The proposed rules arise from the increase in investor wealth and private pool complexity since 1982 which underscores the need to strengthen investor protections. Excepting small entities from the proposed rules could compromise the overall effectiveness of the proposed rules. Nevertheless, we request comment on whether it is feasible or appropriate for small entities to have special requirements or timetables for compliance with the proposed rules. Should the proposed rules be altered to ease the regulatory burden on small entities?

We do not believe that clarification, consolidation, or simplification of the compliance requirements is feasible. The proposed rules contain a straightforward two-step approach designed to help ensure that only investors that are capable of evaluating the merits and risks of investments in certain 3(c)(1) Pools may invest in such pools. We request comment on ways to clarify, consolidate, or simplify any part of the proposed rules.

We do not believe that the use of performance rather than design standards is feasible. We are concerned that current standards established to qualify persons as accredited investors may be insufficient under certain circumstances. The proposed rules would revise the definition of accredited investor as it relates to natural persons and may provide important, additional investor protections to natural persons who invest in certain 3(c)(1) Pools.

With respect to exempting small entities from coverage of these proposed rules, we believe such changes would be impracticable. We have endeavored throughout these proposed rules to minimize the regulatory burden on all affected private pools, including small entities,

while meeting our regulatory objectives. Exemption from the proposals for private pools that are small entities would be inconsistent with the Commission's goal of investor protection.

7. Solicitation of Comments.

The Commission encourages the submission of written comments with respect to any aspect of this analysis. Comment is specifically requested on the number of small entities that would be affected by the proposed rules and the likely impact of the proposals on small entities. Commenters are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact. These comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed rules are adopted, and will be placed in the same public file as comments on the proposed rules themselves.

VIII. EFFECTS ON COMPETITION, EFFICIENCY AND CAPITAL FORMATION

Section 2(b) of the Securities Act requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[107]

The proposed rules are designed to provide assurance that an accredited investor has a level of knowledge and financial sophistication and the ability to bear the economic risk of an investment in a 3(c)(1) Pool, as demonstrated by the investor's investment experience and also, for natural persons, that person's net worth or income. These proposed rules may affect efficiency. Since the proposed enhanced eligibility standards would result in a smaller pool of accredited investors eligible to invest in 3(c)(1) Pools, competition among private pools for investors may increase resulting in more efficient allocation of assets among private pools. The proposed standards, however, also may have an inefficient allocation result in certain

[107] 15 U.S.C. 77(b).

circumstances. The proposed rules, for example, may result in certain investors who are knowledgeable and financially sophisticated but who do not meet the parameters of the proposed rules not being able to invest in 3(c)(1) Pools.

Competition may also be affected by the proposed rules. They may promote competition by shrinking the pool of investors eligible to invest in 3(c)(1) Pools. Such a decrease in the investor base may increase competition among 3(c)(1) Pools which could lower profits and thereby possibly result in some sponsors of 3(c)(1) Pools not offering new 3(c)(1) Pools or some potential sponsors of such pools not entering the business.

Finally, the proposed rules would affect capital formation by decreasing the pool of investors from which 3(c)(1) Pools would be able to obtain capital to start or increase the size of their private pools.

We request comment on whether the proposed rules, if adopted, would promote efficiency, competition and capital formation. We specifically request comment on the effect a decrease in the eligible investor base will have on competition. Commenters are solicited for their views on the impact that applying the proposed rules would have on the ability of affected 3(c)(1) Pools to raise capital. For example, commenters are requested to discuss how much capital they believe that 3(c)(1) Pools historically have raised (total amount and percentage of assets of the pool) through the offer and sale of their securities to persons who would meet the current definition of accredited investor under Regulation D, but who would not meet the definition of accredited natural person. Commenters are requested to provide empirical data and other factual support for their views if possible.

IX. STATUTORY AUTHORITY

We are proposing new rules 509 and 216 pursuant to our authority set forth in sections 2(a)(15), 3(b) and 19(a) of the Securities Act [15 U.S.C. 77b(15), 77c(b) and 77s(a)]. We are

proposing new rule 206(4)-8 pursuant to our authority set forth in sections 206(4) and 211(a) of the Advisers Act [15 U.S.C. 80b-6(4) and 80b-11(a)].

List of Subjects

17 CFR Part 230

Investment companies, Reporting and recordkeeping, Securities.

17 CFR Part 275

Reporting and recordkeeping, Securities.

X. TEXT OF PROPOSED RULES

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 230 – GENERAL RULES AND REGULATIONS, SECURITIES ACT OF 1933

1. The general authority citation for Part 230 is revised to read as follows:

Authority: 15 U.S.C. 77b, 77c, 77d, 77f, 77g, 77h, 77j, 77r, 77s, 77z-3, 77sss, 78c, 78d, 78j, 78l, 78m, 78n, 78o, 78t, 78w, 78ll(d), 78mm, 80a-8, 80a-24, 80a-28, 80a-29, 80a-30, and 80a-37, unless otherwise noted.

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2. Section 230.215 is amended by revising paragraphs (e) and (f) to read as follows:

§230.215 Accredited investor.

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(e) Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1,000,000, except that §230.216 shall apply with respect to the sale of securities issued by a "private investment vehicle" as described therein;

(f) Any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year, except that §230.216 shall apply with respect to the sale of securities issued by a "private investment vehicle" as described therein;

* * * * *

3. By adding §230.216 before the undesignated section heading to read as follows:

§230.216 Accredited investor definition for investors in certain private investment vehicles.

(a) Notwithstanding the definition of the term "accredited investor" in §230.215, in connection with the offer and sale of securities issued by an issuer that is a private investment vehicle, other than a venture capital fund, the term "accredited investor" as used in section 4(6) of the Securities Act of 1933 (15 U.S.C. 77(d)(6)) with reference to a natural person for purposes of §230.215(e) or §230.215(f) ("accredited natural person") shall mean a natural person who meets the requirements specified in §230.215(e) or §230.215(f), and who owns (individually, or jointly with that person's spouse) not less than $2.5 million (as adjusted for inflation) in investments.

(b) <u>Definitions</u>. As used in this section, the following terms shall have the meanings indicated:

(1) <u>Private investment vehicle</u> means any issuer that would be an investment company as defined in section 3(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(a)) but for the exclusion provided for in section 3(c)(1) (15 U.S.C. 80a-3(c)(1)) of that Act.

(2) <u>Venture capital fund</u> has the same meaning as "business development company" in section 202(a)(22) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(22)).

(3) Investments means:

(i) Securities (as defined by section 2(a)(1) of the Act (15 U.S.C. 77b(a)(1))), other than securities issued by an issuer that is controlled by the prospective accredited natural person that owns such securities, unless such issuer is:

(A) An investment company, as defined in section 3(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(a)), or a company that would be an investment company under section 3(a) but for the exclusions from that definition provided by sections 3(c)(1) through 3(c)(9) of the Investment Company Act (15 U.S.C. 80a-3(c)(1) through 3(c)(9)), or the exclusions provided by §270.3a-6 or §270.3a-7 of this chapter, or a commodity pool;

(B) A company that:

(1) Files reports pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)); or

(2) Has a class of securities that are listed on a "designated offshore securities market" as such term is defined by Regulation S under the Act (§§230.901 through 230.904); or

(C) A company with shareholders' equity of not less than $50 million (determined in accordance with generally accepted accounting principles) as reflected on the company's most recent financial statements, provided that such financial statements present the information as of a date within 16 months preceding the date on which the prospective accredited natural person acquires the securities of a private investment vehicle;

(ii) Real estate held for investment purposes;

(iii) Commodity interests held for investment purposes. For purposes of this section, commodity interests means commodity futures contracts, options on commodity futures contracts, and options on physical commodities traded on or subject to the rules of:

(A) Any contract market designated for trading such transactions under the Commodity Exchange Act (7 U.S.C. 1 et seq.) and the rules thereunder (17 CFR 1.1 through 190.10); or

(B) Any board of trade or exchange outside the United States, as contemplated in Part 30 of the rules under the Commodity Exchange Act (17 CFR 30.1 through 30.12);

(iv) Physical commodities held for investment purposes. For purposes of this paragraph, physical commodities means any physical commodity with respect to which a commodity interest is traded on a market specified in paragraph (b)(3)(iii) of this section;

(v) To the extent not securities, financial contracts (as such term is defined in section 3(c)(2)(B)(ii) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(c)(2)(B)(ii))) entered into for investment purposes; and

(vi) Cash and cash equivalents (including foreign currencies) held for investment purposes. For purposes of this section, cash and cash equivalents include:

(A) Bank deposits, certificates of deposit, bankers acceptances and similar bank instruments held for investment purposes; and

(B) The net cash surrender value of an insurance policy.

(4) Prospective accredited natural person means a natural person seeking to purchase a security issued by a private investment vehicle.

(5) Related person means a natural person who is related to a prospective accredited natural person as a sibling, spouse or former spouse, or is a direct lineal descendant or ancestor by birth or adoption of the prospective accredited natural person, or is a spouse of such descendant or ancestor.

(c) Solely for purposes of this section:

(1) Investment purposes:

(i) Real estate shall not be considered to be held for investment purposes by a prospective accredited natural person if it is used by the prospective accredited natural person or a related person for personal purposes or as a place of business, or in connection with the conduct of the trade or business of the prospective accredited natural person or a related person, provided that real estate owned by a prospective accredited natural person who is engaged primarily in the business of investing, trading or developing real estate in connection with such business may be deemed to be held for investment purposes. Residential real estate shall not be deemed to be used for personal purposes if deductions with respect to such real estate are not disallowed by section 280A of the Internal Revenue Code (26 U.S.C. 280A).

(ii) A commodity interest or physical commodity owned, or a financial contract entered into, by the prospective accredited natural person who is engaged primarily in the business of investing, reinvesting, or trading in commodity interests, physical commodities or financial contracts in connection with such business may be deemed to be held for investment purposes.

(2) Valuation. For purposes of determining whether a natural person is an accredited natural person, the aggregate amount of investments owned and invested on a discretionary basis by the natural person shall be the investments' fair market value on the most recent practicable date or their cost, provided that:

(i) In the case of commodity interests, the amount of investments shall be the value of the initial margin or option premium deposited in connection with such commodity interests; and

(ii) In each case, there shall be deducted from the amount of investments owned by the natural person the amounts specified in paragraph (c)(3) of this section, as applicable.

(3) Deductions. In determining whether any natural person is an accredited natural person there shall be deducted from the amount of such person's investments the amount of any outstanding indebtedness incurred to acquire or for the purpose of acquiring the investments owned by such person.

(4) Joint investments. In determining whether a natural person is an accredited natural person, there may be included in the amount of such person's investments any investments held individually and fifty percent of any investments (a) held jointly with such person's spouse, and (b) in which such person shares with such person's spouse a community property or similar shared ownership interest. In determining whether spouses who are making a joint investment in a private investment vehicle are accredited natural persons, there may be included in the amount of each spouse's investments any investments owned by the other spouse (whether or not such investments are held jointly). In each case, there shall be deducted from the amount of any such investments the amounts specified in paragraph (c)(3) of this section incurred by each spouse; and

(5) Certain retirement plans and trusts. In determining whether a natural person is an accredited natural person, there may be included in the amount of such person's investments any investments held in an individual retirement account or similar account the investments of which are directed by and held for the benefit of such person.

(6) Inflation adjustments.

(i) On April 1, 2012, and on the 1st day of each subsequent 5-year period, the dollar amount in paragraph (a) of this section shall be adjusted by:

(A) Dividing the annual value of the Personal Consumption Expenditures Chain-Type Price Index (or any successor index thereto), as published by the Department of Commerce, for the calendar year preceding the calendar year in which the adjustment is being made by the annual value of such index (or successor) for the calendar year ending December 31, 2006; and

(B) Multiplying the dollar amount by the quotient obtained in paragraph (c)(6)(i)(A) of this section.

(ii) Rounding. If the adjusted dollar amount determined under paragraph (c)(6)(i) of this section for any period is not a multiple of $100,000, the amount so determined shall be rounded to the nearest multiple of $100,000.

4. Section 230.501 is amended by revising paragraphs (a)(5) and (a)(6) to read as follows:

§230.501 Definitions and terms used in Regulation D.

* * * * *

(a) * * *

(5) Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1,000,000, except that §230.509 shall apply with respect to the sale of securities issued by a "private investment vehicle" as described therein;

(6) Any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year, except that §230.509 shall apply with respect to the sale of securities issued by a "private investment vehicle" as described therein;

* * * * *

5. By adding §230.509 to read as follows:

§230.509 Private investment vehicle.

(a) Notwithstanding the definition of the term "accredited investor" in §230.501, in connection with the offer and sale of securities issued by an issuer that is a private investment vehicle, other than a venture capital fund, the term "accredited investor" in Regulation D (§§230.501 through 230.509) with reference to a natural person for purposes of §230.501(a)(5) or §230.501(a)(6) ("accredited natural person") shall mean a natural person who meets the requirements specified in §230.501(a)(5) or §230.501(a)(6), and who owns (individually, or jointly with that person's spouse) not less than $2.5 million in investments (as adjusted for inflation), or who the issuer reasonably believes meets such qualifications, at the time of the purchase.

(b) Definitions. As used in this section, the following terms shall have the meanings indicated:

(1) Private investment vehicle means any issuer that would be an investment company as defined in section 3(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(a)) but for the exclusion provided for in section 3(c)(1) (15 U.S.C. 80a-3(c)(1)) of that Act.

(2) Venture capital fund has the same meaning as "business development company" in section 202(a)(22) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(22)).

(3) Investments means:

(i) Securities (as defined by section 2(a)(1) of the Act (15 U.S.C. 77b(a)(1))), other than securities issued by an issuer that is controlled by the prospective accredited natural person that owns such securities, unless such issuer is:

(A) An investment company, as defined in section 3(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(a)), or a company that would be an investment company under section 3(a) but for the exclusions from that definition provided by sections 3(c)(1) through 3(c)(9) of the Investment Company Act (15 U.S.C. 80a-3(c)(1) through 3(c)(9)), or the exclusions provided by §270.3a-6 or §270.3a-7 of this chapter, or a commodity pool;

(B) A company that:

(1) Files reports pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)); or

(2) Has a class of securities that are listed on a "designated offshore securities market" as such term is defined by Regulation S under the Act (§§230.901 through 230.904); or

(C) A company with shareholders' equity of not less than $50 million (determined in accordance with generally accepted accounting principles) as reflected on the company's most recent financial statements, provided that such financial statements present the information as of a date within 16 months preceding the date on which the prospective accredited natural person acquires the securities of a private investment vehicle;

(ii) Real estate held for investment purposes;

(iii) Commodity interests held for investment purposes. For purposes of this section, commodity interests means commodity futures contracts, options on commodity futures contracts, and options on physical commodities traded on or subject to the rules of:

(A) Any contract market designated for trading such transactions under the Commodity Exchange Act (7 U.S.C. 1 et seq.) and the rules thereunder (17 CFR 1.1 through 190.10); or

(B) Any board of trade or exchange outside the United States, as contemplated in Part 30 of the rules under the Commodity Exchange Act (17 CFR 30.1 through 30.12);

(iv) Physical commodities held for investment purposes. For purposes of this paragraph, physical commodities means any physical commodity with respect to which a commodity interest is traded on a market specified in paragraph (b)(3)(iii) of this section;

(v) To the extent not securities, financial contracts (as such term is defined in section 3(c)(2)(B)(ii) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(c)(2)(B)(ii))) entered into for investment purposes; and

(vi) Cash and cash equivalents (including foreign currencies) held for investment purposes. For purposes of this section, cash and cash equivalents include:

(A) Bank deposits, certificates of deposit, bankers acceptances and similar bank instruments held for investment purposes; and

(B) The net cash surrender value of an insurance policy.

(4) Prospective accredited natural person means a natural person seeking to purchase a security issued by a private investment vehicle.

(5) Related person means a natural person who is related to a prospective accredited natural person as a sibling, spouse or former spouse, or is a direct lineal descendant or ancestor by birth or adoption of the prospective accredited natural person, or is a spouse of such descendant or ancestor.

(c) Solely for purposes of this section:

(1) Investment purposes:

(i) Real estate shall not be considered to be held for investment purposes by a prospective accredited natural person if it is used by the prospective accredited natural person or

a related person for personal purposes or as a place of business, or in connection with the conduct of the trade or business of the prospective accredited natural person or a related person, provided that real estate owned by a prospective accredited natural person who is engaged primarily in the business of investing, trading or developing real estate in connection with such business may be deemed to be held for investment purposes. Residential real estate shall not be deemed to be used for personal purposes if deductions with respect to such real estate are not disallowed by section 280A of the Internal Revenue Code (26 U.S.C. 280A).

(ii) A commodity interest or physical commodity owned, or a financial contract entered into, by the prospective accredited natural person who is engaged primarily in the business of investing, reinvesting, or trading in commodity interests, physical commodities or financial contracts in connection with such business may be deemed to be held for investment purposes.

(2) Valuation. For purposes of determining whether a natural person is an accredited natural person, the aggregate amount of investments owned and invested on a discretionary basis by the natural person shall be the investments' fair market value on the most recent practicable date or their cost, provided that:

(i) In the case of commodity interests, the amount of investments shall be the value of the initial margin or option premium deposited in connection with such commodity interests; and

(ii) In each case, there shall be deducted from the amount of investments owned by the natural person the amounts specified in paragraph (c)(3) of this section, as applicable.

(3) Deductions. In determining whether any natural person is an accredited natural person there shall be deducted from the amount of such person's investments the amount of any

outstanding indebtedness incurred to acquire or for the purpose of acquiring the investments owned by such person.

(4) Joint investments. In determining whether a natural person is an accredited natural person, there may be included in the amount of such person's investments any investments held individually and fifty percent of any investments (a) held jointly with such person's spouse, and (b) in which such person shares with such person's spouse a community property or similar shared ownership interest. In determining whether spouses who are making a joint investment in a private investment vehicle are accredited natural persons, there may be included in the amount of each spouse's investments any investments owned by the other spouse (whether or not such investments are held jointly). In each case, there shall be deducted from the amount of any such investments the amounts specified in paragraph (c)(3) of this section incurred by each spouse; and

(5) Certain retirement plans and trusts. In determining whether a natural person is an accredited natural person, there may be included in the amount of such person's investments any investments held in an individual retirement account or similar account the investments of which are directed by and held for the benefit of such person.

(6) Inflation adjustments.

(i) On April 1, 2012, and on the 1st day of each subsequent 5-year period, the dollar amount in paragraph (a) of this section shall be adjusted by:

(A) Dividing the annual value of the Personal Consumption Expenditures Chain-Type Price Index (or any successor index thereto), as published by the Department of Commerce, for the calendar year preceding the calendar year in which the adjustment is being made by the annual value of such index (or successor) for the calendar year ending December 31, 2006; and

(B) Multiplying the dollar amount by the quotient obtained in paragraph (c)(6)(i)(A) of this section.

(ii) Rounding. If the adjusted dollar amount determined under paragraph (c)(6)(i) of this section for any period is not a multiple of $100,000, the amount so determined shall be rounded to the nearest multiple of $100,000.

PART 275 – RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940

6. The authority citation for Part 275 continues to read in part as follows:

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

* * * * *

7. Section 275.206(4)-8 is added to read as follows:

§206(4)-8 Pooled investment vehicles.

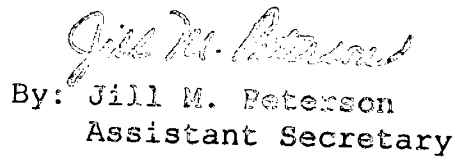
(a) Prohibition. It shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of section 206(4) of the Act (15 U.S.C. 80b-6(4)) for any investment adviser to a pooled investment vehicle to:

(1) Make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or

(2) Otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.

(b) Definition. For purposes of this section "pooled investment vehicle" means any investment company as defined in section 3(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(a)) or any company that would be an investment company under section 3(a) of that Act but for the exclusion provided from that definition by either section 3(c)(1) or section 3(c)(7) of that Act (15 U.S.C. 80a-3(c)(1) or (7)).

By the Commission.



Jill M. Peterson
Assistant Secretary

December 27, 2006

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
December 28, 20006

ADMINISTRATIVE PROCEEDING
File No. 3-12517

In the Matter of

CMERUN CORP.,
COMBINE CORP.,
DIGITAL CONCEPTS INTERNATIONAL, INC.,
INTEGRATED HOMES, INC.,
LIGHTHOUSE FAST FERRY, INC. and
WANNIGAN CAPITAL CORP.

Respondents.

ORDER INSTITUTING PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTION 12(j) OF THE SECURITIES EXCHANGE ACT OF 1934

I.

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

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. CMERUN Corp. ("CMERUN") is a Delaware corporation located in Hudson, Massachusetts with a class of equity securities registered with the Commission pursuant to Section 12(g) of the Exchange Act. CMERUN is delinquent in its periodic filings with the Commission because it has not filed a periodic report since its Form 10-KSB for the period ending September 30, 2000. The filing reported a net loss of approximately $11.6 million for the period November 8, 1999, to September 30, 2000, and $4.2 million in total assets as of

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September 30, 2000. As of August 1, 2006, the company's common stock (symbol "CMER") was traded on the on the over-the-counter markets. The company's common stock has no market makers and is not eligible for the piggyback exemption of Rule 15c2-11(f)(3) of the Exchange Act.

2. Combine Corp. ("Combine") (f/k/a CTC Cosmetics Holdings Co., Inc.) is a former Delaware corporation located in Hamilton, Bermuda with a class of equity securities registered with the Commission pursuant to Section 12(g) of the Exchange Act. The company is delinquent in its periodic filings with the Commission because it has not filed a periodic report since its Form 10-QSB for the period ending November 30, 2001. The filing reported that Combine had no assets and an accumulated deficit during its development stage of approximately $2 million. The company's common stock (symbol "CEBP") is not publicly traded.

3. Digital Concepts International, Inc. ("Digital Concepts") is a dissolved Florida corporation located in San Diego, California with a class of equity securities registered with the Commission pursuant to Section 12(g) of the Exchange Act. The company is delinquent in its periodic filings with the Commission because it never filed any periodic reports after its Form 10-SB filed on March 8, 2002, and amended on July 2, 2002 became effective. As of August 1, 2006, the company's common stock (symbol "DCII") was quoted on the Pink Sheets, had one market maker and is eligible for the piggyback exemption of Rule 15c2-11(f)(3) of the Exchange Act.

4. Integrated Homes, Inc. ("Integrated Homes") is a dissolved Colorado corporation located in Boca Raton, Florida with a class of equity securities registered with the Commission pursuant to Section 12(g) of the Exchange Act. The company is delinquent in its periodic filings with the Commission because it failed to file any periodic reports since its Form 10-SB filed on October 13, 2000 became effective. It had filed an initial Form 10-SB on July 16, 1999 but voluntarily terminated that registration on September 27, 1999 before any periodic reports were due. Prior to the latter filing, the Colorado Secretary of State had administratively dissolved the corporation on September 1, 2000. As of August 1, 2006, the company's common stock (symbol "INHI") was quoted on the Pink Sheets, had four market makers and is eligible for the piggyback exemption of Rule 15c2-11(f)(3) of the Exchange Act.

5. Lighthouse Fast Ferry, Inc. ("Lighthouse") is a revoked New Jersey corporation located in West Caldwell, New Jersey with a class of equity securities registered with the Commission pursuant to Section 12(g) of the Exchange Act. Lighthouse is delinquent in its periodic filings with the Commission because it has not filed a periodic report since a Form 10-QSB for the period ending June 30, 2002. The filing reported a net loss of approximately $6.1 million for the six months ending June 30, 2002, and $14.5 million in total assets as of June 30, 2002. As of August 1, 2006, the company's common stock (symbol "LHFF") was quoted on the Pink Sheets, had four market makers and is eligible for the piggyback exemption of Rule 15c2-11(f)(3) of the Exchange Act.

6. Wannigan Capital Corp. ("Wannigan Capital") (f/k/a ThermoElastic Technologies, Inc.) is a Colorado corporation located in Fox Island, Washington with a class of securities registered with the Commission pursuant to Section 12(g) of the Exchange Act. Wannigan Capital is delinquent in its periodic filings with the Commission because it has not filed a periodic report since its Form 10-KSB for the period ending September 30, 2002. The company reported a net loss of approximately $7.1 million for the year ending September 30, 2002, and $9,884 in total assets as of September 30, 2002. As of August 1, 2006, the company's common stock (symbol "WGAN") was quoted on the Pink Sheets, had four market makers and is eligible for the piggyback exemption of Rule 15c2-11(f)(3) of the Exchange Act.

B. DELINQUENT PERIODIC FILINGS

7. As discussed in more detail above, all of the respondents are delinquent in their periodic filings with the Commission (see Chart of Delinquent Filings), have repeatedly failed to meet their obligation 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. Section 13(a) of the Exchange Act and the rules promulgated thereunder require issuers of securities registered pursuant to Section 12 of the Exchange Act to file with the Commission current and accurate information in periodic reports, even if the registration is voluntary under Section 12(g). Specifically, Rule 13a-1 requires issuers to file annual reports (Forms 10-K or 10-KSB), and Rule 13a-13 requires issuers to file quarterly reports (Forms 10-Q or 10-QSB).

C. VIOLATIONS

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

III.

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

A. Whether the allegations set forth in Section II are true and, in connection therewith, to afford 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 of the Respondents identified in Section II registered pursuant to Section 12 of the Exchange Act.

IV.

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

IT IS FURTHER HEREBY 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 may be deemed in default and the proceedings may be determined against it upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f) and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f) and 201.310].

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

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

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

By the Commission.

Nancy M. Morris
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Attachment: Chart of Delinquent Filings

Chart of Delinquent Filings
In the Matter of Certain Microcap Stocks

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
CMERUN Corp.					
	10-QSB	12/31/00	02/14/01	Not filed	70
	10-QSB	03/31/01	05/15/01	Not filed	67
	10-QSB	06/30/01	08/14/01	Not filed	64
	10-KSB	09/30/01	12/29/01	Not filed	60
	10-QSB	12/31/01	02/14/02	Not filed	58
	10-QSB	03/31/02	05/15/02	Not filed	55
	10-QSB	06/30/02	08/14/02	Not filed	52
	10-KSB	09/30/02	12/29/02	Not filed	48
	10-QSB	12/31/02	02/14/03	Not filed	46
	10-QSB	03/31/03	05/15/03	Not filed	43
	10-QSB	06/30/03	08/14/03	Not filed	40
	10-KSB	09/30/03	12/29/03	Not filed	36
	10-QSB	12/31/03	02/14/04	Not filed	34
	10-QSB	03/31/04	05/15/04	Not filed	31
	10-QSB	06/30/04	08/14/04	Not filed	28
	10-KSB	09/30/04	12/29/04	Not filed	24
	10-QSB	12/31/04	02/14/05	Not filed	22
	10-QSB	03/31/05	05/15/05	Not filed	19
	10-QSB	06/30/05	08/14/05	Not filed	16
	10-KSB	09/30/05	12/29/05	Not filed	12
	10-QSB	12/31/05	02/14/06	Not filed	10
	10-QSB	03/31/06	05/15/06	Not filed	7
	10-QSB	06/30/06	08/14/06	Not filed	4
Total Filings Delinquent	23				
Combine Corp. (f/k/a CTC Cosmetics Holding Co., Inc.)					
	10-KSB	08/31/01	11/29/01	Not filed	61
	10-QSB	02/28/02	04/14/02	Not filed	56
	10-QSB	05/31/02	07/15/02	Not filed	53
	10-KSB	08/31/02	11/29/02	Not filed	49
	10-QSB	11/30/02	01/14/03	Not filed	47

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
	10-QSB	02/28/03	04/14/03	Not filed	44
	10-QSB	05/31/03	07/15/03	Not filed	41
	10-KSB	08/31/03	11/29/03	Not filed	37
	10-QSB	11/30/03	01/14/04	Not filed	35
	10-QSB	02/29/04	04/14/04	Not filed	32
	10-QSB	05/31/04	07/15/04	Not filed	29
	10-KSB	08/31/04	11/29/04	Not filed	25
	10-QSB	11/30/04	01/14/05	Not filed	23
	10-QSB	02/28/05	04/14/05	Not filed	20
	10-QSB	05/31/05	07/15/05	Not filed	17
	10-KSB	08/31/05	11/29/05	Not filed	13
	10-QSB	11/30/05	01/14/06	Not filed	11
	10-QSB	02/28/06	04/14/06	Not filed	8
	10-QSB	05/31/06	07/15/06	Not filed	5
Total Filings Delinquent	19				
Digital Concepts International, Inc.					
	10-QSB	06/30/02	08/14/02	Not filed	52
	10-QSB	09/30/02	11/14/02	Not filed	49
	10-QSB	12/31/02	02/14/03	Not filed	46
	10-KSB	03/31/03	06/29/03	Not filed	42
	10-QSB	06/30/03	08/14/03	Not filed	40
	10-QSB	09/30/03	11/14/03	Not filed	37
	10-QSB	12/31/03	02/14/04	Not filed	34
	10-QSB	03/31/04	05/15/04	Not filed	31
	10-QSB	06/30/04	08/14/04	Not filed	28
	10-QSB	09/30/04	11/14/04	Not filed	25
	10-QSB	12/31/04	02/14/05	Not filed	22
	10-KSB	03/31/05	06/29/05	Not filed	18
	10-QSB	06/30/05	08/14/05	Not filed	16
	10-QSB	09/30/05	11/14/05	Not filed	13
	10-QSB	12/31/05	02/14/06	Not filed	10
	10-KSB	03/31/06	06/29/06	Not filed	6
	10-QSB	06/30/06	08/14/06	Not filed	4
Total Filings Delinquent	17				

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Integrated Homes, Inc.					
	10-QSB	09/30/00	11/14/00	Not filed	73
	10-QSB	12/31/00	02/14/01	Not filed	70
	10-QSB	03/31/01	05/15/01	Not filed	67
	10-KSB	06/30/01	09/28/01	Not filed	63
	10-QSB	09/30/01	11/14/01	Not filed	61
	10-QSB	12/31/01	02/14/02	Not filed	58
	10-QSB	03/31/02	05/15/02	Not filed	55
	10-KSB	06/30/02	09/28/02	Not filed	51
	10-QSB	09/30/02	11/14/02	Not filed	49
	10-QSB	12/31/02	02/14/03	Not filed	46
	10-QSB	03/31/03	05/15/03	Not filed	43
	10-KSB	06/30/03	09/28/03	Not filed	39
	10-QSB	09/30/03	11/14/03	Not filed	37
	10-QSB	12/31/03	02/14/04	Not filed	34
	10-QSB	03/31/04	05/15/04	Not filed	31
	10-KSB	06/30/04	09/28/04	Not filed	27
	10-QSB	09/30/04	11/14/04	Not filed	25
	10-QSB	12/31/04	02/14/05	Not filed	22
	10-QSB	03/31/05	05/15/05	Not filed	19
	10-KSB	06/30/05	09/28/05	Not filed	15
	10-QSB	09/30/05	11/14/05	Not filed	13
	10-QSB	12/31/05	02/14/06	Not filed	10
	10-QSB	03/31/06	05/15/06	Not filed	7
	10-KSB	06/30/06	09/28/06	Not filed	3
Total Filings Delinquent	24				
Lighthouse Fast Ferry, Inc.					
	10-QSB	09/30/02	11/14/02	Not filed	49
	10-KSB	12/31/02	03/31/03	Not filed	45
	10-QSB	03/31/03	05/15/03	Not filed	43
	10-QSB	06/30/03	08/14/03	Not filed	40
	10-QSB	09/30/03	11/14/03	Not filed	37
	10-KSB	12/31/03	03/30/04	Not filed	33
	10-QSB	03/31/04	05/15/04	Not filed	31
	10-QSB	06/30/04	08/14/04	Not filed	28
	10-QSB	09/30/04	11/14/04	Not filed	25

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
	10-KSB	12/31/04	03/31/05	Not filed	21
	10-QSB	03/31/05	05/15/05	Not filed	19
	10-QSB	06/30/05	08/14/05	Not filed	16
	10-QSB	09/30/05	11/14/05	Not filed	13
	10-KSB	12/31/05	03/31/06	Not filed	9
	10-QSB	03/31/06	05/15/06	Not filed	7
	10-QSB	06/30/06	08/14/06	Not filed	4
Total Filings Delinquent	16				
Wannigan Capital Corp. (f/k/a ThermoElastic Technologies, Inc.)					
	10-QSB	12/31/02	02/14/03	Not filed	46
	10-QSB	03/31/03	05/15/03	Not filed	43
	10-QSB	06/30/03	08/14/03	Not filed	40
	10-KSB	09/30/03	12/29/03	Not filed	36
	10-QSB	12/31/03	02/14/04	Not filed	34
	10-QSB	03/31/04	05/15/04	Not filed	31
	10-QSB	06/30/04	08/14/04	Not filed	28
	10-KSB	09/30/04	12/29/04	Not filed	24
	10-QSB	12/31/04	02/14/05	Not filed	22
	10-QSB	03/31/05	05/15/05	Not filed	19
	10-QSB	06/30/05	08/14/05	Not filed	16
	10-KSB	09/30/05	12/29/05	Not filed	12
	10-QSB	12/31/05	02/14/06	Not filed	10
	10-QSB	03/31/06	05/15/06	Not filed	7
	10-QSB	06/30/06	08/14/06	Not filed	4
Total Filings Delinquent	15				

SECURITIES AND EXCHANGE COMMISSION

[Investment Company Act Release No. 27644; 812-13212]

Deutsche Bank Trust Company Americas; Notice of Application

December 28, 2006

Agency: Securities and Exchange Commission ("Commission")

Action: Notice of application for an order pursuant to section 6(c) of the Investment Company Act of 1940 (the "Act") granting an exemption to issuers of asset-backed securities from certain requirements of Rule 3a-7(a)(4)(i) under the Act to enable the Applicant to act as trustee to those issuers and the issuers to rely on Rule 3a-7.

Summary of Application: Applicant requests an order that would permit an issuer of asset-backed securities that is not registered as an investment company under the Act in reliance on Rule 3a-7 under the Act (an "Issuer") to appoint Applicant to act as a trustee to the Issuer when Applicant is affiliated with an underwriter for the Issuer's securities.

Applicant: Deutsche Bank Trust Company Americas.

Filing Dates: The application was filed on July 7, 2005, and amended on December 21, 2006.

Hearing or Notification of Hearing: An order granting the requested relief will be issued unless the Commission orders a hearing. Interested persons may request a hearing by writing to the Commission's Secretary and serving Applicant with a copy of the request, personally or by mail. Hearing requests should be received by the Commission by 5:30 p.m. on January 22, 2007, and should be accompanied by proof of service on Applicant, in the form of an affidavit or, for lawyers, a certificate of service. Hearing requests should state the nature of the writer's interest, the reason for the request, and the issues

contested. Persons who wish to be notified of a hearing may request notification by writing to the Commission's Secretary.

Addresses: Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549. Applicant: 60 Wall Street, New York, New York 10005.

For Further Information Contact: Susan I. Gault-Brown, Senior Counsel, at (202) 551-6869, or David W. Grim, Branch Chief, at (202) 551-6867 (Division of Investment Management, Office of Chief Counsel).

Supplementary Information: The following is a summary of the application. The complete application may be obtained for a fee at the Commission's Public Reference Branch, Room 1580, 100 F Street, NE, Washington, DC 20549 (tel. 202-551-5850).

Applicant's Representations:

1. Applicant is a subsidiary of Deutsche Bank AG.[1] Deutsche Bank AG is a global financial services organization that engages in consumer finance, worldwide corporate banking, investment banking, corporate trust services, and asset management. Applicant is frequently selected to act as trustee to Issuers.

2. An asset-backed securities transaction typically involves the transfer of assets by a seller, usually by a "sponsor," to a special purpose corporate or trust entity that is established for the sole purpose of acting as the Issuer and is structured to be bankruptcy remote and the subsequent issuance of asset-backed securities ("ABS") to investors by the Issuer (an "ABS Transaction").

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1 Applicant also requests that the order apply to an Issuer's appointment, now or in the future, of any other entity controlling, controlled by, or under common control (as defined in section 2(a)(9) of the Act) with Applicant as a trustee for an Issuer. Applicant represents that any other entity relying on this relief now or in the future will comply with the terms and conditions of the application.

3. The parties to an ABS transaction enter into several transaction agreements that provide for the holding of the assets by the Issuer and define the rights and responsibilities of the parties to the transaction ("Transaction Documents"). The operative Transaction Document governing the trustee is referred to herein as the "Agreement."

4. The sponsor of an ABS Transaction assembles the pool of assets by purchasing or funding them, describes them in the offering materials, and sells interests in the assets to investors. The sponsor determines the structure, drafts the documents, and prices the ABS Transaction. The sponsor selects the other parties to the ABS Transaction, including the underwriter, the servicer, and the trustee.

5. The servicer, either directly or through subservicers, manages the assets held by the Issuer. The servicer pays the income from the assets held by the Issuer over to the trustee, and the trustee uses the income, as instructed by the servicer and provided by the Agreement, to pay interest and principal on the ABS, to fund reserve accounts and purchases of additional assets, and to make other payments including fees owed to the trustee and other parties to the ABS Transaction.

6. The sponsor of an ABS Transaction selects the trustee. In selecting a trustee, the sponsor seeks to obtain customary trust administrative and related services for the Issuer at minimal cost. In some instances, other parties to an ABS Transaction may provide recommendations to a sponsor about potential trustees. Ratings agencies may influence the selection of a trustee. An underwriter for an ABS Transaction also may provide advice to the sponsor about trustee selection based on the underwriter's

knowledge of the pricing and expertise offered by a particular trustee in light of the contemplated transaction.

7. If an underwriter affiliated with the Applicant recommends a trustee to a sponsor, both the underwriter's recommendation and any selection of the Applicant by the sponsor will be based upon customary market considerations of pricing and expertise, and the selection will result from an arms-length negotiation between the sponsor and the Applicant. Applicant will not price its services as trustee in a manner designed to facilitate its affiliate being named underwriter.

8. The trustee's role in an ABS Transaction is specifically defined by the Agreement, and under the Agreement the trustee is not expected or required to perform discretionary functions. The responsibilities of the trustee as set forth in the Agreement are narrowly circumscribed and limited to those expressly accepted by the trustee. The trustee negotiates the provisions applicable to it directly with the sponsor and is then appointed by and enters into the Agreement with the Issuer.

9. The trustee usually becomes involved in an ABS Transaction after the substantive economic terms have been negotiated between the sponsor and the underwriters. The trustee does not monitor any service performed by, or obligation of, an underwriter, whether or not the underwriter is affiliated with the trustee. In the unlikely event that the Applicant, in acting as trustee to an Issuer for which an affiliate acts as underwriter, becomes obligated to enforce any of the affiliated underwriter's obligations to the Issuer, the Applicant will resign as trustee for the Issuer consistent with the requirements of Rule 3a-7(a)(4)(i). In such an event, the Applicant will incur the costs associated with the Issuer's procurement of a successor trustee.

10. The sponsor selects one or more underwriters to purchase the Issuer's securities and resell them or to privately place them with buyers obtained by the underwriter. The sponsor enters into an underwriting agreement with the underwriter that sets forth the responsibilities of the underwriter with respect to the distribution of the ABS and includes representations and warranties regarding, among other things, the underwriter and the quality of the Issuer's assets. The obligations of the underwriter under the underwriting agreement are enforceable against the underwriter only by the sponsor.

11. The underwriter may assist the sponsor in the organization of an Issuer by providing advice, based on its expertise in ABS Transactions, on the structuring and marketing of the ABS. This advice may relate to the risk tolerance of investors, the type of collateral, the predictability of the payment stream, the process by which payments are allocated and down-streamed to investors, the way that credit losses may affect the trust and the return to investors, whether the collateral represents a fixed set of specific assets or accounts, and the use of forms of credit enhancements to transform the risk-return profile of the underlying collateral. Any involvement of an underwriter in the organization of an Issuer that occurs is limited to helping determine the assets to be pooled, helping establish the terms of the ABS to be underwritten, and providing the sponsor with a warehouse line of credit with which to purchase the pool assets.

12. As noted above, an underwriter may provide advice to a sponsor regarding the sponsor's selection of a trustee for the Issuer; however, an underwriter's role in structuring a transaction would not extend to determining the obligations of a trustee, and the underwriter is not a party to the Agreement.

13. The underwriter is not a party to any of the Transaction Documents and, except for arrangements involving credit or credit enhancement for an Issuer or remarketing agent activities, typically has no role in the operation of the Issuer after its issuance of securities. The Applicant represents that although an underwriter typically may provide credit or credit enhancement for an Issuer or engage in remarketing agent activities, an underwriter affiliated with the Applicant will not so provide or so engage.

Applicant's Legal Analysis:

1. Applicant requests an order under Section 6(c) of the Act granting an exemption from certain requirements of Rule 3a-7 under the Act.

2. Section 6(c) of the Act gives the Commission the authority to exempt any person or transaction or any class of persons or transactions from any provision of the Act, or from any rule thereunder, if and to the extent such exemption is necessary or appropriate in the public interest; is consistent with the protection of investors; and the purposes fairly intended by the policy and provisions of the Act.

3. Rule 3a-7 provides Issuers that would otherwise fall within the definition of investment company under Section 3(a) of the Act with an exclusion from the definition of investment company. In adopting Rule 3a-7, the Commission stated that it intended to "remove an unnecessary barrier to the use and development of structured financings."[2]

4. Under Rule 3a-7, an Issuer that meets certain conditions is deemed not to be an investment company under Section 3(a) of the Act. One of Rule 3a-7's conditions, set forth in paragraph (a)(4)(i), requires, among other things, that the Issuer appoint a

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[2] Exclusion from the Definition of Investment Company for Structured Financings, Investment Company Act Release No. 19105, 52 SEC Docket 2573 (November 19, 1992) (the "Adopting Release") at 2573.

trustee that is not affiliated with the Issuer or with any person involved in the organization or operation of the Issuer (the "Independent Trustee Requirement"). Applicant states that the phrase "person involved in the organization or operation of the Issuer" includes an underwriter, and Rule 3a-7(a)(4)(i) therefore prohibits an Issuer from appointing a trustee that is affiliated with an underwriter.

5. Applicant requests exemptive relief from Rule 3a-7(a)(4)(i) to the extent necessary to permit an Issuer to appoint the Applicant as a trustee to the Issuer when the Applicant is affiliated with an underwriter involved in the organization of the Issuer.

6. Applicant submits that the requested exemptive relief from the Independent Trustee Requirement is necessary and appropriate in the public interest; is consistent with the protection of investors; and the purposes fairly intended by the policy and provisions of the Act for the following three reasons: (1) due to changes in the banking industry; (2) due to the timing and nature of the roles of the trustee and the underwriter; and (3) because the requested relief is consistent with the policies and purposes underlying the Independent Trustee Requirement and Rule 3a-7.

Changes in the Banking Industry

7. Applicant states that consolidation within the financial industry that occurred throughout the 1990's as a result of bank mergers and sales and related acquisitions of trustee servicing businesses by banks has resulted in a significant decrease in recent years in the number of bank trustees providing services to Issuers. Applicant states that economic and other business factors have also contributed to the trend toward fewer banks offering corporate trust services. Applicant states that bank consolidation has been accompanied by the expansion of banks into investment banking. Applicant

states that banks and bank affiliates are now significant participants in securities underwriting, particularly for ABS Transactions.

8. Applicant states that due to these banking industry changes, most trustees that provide services to Issuers, including the Applicant, have affiliations with underwriters to Issuers. Applicant states that, as a result, when, as is frequently the case, an affiliate of Applicant is selected to underwrite ABS in an ABS Transaction, Rule 3a-7(a)(4)(i)'s Independent Trustee Requirement generally prevents Applicant from serving as trustee for the Issuer.

9. Applicant states that the Independent Trustee Requirement therefore imposes an unnecessary regulatory limitation on trustee selection and causes market distortions by leading to the selection of trustees for reasons other than customary market considerations of pricing and expertise. Applicant states that this result is disadvantageous to the ABS market and to ABS investors and that exemptive relief therefore is necessary and appropriate in the public interest.

Timing and Nature of the Roles of the Trustee and the Underwriter

10. Applicant submits that due to the nature and timing of the roles of the trustee and the underwriter, Applicant's affiliation with an underwriter would not result in a conflict of interest or possibility of overreaching that could harm investors.

11. Applicant states that the trustee's role begins with the Issuer's issuance of its securities, and the trustee performs its role over the life of the Issuer. Applicant states that, in contrast, the underwriter is chosen early in the ABS Transaction process, may help to structure the ABS Transaction, distributes the Issuer's securities to investors, and generally has no further role subsequent to the distribution of the Issuer's securities.

Applicant submits that, consequently, given the nature and timing of their respective roles in an ABS Transaction, an ABS trustee does not monitor the distribution of securities or any other activity performed by underwriters and there is no opportunity for a trustee and an affiliated underwriter to act in concert to benefit themselves at the expense of holders of the ABS either prior to or after the closing of the ABS Transaction.

12. Applicant states that the trustee is neither expected nor required to exercise discretion or judgment. Applicant states that the trustee of the Issuer has virtually no discretion to pursue anyone in any regard other than preserving and realizing on the assets. Applicant states that trustees are not required to pursue securities law or fraud claims on behalf of debt holders and may often be foreclosed from such enforcement because debt holders may have different and conflicting rights.

13. For all of these reasons, Applicant submits that exemptive relief is therefore appropriate and consistent with the protection of investors.

Consistent with Policies and Purposes Underlying the Independent Trustee Requirement and the Rule

14. Applicant submits that the concerns underlying the Independent Trustee Requirement are not implicated if the trustee for an Issuer is independent of the sponsor, servicer, and credit enhancer for the Issuer, but is affiliated with an underwriter for the Issuer, because, in that situation, no single entity would act in all capacities in the issuance of the ABS and the operation of an Issuer. Applicant states that Applicant would continue to act as an independent party safeguarding the assets of an Issuer regardless of an affiliation with an underwriter of the ABS. Applicant submits that, in addition, the concern that affiliation could lead to a trustee monitoring the activities of an

affiliate also is not implicated by a trustee's affiliation with an underwriter, because, in practice, a trustee for an Issuer does not monitor the distribution of securities or any other activity performed by underwriters.

15. Applicant submits that exemptive relief permitting the participation of the Applicant and an affiliated underwriter in an ABS Transaction would be consistent with the broader purposes of Rule 3a-7, because in adopting Rule 3a-7, the Commission intended that, consistent with investor protection, the Rule not hamper the growth and development of the structured finance market. Applicant submits that the requested exemption would allow the selection of a trustee for an ABS Transaction based on the trustee's qualification, rather than technical regulatory restriction, and therefore would alleviate unnecessary market distortions that result from the current Independent Trustee Requirement.

Applicant's Conditions:

Applicant agrees that any order granting the requested relief will be subject to the following conditions:

(1) Applicant will not be affiliated with any person involved in the organization or operation of the Issuer in an ABS Transaction other than the underwriter.

(2) Applicant's relationship to an affiliated underwriter will be disclosed in writing to all parties involved in an ABS Transaction, including the rating agencies and the ABS securities holders.

(3) An underwriter affiliated with Applicant will not be involved in the operation of an Issuer, and its involvement in the organization of an Issuer

will extend only to determining the assets to be pooled, assisting in establishing the terms of the ABS to be underwritten, and providing the sponsor with a warehouse line of credit with which to purchase the pool assets.

(4) An affiliated person of Applicant, including an affiliated underwriter, will not provide credit or credit enhancement to an Issuer if Applicant serves as trustee to the Issuer.

(5) An underwriter affiliated with Applicant will not engage in any remarketing agent activities, including involvement in any auction process in which ABS interest rates, yields, or dividends are reset at designated intervals in any ABS Transaction for which Applicant serves as trustee to the Issuer.

(6) All of an affiliated underwriter's contractual obligations pursuant to the underwriting agreement will be enforceable by the sponsor.

(7) Consistent with the requirements of Rule 3a-7(a)(4)(i), Applicant will resign as trustee for the Issuer if Applicant becomes obligated to enforce any of an affiliated underwriter's obligations to the Issuer.

(8) Applicant will not price its services as trustee in a manner designed to facilitate its affiliate being named underwriter.

By the Commission.

Nancy M. Morris
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
December 28, 2006

IN THE MATTER OF

Digital Concepts International, Inc., Integrated Homes, Inc., Lighthouse Fast Ferry, Inc. and Wannigan Capital 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 Digital Concepts International, Inc., because it is delinquent in its periodic filing obligations under Section 13(a) of the Securities Exchange Act of 1934 ("Exchange Act"), and Rules 13a-1 and 13a-13 thereunder, having never filed a periodic report after its Form 10-SB filed on March 8, 2002, and amended on July 2, 2002, went effective registering its securities.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Integrated Homes, Inc., because it is delinquent in its periodic filing obligations under Section 13(a) of the Exchange Act, and Rules 13a-1 and 13a-13 thereunder, having not filed a periodic report after its Form 10-SB filed on October 13, 2000, went effective registering its securities.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Lighthouse Fast Ferry, Inc., because it is delinquent in its periodic filing obligations under Section 13(a) of the Exchange Act, and Rules 13a-1 and 13a-13 thereunder, having not filed a periodic report since the period ending June 30, 2002.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Wannigan Capital Corp. (f/k/a ThermoElastic Technologies, Inc.), because it is delinquent in its periodic filing obligations under Section 13(a) of the Exchange Act, and Rules 13a-1 and 13a-13 thereunder, having not filed a periodic report since the period ending September 30, 2002.

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

Therefore, IT IS ORDERED, pursuant to Section 12(k) of the Exchange Act, that trading in the above-listed companies is suspended for the period from 9:30 a.m. EST on December 28, 2006, through 11:59 p.m. EST on January 11, 2007.

By the Commission.

Nancy M. Morris
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION

[Release No. IC-27652 ; 812-13351]

FBR Fund Advisers, Inc., et al.; Notice of Application

December 29, 2006

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

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

Summary of Application: Applicants have received a temporary order exempting them from section 9(a) of the Act, with respect to an injunction entered against Friedman, Billings, Ramsey & Co., Inc. ("FBR & Co.") on or about December 22, 2006 by the United States District Court for the District of Columbia, until the Commission takes final action on an application for a permanent order. Applicants also have applied for a permanent order.

Applicants: FBR Fund Advisers, Inc. ("FBR Advisers"), FBR Investment Services, Inc. ("FBRIS"), and FBR Investment Management, Inc. ("FBRIM") (collectively, the "Applicants").[1]

Filing Date: The application was filed on December 22, 2006. Applicants have agreed to file a final amendment during the notice period, the substance of which is reflected in this notice.

Hearing or Notification of Hearing: An order granting the application will be issued unless the Commission orders a hearing. Interested persons may request a hearing by writing to the Commission's Secretary and serving Applicants with a copy of the request, personally or by mail. Hearing requests should be received by the Commission by 5:30 p.m. on January 23, 2007, and should be accompanied by proof of service on Applicants, in the form of an affidavit or, for

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[1] Applicants request that any relief granted pursuant to the application also apply to any other company of which FBR & Co. is or becomes an affiliated person, other than any company of which Emanual J. Friedman is or becomes an affiliated person (together with Applicants, "Covered Persons").

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lawyers, a certificate of service. Hearing requests should state the nature of the writer's interest, the reason for the request, and the issues contested. Persons who wish to be notified of a hearing may request notification by writing to the Commission's Secretary.

Addresses: Secretary, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090. Applicants, c/o William Ginivan, General Counsel, Friedman, Billings, Ramsey Group, Inc., Potomac Tower, 1001 Nineteenth Street North, Arlington, VA 22209.

For Further Information Contact: Marilyn Mann, Senior Counsel, at (202) 551-6813, or Mary Kay Frech, Branch Chief, at (202) 551-6821 (Division of Investment Management, Office of Investment Company Regulation).

Supplementary Information: The following is a temporary order and a summary of the application. The complete application may be obtained for a fee at the Commission's Public Reference Branch, 100 F Street, NE, Washington, DC 20549-0102 (tel. 202-551-5850).

Applicants' Representations:

1. FBR Advisers, FBRIS, and FBRIM are wholly-owned subsidiaries of Friedman, Billings, Ramsey Group, Inc. ("FBR"). FBR, a Virginia corporation, is a diversified financial services holding company that engages in investment banking, institutional brokerage and asset management services, among other activities. FBR Advisers, an investment adviser registered under the Investment Advisers Act of 1940 ("Advisers Act"), serves as investment adviser to certain series of FBR Funds (the "Funds"), an open-end management investment company organized as a Delaware statutory trust and registered under the Act. FBRIS, a broker-dealer registered under the Securities Exchange Act of 1934 ("Exchange Act"), serves as principal underwriter and distributor of shares of the Funds. FBRIM, an investment adviser registered

under the Advisers Act, serves as investment adviser to certain employees' securities companies ("ESCs"), as defined in section 2(a)(13) of the Act, which are investment vehicles formed for the benefit of employees of FBR and its affiliates.

2. On or about December 22, 2006, the United States District Court for the District of Columbia entered a final judgment against FBR & Co., a broker-dealer registered under the Exchange Act, in a matter brought by the Commission (the "Final Judgment").[2] FBR & Co. is a wholly-owned subsidiary of FBR. The Commission alleged in the complaint ("Complaint") that, in connection with a Private Investment in Public Equity offering of stock by CompuDyne Corporation, for which FBR & Co. served as placement agent, FBR & Co. failed to establish, maintain and enforce policies and procedures reasonably designed to prevent the misuse of material, nonpublic information, unlawfully traded while aware of material nonpublic information and conducted unregistered sales of securities. One of the individuals alleged to have been involved in the conduct underlying the Complaint is Emanuel J. Friedman, the former co-chairman and co-chief executive officer of FBR, former chairman and co-chief executive officer of FBR & Co., and former chairman and co-chief executive officer of FBRIM. Without admitting or denying any of the allegations in the Complaint, except as to jurisdiction, FBR & Co. consented to the entry of the Final Judgment. The Final Judgment permanently restrains and enjoins FBR & Co., and its agents, servants, employees, and attorneys, from violating sections 10(b) and 15(f) of the Exchange Act and rule 10b-5 thereunder and sections 5 and 17(a) of the

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[2] Securities and Exchange Commission v. Friedman, Billings, Ramsey & Co., Inc., et al., Final Judgment as to Friedman, Billings, Ramsey & Co., Inc., 06-CV-02160 (RCL) (D.D.C., filed Dec. 22, 2006).

Securities Act of 1933 ("Securities Act") (the "Injunction").[3] FBR & Co. also consented to the payment of disgorgement plus prejudgment interest in addition to civil penalties in an aggregate amount of approximately $3.7 million.[4]

Applicants' Legal Analysis:

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

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3 The Final Judgment also enjoins Mr. Friedman from violating section 5 of the Securities Act and, as a controlling person pursuant to section 20(a) of the Exchange Act, from violating sections 10(b) and 15(f) of the Exchange Act and rule 10b-5 thereunder. The Final Judgment also imposes civil penalties on Mr. Friedman. Mr. Friedman is an affiliated person of FBR under section 2(a)(3)(A) of the Act by virtue of his ownership of 6.09% of the outstanding voting securities of FBR. The requested temporary and permanent orders will not apply to Mr. Friedman or to any company of which Mr. Friedman is or becomes an affiliated person, which currently includes FBR.

4 FBR & Co. also has agreed to certain undertakings designed to ensure that it does not commit future violations with respect to the misuse of material nonpublic information.

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

3. Applicants believe they meet the standards for exemption specified in section 9(c). Applicants state that the prohibitions of section 9(a) as applied to them would be unduly and disproportionately severe and that the conduct of Applicants has been such as not to make it against the public interest or the protection of investors to grant the exemption from section 9(a).

4. Applicants state that although Mr. Friedman was co-chairman and co-chief executive officer of FBR, co-chairman and co-chief executive officer of FBRIM and also participated in the conduct described in the Injunction, Mr. Friedman is no longer employed by FBR, FBRIM or FBR & Co. Applicants also state that none of their officers, directors or employees who are engaged in the provision of investment advisory or underwriting services to the Funds or investment advisory services to the ESCs participated in any way in the conduct underlying the Injunction. Applicants further state that the conduct underlying the Injunction did not involve any Funds or ESCs.

5. Applicants state that the inability to continue providing advisory and underwriting services to the Funds would result in potentially severe hardships for the Funds and their shareholders. Applicants also state that they have distributed, or will distribute as soon as reasonably practicable, written materials, including an offer to meet in person to discuss the

materials, to the boards of directors or trustees of the Funds (the "Boards"), including the directors who are not "interested persons," as defined in section 2(a)(19) of the Act, of such Funds and their independent legal counsel, as defined in rule 0-1(a)(6) under the Act, if any, regarding the Injunction, any impact on the Funds, and the application. Applicants will provide the Boards with all information concerning the Injunction and the application that is necessary for the Funds to fulfill their disclosure and other obligations under the federal securities laws.

6. Applicants also assert that, if they were barred from providing services to the Funds, the effect on their businesses and employees would be severe. Applicants state that they have committed substantial resources to establish an expertise in underwriting and advising the Funds. The Applicants have never before received an exemptive order under section 9(c).

7. Applicants further state that prohibiting FBRIM from continuing to serve as investment adviser to the ESCs is not in the public interest or in furtherance of the protection of investors. Because the ESCs relate to employee retention and compensation matters and are sponsored for employees of FBR and its affiliates, it would not be consistent with the purposes of the employees' securities company provisions of the Act to require another entity not affiliated with FBR to serve as investment adviser to the ESCs. In addition, the participating employees have agreed to participate in the ESCs with the expectation that the ESCs will be managed by their employer.

Applicants' Condition:

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

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

Temporary Order:

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

Accordingly,

IT IS HEREBY ORDERED, pursuant to section 9(c) of the Act, that the Covered Persons are granted a temporary exemption from the provisions of section 9(a), effective as of the date of the Injunction, solely with respect to the Injunction, subject to the condition in the application, until the date the Commission takes final action on an application for a permanent order.

By the Commission.

Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
December 29, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12519

In the Matter of

Cosmetic Center, Inc.,
Discovery Zone, Inc.,
Donlar Biosyntrex Corp.,
Donlar Corp.,
Impax Laboratories, Inc.,
Phoenix Waste Services Company, Inc., and
Telynx, 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").

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Cosmetic Center, Inc. (CIK No. 793520) is a void Delaware corporation located in Columbia, Maryland, with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). The company 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 26, 1998, which reported a net loss of $26,495,000 for the prior nine months. On April 16, 1999, the company filed for bankruptcy under Chapter 11, which was later converted to a Chapter 7 proceeding on September 14, 1999, in the United States Bankruptcy Court for the District of Delaware, which was still pending as of December 18, 2006. As of December 14, 2006, the company's common stock was quoted on the Pink Sheets (symbol "COCQ"), had two market makers, and was eligible for the piggyback exemption of Exchange

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Act Rule 15c2-11(f)(3). The company's stock had an average daily trading volume of 49 shares during the six months ended October 24, 2006.

2. Discovery Zone, Inc. (CIK No. 900392) is a void Delaware corporation located in Elmsford, New York, with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). The company 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, 1998, which reported a net loss of $104,946,000 for the prior year. On April 20, 1999, Discovery Zone filed for bankruptcy under Chapter 11, which was later converted to a Chapter 7 proceeding on May 23, 2000, in the United States Bankruptcy Court for the District of Delaware, which was still pending as of December 18, 2006.

3. Donlar Biosyntrex Corp. (CIK No. 714634) is a dissolved Nevada corporation located in Bedford Park, Illinois, with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). The company is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 2003, which reported a net loss of $4,421,646 for the prior nine months. On March 5, 2003, Donlar Biosyntrex and Donlar Corp. merged, with Donlar Corp. being the surviving entity.

4. Donlar Corp. (CIK No. 1047175) is a dissolved Illinois corporation located in Bedford Park, Illinois, with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). The company 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, 2003, which reported a net loss of $6,483,913 for the prior nine months. On February 26, 2004, Donlar Corp. filed for bankruptcy under Chapter 11, which was converted to a Chapter 7 proceeding on July 13, 2004, in the United States Bankruptcy Court for the Northern District of Illinois, which was still pending as of December 18, 2006. On May 4, 2005, the trustee reported that Donlar Corp.'s estate had a zero balance. As of December 14, 2006, Donlar Corp.'s common stock (symbol "DLRC") was traded on the over-the-counter markets.

5. Impax Laboratories, Inc. (CIK No. 1003642) is a Delaware corporation located in Bedford Park, Illinois, with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). The company is delinquent in its periodic filings with the Commission, having not filed a periodic report since it filed a Form 10-QSB for the period ended September 30, 2004. As of December 14, 2006, the company's common stock was quoted on the Pink Sheets (symbol "IPXL"), had thirty-eight market makers, and was eligible for the piggyback exemption of Exchange Act Rule 15c2-11(f)(3). The company's stock had an average daily trading volume of 261,427 shares during the six months ended December 14, 2006.

6. Phoenix Waste Services Company, Inc. (CIK No. 1008882) is a Delaware corporation located in Newark, New Jersey, with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). The company is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended October 31, 2002, which reported a net loss of $3,844,194 for the prior six months. On May 9, 2003, the company filed for bankruptcy under Chapter 11, which was converted to a Chapter 7 proceeding on July 11, 2003, in the United States Bankruptcy Court for

the District of New Jersey, which was still pending as of December 18, 2006. As of December 14, 2006, the company's common stock was quoted on the Pink Sheets (symbol "PXWSQ"), had five market makers, and was eligible for the piggyback exemption of Exchange Act Rule 15c2-11(f)(3). The company's stock had an average daily trading volume of 18,633 shares during the six months ended December 14, 2006.

7. Telynx, Inc. (CIK No. 852164) is a Delaware corporation located in Sherman Oaks, California, with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). The company is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended October 31, 2004, which reported a net loss of $8,146 for the prior year. In the audit opinion accompanying Telynx's Form 10-KSB for the period ending October 31, 2004, the company's auditors expressed doubt about the company's ability to continue as a going concern in light of its lack of profitable operations and the fact that its liabilities exceeded its current assets. As of December 14, 2006 , the company's common stock was quoted on the Pink Sheets (symbol "TLYN"), had thirteen market makers, and was eligible for the piggyback exemption of Exchange Act Rule 15c2-11(f)(3). The company's stock had an average daily trading volume of 621,638 shares during the six months ended December 14, 2006.

B. DELINQUENT PERIODIC FILINGS

8. This case concerns seven companies with classes of securities registered with the Commission that are delinquent in their periodic reports with the Commission (*see* Chart of Delinquent Filings, attached hereto as Appendix 1). All of the companies at various times had officers or directors who at one time served as officers or directors of Phoenix Waste Services Company, Inc.

9. Each of the respondents either failed to cure their delinquencies after being sent delinquency letters by the Division of Corporation Finance requesting compliance with their periodic filing obligations or, through their failure to maintain a current address on file with the Commission as required by Commission rule, did not receive such letters.

10. Exchange Act Section 13(a) and the rules promulgated thereunder require issuers with classes 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 (Forms 10-K or 10-KSB), and Rule 13a-13 requires issuers to file quarterly reports (Forms 10-Q or 10-QSB).

11. As a result of their failure to file required periodic filings, 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 to institute public administrative proceedings to determine:

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

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

IV.

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

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

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

This Order shall be served forthwith upon Respondents personally, by certified or express mail, or by any other means permitted by the Commission's Rules of Practice.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision not 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.

Nancy M. Morris
Secretary

Attachment

By: Jill M. Peterson
Assistant Secretary

Appendix 1

Chart of Delinquent Filings

In the Matter of Cosmetic Center, Inc., et al.

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Cosmetic Center, Inc.					
	10-K	12/26/98	03/26/99	Not filed	93
	10-Q	03/27/99	05/11/99	Not filed	91
	10-Q	06/26/99	08/10/99	Not filed	88
	10-Q	09/25/99	11/09/99	Not filed	85
	10-K	12/25/99	03/24/00	Not filed	81
	10-Q	03/25/00	05/09/00	Not filed	79
	10-Q	06/24/00	08/08/00	Not filed	76
	10-Q	09/30/00	11/14/00	Not filed	73
	10-K	12/30/00	03/30/01	Not filed	69
	10-Q	03/31/01	05/15/01	Not filed	67
	10-Q	06/30/01	08/14/01	Not filed	64
	10-Q	09/29/01	11/13/01	Not filed	61
	10-K	12/29/01	03/29/02	Not filed	57
	10-Q	03/30/02	05/14/02	Not filed	55
	10-Q	06/29/02	08/13/02	Not filed	52
	10-Q	09/28/02	11/12/02	Not filed	49
	10-K	12/28/02	03/28/03	Not filed	45
	10-Q	03/29/03	05/13/03	Not filed	43
	10-Q	06/28/03	08/12/03	Not filed	40
	10-Q	09/27/03	11/11/03	Not filed	37
	10-K	12/27/03	03/26/04	Not filed	33
	10-Q	03/27/04	05/11/04	Not filed	31
	10-Q	06/26/04	08/10/04	Not filed	28
	10-Q	09/25/04	11/09/04	Not filed	25
	10-K	12/25/04	03/25/05	Not filed	21
	10-Q	03/26/05	05/10/05	Not filed	19
	10-Q	06/25/05	08/09/05	Not filed	16
	10-Q	09/24/05	11/08/05	Not filed	13
	10-K	12/31/05	03/31/06	Not filed	9
	10-Q	03/25/06	05/09/06	Not filed	7
	10-Q	06/24/06	08/08/06	Not filed	4
	10-Q	09/30/06	11/14/06	Not filed	1
Total Filings Delinquent	**32**				

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Discovery Zone, Inc.					
	10-Q	03/31/99	05/17/99	Not filed	91
	10-Q	06/30/99	08/16/99	Not filed	88
	10-Q	09/30/99	11/15/99	Not filed	85
	10-K	12/31/99	03/30/00	Not filed	81
	10-Q	03/31/00	05/15/00	Not filed	79
	10-Q	06/30/00	08/14/00	Not filed	76
	10-Q	09/30/00	11/14/00	Not filed	73
	10-K	12/31/00	04/02/01	Not filed	68
	10-Q	03/31/01	05/15/01	Not filed	67
	10-Q	06/30/01	08/14/01	Not filed	64
	10-Q	09/30/01	11/14/01	Not filed	61
	10-K	12/31/01	04/01/02	Not filed	56
	10-Q	03/31/02	05/15/02	Not filed	55
	10-Q	06/30/02	08/14/02	Not filed	52
	10-Q	09/30/02	11/14/02	Not filed	49
	10-K	12/31/02	03/31/03	Not filed	45
	10-Q	03/31/03	05/15/03	Not filed	43
	10-Q	06/30/03	08/14/03	Not filed	40
	10-Q	09/30/03	11/14/03	Not filed	37
	10-K	12/31/03	03/30/04	Not filed	33
	10-Q	03/31/04	05/17/04	Not filed	31
	10-Q	06/30/04	08/16/04	Not filed	28
	10-Q	09/30/04	11/15/04	Not filed	25
	10-K	12/31/04	03/31/05	Not filed	21
	10-Q	03/31/05	05/16/05	Not filed	19
	10-Q	06/30/05	08/15/05	Not filed	16
	10-Q	09/30/05	11/14/05	Not filed	13
	10-K	12/31/05	03/31/06	Not filed	9
	10-Q	03/31/06	05/15/06	Not filed	7
	10-Q	06/30/06	08/14/06	Not filed	4
	10-Q	09/30/06	11/14/06	Not filed	1
Total Filings Delinquent	**30**				

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Donlar Biosyntrex, Inc.					
	10-QSB	06/30/03	08/14/03	Not filed	40
	10-QSB	09/30/03	11/14/03	Not filed	37
	10-KSB	12/31/03	03/30/04	Not filed	33
	10-QSB	03/31/04	05/17/04	Not filed	31
	10-QSB	06/30/04	08/16/04	Not filed	28
	10-QSB	09/30/04	11/15/04	Not filed	25
	10-KSB	12/31/04	03/31/05	Not filed	21
	10-QSB	03/31/05	05/16/05	Not filed	19
	10-QSB	06/30/05	08/15/05	Not filed	16
	10-QSB	09/30/05	11/14/05	Not filed	13
	10-KSB	12/31/05	03/31/06	Not filed	9
	10-QSB	03/31/06	05/15/06	Not filed	7
	10-QSB	06/30/06	08/14/06	Not filed	4
	10-QSB	09/30/06	11/14/06	Not filed	1
Total Filings Delinquent	**13**				
Donlar Corp.					
	10-KSB	12/31/03	03/30/04	Not filed	33
	10-QSB	03/31/04	05/17/04	Not filed	31
	10-QSB	06/30/04	08/16/04	Not filed	28
	10-QSB	09/30/04	11/15/04	Not filed	25
	10-KSB	12/31/04	03/31/05	Not filed	21
	10-QSB	03/31/05	05/16/05	Not filed	19
	10-QSB	06/30/05	08/15/05	Not filed	16
	10-QSB	09/30/05	11/14/05	Not filed	13
	10-KSB	12/31/05	03/31/06	Not filed	9
	10-QSB	03/31/06	05/15/06	Not filed	7
	10-QSB	06/30/06	08/14/06	Not filed	4
	10-QSB	09/30/06	11/14/06	Not filed	1
Total Filings Delinquent	**12**				

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Impax Laboratories, Inc.					
	10-KSB	12/31/04	03/31/05	Not filed	21
	10-QSB	03/31/05	05/16/05	Not filed	19
	10-QSB	06/30/05	08/15/05	Not filed	16
	10-QSB	09/30/05	11/14/05	Not filed	13
	10-KSB	12/31/05	03/31/06	Not filed	9
	10-QSB	03/31/06	05/15/06	Not filed	7
	10-QSB	06/30/06	08/14/06	Not filed	4
	10-QSB	09/30/06	11/14/06	Not filed	1
Total Filings Delinquent	**7**				
Phoenix Waste Services Company, Inc.					
	10-QSB	01/31/03	03/17/03	Not filed	45
	10-KSB	04/30/03	07/29/03	Not filed	41
	10-QSB	07/31/03	09/15/03	Not filed	39
	10-QSB	10/31/03	12/15/03	Not filed	36
	10-QSB	01/31/04	03/16/04	Not filed	33
	10-KSB	04/30/04	07/29/04	Not filed	29
	10-QSB	07/31/04	09/14/04	Not filed	27
	10-QSB	10/31/04	12/15/04	Not filed	24
	10-QSB	01/31/05	03/17/05	Not filed	21
	10-KSB	04/30/05	07/29/05	Not filed	17
	10-QSB	07/31/05	09/14/05	Not filed	15
	10-QSB	10/31/05	12/15/05	Not filed	12
	10-QSB	01/31/06	03/17/06	Not filed	9
	10-KSB	04/30/06	07/31/06	Not filed	5
	10-QSB	07/31/06	09/14/06	Not filed	3
	10-QSB	10/31/06	12/15/06	Not filed	0
Total Filings Delinquent	**16**				
Telynx, Inc.					
	10-QSB	01/31/05	03/17/05	Not filed	21
	10-QSB	04/30/05	06/14/05	Not filed	18
	10-QSB	07/31/05	09/14/05	Not filed	15
	10-KSB	10/31/05	01/30/06	Not filed	11
	10-QSB	01/31/06	03/17/06	Not filed	9
	10-QSB	04/30/06	06/14/06	Not filed	6
	10-QSB	07/31/06	09/14/06	Not filed	3
Total Filings Delinquent	**7**				

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
December 29, 2006

In the Matter of **Cosmetic Center, Inc.,** **Impax Laboratories, Inc.,** **Phoenix Waste Services Company, Inc., and** **Telynx, 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 Cosmetic Center, Inc., because it has not filed any periodic reports since the period ended September 26, 1998.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Impax Laboratories, Inc., because it has not filed any periodic reports since the period ended September 30, 2004.

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

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

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

Therefore, IT IS ORDERED, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in securities of the above-listed companies is suspended for the period from 9:30 a.m. EST on December 29, 2006, through 11:59 p.m. EST on January 16, 2007.

By the Commission.

Nancy M. Morris
Secretary

Document 53 of 58 Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

Commissioner Nazareth
Not Participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 55023 / December 29, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12518

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

I.

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

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, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Order"), as set forth below.

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III.

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

Respondent

1. Houdek, age 36 years old, is a resident of St. Louis Park, Minnesota. From the fall of 1999 to January 2003, Houdek was the Chief Financial Officer ("CFO") of Stockwalk Group, Inc. ("Stockwalk") and oversaw the accounting department. He was also the Financial Operations Principal ("FINOP") for Stockwalk and its subsidiary, MJK Clearing, Inc. ("MJK") during the same time period. From at least July 2001 through September 2001 (the "relevant time period"), Houdek was a registered representative associated with broker-dealers registered with the Commission. He is also a licensed certified public accountant, but his certificate was inactive during the relevant time period.

Other Relevant Entities and Persons

2. Stockwalk is a Minnesota corporation with its principal place of business in Minneapolis, Minnesota, originally incorporated in the 1990s. Its subsidiary, MJK, was originally incorporated as Miller Johnson and Kuehn, Inc., in 1980. At all relevant times, Stockwalk's common stock was registered under Section 12(g) of the Exchange Act and was traded on the NASDAQ under the ticker "STOK." The common stock has since been delisted. During the relevant time period, Stockwalk had three subsidiaries: MJK, Stockwalk.com, a registered online broker-dealer, and Miller, Johnson, Steichen, Kinnard, Inc. ("MJSK"), a registered full-service broker-dealer.[2] The accounting department for Stockwalk was also responsible for all the financial reporting required of its subsidiaries, including MJK and MJSK. In 2002, Stockwalk reorganized its debt under Chapter 11 of the Bankruptcy Code. The only subsidiary still operating under Stockwalk is MJSK.

3. From January 2001, MJK provided securities clearing functions for Stockwalk's three registered broker-dealers and sixty-five other correspondent brokerage firms. MJK became insolvent on September 25, 2001. MJK and its predecessor, Miller Johnson and Kuehn, Inc., had been registered with the Commission as a broker-dealer since 1981.

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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] Clearing and transaction settlement services were originally provided by MJK Clearing Services, a division within Miller Johnson & Kuehn, Inc. On January 1, 2001, MJK Clearing, Inc. ("MJK") became a wholly-owned subsidiary of Stockwalk, while the brokerage components of Miller Johnson & Kuehn, Inc. were merged with the recently acquired R.J. Steichen and Co., and John G. Kinnard Co. brokerages, to create MJSK, then a wholly-owned subsidiary of MJK.

Summary

4. In July and August 2001, MJK improperly calculated its net capital by failing to reduce its net capital for stock borrow deficits relating to certain securities it borrowed from a counter-party broker dealer, Native Nations Securities, Inc. ("Native Nations"). MJK's stock lending department had failed to collect marks to market owed to MJK by Native Nations when the value of securities MJK had borrowed from Native Nations declined. This resulted in significant stock borrow deficits, which MJK and Stockwalk failed to discover and account for in a timely manner. MJK's miscalculation of its net capital caused it to conduct business while not maintaining sufficient net capital in August 2001 and September 2001. Moreover, the Financial and Operational Combined Uniform Single Reports ("FOCUS Reports") for July and August 2001 filed with the NASD reflected the inaccurate net capital computations. During that time, Stockwalk's accounting department was responsible for MJK's incorrect net capital calculations and inaccurate FOCUS Reports filed with the NASD. Houdek was FINOP for MJK and responsible for reviewing the net capital calculation and ensuring its accuracy. As a result of his conduct, Houdek willfully aided and abetted and caused MJK's violations of the net capital requirements, its filing of incorrect FOCUS Reports, and its failure to file proper notice with the Commission of its net capital deficiencies, in accordance with Rule 17a-11, 17 C.F.R. §240.17a-11. Upon its discovery of the net capital deficiency, MJK immediately contacted the NASD and staff of the Commission.

Improper Net Capital Computations and Failure to Comply with the Notice Requirements

5. On or about July 31, 2001 and August 31, 2001, the accounting department of Stockwalk failed to detect, calculate, and deduct charges related to MJK's stock borrow deficits with Native Nations when calculating MJK's monthly net capital. According to MJK's FOCUS Reports from July and August, MJK calculated and reported excess net capital of $14.7 million on July 31, 2001 and $14.8 million on August 31, 2001.

6. However, proper deduction of charges relating to MJK's stock borrow deficits reveals that MJK actually had excess net capital of $6.2 million on July 31, 2001, and a net capital deficiency of $6.1 million on August 31, 2001. On September 25, 2001, MJK contacted Commission staff to report a net capital deficiency, which prompted Commission examination staff to conduct an exam. In the course of this exam, staff determined that MJK had a net capital deficiency of $70.3 million. Thus, from at least August 31, 2001 through September 25, 2001, MJK conducted business without sufficient net capital.

7. Prior to MJK's miscalculation of its net capital, Stockwalk received a deficiency letter dated July 17, 2001 from the staff of the Commission regarding MJSK, another subsidiary of Stockwalk. The letter stated that, among other things, the accounting department had not been properly reducing MJSK's net worth for certain stock borrow deficits which became necessary after MJSK borrowed securities from MJK. Houdek responded to the deficiency letter, but failed to subsequently ensure that stock borrow deficits were identified and that appropriate

charges for those stock borrow deficits were being made in MJK's calculations of net capital figures.

8. MJK's miscalculation of its net capital during the relevant time period led MJK to file inaccurate July 2001 and August 2001 FOCUS Reports with the NASD.

9. MJK also failed to provide proper notice to the Commission that it was out of compliance with its minimum net capital requirement on August 31, 2001.

Respondent's Omissions as FINOP

10. As MJK's FINOP during the period July 1, 2001 through September 25, 2001, Houdek was responsible for the preparation of all financial reports and the maintenance of the firm's books and records, and was charged with final approval of and responsibility for the firm's net capital computations. Rule 1022(c)(2) of Schedule C of the NASD By-Laws, *NASD Manual* at 3174 (2001).

11. Serving as MJK's FINOP, it was Houdek's responsibility to ensure that the net capital computations were accurate and correctly calculated. The accounting department had the information necessary to calculate the charges for MJK's stock borrow deficits. As Stockwalk's CFO and FINOP, Houdek reviewed all of MJK's net capital calculations and FOCUS Reports for accuracy. However, Houdek failed to fulfill his responsibility as FINOP because he failed to review adequately the documentation which would have revealed MJK's stock borrow deficits and the need to deduct appropriate charges in calculating net capital. Had Houdek properly reviewed MJK's net capital computations and the supporting documents, he would have known that MJK's net capital calculations and FOCUS Reports were inaccurate, and that notice of net capital deficiencies was required.

Violations

12. As a result of the conduct described above, Houdek willfully aided and abetted and caused MJK's violations of Section 15(c)(3) of the Exchange Act and Rule 15c3-1 promulgated thereunder, which prohibits a broker-dealer from effecting transactions in securities in contravention of Commission rules with respect to financial responsibility and requires a broker-dealer to maintain a minimum level of liquid net worth (net capital). Paragraph (c)(2)(iv)(B) of Rule 15c3-1 of the Exchange Act requires a broker-dealer to deduct from its net worth in computing net capital certain unsecured and partly secured receivables. Houdek willfully aided and abetted and caused MJK's failure to deduct charges related to its stock borrow deficits, thereby resulting in MJK's operation of a securities business while it was net capital deficient.

13. As a result of the conduct described above, Houdek willfully aided and abetted and caused MJK's violations of Section 17(a) of the Exchange Act and Rule 17a-5 promulgated thereunder, which require registered brokers or dealers that clear transactions or carry customer accounts, such as MJK, to file accurate monthly and quarterly FOCUS Reports that include net capital computations.

14. As a result of the conduct described above, Houdek willfully aided and abetted and caused MJK's violations of Section 17(a)(1) of the Exchange Act and Rule 17a-11 thereunder, which require every broker or dealer whose net capital falls below the minimum required amount, to give notice that same day to the Commission.

IV.

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

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

A. Respondent Houdek cease and desist from causing any violations and any future violations of Sections 15(c)(3) and 17(a) of the Exchange Act and Rules 15c3-1, 17a-5 and 17a-11 thereunder.

B. Respondent be, and hereby is, suspended from association with any broker or dealer for a period of nine (9) months, effective on the second Monday following the entry of this Order.

C. It is further ordered that Respondent shall, within thirty (30) days of the entry of this Order, pay a civil money penalty in the amount of $20,000 to the United States Treasury. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Jeffrey L. Houdek as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Tracy W. Lo, Securities and Exchange Commission, 175 West Jackson Boulevard, Suite 900, Chicago, Illinois 60604.

By the Commission.

Nancy M. Morris
Secretary

By: Jill M. Peterson
Assistant Secretary

Commissioner Nazareth
Not Participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 55024 / December 29, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12520

In the Matter of **TODD W. MILLER,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AS TO TODD W. MILLER**

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 Todd W. Miller ("Respondent" or "Miller").

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 Proceedings, Making Findings, and Imposing Remedial Sanctions Pursuant Section 15(b) of the Securities Exchange Act of 1934 ("Order"), as set forth below.

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III.

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

1. Miller, 42 years old, is a resident of Edina, Minnesota. From January 2001 through July 2001, Miller was president of MJK Clearing, Inc. ("MJK") and directly supervised MJK's Stock Loan Department ("SL Department"). He became COO of MJK's corporate parent, Stockwalk Group, Inc. ("Stockwalk") in July 2001 and served in that capacity through October 2001. From 1985 to January 2001, when MJK was incorporated, Miller was in charge of the clearing division of MJK's predecessor, Miller, Johnson and Kuehn, Inc. From 1985 to the present, Miller has been a registered representative associated with broker-dealers registered with the Commission. He is currently a registered representative at Stockwalk's sole remaining active subsidiary, Miller Johnson Steichen Kinnard, Inc. ("MJSK").

Other Relevant Entities and Person

2. Stockwalk is a Minnesota corporation with its principal place of business in Minneapolis, Minnesota, originally incorporated in the 1990s. Its subsidiary, MJK Clearing, Inc. ("MJK") was originally incorporated as Miller Johnson and Kuehn, Inc. in 1980. At all relevant times, Stockwalk's common stock was registered under Section 12(g) of the Exchange Act and was traded on the NASDAQ under the ticker "STOK." The common stock has since been delisted. During the relevant time period, Stockwalk had three subsidiaries: MJK, Stockwalk.com, Inc., and MJSK, a full-service broker-dealer.[2] In 2002, Stockwalk reorganized its debt under Chapter 11 of the Bankruptcy Code.

3. From January 2001, MJK provided securities clearing functions for Stockwalk's three registered broker-dealers and sixty-five other correspondent brokerage firms. MJK became insolvent on September 25, 2001. MJK and its predecessor, Miller Johnson and Kuehn, Inc. had been registered with the Commission as a broker-dealer since 1981.

4. Thomas G. Brooks ("Brooks"), 42 years old, is a resident of Eden Prairie, Minnesota. From January 3, 1999 to October 3, 2001, Brooks was the manager of the SL Department at MJK and vice-president of MJK. From 1993 to October 3, 2001, Brooks was a registered representative associated with MJK.

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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] Clearing and transaction settlement services were originally provided by MJK Clearing Services, a division within Miller Johnson & Kuehn, Inc. On January 1, 2001, MJK Clearing, Inc. ("MJK") became a wholly-owned subsidiary of Stockwalk, while the brokerage components of Miller Johnson & Kuehn, Inc. were merged with the recently acquired R.J. Steichen and Co., and John G. Kinnard Co. brokerages, to create MJSK, then a wholly-owned subsidiary of MJK.

Summary

5. From at least July 2001 through September 2001 (the "relevant time period"), Miller supervised Brooks. Miller failed reasonably to supervise Brooks adequately with a view to preventing Brooks' violations of the federal securities laws and regulations. Brooks directly through his own actions, and in his direction of the actions of others in the SL Department, failed to collect millions of dollars of cash collateral owed to MJK. This resulted in massive stock borrow deficits, and ultimately caused MJK to lose millions of dollars. Brooks' conduct also hid MJK's true financial condition from broker-dealers doing business with MJK. During Brooks' employment at MJK, Miller failed to establish or implement any supervisory procedures with a view to preventing and detecting Brooks' violations and instead allowed Brooks to establish and implement all the procedures himself, including the recording of MJK's stock loan and mark to market[3] activities, without any adequate oversight.

Miller was Brooks' Supervisor

6. Miller was the president of MJK from January 2001 until July 2001. Miller was responsible for supervising the clearing activities and the hiring and firing of MJK personnel and developing supervisory procedures. Miller shared the responsibility of supervising Brooks after he was promoted to COO through September 2001.

7. In January 1999, Miller hired Brooks to establish and manage MJK's fledgling SL Department. Miller gave Brooks full authority and complete discretion over the day-to-day activities of the SL Department with very little supervision from Stockwalk and MJK's management, including Miller.

Brooks' Fraudulent Conduct

8. From November 1, 2000, through September 2001, under Brooks' direction, the SL Department borrowed at least two securities from another registered broker-dealer, Native Nations Securities, Inc. ("Native Nations"): Imperial Credit bonds and GenesisIntermedia ("GENI") common stock, which it then loaned out to other broker-dealers.

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[3] Between at least July 2001 and September 2001, MJK's SL Department engaged in stock loan transactions in which MJK acted as a middleman between two broker-dealers, matching a broker-dealer that had a particular security to lend with a broker-dealer that desired to borrow the security. These transactions are referred to as "conduit" transactions. When securities are borrowed and loaned in a conduit transaction, the borrowing broker-dealer posts cash collateral with the lender equaling or slightly exceeding the value of the borrowed securities.

Generally, if the market value of a security in a conduit transaction declines or increases, the broker-dealers engaged in the transaction "mark to market" or "mark" the positions by adjusting the amount of collateral to reflect the market value of the securities. If the value of the securities decreases, the borrowing broker-dealer records the reduced value of the security on its books and the lending broker dealer returns the excess collateral. Conversely, when the market value of the borrowed securities increases, the borrowing broker-dealer records the increased market value and posts additional collateral with the lending broker-dealer. MJK's SL Department followed this practice except with respect to the GenesisIntermedia and Imperial Credit transactions with Native Nations on the occasions cited herein.

9. From July 2001 through September 2001, the SL Department failed to collect marks to market owed to MJK by Native Nations on stock loan transactions involving Imperial Credit bonds when the value of those bonds declined. In September 2001, the SL Department failed to collect marks to market owed to MJK by Nation Nations when the value of GENI common stock declined. Brooks directed the SL Department not to collect those marks owed to MJK by Native Nations because he had arranged with Native Nations that it would pay MJK a higher rebate on the money MJK had posted as collateral with Native Nations for those securities.

10. During this same time period, other broker-dealers were marking MJK for the decline in value of the Imperial Credit bonds and GENI common stock, which totaled millions of dollars. Brooks continued to pay daily marks out to these other broker-dealers who borrowed Imperial Credit bonds and GENI common stock from MJK as the value of those securities declined. Brooks' failure to collect marks owed to MJK while paying marks owed to other broker-dealers created substantial stock borrow deficits and significant harm to MJK's financial health.

11. On September 24 and 25, 2001, Miller and others discovered the substantial stock borrow deficits and learned of Native Nations' inability to pay the marks it owed to MJK. Miller immediately contacted the NASD and staff of the Commission regarding MJK's net capital deficiency. MJK was placed under the control of the Securities Investor Protection Corporation ("SIPC") and liquidated. MJK went out of business with Native Nations owing MJK uncollected marks of at least $129.8 million for the GENI shares and at least $63.2 million for the Imperial Credit bonds.

12. Based on this conduct, Brooks violated Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder and aided and abetted violations of Sections 15(c)(3) and 17(a) of the Exchange Act and Rules 15c3-3, 17a-3, and 17a-5 thereunder.

Miller Failed to Establish or Implement Supervisory Procedures to Prevent or Detect Brooks' Violations

13. As described above, from at least July 2001 through September 2001, Brooks, among other things, failed to collect marks against Native Nations, resulting from the decline in value of the securities that MJK borrowed from Native Nations. Without ever conferring with Miller, Brooks directed the SL Department to pay marks to other broker-dealers who borrowed GENI and Imperial Credit bonds from MJK and not to collect marks against Native Nations for the same amount during the relevant time period. Brooks' conduct placed MJK at substantial financial risk.

14. During the relevant time period, Miller gave Brooks the responsibility of ensuring that marks were being paid out and collected as due. Miller did not implement any or establish any supervisory procedures or systems that would have reasonably prevented and detected whether Brooks had actually collected marks owed to MJK as it was paying out marks it

owed to other broker-dealers. Miller did not take any steps himself to verify that Brooks was actually collecting or paying marks.

15. During the relevant time period, Miller did not establish or implement any supervisory procedures or systems to monitor the risk taken in the SL Department and Miller took no adequate steps to monitor Brooks in this regard. Miller did not establish credit limits on the broker-dealers with which MJK did business. Miller did not require Brooks to confer or seek his approval concerning with whom MJK could transact business, in what amount, in what securities, or what the appropriate rebate amount should be for collateral borrowed from MJK. By failing to establish supervisory procedures and systems to address whether Brooks executed stock loan transactions only with appropriate counter-parties, Miller allowed Brooks to place MJK at unnecessary financial risk. If Miller had established and implemented such supervisory procedures and systems, it is likely that Brooks' violations could have been prevented and detected.

Miller's Failure to Supervise

16. As a result of the conduct described above, Miller failed reasonably to supervise Brooks, a person subject to his supervision within the meaning of Section 15(b)(4)(E) of the Exchange Act, with a view to preventing Brooks from violating the securities laws and regulations by failing to collect marks owed to MJK from Native Nations.

IV.

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

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

A. Respondent Miller be, and hereby is, barred from association in a supervisory capacity with any broker or dealer, with the right to reapply for association in a supervisory capacity after eighteen (18) months to the appropriate self-regulatory organization, or if there is none, to the Commission.

B. 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.

C. It is further ordered that Respondent shall, within thirty (30) days of the entry of this Order, pay a civil money penalty in the amount of $35,000 to the United States Treasury. Such

payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Todd W. Miller as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Tracy W. Lo, Securities and Exchange Commission, 175 West Jackson Boulevard, Suite 900, Chicago, Illinois 60604.

By the Commission.

Nancy M. Morris
Secretary

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 55021 / December 29, 2006

INVESTMENT ADVISERS ACT OF 1940
Release No. 2577 / December 29, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12355

In the Matter of **VERITAS FINANCIAL ADVISORS, LLC, VERITAS ADVISORS, INC., PATRICK J. COX and RITA A. WHITE,** **Respondents.**	**ORDER MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTIONS 203(e), 203(f), AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940 AS TO VERITAS FINANCIAL ADVISORS, LLC, VERITAS ADVISORS, INC., AND PATRICK J. COX**

I.

On July 5, 2006, the Securities and Exchange Commission ("Commission") instituted administrative and cease-and-desist proceedings against: Veritas Financial Advisors, LLC, pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act"); Veritas Advisors, Inc., pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") and Sections 203(e) and 203(k) of the Advisers Act; Patrick J. Cox, pursuant to Section 21C of the Exchange Act and Sections 203(f) and 203(k) of the Advisers Act; and Rita A. White, pursuant to Section 21C of the Exchange Act and Section 203(f) of the Advisers Act.

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II.

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

III.

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

Settling Respondents

1. **Veritas Financial Advisors, LLC** ("Veritas Financial"), a Massachusetts limited liability company located in Boston, Massachusetts, was organized on or about January 30, 2004, and its certificate of organization was canceled on or about October 6, 2006. It has been registered with the Commission as an investment adviser pursuant to Section 203(a) of the Advisers Act since on or about March 4, 2004.

2. **Veritas Advisors, Inc.** ("Veritas Advisors"), a Massachusetts corporation located in Boston, Massachusetts, was formed on or about November 2, 1993, and it was dissolved on or about October 6, 2006. It was registered with the Commission as an investment adviser pursuant to Section 203(a) of the Advisers Act from at least August 31, 1998 through July 31, 2001, when the Commission canceled its registration because Veritas Advisors ceased making requisite filings with the Commission. Thereafter and through at least April 2005, Veritas Advisors continued to be an investment adviser within the meaning of Section 202(a)(11) of the Advisers Act.

3. **Patrick J. Cox** ("Cox"), age 50, most recently resided in Wellesley, Massachusetts. Cox was the sole owner and principal of both Veritas entities, and at all relevant times he was a person associated with an investment adviser pursuant to Section 202(a)(17) of the Advisers Act. He is a licensed Certified Public Accountant in the State of Ohio, although his license is inactive.

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

Summary

4. This matter involves fraudulent schemes through which Veritas Advisors, an investment adviser, and Cox, its sole principal and an associated person, misappropriated funds from a client (the "Client"). The Client, age 57 and residing in Brookline, Massachusetts, engaged Veritas Advisors for tax and investment advisory services. From at least March 1998 through March 2005, Cox made unauthorized transfers of at least $1,200,000 from at least three of the Client's bank or investment accounts either to himself or Veritas Advisors.

5. Moreover, both Veritas entities, which were controlled solely by Cox at all relevant times, fraudulently failed to disclose their precarious financial condition to clients and did not maintain certain required books and records for investment advisers. Veritas Advisors also did not maintain proper custody of client funds.

6. As a result of the foregoing conduct, Veritas Financial, Veritas Advisors and Cox variously willfully violated or willfully aided and abetted and caused violations of the antifraud and other provisions of the Exchange Act and Advisers Act, as provided herein.

The Veritas Entities and Their Investment Advisory Services

7. From its formation on or about November 2, 1993 until it ceased operating in or about April 2005, Veritas Advisors continuously provided a range of financial and investment advisory services to clients, which included tracking client investments, advising clients on the tax consequences of investments, selecting, interacting with and evaluating investment managers, paying bills for clients, tax return preparation and tax and estate planning. In the course of providing these services, Cox, as Veritas Advisors' principal, had varying amounts of discretion over client bank and brokerage accounts, including, in some cases, authority to transfer funds from client accounts and purchase or sell securities in client accounts.

8. During the foregoing period, Cox informed Veritas Advisors clients about several investment opportunities in which the clients ultimately invested, including a venture operated by Cox's brother to market instructional golf videotapes, and two hedge funds managed by a college acquaintance of Cox. Some clients discussed potential investments with Cox, as Veritas Advisors' principal, while other clients sought investment advice from Cox.

9. During the foregoing period, clients compensated Veritas Advisors by paying a flat fee for all of its services.

10. In October 1998, the Securities Division of the Secretary of the Commonwealth of Massachusetts ("Securities Division") entered a consent order against Veritas Advisors and Cox, which found that, from 1994 through 1998, Veritas Advisors and Cox had provided investment advisory services while not being registered as

investment advisers. The Securities Division censured them, required them to register with the Securities Division and the Commission, and ordered Veritas Advisors to pay back registration fees and administrative costs.

11. On or about August 31, 1998, Veritas Advisors registered with the Commission as an investment adviser (SEC File Number 801-55833).

12. After 1999, Veritas Advisors ceased making the filings with the Commission which were necessary to maintain its registration as an investment adviser. The Commission canceled Veritas Advisors' investment adviser registration on or about July 31, 2001. Thereafter and through at least April 2005, Veritas Advisors continued to provide the same investment advisory services to clients as described above, and Cox, as Veritas Advisors' principal, had equal or greater discretion over client bank and brokerage accounts.

13. On or about January 30, 2004, Cox formed Veritas Financial as an investment advisory business. Veritas Financial registered with the Commission as an investment adviser on or about March 4, 2004 (CRD Number 130614; SEC File No. 801-62868). It has not withdrawn its registration to date, although it has not made requisite filings with the Commission since at least March 31, 2005.

14. Between at least January 30, 2004 and March 31, 2005, the Veritas entities had some common clients and personnel and provided similar services, and, by their own terms, the code of ethics and compliance manual that Veritas Financial adopted in or about October 2004 also applied to Veritas Advisors employees.

15. On or about March 31, 2005, all employees of Veritas Advisors and Veritas Financial, excluding Cox, resigned.

Misappropriation of Client Funds by Veritas Advisors and Cox

16. Between at least March 1998 and March 2005, there were more than fifty unauthorized transfers of cash, totaling at least $1,200,000, from at least three of the Client's bank or investment accounts to Veritas Advisors and Cox.

17. The majority of the unauthorized transfers to Veritas Advisors and Cox occurred through checks drawn on the Client's personal checking account ("checking account"), and deposited into either the Veritas Advisors operating account or Cox's personal checking account. Most of the checks were "signed" with a stamp copy of the Client's signature ("signature stamp"). The Client had arranged for Veritas Advisors to pay her household expenses from her checking account, and Veritas Advisors kept the signature stamp at its offices for that purpose. In some cases, Cox, who was a signatory on the Client's checking account, signed the checks.

18. A few of the unauthorized transfers to Veritas Advisors and Cox were made by wire. The wire transfers originated from one of three of the Client's accounts –

her checking account, an investment account and, in one instance, a charitable remainder trust account. These transfers occurred pursuant to written requests from Veritas Advisors that were signed by Cox.

19. The Client's investment account ("bond account") consisted of bonds that had to be sold in order to generate cash. During the relevant period, there were at least monthly transfers of cash from the Client's bond account (following the sale of bonds) to her checking account. These transfers all were made by wire at the direction of Veritas Advisors, and Cox signed the wire transfer requests. Cox knew of these transfers and also knew that bonds in the bond account had to be sold in order to generate the cash that was transferred to the checking account and, in some cases, directly to Veritas Advisors and Cox.

20. At all relevant times, Cox continually withdrew funds from the Veritas Advisors operating account by making checks payable to himself and depositing them into his personal checking account. Therefore, Cox personally benefited from at least some of the cash transfers from the Client's accounts to Veritas Advisors.

21. The Client did not authorize the above-described transfers to Veritas Advisors and Cox. Although Cox had limited authority to transfer funds from the Client's accounts (e.g., for the payment of her household expenses), he could not use that authority to transfer funds for his personal benefit or that of Veritas Advisors.

Other Findings

22. Between at least March 1998 and April 2005, the Veritas entities and Cox were experiencing significant financial problems that were reasonably likely to impair their ability to provide services to clients and that should have been disclosed to clients pursuant to Rule 206(4)-4 of the Advisers Act but were not disclosed. For example, Veritas Advisors' rent for the office space it leased was often in arrears. There also were numerous cash shortfalls in the Veritas Advisors operating account. Veritas Advisors did not have sufficient funds to pay the salaries of its employees for March 2005. Veritas Financial similarly was thinly capitalized and relied on Veritas Advisors to pay all of its expenses, including filing fees for its registration with the Commission as an investment adviser. Veritas Advisors and Cox misappropriated funds from the Client, as described above, to alleviate these and other financial problems.

23. Between at least March 1998 and April 2005, the Veritas entities, which were controlled by Cox, did not maintain certain required books and records for investment advisers, including a general ledger and financial statements pursuant to Rules 204-2(a)(2) and 204-2(a)(6) of the Advisers Act.

24. Between at least March 1998 and April 2005, Veritas Advisors, which was controlled by Cox, did not comply with the custody requirements of Rule 206(4)-2 of the Advisers Act. For many clients, Cox, as Veritas Advisors' principal, had discretion over client accounts, including limited authority to transfer funds from client accounts and sell

bonds in client accounts. Veritas Advisors also received copies of clients' brokerage and bank account statements. However, Veritas Advisors did not send account statements to clients as often as required by the custody rule, if at all. Veritas Advisors also kept physical stock certificates at its offices, instead of with a qualified custodian, as required by the rule.

25. Between at least July 31, 2001, when it ceased being registered with the Commission as an investment adviser, and April 2005, Veritas Advisors, which was controlled by Cox, was in the business of providing investment advice for compensation without being registered with the Commission as required by Section 203(a) of the Advisers Act and rules thereunder. During the foregoing period, Veritas Advisors had at least fifteen clients and at least $25,000,000 in assets under management, and no statutory exemptions from the registration requirement or prohibitions on registration applied.

Violations

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

27. As a result of the conduct described above, Cox willfully aided and abetted and caused Veritas Advisors' violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

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

29. As a result of the conduct described above, Cox willfully aided and abetted and caused Veritas Advisors' violations of Sections 206(1) and 206(2) of the Advisers Act.

30. As a result of the conduct described above, Veritas Financial and Veritas Advisors, acting through Cox, willfully violated Section 206(4) of the Advisers Act, which prohibits investment advisers from engaging in acts, practices or courses of business which are fraudulent, deceptive or manipulative, as defined by rules and regulations thereunder, and Rule 206(4)-4 thereunder, which requires investment advisers registered or required to be registered with the Commission to disclose to clients all material facts with respect to financial conditions that are reasonably likely to impair the adviser's ability to meet contractual commitments to clients if the adviser has discretionary authority or custody over client funds or securities.

31. As a result of the conduct described above, Cox willfully aided and abetted and caused the Veritas entities' violations of Section 206(4) of the Advisers Act and Rule 206(4)-4 thereunder.

32. As a result of the conduct described above, Veritas Advisors, acting through Cox, willfully violated Section 206(4) of the Advisers Act, which prohibits investment advisers from engaging in acts, practices or courses of business which are fraudulent, deceptive or manipulative, as defined by rules and regulations thereunder, and Rule 206(4)-2 thereunder, which imposes requirements upon investment advisers registered or required to be registered with the Commission concerning custody of client funds or securities.

33. As a result of the conduct described above, Cox willfully aided and abetted and caused Veritas Advisors' violations of Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder.

34. As a result of the conduct described above, Veritas Financial and Veritas Advisors, acting through Cox, willfully violated Section 204 of the Advisers Act and Rule 204-2 thereunder, which require investment advisers registered or required to be registered with the Commission to maintain and preserve certain books and records, including a general ledger pursuant to Rule 204-2(a)(2) and financial statements pursuant to Rule 204-2(a)(6).

35. As a result of the conduct described above, Cox willfully aided and abetted and caused the Veritas entities' violations of Section 204 of the Advisers Act and Rules 204-2(a)(2) and 204-2(a)(6) thereunder.

36. As a result of the conduct described above, Veritas Advisors, acting through Cox, willfully violated Section 203(a) of the Advisers Act, which prohibits investment advisers from making use of the mails or any means or instrumentality of interstate commerce in connection with their business as investment advisers unless they are registered with the Commission.

37. As a result of the conduct described above, Cox willfully aided and abetted and caused Veritas Advisors' violations of Section 203(a) of the Advisers Act.

IV.

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

Accordingly, it is hereby ORDERED as to Veritas Financial pursuant to Section 203(e) of the Advisers Act that:

A. Veritas Financial shall be and hereby is censured for willfully violating Sections 204 and 206(4) of the Advisers Act and Rules 204-2(a)(2), 204-2(a)(6) and 206(4)-4 thereunder;

B. Veritas Financial's registration as an investment adviser shall be and hereby is revoked; and

C. Any reapplication for registration as an investment adviser by Veritas Financial 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 Veritas Financial, 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.

It is hereby further ORDERED as to Veritas Advisors pursuant to Section 203(e) of the Advisers Act that:

D. Veritas Advisors shall be and hereby is censured for willfully violating Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and Sections 203(a), 204, 206(1), 206(2) and 206(4) of the Advisers Act and Rules 204-2(a)(2), 204-2(a)(6), 206(4)-2 and 206(4)-4 thereunder.

It is hereby further ORDERED as to Cox pursuant to Section 21C of the Exchange Act and Sections 203(f) and 203(k) of the Advisers Act that:

E. Cox shall cease and desist from committing or causing any violations and any future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and Sections 203(a), 204, 206(1), 206(2) and 206(4) of the Advisers Act and Rules 204-2(a)(2), 204-2(a)(6), 206(4)-2 and 206(4)-4 thereunder;

F. Cox shall be and hereby is barred from association with any investment adviser;

G. Any reapplication for association by Cox 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 Cox, 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; and

H. Cox shall, within 21 days of the entry of this Order, pay a civil money penalty in the amount of $120,000 to the Securities and Exchange Commission. Such payment shall be: (a) made by United States postal money order, certified check, bank cashier's check or bank money order; (b) made payable to the Securities and Exchange Commission; (c) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Alexandria, Stop 0-3, VA 22312; and (d) submitted under cover letter that identifies Cox as a respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Silvestre A. Fontes, Senior Trial Counsel, Division of Enforcement, U.S. Securities and Exchange Commission, Boston District Office, 33 Arch Street, 23rd Floor, Boston, MA 02110.

By the Commission.

Nancy M. Morris
Secretary

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

CORRECTED COPY

SECURITIES EXCHANGE ACT OF 1934
Release No. 55030 / December 29, 2006

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2529 / December 29, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12521

In the Matter of

WHITEMARK HOMES, INC.,
KENNETH L. WHITE,
ROBERT B. EARLY, AND
MITCHELL R. GORDON,

Respondents.

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

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against Whitemark Homes, Inc. ("Whitemark"), Kenneth L. White, Robert B. Early, and Mitchell R. Gordon (collectively, "Respondents").

II.

In anticipation of the institution of these proceedings, Respondents have each submitted an Offer of Settlement (collectively, 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

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the status of purchase options. Early signed filings with the Commission in which Whitemark omitted to disclose information relating to the status of purchase options.

Improper Reallocation of the NFC Purchase Price

13. When Whitemark acquired NFC in 2001, it allocated the price it paid to purchase NFC to the various assets it acquired based on the appraised value of each asset. Later, in its financial statements for the third quarter of 2002, Whitemark changed its method for allocating the purchase price for the NFC acquisition and instead based its allocation on the projected cash flows Whitemark expected to realize from each development project. When Whitemark reallocated the NFC purchase price, Whitemark calculated the expected future cash flows from the development projects based in part on events that occurred after the NFC acquisition.

14. Whitemark's change in method for accounting for the NFC acquisition and consideration of post-acquisition events when reallocating the NFC purchase price were improper under GAAP. In addition, Whitemark did not disclose its change in allocation method in its original and amended Forms 10-Q for the third quarter of 2002.

15. Also in the third quarter of 2002, Whitemark decided to reduce its inventory account to write off most of the value associated with two development projects for which its purchase options had expired. Whitemark wrote off values associated with these projects based on its reallocation of the NFC purchase price, and as a result reported a net loss for the quarter of approximately $1.9 million. Had Whitemark written off the same assets without reallocating the NFC purchase price, it would have reported a net loss for the quarter of approximately $29.9 million. Since Whitemark's reallocation of the NFC purchase price was improper, its adjustments to write off the value of these development projects were insufficient. As a result, Whitemark materially overstated its inventory, materially understated its associated expenses, and materially understated its net loss for the third quarter of 2002. Whitemark also did not disclose the impact of the reallocation on its adjustments associated with these two development projects.

16. In its original and amended Forms 10-Q for the third quarter of 2002, as in previous filings, Whitemark represented that it valued purchase options based on the excess of their fair market value over their respective option prices. In light of its new method for allocating the NFC purchase price, this statement was incorrect.

17. Gordon, in consultation with White and others, performed the reallocation of the NFC purchase price. Although White and Gordon were responsible for the accuracy of Whitemark's periodic filings, neither of these officers took the steps necessary to assure that Whitemark's reallocation of the NFC purchase price conformed with GAAP, that Whitemark made appropriate financial statement adjustments for discontinued development projects, or that Whitemark made appropriate disclosures about the reallocation and its effect. White and Gordon signed filings with the Commission in which Whitemark materially misstated its financial results and valuation methodology, and omitted to disclose information associated with the reallocation of the NFC purchase price.

Books, Records, and Internal Controls

18. As described above, Whitemark improperly recorded its inventory and expenses for the year ended December 31, 2001, and for each of the first three quarters of 2002. Therefore, its books, records and accounts did not, in reasonable detail, accurately and fairly reflect its transactions and dispositions of assets. White, Early, and Gordon were responsible for Whitemark's books, records, and accounts but failed to take the steps necessary to assure their accuracy.

19. Whitemark failed to implement internal accounting controls relating to its inventory, expenses, and net income which were sufficient to provide reasonable assurances that its accounts were accurately stated in conformity with GAAP. White, Early, and Gordon were responsible for Whitemark's internal accounting controls but failed to take the steps necessary to assure their sufficiency.

Violations

20. As a result of the conduct described above, Whitemark violated Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11, and 13a-13 thereunder, which require an issuer to file annual, current, and quarterly reports that are accurate and that contain such further material information as may be necessary to make the required statements, in light of the circumstances under which they were made, not misleading. Due to acts or omissions they knew or should have known would contribute to such violations during their respective tenures at Whitemark, White was a cause of Whitemark's violations of each of these provisions; Early was a cause of Whitemark's violations of Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1, and 13a-11 thereunder; and Gordon was a cause of Whitemark's violations of Section 13(a) of the Exchange Act and Rules 12b-20, 13a-11, and 13a-13 thereunder.

21. As a result of the conduct described above, Whitemark violated Section 13(b)(2)(A) of the Exchange Act and Rule 13b2-1 thereunder, which require reporting companies to make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect their transactions and dispositions of their assets, and prohibit persons from directly or indirectly falsifying or causing to be falsified any book, record, or account. White and Gordon each were a cause of Whitemark's violations of Section 13(b)(2)(A) of the Exchange Act and Rule 13b2-1 thereunder, and Early was a cause of Whitemark's violations of Section 13(b)(2)(A) of the Exchange Act, due to acts or omissions they knew or should have known would contribute to such violations.

22. As a result of the conduct described above, Whitemark violated Section 13(b)(2)(B) of the Exchange Act, which requires all reporting companies to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in conformity with GAAP. White, Early, and Gordon each were a cause of Whitemark's violations of Section 13(b)(2)(B) of the Exchange Act due to acts or omissions they knew or should have known would contribute to such violations.

IV.

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

Accordingly, it is hereby ORDERED that:

A. Respondent Whitemark 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, 13a-13, and 13b2-1 thereunder.

B. Respondent White cease and desist from causing any violations and any future violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11, and 13a-13 thereunder, and cease and desist from committing or causing any violations and any future violations of Rule 13b2-1 under the Exchange Act.

C. Respondent Early cease and desist from causing any violations and any future violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1, and 13a-11 thereunder.

D. Respondent Gordon cease and desist from causing any violations and any future violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-11, and 13a-13 thereunder, and cease and desist from committing or causing any violations and any future violations of Rule 13b2-1 under the Exchange Act.

E. IT IS FURTHERED ORDERED that Respondent White shall, within thirty days of the entry of this Order, pay disgorgement in the amount of $31,180 and prejudgment interest in the amount of $5,374 to the United States Treasury. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Alexandria, Stop 0-3, VA 22312; and (D) submitted under cover letter that identifies Kenneth L. White as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Laura M. Metcalfe, Assistant Regional Director, Securities and Exchange Commission, 1801 California St., Ste. 1500, Denver, Colorado 80202.

By the Commission.

Nancy M. Morris
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. 55031 / December 29, 2006

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2530 / December 29, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12522

In the Matter of

PAUL HEIDBRINK, CPA,

Respondent.

ORDER INSTITUTING PUBLIC ADMINISTRATIVE PROCEEDINGS PURSUANT TO RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that public administrative proceedings be, and hereby are, instituted against Paul Heidbrink, CPA ("Respondent" or "Heidbrink") pursuant to Rule 102(e)(1)(ii) of the Commission's Rules of Practice.[1]

II.

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

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[1] 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.

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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 Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

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

A. SUMMARY

These proceedings arise from Paul Heidbrink's audit and three quarterly reviews of the financial statements of Whitemark Homes, Inc. ("Whitemark"). Whitemark misstated its inventory and other accounts in filings with the Commission relating to the year ended December 31, 2001, and the quarters ended March 31, 2002, June 30, 2002, and September 30, 2002. Heidbrink conducted audits or quarterly reviews of the financial statements Whitemark included in each of these filings, but failed to perform procedures in accordance with Generally Accepted Auditing Standards ("GAAS").

B. RESPONDENT AND RELEVANT ENTITY

1. Respondent Paul Heidbrink, age 55, is a certified public accountant licensed in the State of Florida since 1974. Heidbrink is a partner in Beemer, Pricher, Kuehnhackl, and Heidbrink, PA ("Beemer"), an accounting firm located in Winter Park, Florida.

2. Whitemark, a Colorado corporation based in Oveido, Florida, develops and builds residential communities. Whitemark stock is registered under Section 12(g) of the Exchange Act, and has been traded on the Over the Counter Bulletin Board since April 2001.

C. FACTS

1. During the relevant period, Heidbrink served as the engagement partner for Beemer's annual audit and quarterly reviews of Whitemark's financial statements. As the engagement partner, Heidbrink planned and supervised the services Beemer provided to Whitemark.

2. Whitemark's 2001 Form 10-K contained an unqualified audit report representing that Beemer had conducted an audit in accordance with GAAS and that Whitemark's financial statements were presented in conformity with generally accepted accounting principles ("GAAP"). In fact, however, Heidbrink did not conduct Beemer's audit of Whitemark's financial statements for the year ended December 31, 2001, in accordance with GAAS, and Whitemark's financial statements were not presented in conformity with GAAP. Heidbrink also failed to conduct

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

Beemer's reviews of Whitemark's financial statements for the first three quarters of 2002 in accordance with GAAS.

3. The objective of an audit of financial statements by an independent auditor is the expression of an opinion on the fairness of their presentation in conformity with GAAP. GAAS requires that auditors exercise due professional care in performing an audit and in preparing the audit report. Due professional care requires that the auditor exercise professional skepticism, which includes an objective evaluation of audit evidence.[3] GAAS also requires an auditor to obtain and evaluate sufficient competent evidential matter.[4]

4. In an audit, the auditor should perform procedures to determine whether disclosure of events occurring subsequent to the period of the financial statements is required to assure a fair presentation of the financial statements.[5] Such procedures include making inquiries of management. In addition, an auditor should make additional inquiries or perform additional procedures as appropriate to dispose of questions that arise during the subsequent events review.[6]

5. In a quarterly review, the accountant's procedures should include reading the financial information to consider whether, on the basis of information coming to the accountant's attention, the information to be reported is presented in conformity with GAAP.[7] An accountant should consider the consistency of management's statements in light of the results of other inquiries.[8] Additionally, the procedures for a review may be modified to take the results of previous audit procedures into consideration.[9] An accountant conducting a quarterly review should also inquire about the manner in which changes in accounting practices and their effects are to be reported in the quarterly financial statements.[10]

CONSOLIDATION WITHOUT CONTROL

6. For each of the relevant periods, Whitemark overstated its inventory account as a result of its consolidation of the financial statements of entities it did not control. In the audit of Whitemark's financial statements for the year ended December 31, 2001, Heidbrink did not obtain sufficient competent evidential matter with respect to Whitemark's consolidation of these entities. Heidbrink was aware that Whitemark held only options to purchase the consolidated entities.

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[3] Codification of Statements on Auditing Standards (AU), §§230.07-.08.
[4] AU §326.25.
[5] AU §560.12.
[6] Id.
[7] AU §722.13.
[8] Id.
[9] AU §722.19.
[10] AU §722.16.

EXPIRED OPTIONS

7. For each of the relevant periods, Whitemark also included in its inventory account the value of certain options its subsidiary held to purchase development properties or to purchase entities that owned development properties. Pursuant to the contracts with the property owners, five of these purchase options were set to expire in the first quarter of 2002. Although Whitemark filed its Form 10-K for the year ended December 31, 2001 after the expiration of these options, it did not disclose that these options had expired by their express terms. Whitemark also did not make appropriate adjustments to its financial statements when these options expired by their express terms in the first quarter of 2002, and continued to carry values associated with these purchase options in its inventory account through the second and third quarters of 2002. As a result, Whitemark overstated its inventory, understated its associated expenses, and understated its net losses in its Forms 10-Q for the first three quarters of 2002.

8. Heidbrink's audit workpapers contained documents showing that many of Whitemark's options expired by their express terms in January 2002. In March 2002, Whitemark's management represented to Heidbrink that it continued to hold rights to exercise all options. Heidbrink issued Beemer's audit report after the express expiration of these options. In the audit of Whitemark's financial statements for the year ended December 31, 2001, Heidbrink did not perform appropriate additional procedures to assure that Whitemark still held these options or had appropriately disclosed their expiration as a subsequent event.

9. Whitemark's management informed Heidbrink that Whitemark had appropriately recorded its assets in its financial statements for each of the first three quarters of 2002. In the quarterly reviews of these financial statements, Heidbrink did not appropriately consider management's representations in conjunction with knowledge he previously obtained during the annual audit showing that many of Whitemark's purchase options were set to expire by their terms in January 2002. Heidbrink did not modify his review procedures to resolve inconsistencies about the dates on which these options expired.

IMPROPER REALLOCATION OF PURCHASE PRICE

10. In its financial statements for the third quarter of 2002, Whitemark improperly changed its method for allocating the purchase price of a previously-acquired subsidiary and improperly considered post-acquisition events to reallocate the purchase price among the assets acquired. Had Whitemark not changed its allocation method, it would have reported a substantially greater net loss for the quarter. Whitemark's financial statements also failed to disclose Whitemark's change in accounting method and its effect, and did not accurately state Whitemark's method of valuing those assets.

11. In his quarterly review of Whitemark's financial statements for the quarter ended September 30, 2002, Heidbrink reviewed Whitemark's reallocation of the purchase price for the prior acquisition. Heidbrink did not appropriately consider whether Whitemark's change in method and consideration of post-acquisition events when performing the reallocation conformed

with GAAP. Heidbrink also did not inquire about Whitemark's lack of disclosure regarding its change in accounting practice and the effect this change had on Whitemark's financial statements. Heidbrink further did not identify Whitemark's incorrect disclosure of its valuation method in the notes to its financial statements.

FINDING

12. Based on the foregoing, the Commission finds that Heidbrink engaged in improper professional conduct pursuant to 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 Respondent Heidbrink's Offer.

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

1. Heidbrink is denied the privilege of appearing or practicing before the Commission as an accountant for six months from the date of this Order.

2. As long as he practices before the Commission as 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, Heidbrink'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; and/or

3. As long as he appears or practices before the Commission as an independent accountant:

(a) Heidbrink, or the public accounting firm with which he is associated, is and will remain registered with the Public Company Accounting Oversight Board ("Board") in accordance with the Sarbanes-Oxley Act of 2002; and

(b) Heidbrink will 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.

By the Commission.

Nancy M. Morris
Secretary

By: Jill M. Peterson
Assistant Secretary