SECURITIES AND EXCHANGE COMMISSION

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

CHRISTOPHER COX, CHAIRMAN

PAUL S. ATKINS, COMMISSIONER

KATHLEEN L. CASEY, COMMISSIONER

35 Documents

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 275 and 279

[Release No. IA-2711; 34-57419; File No. S7-10-00]

RIN 3235-AI17

Amendments to Form ADV

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule and form amendments.

SUMMARY: The Securities and Exchange Commission is reproposing amendments to Part 2 of Form ADV, and related rules under the Investment Advisers Act, to require investment advisers registered with us to deliver to clients and prospective clients a brochure written in plain English. These amendments are designed to require advisers to provide clients and prospective clients with clear, current, and more meaningful disclosure of the business practices, conflicts of interest (including those related to soft dollar practices), and background of investment advisers and their advisory personnel. Advisers would file their brochures with us electronically, and we would make them available to the public through our Web site. The Commission also is proposing to withdraw, as duplicative, the Advisers Act rule requiring advisers to disclose certain disciplinary and financial information.

DATES: Comments should be received on or before May 16, 2008.

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 S7-10-00 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 S7-10-00. 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 on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: David W. Blass, Assistant Director, Daniel S. Kahl, Branch Chief, or Vivien Liu, Senior Counsel, at (202) 551-6787 or

<IArules@sec.gov>, Office of Investment Adviser Regulation, Division of Investment Management, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-5041.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission ("Commission") is proposing amendments to rules 203-1, 204-1, 204-2, and 204-3 [17 CFR 275.203-1, 275.204-1, 275.204-2, and 275.204-3]; and amendments to Form ADV [17 CFR 279.1] under the Investment Advisers Act of 1940 [15 U.S.C. 80b] ("Advisers Act" or "Act").[1] The Commission is also proposing to withdraw rule 206(4)-4 [17 CFR 275.206(4)-4] under the Advisers Act.

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[1] Unless otherwise noted, when we refer to rule 203-1, 204-1, 204-2, or 204-3, or any paragraph of these rules, we are referring to 17 CFR 275.203-1, 275.204-1, 275.204-2, or 275.204-3, respectively, of the Code of Federal Regulations in which these rules are published.

I. BACKGROUND

Investment advisers provide a wide range of investment advice to numerous types of clients. From individuals and families seeking to save for college and plan for retirement to multinational institutions managing billions of dollars, clients seek the services of investment advisers to help them evaluate their investment needs, plan for their economic future, develop and implement investment strategies, and cope with the ever-growing complexities of the financial markets. Today, the more than 10,000 advisers registered with us provide advice to nearly 20 million clients.[2]

Unlike the laws of many other countries, the U.S. federal securities laws do not prescribe minimum experience or qualification requirements for persons providing investment advice. They do not establish maximum fees that advisers may charge. Nor do they preclude advisers from having substantial conflicts of interest that might adversely affect the objectivity of the advice they provide. Rather, investors have the responsibility, based on disclosure they receive, for selecting their own advisers, negotiating their own fee arrangements, and evaluating their advisers' conflicts. Therefore, it is critical that clients and prospective clients receive sufficient information about the adviser and its personnel to permit them to make an informed decision about whether to engage an adviser, and having engaged the adviser, how to manage that relationship.

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[2] These figures are based on data derived from investment advisers' responses to questions on Part 1A of Form ADV reported through the Investment Adviser Registration Depository ("IARD") as of January 31, 2008.

Since 1979, the Commission has required investment advisers registered with us to provide clients and prospective clients with a disclosure statement providing information about the adviser, its business practices, the fees it charges, and its conflicts of interest.[3] Part 2 of Form ADV, the form advisers use to register with us under the Advisers Act, sets out the requirements for the disclosure statement.[4] Today, Part 2 requires advisers to respond to a series of multiple-choice and fill-in-the-blank questions organized in a "check-the-box" format, supplemented in some cases with brief narrative responses. Advisers have the option of providing information in an entirely narrative format in lieu of the "check-the-box" approach, although we believe few do.

In April 2000, we proposed to require each adviser registered with us to give clients a narrative brochure that describes the adviser's business, conflicts of interest (including conflicts resulting from the adviser's receipt of "soft dollar" benefits), disciplinary history, and other important information necessary to make an informed decision about whether to rely on the adviser for advice.[5] Our proposal was designed to

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[3] Investment Adviser Requirements Concerning Disclosure, Recordkeeping, Applications for Registration and Annual Filings, Investment Advisers Act Release No. 664 (Jan. 30, 1979) [44 FR 7870 (Feb. 7, 1979)] (adopting rule 204-3 requiring brochure delivery to advisory clients and prospective clients).

[4] Advisers use Form ADV to apply for registration with us or with state securities authorities, and must keep it current by filing periodic amendments as long as they are registered. See rules 203-1 and 204-1. Form ADV has two parts. Current Part 2 contains the requirements for the disclosure statement that advisers must provide to prospective clients and offer to clients annually. Part 2 currently is designated as "Part II." For ease of reference, we refer to the second part of Form ADV as "Part 2" throughout this release. Part 1 of Form ADV provides us with information that we need to process registrations and to manage our regulatory and examination programs.

[5] Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV, Investment Advisers Act Release No. 1862 (Apr. 5, 2000) [65 FR 20524 (Apr. 17, 2000)] ("Proposing Release") at Section II.D.2. We noted in the Proposing Release that in some cases an adviser's response to a question using a check-the-box approach may be

require advisers to disclose this information in a clearer, more meaningful format than the current check-the-box approach.[6] We received more than 70 comments in response to our 2000 proposal.[7] We continue to believe that we need a better approach to client disclosure than the current "check-the-box" approach. In light of the time that has passed since the original proposal, and in order to provide all persons who are interested in this matter an opportunity to comment on some of the modifications we have made in response to comments on our 2000 proposal, we are today reproposing amendments to Part 2 of Form ADV and related rules under the Advisers Act.[8] In light of the changes we

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accurate but a client may, because of the mandated format of the disclosure, not accurately perceive the adviser's practices.

6 In the Proposing Release, we also proposed extensive amendments to Part 1 of Form ADV, including changes necessary to permit advisers to file that part of the form with us electronically. In September 2000, we adopted amendments to Part 1A and related rules, but, as we noted at the time, we deferred adoption of amendments to Part 2 so that we could consider more fully the many comments we received on Part 2. Electronic Filing by Investment Advisers; Amendments to Form ADV, Investment Advisers Act Release No. 1897 (Sept. 12, 2000) [65 FR 57438 (Sept. 22, 2000)] ("Electronic Filing Adopting Release"). Today, all SEC-registered advisers must file Part 1A (as well as amendments) electronically through IARD. IARD was built and is maintained for the Commission and the state securities administrators by the Financial Industry Regulatory Authority ("FINRA"). In September 2001, we launched a Web site (http://www.adviserinfo.sec.gov), which provides free public access to information that advisers file on Part 1A. As we discuss in more detail in Section II.C below, firms' brochures would be available on the Commission's Web site.

7 The comment letters and a summary of the comments prepared by Commission staff are available for public inspection and photocopying in the Commission's Public Reference Room, 100 F. Street, NE, Washington, DC (File No. S7-10-00). Comments submitted to us electronically are available at http://www.sec.gov/rules/proposed/s71000.shtml. The summary of comments is available at http://www.sec.gov/rules/extra/iardsumm.htm.

8 In addition, we note that Form ADV is used by advisers both to register with the Commission and with state regulatory authorities. In general, this Release discusses the Commission's proposed rules and amendments that would affect advisers registered with the Commission. We understand that the state securities authorities intend to make similar changes that affect advisers registered with the states. The draft form accompanying today's reproposal contains certain proposed items and instructions for Part 2 (proposed Item 20 of Part 2A, proposed Item 11 of Appendix 1 to Part 2A, and proposed Item 7 of Part 2B) that would be applicable only to state-registered advisers. State-registered advisers would be required by state, rather than federal law, to respond

are proposing to Part 2, the Commission also is proposing to withdraw rule 206(4)-4 (requiring advisers to disclose certain financial and disciplinary information to clients).

II. DISCUSSION OF FORM ADV, PART 2

A. Part 2A: The Firm Brochure

1. Proposed Format

We are proposing to require registered advisers to provide prospective and existing clients with a narrative brochure written in plain English.[9] The brochure would describe the adviser's services, fees, business practices, and conflicts of interest with clients. Advisers would file their brochures electronically through the IARD, and the public would benefit by having access to these brochures through the Commission's Web site. We believe that the amendments we are proposing today will greatly improve the ability of clients and prospective clients to evaluate firms offering advisory services and the firms' personnel, and to understand relevant conflicts of interest that the firms and their personnel face and their potential effect on the firms' services.

Commenters supported the narrative format we proposed in 2000 and agreed that it would promote more effective client communications.[10] One stated that it would give an adviser "sufficient flexibility to present and explain its business practices in a

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to these items. Completion of these items, therefore, would not be an SEC requirement, and these items are not included in this Release as a proposed SEC rule. We will accept any comments and forward them to the North American Securities Administrators Association ("NASAA") for consideration by the state securities authorities. We request that you clearly indicate in your comment letter which of your comments relate to these items. Commenters alternatively may send comments relating to these items directly to NASAA at the following email address: part2comments@nasaa.org.

[9] Proposed General Instructions 1 and 2 to Part 2 of Form ADV.

[10] See, e.g., Comment Letter of Consumer Federation of America (June 22, 2000) ("CFA Letter"); Comment Letter of Teachers Insurance and Annuity Association and College Retirement Equities Fund (June 13, 2000) ("TIAA-CREF Letter").

meaningful way."[11] Another stated that the new narrative format would eliminate a number of problems identified with the current form.[12]

We request further comment on the proposed narrative format, including comment on whether it is the right approach. Will the flexibility of the form allow advisers to present clear and meaningful disclosure to their clients? Will this flexibility minimize the burden on advisers in preparing their brochures? In considering our proposed amendments to Part 2 in their entirety, commenters should consider whether there are disclosures that are best made in a tabular or other non-narrative format and whether our proposal provides sufficient flexibility to permit that type of disclosure.

2. Brochure Items

We are proposing a Part 2A for advisers that would contain nineteen separate items, each covering a different disclosure topic.[13] The topics covered are generally the same as proposed in 2000.[14] Much of the information that would be required in the

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11 Comment Letter of Association for Investment Management and Research, Advocacy Advisory Committee (June 13, 2000) ("AIMR Letter").

12 TIAA-CREF Letter.

13 Part 2A would have a main body and an appendix, Appendix 1. Appendix 1 contains the requirements for a specialized type of firm brochure – a wrap fee program brochure – and would require disclosure similar to current Schedule H of Part 2 of Form ADV. We are reproposing Appendix 1 with changes described below.

14 Today's proposal does not include an item (which we proposed as Item 17 in 2000) that would have required advisers that advertise or report their investment performance to describe any standards they use to calculate or present that performance. The Securities Industry Association ("SIFMA") argued that the disclosure would be voluminous because many advisers use different types of composites. Comment Letter of the Securities Industry Association (June 13, 2000) ("SIFMA Letter") (the Securities Industry Association has since changed its name to the Securities Industry and Financial Markets Association). The Financial Planning Association ("FPA") argued that the disclosure of calculation standards may not be helpful to investors (Comment Letter of the Financial Planning Association (June 13, 2000) ("FPA Letter")), and the Investment Counsel Association of America ("IAA") argued that clients are not interested in this

brochure concerns conflicts between an adviser's own interests and those of its clients and is disclosure the adviser already must make to clients, as a fiduciary, under the Act's anti-fraud provisions.[15] Thus, many of the proposed disclosure requirements are designed to give advisers guidance on fulfilling their statutory disclosure obligations to clients.[16]

Some commenters applauded our 2000 proposal as appropriately identifying information that advisers should disclose to clients.[17] Others, however, maintained that the proposed form contained too many items and would require too much detailed information, in particular with respect to advisers' policies and procedures.[18] These commenters raised legitimate concerns, which we have addressed in three ways. First, our instructions to Part 2A would clarify that an adviser must respond only to the items that apply to its business.[19] Second, we have incorporated into our proposed Part 2A

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type of information. Comment Letter of the Investment Counsel Association of America (June 13, 2000) ("June 2000 IAA Letter") (the Investment Counsel Association of America has since changed its name to the Investment Adviser Association). In response to the concerns raised by commenters, we are not reproposing that item. Today's proposal does, however, include a new item on performance fees and side-by-side management (Item 6). Additionally, at the request of state securities regulators, the form we are proposing today includes a separate item containing additional requirements for state-registered advisers (Item 20).

15 Under the Advisers Act, an adviser has an affirmative obligation of utmost good faith and full and fair disclosure of all material facts to its clients, as well as a duty to avoid misleading them. See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963); In the Matter of Arleen W. Hughes, Exchange Act Release No. 4048 (Feb. 18, 1948). See also Advisers Act section 206 [15 U.S.C. 80b-6].

16 The items in proposed Part 2A will not cover every possible conflict. As a result, delivering a brochure prepared in accordance with Part 2 may not fully satisfy an adviser's disclosure obligations. We make this point clear in both the proposed form and the brochure rule. See proposed General Instruction 3 to Part 2; proposed rule 204-3(g).

17 See, e.g., CFA Letter; TIAA-CREF Letter.

18 See, e.g., June 2000 IAA Letter; Comment Letter of the Investment Company Institute (June 13, 2001) ("ICI Letter").

19 Proposed General Instruction 1 to Part 2 of Form ADV. An adviser whose business is solely financial planning, for example, would not need to discuss how it manages client

many suggestions from commenters for improving the form, including omitting some information that commenters convinced us is not necessary.[20]

Third, we have re-written several items to require advisers to explain succinctly how they address the conflicts of interest they identify, rather than disclosing their "policies and procedures" as we originally proposed.[21] As commenters noted, requiring disclosure of policies and procedures could result in disclosure that would be lengthy, technical in nature, difficult to read, and that ultimately may not help clients understand how firms address their conflicts.[22] As re-written, we believe these items would give advisers the flexibility to give clients a general understanding of how they address their conflicts. For example, an adviser with an affiliated financial service provider might simply explain that it does not recommend investment products sold by its affiliate, or an adviser with an affiliated broker-dealer might explain that it executes client securities

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assets in response to Items 4.D and 4.E of Part 2A. An adviser that receives only asset-based fees need not discuss conflicts resulting from commission-based compensation payments in response to Item 5.E of Part 2A. An adviser without disciplinary information would not need to respond to Item 9 of Part 2A. An adviser that does not have custody of client funds or securities would not need to respond to Item 15 of Part 2A.

Additionally, as currently permitted by existing rule 204-3(d), an adviser that offers substantially different types of advisory services to different advisory clients, would retain the option to prepare separate brochures so long as each client receives all information about the services and fees that are applicable to that client. See proposed rule 204-3(f) and proposed Instruction 6 to Part 2A. Each brochure may omit information that does not apply to the advisory fees and services it describes. For example, an adviser's brochure describing a particular advisory service need not include the fee schedule for a different advisory service that is not discussed in that particular brochure.

[20] For example, in response to comments, we are proposing to omit the requirement that advisers list all the wrap fee programs in which they participate.

[21] See, e.g., Proposed Items 5, 6, and 11 of Part 2A.

[22] June 2000 IAA Letter; ICI Letter; Comment Letter of Wellington Management Company, LLP (June 22, 2000) ("Wellington Letter").

transactions through its affiliated broker-dealer only if it believes that, in doing so, it would obtain best execution of client transactions.[23]

We request comment on whether our revisions to proposed Part 2A adequately respond to commenters' concerns about our 2000 proposal. Specifically, we request comment on our new approach regarding disclosure of policies and procedures that would require advisers to explain generally how they address conflicts of interest, instead of requiring them to describe their policies and procedures. Also, we request comment on our general instructions that clarify that an adviser need not repeat information in its brochure simply because that information is responsive to more than one item. Will our proposed instruction give advisers sufficient flexibility to avoid unnecessary detail while also providing clients and prospective clients with enough information to make an informed decision about whether to hire or retain an adviser or whether to rely on the investment advice provided by the adviser? If not, commenters should suggest alternative approaches.

Below, we discuss each of the items in our proposed form and the more significant changes we have made from our 2000 proposal. In addition to our specific requests for comment detailed below, we also request comment generally on each of the proposed items.

Item 1. Cover Page. We would require an adviser to disclose on the cover page of its brochure the name of the firm, its business address and telephone number, and the date of the brochure. The cover page also would include a statement that the brochure has

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[23] By giving these examples we do not mean to suggest that these are the only ways for an adviser to address these conflicts of interest.

not been approved by the Commission or any state securities authority.[24] This information already is required by current Part 2 of Form ADV.

In addition, we would require advisers to disclose on the cover page the name and telephone number of a person or service center that a client or prospective client could contact for further information. At the suggestion of commenters, we revised our 2000 proposal to permit an adviser to identify a service center, rather than only an individual, as a contact for further information.[25] Other commenters suggested that advisers be required to present a home page URL to assist investors using electronic search methods.[26] While we recognize the value of this information, we understand that not all advisers maintain Web sites. Thus, we are proposing to require advisers to disclose a Web site address on the brochure cover page only if they have one.

Item 2. Material Changes. We are proposing a requirement that advisers provide clients with a summary of any material changes to their brochures since the last annual update.[27] This requirement is the same as the one we proposed in 2000, and would help clients identify information that has changed since the prior year's brochure and that may

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[24] If the adviser holds itself out as being "registered," the cover page also must explain that registration with the SEC does not imply that the adviser possesses a certain level of skill or training. We have observed that the emphasis on SEC registration, in some advisers' marketing materials, appears to suggest that registration either carries some official imprimatur or indicates that the adviser has attained a particular level of skill or ability. Section 208(a) of the Advisers Act [15 U.S.C. 80b-8(a)] makes such suggestions unlawful.

[25] See FPA Letter; Securities America Advisors, Inc. and Securities America, Inc. (June 12, 2000) ("Securities America Letter").

[26] See, e.g., CFA Letter.

[27] As discussed in more detail in Section II.A.3 below, we are proposing to require advisers to deliver an updated brochure annually within 120 days after the end of the adviser's fiscal year.

be important to them.[28] The summary would appear on the cover page of the brochure or immediately thereafter, or could be included in a separate communication that would accompany the brochure.[29]

One commenter strongly supported the required summary.[30] Others expressed concern that the summary might be too long.[31] One commenter, the IAA, supported the option of having the summary be a separate letter to existing clients rather than part of the brochure. We request comment on our proposed approach to highlighting material changes to an adviser's brochure. If we do not adopt this approach, how else could clients know of potentially significant changes to the services they receive or the risk of new conflicts? Should we require that it be included in an adviser's brochure? Commenters who believe a summary of material changes would result in disclosure that is too lengthy should suggest other methods for ensuring that clients are made aware of important changes from one year to the next.

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28 See Proposing Release at Section II.D.2.a.

29 An adviser would not be required to provide this information to a client or prospective client who has not received a previous version of the adviser's brochure. See proposed Note to Item 2 of Part 2A. Additionally, an adviser would not be required to file the summary with us, and therefore it would not be available on our public disclosure Web site, if the summary is included in a separate communication to clients. This is because the information contained in such a summary is intended to provide existing clients with means to easily identify changes from one annual brochure update to the next. We do not believe that such a summary would be relevant to persons who do not have the previous version of an adviser's brochure. We are, however, proposing an amendment to our recordkeeping rule that would require the adviser to preserve a copy of the communication, so that our staff has access to such separately provided summaries. See proposed rule 204-2(a)(14)(i). See Section IV below.

30 CFA Letter.

31 Comment Letter of the Consortium (June 12, 2000) ("Consortium Letter"); Comment Letter of Jane Katz Crist (June 12, 2000) ("Crist Letter"); June 2000 IAA Letter.

Item 3. Table of Contents. We propose to require advisers to include in their brochures a table of contents detailed enough to permit clients and prospective clients to locate topics easily.[32] In response to our 2000 proposal, one commenter, the Consumer Federation of America ("CFA"), supported the use of a table of contents but urged that the Commission mandate a uniform format so that investors could compare brochures of multiple advisers more easily. We are of the initial view that the wide variety of business activities of the large number of advisers registered with us makes it impractical to develop a uniform format. We request comment on whether our view is correct. Is there a uniform brochure format that would be useful to clients and prospective clients of all the types of advisers registered with us? If we were to mandate a uniform format, how should it look? For example, should we require advisers to present information in their brochures in a standardized order? Should we adopt standardized titles for each separate section of a brochure? Do commenters have other suggestions for making the brochures easier for clients and prospective clients to compare?

Item 4. Advisory Business. Proposed Item 4 would require an adviser to describe its advisory business, including the types of advisory services offered, whether it holds itself out as specializing in a particular type of advisory service, and the amount of client assets that it manages. In computing the amount of client assets that it manages, an adviser would be permitted, as originally proposed, to use a method that differs from the method used in Part 1A of Form ADV to report "assets under management."[33] We believe that because the Part 1A methodology for calculating assets is designed for a

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[32] Current Part 2 of Form ADV also includes a table of contents.

[33] One commenter suggested that advisers be required to use the same methodology in their brochures as is required in Part 1A. See June 2000 IAA Letter.

particular purpose (i.e., for making a bright line determination as to whether an adviser should register with the Commission or with the states), permitting a different methodology for Part 2 disclosure may be appropriate to enable advisers to make disclosure that is more indicative to clients about the nature of their business.[34] Although we are proposing to permit advisers to choose a different method for their brochure disclosure, we also are proposing to require such advisers to keep records describing the method used.[35] We request comment on this provision and on the proposed recordkeeping requirement. We also request comment as to whether we should require such advisers to disclose why they have elected to use a different method.

Commenters largely supported the proposed item, to which we propose to make two revisions.[36] First, we are not proposing to require advisers to list all wrap fee programs in which they participate. Commenters persuaded us that this requirement likely would lengthen brochures unnecessarily.[37] Second, we are eliminating the

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[34] For example, in calculating "assets under management," for purposes of Part 1A, an adviser may include the entire value of a managed portfolio, but only if at least 50 percent of the portfolio's total value consists of securities. See current Form ADV: Instructions for Part 1A. Thus, for Part 1A purposes an adviser would not include other assets (including securities) that it manages in a "non-securities" portfolio. The Part 1A formula for calculating assets under management was designed based on considerations related to the National Securities Markets Improvement Act of 1996 ("NSMIA") division of responsibility for regulation of advisers between the Commission and state securities regulatory authorities. Pub. L. No. 104-290, 110 Stat. 3416 (1996) (as a result of NSMIA, advisers with less than $25 million of assets under management generally are regulated by one or more state securities authority, while the Commission generally regulates those advisers with at least $25 million of assets under management).

[35] Proposed rule 204-2(a)(14)(ii) and proposed Note to Item 4.E of Part 2A.

[36] Current Part 2 presently requires disclosure of similar information to that we are now proposing except in a different format, including information regarding advisory services provided, types of investments that advice is offered on, and investment strategies used. See current Form ADV, Part 2, Item 1 and Item 3.

[37] See Crist Letter; June 2000 IAA Letter.

proposed requirement that advisers list and describe all periodicals or periodic reports that they issue about securities. While Part 2 currently requires this, we believe that clients and prospective clients should be able to understand the nature of an adviser's services without knowing the names of each of its publications.[38]

Some commenters urged the Commission not to require advisers to make additional disclosure if they hold themselves out as specializing in a particular type of advisory service, asserting that this could mislead clients into believing that advisers who specialize pose a greater risk than other advisers.[39] Our reason for requiring advisers to identify their specialized advisory services, however, is not that we believe that those specialties inherently pose additional risks to clients, although we would expect the adviser to disclose specific risks if a specialized advisory service poses those risks. Instead, our proposal simply acknowledges that a client likely would want to know whether an adviser provides specialized advisory services before engaging that adviser.[40] The proposal was designed to reflect disclosure that we understand most advisers typically provide to prospective clients. The proposal also was intended to recognize the

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[38] See Item 1.D of current Part 2 (requiring all advisers to name any publication or report they issue for a fee or on a subscription basis).

[39] See Comment Letter of Greenville Capital Management (May 12, 2000) ("Greenville Letter"). See also Comment Letter of DE Shaw & Co. (July 6, 2000) ("DE Shaw Letter"); Comment Letter of Thomson Financial (June 22, 2001) ("Thomson Letter").

[40] We note that one commenter objected to our characterizing financial planning as a specialized advisory service. Comment Letter of Certified Board of Financial Planners (June 13, 2000) ("CFP Board Letter"). By proposing to include financial planning as an example of a specialized service we are not suggesting in any way that it is a limited service – in fact, we recognize its most marked characteristic is that it seeks to address a wide spectrum of clients' financial needs. However, we note that financial planning has become a distinct profession, and as such, we believe it merits detailed description in the adviser's brochure. See, e.g., Conrad S. Ciccotello et al., Will Consult For Food! Rethinking Barriers To Professional Entry In The Information Age, 40 AM. BUS. L. J. 905 (2003) at 921 ("Personal financial planning as a distinct profession is quite new").

impracticality of having an adviser that offers multiple services describe each one. We request comment on this proposed item generally. Does the item accurately reflect the disclosure most advisers typically provide? Are there other disclosures we should include? Have we included disclosures that are not reflective of those typically provided by most advisers?

Item 5. Fees and Compensation. Item 5 would require an adviser to describe how it is compensated for providing advisory services and to describe the types of other costs, such as brokerage, custody fees, and fund expenses, that clients may pay in connection with the advisory services provided to them by the adviser.[41] As we proposed in 2000, the adviser would be required to disclose its fee schedule and whether its fees are negotiable, discuss whether the firm bills clients or deducts fees directly from the clients' accounts, and explain how often the firm assesses fees. An adviser charging fees in advance also would be required to explain how it calculates and refunds prepaid fees when a client contract terminates.

We are also proposing in Item 5 a requirement that advisers that receive compensation attributable to the sale of a security or other investment product (e.g., brokerage commissions), or whose personnel receive such compensation, must disclose this practice and the conflict of interest it creates and describe how the adviser addresses this conflict.[42] Such an adviser also would be required to disclose to clients that the client

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41 Proposed Items 5.A and 5.C of Part 2A. Part 2 currently requires similar disclosure regarding an adviser's fee schedule, how fees are charged, whether fees are negotiable, and when and how compensation is payable. See Item 1 of current Form ADV.

42 Proposed Item 5.E of Part 2A. Advisers may engage in practices that would be required to be disclosed under multiple items. For example, an adviser may have a financial interest in securities that it recommends to clients (which would be disclosed in response

may purchase the same securities or investment products from brokers that are not affiliated with that adviser.[43] Some commenters argued that an adviser that receives commissions or other payments for sales of securities to clients does not necessarily have a conflict of interest with its clients.[44] This practice, however, gives the adviser and its personnel an incentive to base investment recommendations on the amount of compensation they will receive rather than on the client's best interests.[45] Moreover, disclosure regarding commissions and other similar economic benefits already is required by current Part 2.[46]

We are not proposing a requirement that advisers must disclose the amount or range of mutual fund fees or other third-party fees that clients may pay.[47] Commenters explained that these expenses vary so greatly that attempts to quantify them or describe their range likely would not be useful to clients.[48] Several of these commenters further

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to proposed Items 5 and 10) or the adviser may receive an economic benefit from a non-client (which would be disclosed in response to proposed Items 5 and 12). As noted above, a brochure would not need to repeat information simply because the information is responsive to more than one item. Proposed General Instruction 1 to Part 2.

43 Proposed Item 5.E.2 of Part 2A. In addition, an adviser that receives more than half of its revenue from commissions and other sales-based compensation would be required to explain that commissions are the firm's primary (or, if applicable, exclusive) form of compensation. Proposed Item 5.E.3 of Part 2A. An adviser that charges both advisory fees and commissions would disclose whether it reduces its fees to offset the commissions. Proposed Item 5.E.4 of Part 2A.

44 E.g., Comment Letter of American Express Financial Advisors (June 12, 2000) ("AmEx Letter"); CFP Board Letter; Comment Letter of Richard E. Vodra (Apr. 29, 2000).

45 Because of this conflict of interest, advisers are required by the anti-fraud provisions of the Advisers Act to disclose their receipt of transaction-based compensation to clients. See Proposing Release at n. 137-38 and accompanying text.

46 See current Form ADV, Part 2, Item 13.

47 The current version of Part 2 does not require disclosure of this information.

48 E.g., AmEx Letter; Consortium Letter; Comment Letter of Davis Polk & Wardwell (June 13, 2000) ("DP&W Letter"); ICI Letter; June 2000 IAA Letter; Comment Letter of

argued that these fees are typically negotiated directly between the client and the other service providers, the adviser does not always know the amount of the fees, and that the third party often discloses the fees directly to the client.[49] Would our proposed requirement that advisers disclose information about mutual fund or other third-party fees, while not disclosing the range of those fees, adequately inform clients that they will bear other costs in addition to advisory fees?

Item 6. Performance Fees and Side-By-Side Management. New Item 6 would require an adviser that charges performance fees (or who has a supervised person who manages an account that charges such fees) to disclose this fact.[50] If such an adviser also manages accounts that are not charged a performance fee, the item also would require the adviser to discuss the conflicts that arise from its (or its supervised persons') simultaneous management of these accounts, and to describe generally how the adviser addresses those conflicts.[51]

An adviser charging performance fees to some accounts faces a variety of conflicts because the adviser can potentially receive greater fees from its accounts having

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National Regulatory Services (June 12, 2000); SIFMA Letter; Comment Letter of T. Rowe Price Associates (June 12, 2000) ("T. Rowe Price Letter").

49 See Greenville Letter; DE Shaw Letter; DP&W Letter; June 2000 IAA Letter; ICI Letter; SIFMA Letter.

50 Proposed Item 6. "Performance fees" would be any fees an adviser receives that are based on a share of the capital gains on, or capital appreciation of, the assets of a client. Current Form ADV, Part 2 does not specifically require similar disclosure of performance fees, although an adviser who offers advisory services in exchange for such fees would be required to respond accordingly by marking "Other" in response to current Form ADV, Part 2, Item 1.C(6).

51 As fiduciaries, advisers must disclose all material information regarding any proposed performance fee arrangements as well as any material conflicts posed by the arrangements. See Exemption To Allow Investment Advisers To Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account, Investment Advisers Act Release No. 1731 at n 13-14 and accompanying text (July 15, 1998) [63 FR 39022 (July 21, 1998)].

a performance-based compensation structure than from those accounts it charges a fee unrelated to performance (e.g., an asset-based fee). As a result, the adviser may have an incentive to direct the best investment ideas to, or to allocate or sequence trades in favor of, the account that pays a performance fee. Additionally, conflicts stemming from their clients' differing investment strategies (e.g., clients that pay performance fees who engage in significant short selling) may put an adviser at odds with other clients (e.g., clients who hold long positions).[52] The growth in the number of hedge funds, which typically pay performance-based fees to advisers that may have other advisory clients, makes it likely that more advisers today will need to address this conflict.[53] It is important to note that the conflicts of interest that result from the simultaneous management of performance fee accounts and other accounts are not limited to hedge fund advisers. For example, an adviser would face conflicts of interest if it were to manage a proprietary account that paid performance fees side-by-side other client accounts that did not pay performance fees.

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52 "Another concern is the risk that mutual fund [not paying a performance fee] trades may appear to benefit a hedge fund [paying a performance fee], such as where mutual fund long positions in a security are sold after the hedge fund sells the same security short, or where large mutual fund purchases of a security are made after a hedge fund has purchased the same security." Kenneth R. Gerstein, Alternative Investments in the Mutual Fund World, Materials prepared for ICI/IBA 2001 Mutual Funds and Investment Management Conference, at XII-8.

53 In a 2003 report, our Division of Investment Management highlighted its concerns regarding disclosure of conflicts of interest by advisers that advise hedge funds at the same time they advise other clients that do not pay a performance fee. See Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission ("Staff Report on the Implications of Hedge Funds"), available at http://www.sec.gov/spotlight/hedgefunds.htm. The staff noted that because performance fees paid to hedge fund advisers are significantly higher than the asset-based fees paid on traditional accounts, advisers have additional incentives to favor their hedge fund clients over other clients by allocating investment opportunities to a hedge fund.

We request comment on our approach requiring disclosure of conflicts arising from side-by-side management of accounts that pay performance fees and those that do not. Would our proposed requirement elicit sufficient information to allow a client to understand the conflicts that arise when an adviser manages performance fee accounts alongside accounts that do not charge performance fees? If not, what additional information would be helpful?

Item 7. Types of Clients. We are proposing Item 7 in the same form as we proposed it in 2000.[54] The one commenter that addressed this item, the FPA, commented favorably on it. As proposed, the brochure would describe the types of advisory clients the firm generally has, as well as the firm's requirements for opening or maintaining an account, such as minimum account size.[55] We request comment on this approach.

Item 8. Methods of Analysis, Investment Strategies and Risk of Loss. We also are proposing Item 8 in the same form as we proposed it in 2000. This item would require advisers to describe their methods of analysis and investment strategies.[56] In addition, proposed Item 8 would require an adviser to discuss the risks clients face in following the adviser's advice or permitting the adviser to manage assets. Advisers that offer a wide variety of advisory services could simply explain that investing in securities

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[54] As originally proposed, this was Item 6. Because we have added a new proposed Item 6 (described above), this and subsequent items have been renumbered.

[55] Proposed Item 7 of Part 2A. Current Part 2 requires "check-the-box" disclosure regarding types of advisory clients. See current Form ADV, Part 2 Item 2. Existing Part 2 currently also requires disclosure regarding whether an adviser providing certain advisory services imposes a minimum dollar value of assets or other conditions for starting or maintaining accounts. See current Form ADV, Part 2 Item 10.

[56] Presently, Item 4 of current Part 2 requires check-the-box disclosure of similar information regarding methods of analysis and investment strategies used. See current Form ADV, Part 2 Item 4.

involves a risk of loss. Advisers that use primarily a particular method of analysis, strategy, or type of security would be required to explain the specific material risks involved, with more detail if those risks are significant or unusual.

Some commenters supported this proposed disclosure requirement as central to the adviser's fiduciary relationship with the client.[57] Others questioned why multi-strategy firms would not be required to make the same level of disclosure.[58] Multi-strategy advisers must already disclose the risks associated with strategies that they recommend to clients, but the brochure may not be the best place to make that disclosure. For example, disclosure of this information may lengthen the brochure unnecessarily given that different clients would be pursuing different strategies, each of which poses specific and different risks, and clients may only need to understand the risks to which they are exposed.[59] Accordingly, we would not require these advisers to list in the brochure the risks involved in each type of security or trading strategy. In such cases, required risk disclosure with respect to particular strategies could be made separately to those clients to whom such disclosure is relevant. We request comment on our approach. Also, we request comment on whether there are particular risks associated with particular strategies, analyses, or securities that warrant specific disclosure, and if so what are they?

Item 8 also would require specific disclosure of how strategies involving frequent trading can affect investment performance. Commenters on this proposal in 2000 noted that an amount of trading that is inappropriately frequent for one type of security or client

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57 AIMR Letter; CFA Letter.

58 DE Shaw Letter; Greenville Letter.

59 Advisers utilizing multiple strategies would, of course, be free to disclose in their brochures the risks associated with each strategy.

may be appropriate in the context of a different type of security or client.[60] Does our proposal provide advisers enough flexibility to explain the degree to which frequent trading is appropriate in the context of their business? Also, two commenters recommended that that the Commission define the term "frequent trading of securities."[61] We have not proposed a definition, but instead propose to permit firms some flexibility in determining whether strategies they employ involve frequent trading. As those commenters pointed out, the term "frequent" is relative both to the client (i.e., an investment strategy involving frequent trading that is inappropriate for one type of client may be appropriate for another), and to the security being traded. We are concerned that a definition of the term "frequent trading" may not be sufficiently flexible to accommodate different types of securities or the different types of advisory clients. We request comment on our concern. Should we define the term "frequent trading"? If so, commenters are invited to submit suggested text for such a definition.

Finally, our proposed Item 8 would require advisers to discuss their practices regarding cash balances in client accounts. The IAA commented that these practices vary depending on the types of accounts and directions from clients and that meaningful disclosure about these practices would be difficult. Our proposal does not require exhaustive disclosure about, for example, all possible directions that all of an adviser's clients may give it. Instead, the proposal would require a concise, general explanation of the adviser's practices with respect to situations in which a particular client has not provided the adviser specific directions for handling cash balances. Does our proposal

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[60] June 2000 IAA Letter; T. Rowe Price Letter.

[61] June 2000 IAA Letter; T. Rowe Price Letter.

provide advisers with enough flexibility to explain their practices in a meaningful manner? If not, commenters are invited to suggest how to make the disclosures more meaningful.

Item 9. Disciplinary Information. We are proposing Item 9 to require an adviser to disclose in its brochure material facts about any legal or disciplinary event that is material to a client's evaluation of the integrity of the adviser or its management. These requirements are similar, though as discussed below, not identical to those we proposed in 2000, and they would continue to incorporate into the brochure the disciplinary disclosure currently required by rule 206(4)-4. Under that rule, advisers can make disciplinary disclosure to clients either orally or in writing. Because of the importance of this information to clients, we proposed in 2000 and now repropose to require advisers to make this disclosure in their brochures.[62]

As proposed (and as currently reflected in rule 206(4)-4), Items 9.A, B, and C would provide a list of disciplinary events that are presumptively material if they occurred in the previous 10 years.[63] The list would include, among other events, any convictions for theft, fraud, bribery, perjury, forgery, and violations of securities laws by the adviser or one of its executives. Disciplinary events such as these reflect the integrity of the

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[62] Current Part 2 of Form ADV does not include an item related to disciplinary issues, however, Item 11 in Part 1A of Form ADV does require disclosure of specified disciplinary events. Such disclosure is filed with the Commission as part of the firm's filing on IARD, but may not in all cases be provided to clients.

[63] The list of disciplinary events is similar to the list of events currently presumed material under existing rule 206(4)-4(b). Reproposed Item 9 cautions advisers, however, that the events listed in that item are those that are presumed to be material and do not constitute an exhaustive list of material disciplinary events.

adviser and its management persons and therefore are presumptively material to clients.[64] The adviser would be permitted to rebut this presumption, in which case no disclosure to clients would be required. We would, however, require an adviser rebutting a presumption of materiality to document that determination in a memorandum and retain that record in order to better permit our staff to monitor compliance with this important disclosure requirement.[65] A note in Item 9 would explain four factors the adviser should consider when assessing whether the presumption can be rebutted.[66]

We request comment with respect to the list of disciplinary events that are presumptively material. Are there additional types of disciplinary events that we should list? Are there disciplinary events listed that we should remove or modify? Should we expand the list to include disclosure of all cease and desist and censure orders entered against an adviser or its management persons? In addition, we request comment on the terms we use in this item. For example, we propose to state in Item 9 that an adviser must disclose if it (or any of its management persons) has been involved in one of the events listed in that item. We propose to continue to define the term "involved" using the

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64 See Proposing Release at n. 145-150 and accompanying text.

65 Proposed rule 204-2(a)(14)(iii), discussed below in Section IV. Proposed Item 3 of Part 2B, discussed below, requires a brochure supplement to contain disclosure of legal or disciplinary events involving the adviser's supervised persons. Proposed rule 204-2(a)(14)(iii) would require the same memorandum in the event the adviser does not disclose an event described in Item 3 of Part 2B.

66 These factors are: (1) the proximity of the person involved in the disciplinary event to the advisory function; (2) the nature of the infraction that led to the disciplinary event; (3) the severity of the disciplinary sanction; and (4) the time elapsed since the date of the disciplinary event. These are the same factors advisers use to assess materiality under current rule 206(4)-4. See Financial and Disciplinary Information that Investment Advisers Must Disclose to Clients, Investment Advisers Act Release No. 1083 (Sept. 25, 1987) [52 FR 36915 (Oct. 2, 1987)] ("Rule 206(4)-4 Adopting Release"). We have removed, as unnecessary, a sentence from the note that was contained in the Proposing Release that explained that an adviser's determination is not binding on us or a court.

same definition that currently exists in Form ADV.[67] We request comment on the proposed use of the term "involved" in this item and our proposed use of the current definition of that term.

As proposed in 2000, this item also would have required advisers subject to a Commission administrative order to provide clients with a copy of that order. Several commenters urged us not to require advisers to deliver copies of Commission administrative orders to all clients, arguing among other things, that not all orders would be material to clients and that rather than imposing a blanket requirement, delivery of orders should remain a subject of settlement negotiation.[68] We are not proposing this requirement because we agree with commenters' suggestion that we are able to require, where appropriate, delivery of orders in individual proceedings. Nonetheless, we request further comment as to whether we should require delivery of all or, alternatively, some specific category of administrative orders. Commenters supporting delivery of orders should explain how clients would benefit from delivery.

In the Proposing Release, we also specifically requested comment about whether we should require disclosure of certain arbitration awards or claims. Several commenters urged us to include arbitration claims or awards in the list of disciplinary events because

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67 The current Glossary to Form ADV defines the term "involved" to mean "Engaging in any act or omission, aiding, abetting, counseling, commanding, inducing, conspiring with or failing reasonably to supervise another in doing an act."

68 E.g., AmEx Letter; ICI Letter; Comment Letter of PaineWebber Incorporated and Mitchell Hutchins Asset Management Inc. (June 19, 2000) ("Paine Webber Letter"); T. Rowe Price Letter; Comment Letter of Wilmer, Cutler & Pickering (June 13, 2000) ("Wilmer Letter").

that information could be useful to the evaluation of an adviser's integrity,[69] while others urged us not to require that disclosure at all, arguing that arbitration claims and awards are not necessarily an indication of wrongdoing.[70] We request further comment on whether we should require disclosure of arbitration awards, settlements, or claims. Also, should we require disclosure of damages in a civil proceeding? Should we require disclosure of such damages, or arbitration claims, settlements, or awards above a specified amount? If so, would $10,000 be an appropriate amount? If not, what would be an appropriate threshold amount?

Because advisers would include disciplinary disclosures in their advisory brochures if this proposal is adopted, we propose to rescind rule 206(4)-4, which requires disclosure of disciplinary information, but does not specify the means of conveying this disclosure.[71] If we adopt our proposed amendments to Item 9, we would expect to make rescission of rule 206(4)-4 effective on the date by which advisers must deliver their narrative brochures to existing clients and begin delivering their brochures to prospective clients. Some advisers, however, may have clients to whom they are not required to deliver a brochure, for example certain clients receiving impersonal investment advice or

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69 AICPA Letter; CFA Letter; Comment Letter of the Pennsylvania Securities Commission (June 12, 2000) ("Penn. Securities Commission Letter").

70 See, e.g., Amex Letter; DP&W Letter; Wilmer Letter.

71 In addition to requiring disclosure of certain disciplinary information, rule 206(4)-4 currently requires an adviser to disclose certain financial information to clients. As with the disciplinary disclosure, this requirement would also be incorporated into the new brochure. Similar to current rule 206(4)-4(a)(1), proposed Item 18.B of Part 2A would require certain advisers to disclose any financial condition that is reasonably likely to impair their ability to meet contractual commitments to clients. See note 125 below and accompanying text.

registered investment companies and business development companies.[72] For these advisers, their fiduciary duty of full and fair disclosure would require them to continue to disclose to all their clients any material disciplinary or legal events or inability to meet contractual commitments.[73] Nonetheless, we request comment about whether we should rescind rule 206(4)-4. Should we retain the rule to clarify the disclosure obligations of advisers in situations in which they have no brochure delivery obligations?

Item 10. Other Financial Industry Activities and Affiliations. We are proposing Item 10 to require advisers to describe material relationships or arrangements the adviser (or any of its management persons) has with related financial industry participants, any material conflict of interest that the relationships or arrangements create, and how they address the conflict.[74] In addition, if an adviser selects or recommends other advisers for clients, proposed Item 10 would require it to disclose any compensation arrangements or other business relationships between the two advisory firms, as well as the conflicts created.[75] The disclosure that Item 10 would require would help clients be more aware of

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[72] Our proposed requirements for which clients an adviser must deliver a brochure are discussed in Section II.A.3 below.

[73] See generally Rule 206(4)-4 Adopting Release (explaining that rule 206(4)-4 was designed to "remind advisers of their obligation to disclose to clients material facts about precarious financial conditions and certain disciplinary events").

[74] Currently, Part 2 of Form ADV requires disclosure regarding an adviser's other financial industry or affiliations, but does not specifically state that an adviser must describe the related conflicts of interest and how they are addressed. See current Form ADV, Part 2 Item 8.

[75] In 2005, our Office of Compliance Inspections and Examinations issued a report of their targeted exams of pension consultants that highlighted some of the conflicts faced by pension consultants who have business relationships with money managers they recommend to their pension clients: Staff Report Concerning Examinations Of Select Pension Consultants (May 16, 2005), available at http://www.sec.gov/news/studies/pensionexamstudy.pdf. The report noted that, for a number of pension consulting firms, compensation received from money managers

advisers' other financial industry activities and affiliations that can create conflicts of interest and impair the objectivity of investment advice.

One commenter, the CFA, applauded the disclosure required by this proposed item, stating that it would "significantly enhance client understanding of these relationships." Others requested clarification about, among other things, the interaction of the disclosure required by this item and that required by other items, the amount of detail advisers must provide to clients about their internal procedures, and what constitutes a material relationship.[76] Because of the considerable variety among the types of advisers registered with us and the diverse range of their relationships and affiliations in the financial industry, we do not propose to define which relationships or arrangements are material. We request comment on whether, despite the breadth of the financial industry, we should attempt to do so. If so, commenters are invited to provide suggestions of how to craft such a definition so as to capture relationships or arrangements involving material conflicts of interest.

We request further comment on our proposed Item 10. Will the disclosure required by Item 10 be adequate to allow a client to evaluate the conflicts of an adviser, and therefore better manage its relationship with the adviser? If not, what additional or more specific information should an adviser be required to disclose?

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comprised a significant part of their annual revenue but that pension consultants often did not provide adequate disclosure of the conflicts created by this practice to pension plan clients. Proposed Item 10 recognizes that these potential conflicts of interest are not limited to pension consultants and thus, would require disclosure by any adviser to whom it is relevant.

[76] See, e.g., FPA Letter; June 2000 IAA Letter; Thomson Letter. We note that Item 8 of current Part 2 already requires an adviser to disclose certain relationships with a related person "that are material to its advisory business or its clients."

Item 11. Code of Ethics, Participation or Interest in Client Transactions and Personal Trading.

Code of Ethics. Proposed Item 11.A would require each adviser to describe briefly its code of ethics and to state that a copy is available upon request. In 2004, we adopted rule 204A-1[77] under the Advisers Act and amended current Item 9, which, as a result, today requires advisers to make this same disclosure.[78] The description of an adviser's code of ethics required by proposed Item 11.A may include matters also responsive to other items, including those discussed below and, in particular, personal trading by advisory personnel. If so, the disclosure need not be repeated.[79]

Participation or Interest in Client Transactions. If the adviser or a related person recommends to clients or buys or sells for clients securities in which the adviser or a related person has a material financial interest, Item 11.B would require the brochure to discuss this practice and the conflicts presented.[80] Conflicts could arise, for example, when an adviser recommends that clients invest in a pooled investment vehicle that the firm advises or serves as the general partner, or when an adviser with a material financial interest in a company recommends that a client buy shares in that company's public offering. An adviser engaging in these practices may have an incentive to base its advice

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[77] 17 CFR 275.204A-1.

[78] Investment Adviser Codes of Ethics, Investment Advisers Act Release No. 2256 (July 2, 2004) [69 FR 41696 (July 9, 2004)] ("Code of Ethics Adopting Release").

[79] Proposed General Instruction 1 to Part 2.

[80] Proposed Item 11.B. This item incorporates many of the disclosure requirements of current Item 9 of Part 2 and is identical to the Item 10.B we proposed in 2000. An adviser's related persons are: (1) the adviser's officers, partners, or directors (or any person performing similar functions); (2) all persons directly or indirectly controlling, controlled by, or under common control with the adviser; (3) all of the adviser's current employees; and (4) any person providing investment advice on the adviser's behalf. See Form ADV: Glossary.

on its own financial interests rather than the interest of clients, and the item is designed to help clients understand that conflict. The item would require advisers to disclose any practices giving rise to these conflicts, the nature of the conflicts presented, and how the adviser addresses the conflicts.[81] The requirements of the proposed item are similar to the disclosures presently required under Item 9 of current Part 2.[82]

We request that commenters consider the proposed item and evaluate whether it would require sufficient disclosure to address our concerns.

Personal Trading. Items 11.C and 11.D would require disclosure regarding personal trading by the adviser and its personnel. Because of the information they have, advisers and their personnel are in a position to abuse clients' positions by, for example, placing their own trades before or after client trades are executed in order to benefit from any price movements due to the clients' trades.[83] These practices not only may affect the objectivity of the adviser's recommendations, but also can harm clients by adversely

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[81] We are not proposing to require an adviser that relies on our recently adopted rule 206(3)-3T under the Advisers Act with respect to its principal trades with its advisory clients to disclose in Part 2 of Form ADV the information required by paragraph (a)(3) of that rule. Rule 206(3)-3T(a)(3) [17 CFR § 275. 206(3)-3T(a)(3)]. See also Temporary Rule Regarding Principal Trades with Certain Advisory Clients, Investment Advisers Act Release No. 2653 (Sept. 24, 2007) [72 FR 55022 (Sept. 28, 2007)]. Rule 206(3)-3T sets out an alternative means for advisers that also are registered broker-dealers to comply with their obligations under section 206(3) of the Advisers Act with respect to principal trades with their clients. One condition of the rule is that an adviser relying on it must provide its clients with prospective written disclosure to the advisory client explaining (i) the circumstances under which the investment adviser directly or indirectly may engage in principal transactions, (ii) the nature and significance of conflicts with its client's interests as a result of the transactions, and (iii) how the investment adviser addresses those conflicts. Although we do not propose to require advisers to disclose this information in their brochures, they may do so if they wish.

[82] See current Form ADV, Part 2 Item 9.

[83] This practice is known as "front-running." See Investment Adviser Codes of Ethics, Investment Advisers Act Release No. 2209 (Jan. 20, 2004) [69 FR 4040 (Jan. 27, 2004)] at n. 18 and accompanying text.

affecting the prices at which their trades are executed. Item 11.C would require an adviser to disclose whether it or a related person (e.g., advisory personnel) invests – or is permitted to invest – in the same securities that it recommends to clients, or in related securities such as options or other derivatives. If so, the brochure must discuss the conflicts presented and describe how the firm addresses the conflicts. Item 11.D would require a similar discussion, but focuses on the specific conflicts an adviser has when it or a related person trades in the same securities at or about the same time as a client.[84] In response to this item, an adviser might explain how its internal controls, including its code of ethics, prevent the firm and its staff from buying or selling securities contemporaneously with client transactions.[85] Similar disclosure is already required under Item 9.E of current Part 2.

We proposed a similar item in 2000 on which we received no comment. Since that time, advisers have adopted codes of ethics that must address personal trading by certain advisory personnel and thus must address, at least in part, the concerns raised by this item. In light of this, should we further revise the item? If so, how?

Item 12. Brokerage Practices. Proposed Item 12 would require advisers to describe how they select brokers for client transactions and determine the reasonableness

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[84] Some situations, such as when an adviser owns shares in a company it recommends to clients, may be covered by both proposed Items 11.B and 11.C, as well as others, such as Item 5. Other situations, such as when an adviser sells its holdings of a security it purchases for clients, would come under proposed Item 11.C, and potentially 11.D. Further, some of these control procedures may be included in the adviser's code of ethics and in the description of the code. A brochure would not need to repeat disclosure simply because it is responsive to more than one item.

[85] Advisers would not be required to provide this disclosure with respect to securities that are not "reportable securities" under rule 204A-1, such as shares in unaffiliated mutual funds. See rule 204A-1. Such securities are not reportable under rule 204A-1 because they appear to present little opportunity for front-running. See Code of Ethics Adopting Release, above note 78, at n. 42 and accompanying text.

of brokers' compensation. The item also would require advisers to disclose how they address conflicts arising from their receipt of "soft dollars," i.e., the receipt of benefits such as research in connection with client brokerage.

This item, which we discuss in more detail below, is largely the same as originally proposed, but with two changes urged by commenters. First, we have omitted a proposed requirement that advisers disclose in their brochures whether they negotiate commissions.[86] Commenters informed us that few advisers "negotiate" commission rates in the literal sense suggested by the Proposing Release.[87] Second, we have omitted the proposed requirement that advisers disclose whether they participate in commission recapture programs. We understand that these programs are not typically sponsored or promoted by advisers, but are more likely driven by client demands. We request comment on our understanding of these practices. Should we require brochure disclosure in either instance?

Soft Dollar Practices. Many advisers receive brokerage and research services in reliance on section 28(e) of the Exchange Act, as well as other "soft dollar" products and services, provided by particular brokers in connection with client transactions.[88] As we have previously noted, use of client securities transactions to obtain research and other benefits creates incentives that can result in conflicts of interest between advisers and

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86 See Proposing Release at n. 178-179 and accompanying text.

87 June 2000 IAA Letter; SIFMA Letter. Of course, advisers must consider commission rates as part of their duty to seek best execution. See Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters, Exchange Act Release No. 23170 (Apr. 23, 1986) [51 FR 16004 (Apr. 30, 1986)] ("1986 Soft Dollar Release") at Section V.

88 Nearly 60 percent of advisers registered with the Commission report on Form ADV, Part 1A, Item 8.E that they or a related person receive soft dollar benefits in connection with client transactions. (IARD Data as of Sept. 30, 2007).

their clients.[89] Because of these conflicts, we have long required advisers to disclose their policies and practices with respect to their receipt of soft dollar benefits in connection with client securities transactions.[90] Some commenters questioned the conflicts we identified and complained that the item would tend to cast aspersions on the use of soft dollar arrangements that are commonplace, such as those that fit within the safe harbor established by section 28(e).[91] Our intent is not to create a negative impression regarding soft dollars arrangements, but rather to require full disclosure of arrangements that we believe involve significant conflicts of interest.

Our 2000 proposal responded to a 1998 report from our Office of Compliance Inspections and Examinations that concluded that advisers' disclosure often failed to provide sufficient information for clients or prospective clients to understand the

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89 Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, Exchange Act Release No. 54165 (July 18, 2006) [71 FR 41978 (July 24, 2006)] ("2006 Soft Dollar Release") ("[u]se of client commissions to pay for research and brokerage services presents money managers with significant conflicts of interest, and may give incentives for managers to disregard their best execution obligations when directing orders to obtain client commission services as well as to trade client securities inappropriately in order to earn credits for client commission services"). Section 28(e) of the Exchange Act provides a limited "safe harbor" for advisers with discretionary authority in connection with their receipt of soft dollar benefits. Under section 28(e), a person who exercises investment discretion over a client account has not acted unlawfully or breached a fiduciary duty solely by causing the account to pay more than the lowest commission rate available, so long as that person determines in good faith that the commission amount is reasonable in relation to the value of the brokerage and research services provided. Advisers must disclose their receipt of soft dollar benefits to clients, regardless of whether the benefits fall inside or outside of the safe harbor. See 1986 Soft Dollar Release, above note 87, at n. 33.

90 Item 12 of current Part 2.

91 Comment Letter of the Alliance In Support of Independent Research (June 13, 2000) ("Alliance Letter"); ICI Letter; SIFMA Letter.

advisers' soft dollar practices and the conflicts those practices present.[92] In its report, OCIE noted that most advisers' descriptions were simply boilerplate, and urged that we consider amending Form ADV to require better disclosure.[93] We request comment on whether our proposed item would achieve this goal.

Item 12 would require an adviser that receives soft dollar benefits in connection with client securities transactions to disclose its practices.[94] The proposed item would require a brochure's description of soft dollar practices to be specific enough for clients and prospective clients to understand the types of products or services the adviser is acquiring and permit them to evaluate conflicts.[95] Disclosure must be more detailed for products or services that do not qualify for the safe harbor in section 28(e) of the Exchange Act, such as research that does not aid in the adviser's investment decision-making process. Will the proposed disclosure be sufficient to adequately inform clients?

Item 12 also would require an adviser to describe the types of conflicts it has when it accepts soft dollar benefits[96] and to disclose how it addresses those conflicts.[97]

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92 Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds (Sept. 22, 1998), available at http://www.sec.gov/news/studies/softdolr.htm.

93 Id.

94 The soft dollar benefits covered include any research, or other products or services, whether created or developed by the broker-dealer itself or by a third party. See note to proposed Item 12.A.1 of Part 2A.

95 In this regard, the proposed item would incorporate the standard for advisers we set out in our 1986 Soft Dollar Release. Our 2006 Soft Dollar Release preserved this provision of the 1986 Soft Dollar Release. See 2006 Soft Dollar Release, above note 89, at n. 68 and accompanying text.

96 An adviser accepting soft dollar benefits would have to explain that (a) the adviser benefits because it does not have to produce or pay for the research or other products or services acquired with soft dollars, and (b) the adviser therefore has an incentive to select or recommend brokers based on the adviser's interest in receiving these benefits, rather than on the client's interest in getting the best execution.

The item would require the adviser to explain whether it uses soft dollars to benefit all client accounts or only those accounts whose brokerage "pays" for the benefits, and whether the adviser seeks to allocate the benefits to client accounts proportionately to the soft dollar credits those accounts generate. The item also would require the adviser to explain whether it "pays up" for soft dollar benefits.[98] As we noted above, some commenters to our 2000 proposal questioned our description of the conflicts of interest identified in the item.[99] We ask commenters to consider these descriptions.

Client Referrals. If an adviser uses client brokerage to reward brokers for client referrals, it also would be required to disclose this practice, the conflict it creates, and any procedures the adviser used to direct client brokerage to referring brokers during the last fiscal year, i.e., the system of controls used by the adviser when allocating brokerage.[100] This practice presents advisers with significant conflicts of interest because they may have a bias towards referring brokers.[101] Part 2 currently requires advisers to disclose these arrangements, but does not specifically require that such description discuss the conflicts of interest created.[102]

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[97] See proposed Item 12.A.1.f of Part 2A, which is substantively the same as Item 12.B of current Part 2.

[98] "Paying up" refers to a manager causing a client account to pay more than the lowest available commission rate in exchange for soft dollar products or services. Item 12 of current Part 2 requires advisers to disclose "whether clients pay commissions higher than those obtainable from other brokers in return for . . . products and services."

[99] See above note 91 and accompanying text.

[100] Proposed Item 12.A.2 of Part 2A.

[101] See Proposing Release at n. 177 and accompanying text.

[102] See current Form ADV, Part 2, Item 13.B.

Proposed Item 12.A.2 is substantially the same as we proposed in 2000. The one commenter that addressed it – CFA – expressed support for the item as proposed, and we request further comment.

Trade Aggregation. Clients engaging an adviser can benefit when the adviser negotiates lower commissions or "bunches" trades to obtain volume discounts on execution costs.[103] Item 12 would require the adviser to describe whether and under what conditions it engages in these practices. If the adviser does not bunch trades when it has the opportunity to obtain discounts, the adviser would be required to explain in the brochure that clients may pay higher brokerage costs. We request comment on this requirement. Should we also require an adviser to discuss whether and under what conditions it breaks up large orders to purchase or sell securities (e.g., to mitigate the impact of the transaction on the market value of the securities)?

Directed Brokerage. Clients sometimes instruct their adviser to send transactions to a specific broker-dealer for execution. Clients may initiate this type of arrangement for a variety of reasons, such as favoring a family member or friend or compensating the broker-dealer indirectly for services it provides to the client. But the arrangement may also be initiated by the adviser, who may benefit, for example, when brokerage is directed to its affiliated broker-dealer. In either case, clients directing (or agreeing to direct) brokerage need to understand the consequences of directing brokerage, including the possibility that their accounts will pay higher commissions and receive less favorable execution.[104]

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[103] Broker-dealers may, for example, offer lower commission costs.

[104] 1986 Soft Dollar Release, above note 87 at n. 44.

If an adviser permits clients to direct brokerage, we would require the brochure to explain that the adviser may be unable to obtain best execution, and that directing brokerage may cost clients more money.[105] If, however, the adviser routinely recommends, requests or requires clients to direct brokerage, the adviser also would be required to describe in its brochure the adviser's practice, to disclose that not all advisers require directed brokerage, and to discuss any broker-dealer relationship that creates a material conflict of interest.[106]

Commenters favored the item.[107] One pointed out, however, that many clients direct brokerage subject to best execution.[108] In such situations, the disclosure required by proposed Item 12.A.3.b is not relevant because the adviser would be required to seek best execution. To avoid disclosure that may not be helpful to clients, we have modified the item to permit advisers to omit the disclosure if the adviser only permits clients to direct brokerage subject to the adviser's ability to obtain best execution. We request further comment on the proposed disclosures regarding directed brokerage.

Item 13. Review of Accounts. Proposed Item 13 would require an adviser to disclose whether, and how often, it reviews clients' accounts or financial plans, and to identify who conducts the review. An adviser that reviews accounts, but not regularly, would explain what circumstances trigger an account review. This disclosure is similar to

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105 Proposed Item 12.A.3.b of Part 2A.

106 Proposed Item 12.A.3.a of Part 2A. Currently, Item 12 of Part 2 requires disclosure of similar information in cases where an adviser or a related person suggests brokers to clients and where an adviser has authority to determine the broker or dealer to be used.

107 CFA Letter; Comment Letter of the Florida State Board of Administration (June 13, 2000) ("Florida Board Letter"); June 2000 IAA Letter.

108 Comment Letter of Frank Russell Securities (June 13, 2000).

that presently required by Item 11 of current Part 2.[109] Commenters who addressed this item supported it as being helpful to clients.[110] We are proposing this item with no change from the 2000 proposal and we request further comment on it.

Item 14. Payment for Client Referrals. Item 14 would require an adviser to describe any cash or other payment that it or a related person makes for client referrals. The brochure also would disclose whether the adviser receives any benefit, including sales awards or prizes, from a non-client for providing advisory services to clients.[111] This item is the same as we proposed it in 2000 and we request further comment on it. Similar disclosure is already required by current Part 2 which requires an adviser to disclose whether it has any arrangements where it directly or indirectly compensates any person for client referrals and to describe such arrangements.[112] Current Part 2 also requires an adviser to disclose whether it receives a cash payment or some economic benefit from non-clients in connection with giving advice to clients.[113] We request further comment on our proposed Item 14.

Item 15. Custody. We have updated this item from our 2000 proposal to reflect subsequent amendments to rule 206(4)-2 (our investment adviser custody rule).[114] The

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109 See current Form ADV, Part 2, Item 11.

110 CFA Letter; FPA Letter.

111 Proposed Item 14 would require advisory firms to disclose economic benefits they receive. As discussed below in Section II.B.3 of this Release, Part 2B would require advisers to disclose economic benefits a supervised person receives.

112 See current Form ADV, Part 2, Item 13.B.

113 See current Form ADV, Part 2, Item 13.A.

114 See Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2176 (Sep. 25, 2003) [68 FR 56692 (Oct. 1, 2003)] ("Custody Rule Release"). "Custody" would have the same meaning as it currently has in Form ADV and is based on the term as defined in rule 206(4)-2. See Form ADV: Glossary.

protections afforded clients as a result of compliance with the amended rule reduce the need for much of the disclosure requirements we proposed in 2000. Today, most advisers that have custody of client securities or funds comply with the rule by maintaining these client assets with a qualified custodian (such as a broker-dealer or bank) that directly sends account statements to the adviser's clients.[115] These advisers would be required only to explain that clients will receive these account statements from their custodians and should review them carefully. If, however, clients do not receive, from one or more qualified custodians, account statements covering all of the funds and securities over which an adviser has custody, Item 15 would require the adviser to disclose that it has custody and to explain the risks that clients will face as a result.[116]

We request comment on this proposed disclosure item. In particular, we request comment about whether we should further revise this item in light of the amended investment adviser custody rule.

An adviser has custody if it, directly or indirectly, holds client funds or securities, has any authority to obtain possession of them, or has the ability to appropriate them. For example, an adviser has custody if it has a general power of attorney over a client's account or signatory power over a client's checking account. For a more detailed discussion of what activity constitutes "custody," see Custody Rule Release, at Section II.A.

115 Rule 206(4)-2 defines a "qualified custodian" as a bank, a savings association, a broker-dealer, a futures commission merchant (but only with respect to clients' funds, security futures, and other securities incidental to transactions in futures), or a foreign financial institution that customarily holds financial assets for its customers and segregates the advisory clients' assets from its proprietary assets. Under the rule, a registered adviser with custody must either have a reasonable basis for believing that the qualified custodian sends quarterly account statements directly to the client or send its own quarterly account statements to the client, in which case the adviser must also undergo an annual surprise examination by an independent public accountant to verify client funds and securities.

116 We note that current Part 2 of Form ADV does not have an equivalent to Item 15 of reproposed Part 2A.

Item 16. Investment Discretion. Item 16 would require advisers with discretionary authority over client accounts to disclose these arrangements in their brochure,[117] and any limitations clients may (or customarily do) place on this authority.[118] This item is the same as originally proposal. Both of the commenters who addressed the proposed item supported it.[119] We request further comment on our proposed Item 16.

Item 17. Voting Client Securities. Item 17 would require advisers to disclose their proxy voting practices. We have revised the item to reflect the adoption of rule 206(4)-6 under the Advisers Act, which, among other things, requires advisers registered with the Commission to disclose certain information about their proxy voting practices.[120] We also have added a new requirement, discussed below, to describe information about an adviser's use of third-party proxy voting services.

Item 17 would require advisers to disclose whether they will accept authority to vote client securities and, if so, to briefly describe the voting policies they adopted under rule 206(4)-6. In addition, each adviser must describe whether (and how) clients can

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117 Currently, Items 12.A and 12.B of Part 2 require information about the adviser's investment discretion and any limitations on it. We propose to continue requiring this information but to clarify, through our proposed definitions in Form ADV, that an adviser has "discretionary authority" if it is authorized to make purchase and sale decisions for client accounts. This definition of discretionary authority is derived from section 3(a)(35) of the Exchange Act [15 U.S.C. 78c(a)(35)]. An adviser also has discretionary authority if it is authorized to select other advisers for the client.

118 For example, clients may not understand that they may ask the adviser not to invest in securities of particular issuers.

119 CFA Letter; FPA Letter.

120 See Proxy Voting by Investment Advisers, Investment Advisers Act Release No. 2106 (Jan. 31, 2003) [68 FR 6585 (Feb. 7, 2003)]. Rule 206(4)-6 requires advisers to adopt and implement written voting policies and procedures. Advisers are also required to keep certain records relating to their voting. Advisers that exercise voting authority over client securities must describe their voting policies and procedures to clients and furnish clients with a complete copy upon request.

direct the advisers to vote in a particular solicitation, how the adviser addresses conflicts of interest when it votes securities, and how clients can obtain information from the adviser on how the adviser voted their securities. Item 17 also would require an adviser to explain that clients may obtain a copy of the adviser's proxy voting policies and procedures upon request. Advisers that do not have authority to vote securities would have to disclose how clients will receive their proxies and other solicitations.

Finally, we have added a new paragraph B of Item 17. If advisers routinely rely on one or more third-party proxy voting services to advise them in connection with voting client securities, then the advisers would be required to list the proxy voting services that the advisers use and to describe how they select the proxy voting services. The paragraph also would require disclosure of whether these advisers permit clients to direct the use of a particular proxy voting service with respect to the securities held in the clients' accounts. An adviser would not need to identify a proxy voting service that a client directs the adviser to use unless the adviser uses the service for the purpose of voting the securities of other clients. Finally, the new paragraph would require advisers to disclose how they pay for proxy voting services.

We believe that clients are interested in knowing whether their adviser is outsourcing its proxy analysis or otherwise using third-party proxy voting services, whether it is doing so in response to direction from another client, and how the adviser is paying for those services. We believe that clients would want to know of potential conflicts of interest that may arise from an adviser's use of proxy voting services, including possibly accommodating one client by hiring a proxy voting service to influence the voting of another client's securities.

Several commenters favored the item when we proposed it in 2000.[121] We request comment on our proposed revisions. Rule 206(4)-6 already requires advisers to disclose much of the information that the proposed item would require. Thus, one principal effect of the item would be to require the rule 206(4)-6 disclosure in the brochure. Should any of that disclosure not be required in the brochure?

Should we require disclosure of the circumstances relating to an adviser's use of third-party proxy voting services? Specifically, would clients be interested in knowing the identity of the proxy voting services that are utilized by their advisers and how these services are selected? Would clients be interested in knowing whether advisers permit their clients to direct the use of particular proxy voting services? Would clients be interested in knowing the amounts that advisers pay third-party proxy voting services? Would clients be interested in knowing whether their advisers are paying for the services directly or through soft dollars?[122]

Item 18. Financial Information. This item would require disclosure of certain financial information about the adviser when material to clients. Proposed Item 18 of Part 2A would continue to require each adviser that requires prepayment of fees to give

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121 See Comment Letter of Professor Aaron Brown, Yeshiva University (May 10, 2000); Comment Letter of Council of Institutional Investors (June 12, 2000); Florida Board Letter; Comment Letter of The Corporate Monitoring Project (June 3, 2000); Comment Letter of James McRitchie (May 24, 2000); Comment Letter of Paul Nissenbaum (May 9, 2000). Four commenters were concerned about the length of the disclosure that a description of proxy procedures would entail. See AmEx Letter; June IAA 2000 Letter; Comment Letter of Charles Schwab & Co. (June 14, 2000) ("Schwab Letter"); Thomson Letter; Wellington Letter. We note in response to these commenters concerns that the proposed item would only require a brief description of an adviser's policies and procedures and not verbatim incorporation of them.

122 For a discussion of whether proxy voting services and other proxy services are within the safe harbor under section 28(e) of the Exchange Act, see 2006 Soft Dollar Release, above note 89, at section III.C.5.

clients an audited balance sheet showing the adviser's assets and liabilities at the end of its most recent fiscal year.[123] Prepayment of fees exposes clients to the risk that the firm may become insolvent and unable to refund unearned fees. The proposed item also would require each adviser to disclose any financial condition reasonably likely to impair the adviser's ability to meet contractual commitments to clients if the adviser has discretionary authority over client assets, has custody of client funds or securities, or requires or solicits prepayment of more than $1,200 in fees per client and six months or more in advance.[124] These clients are exposed to the risk that their assets may not be properly managed if the adviser becomes insolvent and ceases to do business.[125] Finally, proposed Item 18 would require an adviser that has been the subject of a bankruptcy petition during the past ten years to disclose that fact to clients.[126]

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[123] Currently, Item 14 of existing Part 2 requires (through Schedule G) an audited balance sheet if the adviser requires prepayment of more than $500 in fees per client and six or more months in advance. We would increase the threshold amount from $500 to $1,200 to reflect the effects of inflation, based upon the Personal Consumption Expenditures Chain-Type Price Index as published by the U.S. Department of Commerce, since we adopted Form ADV in 1979. As in the 2000 proposal, we also propose to require an audited balance sheet from advisers that solicit clients to prepay fees over $1,200.

[124] This disclosure is currently required by rule 206(4)-4. In its release adopting rule 206(4)-4 the Commission noted that a determination about what constitutes financial condition reasonably likely to impair an adviser's ability to meet contractual commitments is inherently factual in nature but would generally include insolvency or bankruptcy. See Rule 206(4)-4 Adopting Release, above note 66 at n. 6.

[125] As discussed above, we propose to rescind rule 206(4)-4. We caution advisers, however, that their fiduciary duty of full and fair disclosure may require them to continue to disclose any material legal event or precarious financial condition promptly to all clients, even clients to whom they may not be required to deliver a brochure or amended brochure. See Rule 206(4)-4 Adopting Release, above note 66 at n. 2-3 and accompanying text.

[126] This requirement conforms with our already stated position that bankruptcy generally constitutes a 'financial condition reasonably likely to impair the adviser's ability to meet contractual commitments to clients' requiring disclosure under rule 206(4)-4. See Rule 206(4)-4 Adopting Release, above note 66 at n. 6.

This item is largely the same as the one we proposed in 2000, which commenters generally supported.[127] However, we have made revisions to reflect subsequent amendments to Form ADV that were made in conjunction with changes to the adviser custody rule.[128] As a result, Item 18 no longer would require an adviser to supply clients with an audited balance sheet solely because the adviser has custody. Moreover, we now propose to exclude advisers from the balance sheet requirement if they require prepaid fees but are qualified custodians or insurance companies. These firms are subject to capital and regulatory requirements, designed to guard against insolvency, that eliminate the need for an adviser to deliver a balance sheet. Are there other circumstances in which it would be unnecessary for an adviser to deliver a balance sheet to its clients? Alternatively, are there additional circumstances in which it would be appropriate for us to require an adviser to deliver a balance sheet?

Item 19. Index. The brochure filed with us would be required to include an index of the items required by Part 2A indicating where in the brochure the adviser addresses each item.[129] This index is intended to facilitate review by our staff for compliance with the requirements of Part 2A. The adviser would not be required to provide the index to its clients. The index would, however, be required to be appended to the brochure as

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[127] See, e.g., CFA Letter; June 2000 IAA Letter. Although some commenters to our 2000 proposal raised concerns regarding exceptions to delivery of balance sheets, the Commission subsequently considered and addressed this issue in adopting its changes to the custody rule. See Custody Rule Release, above note 114.

[128] See Custody Rule Release, above note 114.

[129] Although an index is not required by current Part 2 of Form ADV, the requirement in Proposed Item 19 is similar to the index that current Schedule H now requires.

filed through the IARD. We proposed the same index requirement in 2000.[130] We request further comment on our proposal to require advisers to include an index in their brochures.

Part 2A Appendix 1: The Wrap Fee Program Brochure. Advisers that sponsor wrap fee programs[131] would continue to be required to prepare a separate, specialized firm brochure (a "wrap fee program brochure" or "wrap brochure") for clients of the wrap fee program in lieu of the sponsor's standard advisory firm brochure.[132] The items in proposed Appendix 1 to Part 2A would contain the requirements for a wrap fee program brochure, and would be substantially similar to those currently in Schedule H. However, as we did in 2000, today we are proposing some changes from current Schedule H to incorporate many of our proposed amendments to the Part 2A firm brochure. We also are proposing an additional disclosure requirement to the wrap fee brochure.

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130 In their comments responding to the 2000 proposal, the ICI and IAA opposed this item, arguing that requiring both an index and a table of contents seemed redundant. See ICI Letter; June 2000 IAA Letter. The CFA, however, endorsed the requirement. See CFA Letter.

131 Under wrap fee programs, which are also sometimes referred to as "separately managed accounts," advisory clients pay a specified fee for investment advisory services and the execution of transactions. The advisory services may include portfolio management and/or advice concerning selection of other advisers, and the fee is not based directly upon transactions in the client's account.

132 We adopted the requirement for a separate brochure for wrap fee clients in 1994. See Disclosure by Investment Advisers Regarding Wrap Fee Programs, Investment Advisers Act Release No. 1411 (Apr. 19, 1994) [59 FR 21657 (Apr. 26, 1994)] (adopting rules to require wrap fee sponsors to give wrap fee clients separate brochures). As proposed in 2000, advisers whose entire advisory business is sponsoring wrap fee programs would prepare a wrap brochure but would not be required to prepare a standard advisory firm brochure. See proposed Instruction 7 to Part 2A of Form ADV. An adviser would have to prepare both a standard firm brochure and a wrap fee brochure if it both sponsors a wrap fee program and provides other types of advisory services, and would deliver both a standard and a wrap brochure to a client who receives both types of services. Wrap fee sponsors would, like other advisers, be required to provide brochure supplements to their wrap fee clients.

We propose to require an adviser to disclose whether any of its related persons are portfolio managers in the program and to describe the conflicts that may be present.[133] For example, an adviser may have an incentive to select a related person to participate as a portfolio manager based on the person's affiliation with the adviser, rather than based on expertise or performance. The item would require advisers to disclose whether related person portfolio managers are subject to the same selection and review as the other portfolio managers who participate in the wrap fee program and, if they are not, how they are selected and reviewed.

We request comment on this proposed modification to Appendix 1 to Part 2A. Wrap fee programs have evolved in the marketplace, resulting in many different models that all meet the definition of wrap fee program.[134] As a result of these various structures, are there other disclosures that we should consider including in Appendix 1 that would enhance a client's ability to understand the conflicts of interest in wrap fee programs? Are there disclosure items in proposed Appendix 1 that are unnecessary or would not be useful to clients?

3. Delivery and Updating of Brochures

The Commission also is proposing amendments to rule 204-3, our rule under the Advisers Act that requires registered advisers to update and deliver their brochures to clients and prospective clients.

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133 Proposed Item 6.B of Appendix 1. We propose to redesignate the item originally proposed as Item 6.B (requiring additional disclosures if the wrap fee sponsor or any of its employees act as a portfolio manager for a wrap fee program described in the wrap brochure) as new Item 6.C.

134 For example, some wrap fee program sponsors have begun to transition from platforms offering a selection of individual portfolio managers to those instead offering a selection of model portfolios.

a. Delivery to Clients

Initial Delivery. Similar to the existing requirements, an adviser would be required to deliver a current firm brochure before or at the time it enters into an advisory contract with the client.[135] As provided under the current rule, advisers would not be required to deliver brochures to certain advisory clients receiving only impersonal investment advice[136] or to clients that are investment companies registered under the Investment Company Act of 1940 ("Company Act").[137] We propose expanding the latter exception to cover advisers to business development companies ("BDCs") that are subject to section 15(c) of the Company Act. That section requires the boards of directors to request, and the adviser to furnish, information to enable the board to evaluate the terms of the proposed advisory contract.[138] Because of this safeguard, we believe that

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135 Proposed rule 204-3(b)(1). Rule 204-3 currently requires a registered adviser to furnish each client and prospective client with a written disclosure statement which may be either a copy of the adviser's completed Part 2 or a written document containing the information required by Part 2. Currently, such delivery must occur at least 48 hours before entering into the advisory agreement, or at the time of entering into the agreement if the client has the right to terminate the agreement without penalty within five business days thereafter. We are proposing to simply require that the adviser deliver the brochure before or at the time of entering into the agreement.

136 Proposed rule 204-3(c)(1) and proposed Instruction 1 to Part 2A. Advisers would not be required to deliver brochures to advisory clients receiving only impersonal investment advice for which the adviser charges less than $500 per year. Currently, the dollar amount threshold to trigger this exception is $200. See rule 204-3. We are proposing to increase this threshold to $500 to reflect the effects of inflation, based upon the Personal Consumption Expenditures Chain-Type Price Index as published by the U.S. Department of Commerce, since rule 204-3 was adopted in 1979.

137 Proposed rule 204-3(c)(1) and proposed Instruction 1 to Part 2A. This does not suggest, however, that investment company directors would no longer receive the disciplinary and financial information that the fund's adviser currently provides under existing rule 206(4)-4, which we are proposing to move into the brochure. Section 15(c) of the Investment Company Act [15 U.S.C. 80a-15(c)] separately requires fund directors to request and evaluate information about the adviser in connection with annual renewal of the advisory contract, and requires the adviser to provide it.

138 See note 137 above.

proposing a separate obligation for those types of entities to deliver a brochure is not necessary. We note that an adviser would not have to prepare a brochure if it does not have any clients to whom a brochure would have to be delivered, thus saving advisers time and expense.[139]

Annual and Interim Delivery. Currently, rule 204-3 requires advisers to annually deliver, or offer to deliver upon request, a written disclosure statement (either a copy of the adviser's Part 2 or a brochure containing the information required by Part 2) to each of its advisory clients.[140] In 2000, we proposed to require advisers to deliver an updated brochure, or a "sticker" identifying the stale information and including the updated information, whenever information in the brochure became materially incorrect during the year.[141] We expressed concern that few clients requested an updated brochure and were instead relying on "stale" brochures. We analogized our updating proposal to the obligations of mutual funds to update their prospectuses and expressed the view that the additional costs the proposed updating requirements might impose could be reduced by electronic delivery of the updating information. We also pointed out that, as fiduciaries, advisers must already provide their clients with updated information to comply with their obligations under the anti-fraud provisions of the Advisers Act.

Several commenters supported our proposal, particularly the proposal to require advisers to update their brochures throughout the year.[142] Other commenters objected,

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139 Proposed Instruction 5 to Part 2A.

140 Rule 204-3(c). An adviser's offer to deliver the disclosure statement must be in writing.

141 See Proposing Release at Section II.D.2.

142 See, e.g., AIMR Letter; CFA Letter; Comment Letter of Yasmin Mansoor (May 28, 2000); Penn. Securities Commission Letter; Securities America Letter.

primarily citing the burden on advisers.[143] Some commenters argued that advisers currently meet their obligations under the anti-fraud provisions through different types of communications with clients, some of which are informal, and urged us not to impose a formal updating requirement.[144] One commenter, the IAA, expressed agreement with our concern that clients may be relying on stale information and urged a compromise approach under which the Commission would require advisers to deliver their brochure to clients annually, but would not specify the means of updating information between the annual updates.[145]

Today, we are proposing an approach similar to the one suggested by the IAA, which we believe may strike an appropriate balance between our concerns and those expressed by commenters. In addition to the initial delivery requirement, the proposed amendments would require each registered adviser to deliver its current brochure to existing clients at least once each year no later than 120 days after the end of the adviser's fiscal year.[146] Thus, clients would receive an updated brochure about the same time each year (identifying changes from the previous year's brochure) shortly after the date by which advisers are already required to file their amended Form ADV with us.[147]

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143 See, e.g., AmEx Letter; Crist Letter; DP&W Letter; ICI Letter; SIFMA Letter.

144 See, e.g., Comment Letter of Merrill Lynch, Pierce, Fenner & Smith, Inc. (June 22, 2000) ("Merrill Letter"); Paine Webber Letter; Schwab Letter.

145 Comment Letter of the IAA (May 24, 2001) ("May 2001 IAA Letter").

146 Proposed amended rule 204-3(b) and proposed Instruction 2 to Part 2A.

147 As discussed below, rule 204-1 requires an adviser registered with the Commission to annually revise its Form ADV, including its brochure, within 90 days of its fiscal year end. Advisers typically provide clients with reports quarterly, and the proposed 120-day period is designed to provide sufficient flexibility to allow advisers to include the updated brochure in a routine quarterly mailing to clients. We expect that permitting an adviser to send the brochure together with these routine mailings could substantially

We are proposing to require an adviser to deliver an interim update to clients only when the adviser amends its brochure to add a disciplinary event, or to materially change information already disclosed, in response to Item 9 of Part 2A.[148] We believe that such circumstances warrant a formal delivery requirement because of the importance of disciplinary information to clients.[149] We believe such disciplinary events are important because, unlike some of the other disclosure items, they are more likely to reflect directly upon an adviser's integrity and may affect a client's trust and confidence in the adviser.

We request comment generally on our proposed delivery requirement and, in particular, on the proposed requirements regarding delivery of updates. Should we require delivery of interim updates of the brochure in additional circumstances besides those involving disclosure of disciplinary information in response to Item 9? Should we require brochure delivery more frequently than annually? We also request comment with respect to the timing of annual delivery. Is the proposed provision to require annual delivery no later than 120 days after the end of the adviser's fiscal year reasonable? Does

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reduce delivery costs. See Section VII below. Advisers may, of course, deliver updated brochures electronically with client consent, in which case they would bear significantly lower delivery costs. Proposed Instruction 3 to Part 2A. See also Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information, Investment Advisers Act Release No. 1562 (May 9, 1996) [61 FR 24644 (May 15, 1996)] (publishing Commission interpretive guidance with respect to use of electronic media to fulfill investment advisers' disclosure delivery obligations).

148 Proposed rule 204-3(e). Nonetheless, as fiduciaries advisers have an ongoing obligation to inform their clients of any material information that could affect the advisory relationship. As a result, advisers may be required to disclose material changes to clients between annual updating amendments even if those changes do not trigger delivery of an interim update. See Note to Proposed Instruction 2 to Part 2A; see also Form ADV: General Instruction 4.

149 Currently, existing rule 206(4)-4 requires disclosure of such disciplinary events. The proposed requirement of interim updates to the brochure would require that such disclosure be written.

it adequately enable advisers to minimize costs by making delivery in conjunction with existing mailings?

b. Updating Part 2 of Form ADV

Similar to the existing requirements, the proposed rules would require advisers to keep the brochures they file with us current by updating them at least annually, and updating them promptly when any information in the brochures becomes materially inaccurate.[150] In the case of both annual and interim updates, advisers will be able to make changes to their brochures using their own computers and then simply submit the revised versions of their brochures through IARD.[151] In some cases, an adviser will be required to submit an annual updating amendment, but may not have any changes to make to its brochure (because the currently filed brochure does not contain any materially inaccurate information). The IARD system will give the adviser the option of indicating on IARD that its current brochure does not contain any materially inaccurate information and that the adviser is not attaching another brochure. Although previously-filed versions

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150 See proposed amended rule 204-3(g), and proposed Instruction 4 to Form ADV, Part 2A. As discussed above, the proposed updating requirement would be similar to the existing standard. See current rule 204-1 and Form ADV: General Instruction 4. Additionally, proposed Instruction 4 to Part 2A and a proposed Note to Item 4.E would state that an adviser does not need to update its brochure solely because the amount of its client assets has materially changed. This proposed instruction reflects our understanding that in most cases the amount of an adviser's assets under management will likely continually change over the course of a year due to market fluctuations, and that requiring advisers to update their brochure in each instance would be burdensome and of limited value. This approach is similar to that we currently take with respect to advisers' obligations to update assets under management reported in Item 5 of Form ADV, Part 1A. See Form ADV: General Instruction 4. For similar reasons, proposed Instruction 4 to Part 2A also would state that an adviser does not need to update its brochure solely because its fee schedule has changed. Advisers would, however, be required to update their brochure to reflect material changes with respect to listed assets and fee schedules if they are otherwise updating their brochure for a separate reason.

151 Proposed rule 204-1(b).

of an adviser's brochures will remain stored as Commission records in the IARD system, as with an adviser's Part 1A filings, only the most recent version of an adviser's brochure will be available through the Commission's public disclosure Web site.[152] The purpose of the public disclosure Web site is to provide the public with current information about advisers, rather than historic information.[153]

We request comment generally with respect to our proposed requirements for updating brochures. We request comment specifically about the proposal to require ongoing updating. Should we develop different updating requirements for the different disclosure items of the brochure in a manner similar to the updating requirements for Form ADV, Part 1A (e.g., require more frequent updating with respect to changes to an adviser's listed fee schedule)? We also request comment about whether we should make advisers' historical brochure filings available via the Commission's public disclosure Web site.

B. Part 2B: The Brochure Supplement

In 2000, we expressed our concern that, because the information in current Part 2 concerns the advisory firm, clients may not receive information they want and need about the firm's employees with whom they have contact and on whom they rely for investment advice.[154] In the case of smaller advisers, the current disclosure requirements, which focus on the senior executives of the advisory firm, may be adequate. But in large

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152 See note 6 above. In the case of an adviser that prepares, files and delivers to clients separate brochures for the various different advisory services it offers, the most recent version of each of its brochures would be available via the public disclosure Web site.

153 Advisers' historic brochure filings would be available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549.

154 For example, current Part 2 requires background information only on firm executives and members of the firm's "investment committee." Item 6 of Part 2 of Form ADV.

advisory firms, which account for a significant number of SEC-registered advisers, clients may never meet the firm's senior executives, who may be located in a different city and may have only an indirect effect on the advice given to the client.[155] We believe clients of these firms also are interested in the background, disciplinary record (if any), and qualifications of the individuals with whom they are dealing.

Therefore, we proposed in 2000, and are today reproposing, a requirement that adviser brochures be accompanied by brochure supplements that provide information about the advisory personnel on whom clients rely for investment advice. A brochure supplement ordinarily would be less than a page long and would contain information about the educational background, business experience, and disciplinary history (if any) of the supervised person who provides advisory services to that client.[156]

We received a large number of comments on the brochure supplement proposal. Several commenters, including those representing financial planners, investment consultants, and consumer groups, praised the supplement as a highly practical and beneficial tool for informing clients about the qualifications and background of the individuals on whom they rely for investment advice.[157] Several others, including a number of investment advisers, argued that ensuring proper distribution of supplements at

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[155] Based on advisers' responses to questions on Part 1A of Form ADV as of September 30, 2007, more than 475 of the investment advisers registered with the Commission report on Part 1A of their Form ADV that they have more than 50 employees who perform investment advisory functions on behalf of the firm. (IARD Data as of Sept. 30, 2007).

[156] Proposed rule 204-3(b)(2).

[157] E.g., AIMR Letter; CFA Letter; Consortium Letter; FPA Letter; Comment Letter of the Investment Management Consultants Association (June 12, 2000).

large firms would be costly and burdensome.[158] Some maintained that clients do not want the information that would be contained in a supplement.[159] Another commenter, the IAA, acknowledged that consumers hiring professionals in any field often inquire about the individuals' credentials in addition to the firm's reputation, but urged that we narrow the rule so as not to require advisers to deliver the supplement to institutional clients.[160]

We continue to believe that information contained in the brochure supplement may be very important to clients. In response to commenters' concerns, however, we have made a number of changes that are intended to reduce burdens on advisers subject to the rule. As discussed in more detail below, we would modify the delivery requirement, reduce the number of types of clients to whom advisers would be required to provide supplements, clarify the format of the supplements to maximize the amount of flexibility advisers have in preparing a supplement, and limit the information that would have to be included in the supplement.

1. Delivery and Updating

We originally proposed to require that each adviser provide its clients with a brochure supplement for each supervised person who provides advisory services to that

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158 E.g., AmEx Letter; June 2000 IAA Letter; ICI Letter; Comment Letter of Legg Mason, Inc. (June 13, 2000) ("Legg Mason Letter"); Merrill Letter; Paine Webber Letter; Comment Letter of Salomon Smith Barney Inc. (June 13, 2000) ("Salomon Letter"); Schwab Letter; SIFMA Letter; TIAA-CREF Letter; T. Rowe Price Letter; Comment Letter of United Services Planning Association, Inc. and Independent Research Agency for Life Insurance, Inc. (June 12, 2000) ("USPA Letter"); Wellington Letter.

159 Merrill Letter; Salomon Letter; Schwab Letter; SIFMA Letter.

160 May 2001 IAA Letter.

client.[161] In response to comments, we are limiting the circumstances in which an adviser would be required to deliver the supplement.[162]

The proposed amendments would require that a client be given a brochure supplement for each supervised person who (i) formulates investment advice for that client and has direct client contact,[163] or (ii) makes discretionary investment decisions for that client's assets, even if the supervised person has no direct client contact.[164] We believe that requiring supplements for these categories of supervised persons would provide clients with the information they want and need about the particular individuals on whom they will rely for investment advice. We originally proposed, but have eliminated, a provision requiring delivery of a supplement for a supervised person who

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161 See Proposing Release at Section II.D.2.

162 See note 158 above. A number of commenters argued that advisers should only be required to deliver brochure supplements of supervised persons who actually formulated investment advice. Crist Letter; June 2000 IAA Letter; ICI Letter; TIAA-CREF Letter; T. Rowe Price Letter. Nine commenters argued that brochure supplements should not be required of supervised persons who act as solicitors. Crist Letter; DP&W Letter; Comment Letter of Federated Investors Inc. (June 13, 2000) ("Federated Letter"); FPA Letter; June 2000 IAA Letter; ICI Letter; TIAA-CREF Letter; T. Rowe Price Letter; USPA Letter. Some commenters urged limiting delivery to certain types of clients, such as "retail" clients, but not to sophisticated or institutional clients.

163 An adviser would not have to provide a supplement for a third-party solicitor because solicitors already must deliver a disclosure document to potential advisory clients. Rule 206(4)-3 [17 CFR 275.206(4)-3].

164 An adviser would not, however, have to provide a supplement for a supervised person who provides discretionary advice only as part of a team and has no direct client contact as we believe that when investment advice is formulated by a team, specific information about each individual team member takes on less importance. Proposed Instruction 1 to Part 2B.

The supervised person's supplement must be given to the client at or before the time that supervised person begins to provide advisory services to that client. Proposed rule 204-3(b)(2) and proposed Instruction 3 to Part 2B. Although the amendments we are proposing today would require the advisory firm to deliver the brochure supplement, we recognize that in most cases advisers' supervised persons will actually deliver the required supplements to clients on behalf of the advisory firm.

merely communicates investment advice. Commenters pointed out that our original proposal would have required disclosure of the backgrounds of client service representatives who transmit investment advice to clients, but who have no influence on the advice given. To limit disclosure about employees with whom a client may have no contact or about employees who do not influence the advice given to the client, we have more narrowly tailored the proposed supplement delivery requirements so that a particular client would receive disclosure specifically about those persons on whom he relies for investment advice.

As reproposed, an adviser generally would be required to provide its clients with a brochure supplement for each supervised person who provides advisory services as described above. However, advisers would not be required to deliver supplements to four types of clients: (i) clients to whom an adviser is not required to deliver a firm brochure (e.g., registered investment companies and business development companies); (ii) clients who receive only impersonal investment advice;[165] (iii) clients who are "qualified purchasers;"[166] and (iv) certain "qualified clients" who also are officers, directors,

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165 This exception from the supplement delivery requirement differs slightly from the exception from the brochure delivery requirement, in that it does not depend on the cost of the impersonal advisory services involved. This is because in situations involving impersonal advisory services, the nature of the services are such that supervised persons of the adviser are unlikely to be directly providing advisory services to clients. As a result, we believe that in such situations requiring supplement delivery would result in an unnecessary expense with little appreciable benefit. We believe, however, that delivery of a firm brochure would be useful where the cost of the impersonal advisory services is significant, that is $500 or above.

166 "Qualified purchasers," as defined under section 2(a)(51)(A) of the Investment Company Act of 1940 [15 USC 80a-2(a)(51)(A)], include, among others, natural persons who own $5 million or more in investments and persons who manage $25 million or more in investments for their account or other accounts of other qualified purchasers.

employees and other persons related to the adviser.[167] An adviser that does not have any clients to whom a supplement would have to be delivered would not have to prepare any supplements. Similarly, an adviser would not have to prepare a supplement for any supervised person who does not have clients to whom the adviser must deliver a supplement.

The first two categories of clients were included in our 2000 proposal. Commenters did not address these exceptions to the supplement delivery requirement. We propose to add the latter two exceptions in response to several commenters' arguments that certain institutional and sophisticated clients do not need the protections of the brochure supplement requirement because they are in a position to obtain, and frequently do obtain, information about the advisory personnel on whom they rely for investment advice.[168]

We request comment on our assumption that some clients do not need the protections afforded by a requirement that an adviser deliver a brochure supplement even though we would continue to require delivery of the brochure. Should we use a higher threshold to exclude clients, such as "Qualified Institutional Buyers?"[169] Should we use a

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[167] Rule 205-3(d)(1)(iii) defines certain related persons of an adviser as "qualified clients," including: (i) any executive officers, directors, trustees, general partners, or persons serving in a similar capacity, of the advisory firm; and (ii) any employees of the advisory firm (other than employees performing solely clerical, secretarial or administrative functions) who, in connection with their regular functions or duties, participate in the investment activities of the firm and have been performing such functions or duties for at least 12 months.

[168] See DE Shaw; Federated Letter; June 2000 IAA Letter; T. Rowe Price Letter; Wellington Letter.

[169] "Qualified Institutional Buyer," as defined under rule 144a of the Securities Act of 1933 [17 CFR 230.144a], includes entities that own and invest on a discretionary basis at least $100 million in securities.

lower one, and exclude all clients who are "qualified clients" under rule 205-3, rather than just those qualified clients that are officers, directors and employees of the adviser?[170] In December 2006, the Commission proposed, but has not adopted, new rules 509 and 216 under the Securities Act of 1933, that would define the term "accredited natural person."[171] We ask for comment on whether we should create an exclusion from supplement delivery for accredited natural persons. In particular, with respect to natural persons, we request comment on whether "accredited natural person" or "qualified client" is the appropriate standard to use or whether it would be more appropriate to use the higher "qualified purchaser" standard.[172]

In 2000, we proposed to require that advisers promptly deliver to existing clients a revised supplement (or a sticker) whenever information in the supplement became materially inaccurate.[173] Today, we propose to reduce the frequency with which advisers would have to deliver clients an updated supplement so that they would only deliver them to existing clients when new disclosure of a disciplinary event, or a material change to

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170 "Qualified client," as defined under rule 205-3 of the Advisers Act [17 CFR 275.205-3], includes natural persons with $750,000 under management with the adviser and individuals who have a net worth of $1.5 million.

171 Proposed new rules 509 and 216 under the Securities Act of 1933 would add to the existing definition of "accredited investor" and apply to private offerings of certain unregistered investment pools. As proposed, these rules would define the term "accredited natural person" under Regulation D and Section 4(6) of the Securities Act. "Accredited natural person" would be 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. See Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, Investment Advisers Act Release No. 2576 (Dec. 27, 2006) [72 FR 400 (Jan. 4, 2007)]. In August 2007, we proposed further general amendments to the definition of accredited investor. See Revisions of Limited Offering Exemptions in Regulation D, Securities Act Release No. 8828 (Aug. 3, 2007) [72 FR 45116 (Aug. 10, 2007)].

172 See note 166 above.

173 Proposing Release at n. 215.

disciplinary information already disclosed, in response to proposed Part 2B, Item 3, which we believe is critical information for clients. As we noted above, we believe disciplinary information is important because it reflects upon the supervised person's integrity and may affect a client's trust and confidence in that person.

As with the brochure, advisers would have to amend a brochure supplement promptly if information in it becomes materially inaccurate, and any new clients who would be required to receive that supplement must be given the amended version (or the "old" supplement and a sticker). Supplements, like brochures, could be delivered on paper or electronically.[174] However, unlike the delivery requirement for firm brochures, and because we believe most information in the supplement is less likely to become materially inaccurate over time, advisers would not be required to deliver supplements to existing clients annually. We request comment generally on the proposed updating and delivery requirements for brochure supplements. We also request comment on our proposal to require advisers to deliver updated supplements to clients describing changes to disciplinary information. Should we also require updated supplements to be delivered if other information changes?

2. Format

The proposed amendments would require advisers to write their supplements in plain English, but would give advisers considerable flexibility in presenting information in a format that best suits their firms.[175] This flexibility is designed to reduce the cost of preparing and delivering supplements. Advisers would be permitted to include

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[174] Proposed Instruction 4 to Part 2B.

[175] See Proposed Instruction 6 to Part 2B.

supplement information in the firm's brochure, an approach that may be attractive to smaller firms with few persons for whom they would be required to prepare supplements.[176] Advisers could also elect to prepare a supplement for each supervised person, or alternatively, they could prepare separate supplements for different groups of supervised persons (e.g., all supervised persons in a particular office or work group). We request comment generally on the proposed format for brochure supplements.

3. Supplement Items

Most commenters who addressed the proposed items supported the proposed content of the brochure supplements.[177] As we are proposing it today, Part 2B would consist of six items. We are proposing to omit two that we originally proposed in 2000. We would omit originally proposed Item 7, which would have required disclosure if the supervised person had been the subject of a bankruptcy petition during the past 10 years.[178] Commenters asserted that a personal bankruptcy is not necessarily indicative of a supervised person's investment advisory skills and thus need not be disclosed in the brochure supplement. In light of these comments, we have eliminated this item. Should we require disclosure of personal bankruptcies in supplements and, if so, why? We are proposing most of the other items, each of which we discuss below, as originally

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176 IARD data as of September 30, 2007 indicate that nearly 82 percent of advisers registered with us have 10 or fewer employees performing investment advisory functions on their behalf. Over 67 percent have five or fewer employees performing advisory functions.

177 E.g., AIMR Letter; CFA Letter; CFP Board Letter.

178 In 2000, we proposed disclosure of bankruptcy filings of supervised persons. We are, as discussed above, proposing Item 18 of Part 2A, which would require the firm's brochure to disclose whether the advisory firm has been the subject of a bankruptcy petition during the past 10 years.

proposed. In addition to our specific requests for comment, we request comment generally on each of these items.

Item 1. Cover Page. The supplement's cover page would include information identifying the supervised person and the advisory firm.

Item 2. Educational Background and Business Experience. Item 2 would require the supplement to describe the supervised person's formal education and his or her business background for the past five years.[179] If the supervised person either has no formal education after high school or has no business background, the adviser would have to disclose this fact in the supplement.

We are not, as originally proposed, including the requirement to describe professional designations or attainments. Advisers would be permitted, however, to include information about professional designations and attainments in the supplement if they so choose.[180] We are concerned that in light of the already large number and variety of existing designations, requiring such information may encourage the proliferation of fictitious and meaningless designations. In addition, our staff and other securities regulators have warned that investors may be confused by some professional designations, such as those that imply expertise in providing services to seniors.[181] We

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[179] Currently, Item 6 of Part 2 of Form ADV requires this information about the adviser's principal executive officers and about individuals who determine general investment advice on behalf of the adviser.

[180] Some commenters, however, supported disclosure of professional designations (AIMR Letter; CFP Board Letter; FPA Letter).

[181] See Protecting Senior Investors: Report of Securities Firms Providing "Free Lunch" Sales Seminars, Joint Report by the Staff of the Commission's Office of Compliance Inspections and Examinations, NASAA, and FINRA (available at http://www.sec.gov/spotlight/seniors/freelunchreport.pdf); Staff Update, "Senior" Specialists and Advisors: What You Should Know About Professional Designations

request comment about this approach. Should we require disclosure about professional designations and attainments? Are there additional items related to educational background and business experience that we should include? Have we included disclosure items that are not relevant?

Item 3. Disciplinary Information. Item 3 would require disclosure of any legal or disciplinary event that is material to a client's evaluation of the supervised person's integrity. Many commenters supported our 2000 proposal.[182] One commenter, the United Services Planning Association, opposed it, saying that such disclosure would be punitive and unnecessary. Some others suggested that the scope of the required disciplinary disclosure be narrowed, or that advisers might not have the information about their supervised persons' disciplinary history.[183] Two commenters, SIFMA and the FPA, recommended limiting the disclosure to events that are the subject of a final order or judgment, and not requiring disclosure if the supervised person is named in a pending criminal proceeding. Four commenters supported our proposal to require disclosure if a supervised person's professional designations are suspended or revoked, arguing that consumers would benefit from having full disclosure of all relevant information.[184] Three commenters opposed that disclosure, arguing among other things, that suspension or

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(available at http://www.sec.gov/investor/pubs/senior-profdes.htm). While we acknowledge that a number of well-regarded professional designations and attainments exist, the required credentials, training, and experience associated with different designations varies widely.

182 AIMR Letter; CFA Letter; CFP Board Letter; FPA Letter.

183 E.g., AmEx Letter; ICI Letter; Greenville Letter; Legg Mason Letter; Securities America Letter.

184 AIMR Letter; CFA Letter; CFP Board Letter; FPA Letter.

revocation proceedings do not "guarantee due process" and could occur for "mundane" reasons (e.g., failure to pay dues).[185]

In general, we believe that advisory clients would consider the listed disciplinary events critically important in determining whether to hire or retain an adviser or any specific supervised person of that adviser. We believe it is important that clients have information concerning disciplinary events that involve the persons who are substantially responsible for the investment advice that clients receive. Thus, we are proposing Item 3 largely as we proposed it in 2000 to require substantially the same disclosure requirements for the supervised person's disciplinary history as we are proposing for the firm's disciplinary history.[186]

In response to comments, we have clarified that an adviser would be required to disclose a proceeding that revoked or suspended the supervised person's professional attainment, designation, or license only if the action was a result of a violation of rules

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[185] AmEx Letter; June 2000 IAA Letter; T. Rowe Price Letter.

[186] As in proposed Item 9 of Part 2A, proposed Item 3 of Part 2B would include a list of events that are presumptively material if they occurred in the prior 10 years. The list parallels the proposed list of legal and disciplinary events in Item 9 of Part 2A that must be disclosed in the firm brochure and which are derived from the existing disclosure requirements set out in rule 206(4)-4. The list also is substantially similar to the list of disciplinary events advisers are already required to disclose in response to Item 11 of Form ADV, Part 1A. With respect to commenter's concerns regarding the burdens of requiring disclosure of "pending criminal proceedings," the required disclosure is narrow, as it would not include other investigations, or arrests or similar charges effected in the absence of a formal criminal indictment or information (or equivalent formal charge). See Form ADV: Glossary.

As under proposed Item 9 of Part 2A, proposed Item 3 of Part 2B would permit an adviser to rebut the presumption with respect to a particular event, in which case no disclosure to clients about the event would be required. We would, however, require an adviser rebutting a presumption of materiality to document that determination in a memorandum and retain that record in order to better permit our staff to monitor compliance with this important disclosure requirement. The same standard as under Item 9 would apply, and similarly, a note in Item 3 would explain four factors the adviser should consider when assessing whether the presumption can be rebutted.

relating to professional conduct.[187] We also added a proposed requirement that the supplement describe any event over which the supervised person has ever resigned or otherwise relinquished a professional attainment, designation or license in anticipation of it being suspended or revoked (other than for suspensions or revocations for failure to pay membership dues). We believe clients would wish to know about these kinds of events as they may reflect on the integrity of the supervised person.

We believe our proposal strikes an appropriate balance among the concerns raised by commenters. We request comment on whether it does. Are there listed disciplinary events that we should remove or modify? Are there additional types of disciplinary events that we should list? For example, should we require disclosure of all cease and desist and censure orders? Are there other events, such as arbitration claims or awards, which could be characterized as disciplinary and should be disclosed in a supplement? If we were to require advisers to make disclosure regarding arbitration claims or awards, should we require such disclosure only if the award or claim exceeds a specified amount? If so, what should that amount be?[188] Is any of the proposed information not useful to advisory clients?

Item 4. Other Business Activities. Item 4 would require an adviser to describe other business activities of its supervised person. The item specifically would require disclosure with respect to other capacities in which the supervised person participates in any investment-related business and any conflicts of interest such participation may

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187 See CFP Board Letter; T. Rowe Price Letter.

188 Determining whether to include disclosure of arbitration proceedings in brochure supplements raises the same issues as would be involved in requiring such disclosure in firm brochures. See discussion above at notes 69-70 and accompanying text.

create.[189] In addition, we would require the supplement to include information about any compensation, including bonuses and non-cash compensation, the supervised person receives based on the sales of securities as well as an explanation of the incentives this type of compensation creates.[190] As we noted in the Proposing Release, this practice creates an incentive for the supervised person to base investment recommendations on his own compensation rather than on clients' best interests.[191] We are also proposing, with some revisions, a requirement to disclose other business activities or occupations that the supervised person engages in for pay.[192] Clients may have different expectations of an individual whose sole business is providing investment advice than of an individual who is engaged in other substantial business activities.

One commenter, the CFA, enthusiastically supported our proposal, stating that clients would benefit greatly from disclosures about a supervised person's other business activities. Two others, T.Rowe and the IAA, argued that disclosure of other business activities should be limited to substantial investment-related activities that provide a major source of that person's income. We would continue to require disclosure of other business activities because we believe that, as reflected in the CFA's comments, investors would find this information helpful in assessing the conflicts created by those activities. We are not limiting the proposed disclosure of other investment-related activities to those characterized as "substantial," because we believe the client is in the best position to

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[189] Proposed Item 4.A of Part 2B.

[190] Proposed Item 4.A.2 of Part 2B.

[191] See Proposing Release at n. 219 and accompanying text.

[192] Proposed Item 4.B of Part 2B.

assess the significance of any other business activities and the impact that they may have on their advisory relationship.

We are, however, proposing to require disclosure about only those non-investment-related business activities or occupations that provide a substantial source of the supervised person's income or that involve a substantial amount of the supervised person's time. We believe this responds to commenters' concerns by eliminating unnecessary disclosure about relatively insignificant other business activities, while still requiring important disclosures that inform clients of the supervised person's primary business activities. We request comment as to this approach. We request comment specifically with regard to whether this information would be useful to a client's evaluation of a supervised person's competence. Further, we have not defined "substantial" for purposes of this item, preferring instead to leave some flexibility for advisers to determine whether their supervised persons' non-investment related business provides a substantial source of income or involves a substantial amount of time. Is our approach appropriate?

Item 5. Additional Compensation. This proposed item would require that the supplement describe arrangements in which someone other than a client gives the supervised person an economic benefit (such as a sales award or other prize) for providing advisory services.[193] The proposed item would specify that regular salary need not be disclosed.

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193 Bonuses based (in part or whole) on sales, client referrals or new accounts would trigger required disclosure, but other bonuses would not.

One commenter, the CFA, strongly supported this proposed item, while two others objected, arguing that it would require disclosure of confidential and proprietary business information of the adviser.[194] While we understand that firms may wish to keep sales awards or prizes, and similar incentive structures, confidential, these types of arrangements can create significant and material conflicts of interest that may bias the advice being presented. We believe clients need to know about these arrangements in order to assess the advisory services of a firm's supervised person. Are we correct? In addition, we request comment on alternatives that might strike a different balance between concerns about disclosure of advisers' confidential and proprietary business information with clients' need to be informed of material conflicts of interest.

Item 6. Supervision. This item would require an adviser to explain how the firm monitors the advice provided by its supervised person.[195] It also would require a firm to provide the client with the name, title and telephone number of the person responsible for supervising the advisory activities of the supervised person. This information would permit the client to contact other advisory personnel when necessary to address any problems in the advisory relationship. We are proposing this item in the same form as we proposed it in 2000. Commenters who addressed the item supported disclosure of information on the supervision of the individual that is the subject of the supplement.[196]

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194 DE Shaw Letter; DP&W Letter.

195 As we discuss in more detail above in Section II.B.1of this Release, we have narrowed the scope of supervised persons who would need a supplement. As a result, we do not believe it is necessary to propose, as we did in 2000, to require the supplement to discuss who formulates the advice a supervised person gives to clients.

196 See AIMR Letter; CFA Letter.

C. Filing Requirements, Public Availability, and Transition

We propose to amend our rules to require advisers to file their new brochures with us electronically through the IARD system, which would permit us to make them publicly available through our Web site.[197] Part 1 of Form ADV has been filed electronically and the information contained in it publicly available since 2001. At the time we adopted the amendments to Part 1, we exempted advisers from submitting Part 2 to us because the IARD was not ready to accept those filings.[198] The required system functionality is now available, and we therefore propose to reinstate the filing requirement so that we, and members of the public, may have ready access to adviser brochures.

The IARD is able to accept brochure filings using the Adobe Portable Document Format ("PDF"), which would allow advisers to capture information from any application on any computer system.[199] Utilizing PDF format would promote accessibility to brochure filings by enabling users of our public disclosure Web site to access and read brochures filed on IARD without having to possess the particular software used by each adviser to prepare its brochure.[200] The PDF format, which limits transferability of computer viruses, also permits full-text search features that make it easy to locate words,

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197 Proposed rule 204-1(b). In some cases an adviser will not have to file a brochure because it is not required to deliver one. See above Section II.A.3 of this Release. When an adviser has not submitted a brochure as part of its Form ADV filing, the IARD system will generate an automated message asking an adviser that has not attached a brochure to its filing to confirm that it is not required to prepare a brochure.

198 See Note to current rule 204-1(c).

199 IARD system functionality for electronic filing of brochures is currently operational and the state securities regulators have been running a voluntary pilot program for advisers to file the current version of Part 2 using PDF.

200 PDF reader software is widely available and is a standard feature on most word processing software. Additionally, users may download this software for free from the Internet.

bookmarks, and data fields within a brochure, and it permits the IARD to accept brochures that include graphics and charts, so that advisers who choose to use more elaborate brochures need not also prepare a plain text version solely for purposes of filing it with the Commission. We believe that the ability to accept PDF filings presents the most flexible and cost-efficient approach.[201] We request comment about whether advisers currently have access to PDF conversion software. We also request comment, however, on whether we should permit advisers to file their brochures in other electronic formats. If so, which ones and why? Should we consider requiring advisers to file brochure information that makes use of data tagging technologies and taxonomies such as eXtensible Business Reporting Language ("XBRL")?[202]

The IARD will provide advisers with access to the Part 2 Items and instructions. Instead of completing Part 2 on-line, advisers will create their brochure on their own

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201 PDF converter software is already widely available and in many cases comes as a standard feature on word processing software. We anticipate that most, if not all, investment advisers will have access to such software, and thus would not need to incur additional expense associated with filing their brochure in PDF format were we to adopt this proposal. We are currently exploring options with the FINRA for making PDF converter software available to those investment advisers that do not already have it.

202 Data tagging uses standard definitions (or data tags) to translate text-based information into data that is interactive, i.e., data that can be retrieved, searched, and analyzed through automated means. XBRL is a language for the electronic communication of business and financial data that was developed as an open source specification that describes a standard format for tagging financial and other information to facilitate the preparation, publication, and analysis of that information by software applications. In 2005 we adopted rules instituting a program that permits certain filers, on a voluntary basis, to submit specified, supplemental disclosure tagged in XBRL format as an exhibit to certain filings on the Commission's Electronic Data Gathering, Analysis and Retrieval System ("EDGAR"). See XBRL Voluntary Financial Reporting Program on the EDGAR System, Securities Act Release No. 8529 (Feb. 3, 2005) [70 FR 6556 (Feb. 8, 2005)]. In July 2007, we extended the voluntary reporting program to enable mutual funds to submit supplemental tagged information contained in the risk/return summary section of their prospectuses. Extension Of Interactive Data Voluntary Reporting Program On The Edgar System To Include Mutual Fund Risk/Return Summary Information, Securities Act Release No. 8823 (July 11, 2007) [72 FR 39290 (July 17, 2007)].

computers and then attach the completed document to their filing on IARD, much like attaching a document to an e-mail. To update brochures, advisers will make the necessary changes on their own computers and then attach the revised versions to an IARD filing. The IARD will not accept an annual updating amendment without an updated brochure. However, if no changes are necessary when an adviser is submitting its annual updating amendment, an adviser will have the option of indicating on IARD that its current brochure does not contain any materially inaccurate information. If an adviser ceases to use a particular brochure, it will be able to eliminate it from its current filing. Our Web site will make only the firm's current filings publicly available because that filing should contain the most up-to-date information about the adviser.[203]

As proposed, advisers would not be required to file brochure supplements or supplement amendments with the Commission and therefore they will not be available on the Commission's public disclosure Web site.[204] We are not proposing to require filing of supplements so as to reduce the potential burdens on advisers and because the supplement disclosure requirement is designed primarily to provide advisers' clients with background information about the particular supervised persons with whom they are dealing. We believe this information is less likely to be of interest to the general

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[203] As discussed above, historical filings would nonetheless be available for public inspection and copying in the Commission's Public Reference Room. See above note 153.

[204] Proposed rules 203-1(b) and 204-1(c) and proposed Instruction 8 to Part 2B of Form ADV. Because brochure supplements would not be filed with us, they would not be required as part of any state notice filing. Section 307(a) of the National Securities Market Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996) (state securities authorities may only require SEC-registered advisers to file with the states copies of those documents advisers have filed with the Commission).

investing public.[205] Advisers would be required, however, to maintain copies of all supplements and amendments in their files.[206] We request comment on our approach. Should we require brochure supplements and amendments to brochure supplements to be filed with us through the IARD system and be made to available to the public through our Web site?

To provide adequate notice and opportunity to comply with the proposed brochure filing requirements, new applicants for registration with us as investment advisers would not be required to include their brochures as part of their initial application for registration until the date six months after the effective date of the amendments. After that date, however, the Commission would not accept any initial application for registration as an investment adviser that does not include a brochure that satisfies the requirements of Part 2A of Form ADV.[207]

Similarly, we believe it would be helpful to provide sufficient time for advisers already registered with us to prepare the new brochure and brochure supplements. Accordingly, we propose to implement a transition schedule requiring advisers to comply with the new Part 2 requirements by the date they must make their next annual updating amendment to Form ADV following the date the revised form becomes effective. In no case, however, would any adviser be required to comply with the new requirements

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205 We note that the disciplinary history of an adviser's supervised persons is required to be reported as part of the adviser's filing of Part 1 of Form ADV, and is available to the Commission through the IARD and to the public via the Commission's public disclosure Web site.

206 Proposed rules 203-1(b) and 204-1(c) and proposed Instruction 8 to Part 2B of Form ADV.

207 Proposed rule 203-1(a)(2).

earlier than six months after they become effective.[208] We request comment on our proposed implementation plan. Would a six-month period from the effective date of the revised form provide enough time for advisers to complete their new brochures? If not, please explain why and how much time advisers would need to complete their new brochures. Should implementation of the brochure requirements be on a separate timetable from implementation of the brochure supplement requirements?

III. AMENDMENTS TO FORM ADV INSTRUCTIONS AND GLOSSARY

In conjunction with the proposed Part 2 amendments, we are also proposing to make conforming amendments to the General Instructions and the Glossary of Terms for Form ADV. We propose amending the General Instructions to Form ADV to include instructions regarding brochure filing requirements. Similarly, we would amend the Glossary of Terms to add the following five terms that are used in proposed Part 2: (i) "brochure;"[209] (ii) "brochure supplement;"[210] (iii) "investment adviser representative;"[211] (iv) "supervised person;"[212] and (v) "wrap brochure or wrap fee

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208 Proposed rule 204-1(b)(2).

209 "Brochure" would mean: "A written disclosure statement that your firm is required to provide to clients and prospective clients." See Form ADV: Glossary.

210 "Brochure supplement" would mean: "A written disclosure statement containing information about certain of your supervised persons that your firm is required by Part 2B of Form ADV to provide to clients and prospective clients." See Form ADV: Glossary.

211 "Investment adviser representative" would mean:

> Any of your firm's supervised persons (except those that provide only impersonal investment advice) is an investment adviser representative, if --
>
> - the supervised person regularly solicits, meets with, or otherwise communicates with your firm's clients,
> - the supervised person has more than five clients who are natural persons and not high net worth individuals, and

program brochure."[213] We also would update the Glossary to reflect cross-references to these new terms, and cross-references to existing Glossary entries used in the revised portions of the Form.

We also are proposing to update the Glossary to correct a discrepancy in the definition of "Non-Resident" to make it consistent with the definition in rule 0-2, the Advisers Act rule related to the procedures for serving process, pleadings, and other papers on non-resident investment advisers, and advisers' non-resident general partners and managing agents. This proposed revision would properly effect the Commission's intent at the time the Glossary was originally adopted, that the definition of "Non-Resident" in the Glossary be the same as that in rule 0-2.[214] Although technical in nature, this amendment may potentially result in an increased number of corporate entities qualifying as non-resident general partners or managing agents of SEC-registered advisers. Certain entities would be required to file Form ADV-NR with the Commission

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- more than ten percent of the supervised person's clients are natural persons and not high net worth individuals. See Form ADV: Glossary.

212 "Supervised person" would mean: "Any of your officers, partners, directors (or other persons occupying a similar status or performing similar functions), or employees, or any other person who provides investment advice on your behalf and is subject to your supervision or control." See Form ADV: Glossary.

213 "Wrap brochure or wrap fee program brochure" would mean: "The written disclosure statement that sponsors of wrap fee programs are required to provide to each of their wrap fee program clients." See Form ADV: Glossary.

214 This proposed amendment would change the definition of "Non-Resident" to include "a corporation incorporated in or having its principal place of business in any place not subject to the jurisdiction of the United States." (Emphasis added). See rule 0-2(b)(2) [17 CFR 275.0-3(b)(2)]. The current Glossary definition includes a "corporation incorporated in and having its principal place of business in any place not subject to the jurisdiction of the United States." (Emphasis added). See Form ADV: Glossary. Inclusion in the current Glossary definition of the conjunctive "and" rather than the disjunctive "or" was unintentional.

to appoint agents for service of process because they relied on the glossary definition and did not previously file the form.

We request comment on these proposed amendments.

IV. AMENDMENTS TO RULE 204-2

We also are proposing conforming amendments to Advisers Act rule 204-2, the rule that sets forth the requirements for maintaining and preserving specified books and records, to require SEC-registered investment advisers to retain copies of each brochure, brochure supplement, and each amendment to the brochure and supplements that are prepared as required under the rule 204-3.[215] This proposed change is designed to update the books and records rule in light of our proposed changes to Part 2.[216] Additionally, the proposed amendments would require SEC-registered advisers to prepare and preserve documentation of the method they use to compute managed assets for purposes of Item 4.E in Part 2A of Form ADV, if that method differs from the method used to calculate "assets under management" in Part 1A of Form ADV.[217] The amendments also would require advisers to prepare and preserve a memorandum describing any legal or disciplinary event listed in Item 9 in Part 2A and Item 3 in Part 2B of Form ADV for the period the event is presumed material, if the event is not disclosed in the adviser's

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215 Proposed rule 204-2(a)(14)(i). The proposed rule also would require advisers to keep and maintain a copy of any summary of material changes that is not included in the brochure or brochure supplements, as well as a record of the dates that each brochure, supplement, amendment, and summary of material change was given to any client. See discussion above at notes 27-29 and accompanying text.

216 Currently, rule 204-2(a)(14) requires advisers to maintain copies of written statements and amendments given or delivered to any client or prospective client under existing rule 204-3. Thus, advisers already are required to maintain copies of their brochures.

217 See discussion above at note 33.

brochure or the relevant brochure supplement.[218] These records would be required to be maintained in the same manner, and for the same period of time, as other books and records required to be maintained under rule 204-2(a). We request comment on these proposed amendments.

V. GENERAL REQUEST FOR COMMENT

The Commission requests comment on the amendments proposed in this Release, suggestions for other additions to the amendments, 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 amendments on the economy on an annual basis. Commenters should provide empirical data to support their views.

VI. PAPERWORK REDUCTION ACT

Certain provisions of the rule and form amendments that we are proposing today contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[219] The Commission is submitting these proposed amendments 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 titles for these collections of information are "Form ADV," "Rule 204-2," "Rule 204-3," and "Rule 206(4)-4," all under the Advisers Act. These rules and forms contain currently approved collection of information numbers under OMB control numbers 3235-0049, 3235-0278, 3235-0047,

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[218] See discussion above at notes 65-66 and accompanying text, and note 186.

[219] 44 U.S.C. 3501 et seq.

and 3235-0345, respectively. An agency may not sponsor, conduct, or require response to an information collection unless it displays a currently valid OMB number.

The respondents to the collections of information are investment advisers registered or applying for registration with us. We use the information to determine eligibility for registration with us and to manage our regulatory and examination programs. Clients use certain of the information to determine whether to hire or retain an adviser.

The amendments to Form ADV we are proposing involve three distinct "collections of information" for purposes of the Paperwork Reduction Act. The first is the collection of information connected with Form ADV itself, specifically our proposed amendments to Part 2 of Form ADV. The second collection of information involved is that under the proposed amendment to rule 204-2, which requires advisers to maintain and preserve specified books and records. The third collection involved is that related to a proposed amendment to rule 204-3, which requires advisers to deliver certain of the information required under Form ADV to their clients.

In addition, we are proposing to withdraw rule 206(4)-4, the rule requiring advisers to disclose certain disciplinary and financial information, because that rule will become duplicative if the amendments to Part 2 of Form ADV are adopted. We incorporate the discussion of our proposed withdrawal of rule 206(4)-4 into the discussion of Part 2 of Form ADV below.

A. Amendments to Form ADV (17 CFR 275.203-1, 275.204-1, and 279.1)

We are proposing amendments to Part 2 of Form ADV to provide advisory clients with clear, current, and more meaningful disclosure in a narrative, plain English format.

Rules 203-1 and 204-1 already require every applicant for investment adviser registration with us to file Form ADV through the IARD and require every investment adviser registered with us to file amendments to Form ADV through the IARD at least annually.[220] As proposed, the amendments to rules 203-1 and 204-1 and to Part 2 of Form ADV also would require advisers registered with us to prepare and electronically file firm brochures required by Part 2A, and to maintain copies of brochure supplements that they deliver to clients.

The information required by the proposed amendments to Form ADV is mandatory. Responses are not kept confidential. Under section 204 of the Advisers Act, investment advisers required to register with the Commission must make and keep certain records, including those related to Form ADV, for prescribed periods, generally for a period of at least five years, and must make and disseminate certain reports. In 2000, when we originally proposed revisions to Form ADV (including Part 2), we sought OMB approval of the increased burden stemming from the revised form.[221] The collection of information was approved and has subsequently been amended. The currently approved total annual burden for all advisers completing, amending, and filing revised Form ADV (Parts 1 and 2) with us, is 109,678 hours.[222] Because of the passage of time and

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220 Presently, advisers must submit Part 1 of Form ADV to us through the IARD system, but are not required to submit a copy of current Part 2 of Form ADV to the Commission if they maintain in their files a copy of their Part 2 (and of any brochure they deliver to clients). The copy they maintain in their files is considered filed with the Commission.

221 See Proposing Release, above note 5.

222 The paperwork burdens associated with rules 203-1 and 204-1 are included in the approved annual burden associated with Form ADV and thus, do not entail a separate collection of information.

modifications to the original proposal, we intend to resubmit the collection of information under Form ADV to OMB for approval.

1. Part 2 of Form ADV

In the Proposing Release, we acknowledged that the proposed amendments to Form ADV (including those to Part 2) would at first increase the then-current paperwork burden because most advisers would have to redraft and disseminate a narrative brochure and brochure supplements. We noted that most of the new paperwork burden would be incurred in this initial preparation, specifically in drafting the narrative text. We further observed that once the adviser has redrafted its narrative brochure, proposed Parts 2A and 2B were not expected to result in any significant burden increase over time (except for changes to the brochure that are necessitated by changes in the adviser's business). We continue to believe that the initial paperwork burden will be higher and that the efficiencies of filing through IARD, over time, are expected to reduce the initial burdens associated with completing the revised Form ADV.

The Commission staff previously estimated that during the first year that an adviser responds to Form ADV, including amended Part 2, an average investment adviser's total collection of information burden would be 22.25 hours per adviser.[223] We estimated that this average annual burden per adviser would apply to both new registrants applying for registration with us, as well as to current registrants required to amend their

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223 In the Proposing Release we estimated that during the first year, advisers' use of the revised form would result in an average annual collection burden of 22 hours per adviser. See Section IV of the Proposing Release. In conjunction with adoption of our rule requiring advisers to adopt codes of ethics, we amended this estimated burden by adding 0.25 hours to reflect the requirement that an adviser's Part 2 contain a description of its code of ethics and a statement that a copy of the code is available upon request. See Code of Ethics Adopting Release above note 78.

Form ADVs as a result of the proposed revisions. This estimate included time for preparation of brochures and brochure supplements in addition to the burden of preparing Part 1A. A few commenters, particularly those representing large advisory firms, disagreed with the Commission staff's estimate, arguing that it would take advisers much more time to complete and distribute their new narrative brochure and brochure supplements.[224] Large firms asserted that they would have "thousands" of employees for whom supplements would have to be prepared.

We appreciate the different costs that small versus large firms may experience, and so we have made it clear that our estimate is an average that takes into consideration the thousands of advisers that have a small number of employees as well as the few advisers that have thousands of employees. As of September 30, 2007, there were 10,817 investment advisers registered with the Commission, and nearly 82 percent of these advisers have 10 or fewer employees performing advisory functions on their behalf compared to less than one third of one percent of advisers who have more than 1,000 employees.[225] Moreover, the paperwork burden of preparing a narrative firm brochure is likely to vary substantially among advisers, in part because proposed Part 2A would give an adviser considerable flexibility in structuring its disclosure, and also because the amount of disclosure required would vary among advisers.[226] The burdens associated

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224 See, e.g., Crist Letter; SIFMA Letter; Comment Letter Dechert Price and Rhoads (June 14, 2000).

225 See note 176 above.

226 Additionally, since the 2000 proposal, we have made certain revisions to the proposed form that scale back the types of clients for whom brochures and supplements must be delivered. These revisions should actually have the effect of reducing the number of advisers who are required to prepare and update brochures, and thus may actually reduce somewhat the burden of the revised Form ADV from what was originally proposed.

with preparing the new brochures will depend on the size of the adviser, the complexity of its operations, and the extent to which its operations present conflicts of interest with clients. Many of the new items imposing the most rigorous disclosure requirements may not apply to certain small advisers because, for example, those advisers may not have soft dollar or directed brokerage arrangements, or may not have custody of client assets. Accordingly, based on our consultations with industry representatives, we estimate that the average initial annual burden associated with Form ADV may range from as little as 5 hours for smaller advisers, to approximately 50 hours for medium-sized advisers, to as much as nearly 3,300 hours for larger advisers.[227] Based on IARD data, we estimate that there are approximately 8,835 small advisers, 1,952 medium-sized advisers, and 30 large advisers.[228] As such, we believe that 22.25 hours remains an accurate reflection of the time that it will take the average adviser to complete revised Form ADV (including both Parts 1 and 2).[229]

As under the currently approved collection, the estimated initial burdens associated with using the revised form would be amortized over the estimated period that advisers would use their revised brochure. Thus, we have amortized the paperwork burdens of the revised form over a three-year period.[230] Respondents under this

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227 For purposes of this estimate, we have categorized small advisers as those with 10 or fewer employees, medium-sized advisers as those with between 11 and 999 employees, and large advisers as those with 1,000 or more employees.

228 Unless otherwise noted, the IARD data cited below is based on advisers' responses to questions on Part 1A of Form ADV as of September 30, 2007.

229 [8,835 small advisers x an estimated 5 hours/adviser] + [1,952 medium-sized advisers x an estimated 50 hours/adviser] + [30 large advisers x an estimated 3,296 hours/adviser] = 240,655 hours total. 240,655 hours / 10,817 total advisers = 22.25 hours/adviser.

230 In the Proposing Release, the Commission staff chose a fifteen-year amortization period to reflect the anticipated period of time that advisers would use the revised form.

collection of information would be advisers currently registered with the Commission as well as new applicants for investment adviser registration with the Commission. We estimate that approximately 1,000 new applicants apply for registration as investment advisers each year. Thus, in combination with the approximately 10,817 existing investment advisers registered with the Commission, we estimate that the total number of respondents under this collection of information would be 11,817 advisers. Based on the estimated average collection of information burden of 22.25 hours per adviser, the total initial collection of information would amount to 22,250 hours for new registrants and 240,678.25 hours for currently registered advisers that re-file Form ADV (including Part 2) through the IARD system, for a total of 262,928.25 hours.[231] Amortizing this total burden imposed by Form ADV over a three-year period would result in an average burden of an estimated 87,643 hours per year,[232] or of 7.42 hours per year for each new applicant and for each adviser currently registered with the Commission that would re-file through the IARD.[233]

We further estimate that some advisers may incur a one-time initial cost including outside legal fees in connection with preparation of Form ADV (including preparation of Part 2). As we discuss above, advisers subject to the Form ADV requirements vary widely in terms of the size, complexity and nature of their advisory business, and thus, the

However, for purposes of our current proposal, we are amortizing the estimated burden over a shorter period of time – three years – and have submitted to OMB an amendment to this collection of information to reflect this approach.

231 Based on historic IARD registration data, we estimate that approximately 1,000 new applicants for registration with the Commission each year. (10,817 current registrants x 22.25 hours) + (1,000 new applicants x 22.25 hours) = 240,678.25 hours + 22,250 hours = 262,928.25 hours.

232 262,928.25 hours / 3 years = 87,642.75 hours/year.

233 87,643 hours / 11,817 advisers = 7.42 hours/adviser.

amount of disclosure required, would vary substantially among advisers. Accordingly, the amount of time, and thus cost, required for outside legal review is likely to vary substantially among those advisers who elect to obtain outside legal assistance. We estimate that the initial per adviser cost related to preparation of Form ADV may range from as little as $1,200 for smaller advisers, to $4,400 for medium-sized advisers, to as much as $10,400 for larger advisers.[234] Similarly, whether an adviser even seeks outside legal services in drafting their Form ADV will depend on the size, complexity and nature of their advisory business. We believe that a substantial percentage of advisers, particularly smaller advisers, are unlikely to seek such outside legal services. We estimate that only a quarter of smaller advisers, or about 2,209 advisers, are likely to seek outside legal services. Similarly, we estimate that approximately half of medium-sized advisers, or 976 advisers, are likely to seek such services.[235] On the other hand, advisers with more significant conflicts are more likely to engage outside legal services to assist in preparation of Form ADV. On this basis we estimate that all of the 30 larger advisers registered with the Commission are likely to incur costs related to such outside legal services. Thus, we estimate that approximately 3,215 advisers, will elect to obtain outside legal assistance, for a total cost among all respondents of $7,257,200.[236]

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[234] Outside legal fees are in addition to the projected hourly per adviser burden discussed above. $400 per hour for legal services x 3.0 hours per small adviser = $1,200. $400 per hour for legal services x 11 hours per medium-sized adviser = $4,400. $400 per hour for legal services x 26 hours per large adviser = $10,400. The hourly cost estimate of $400 is based on our consultation with advisers and law firms who regularly assist them in compliance matters.

[235] 8,835 small advisers x 0.25 = 2,208.75. 1,952 medium-sized advisers x 0.5 = 976.

[236] ($1,200 x 2,209 advisers) + ($4,400 x 976 advisers) + ($10,400 x 30 advisers) = $7,257,200.

In addition to the burdens associated with initial completion and filing of the revised form, we estimate that on average, each adviser filing Form ADV through the IARD system will likely amend its form 1.5 times during the year.[237] We estimate that the collection of information burden for amendments would be 0.75 hours per amendment. Thus, we estimate that advisers will file an estimated total of 17,725.5 amendments per year for an estimated total paperwork burden of 13,294 hours per year.[238]

Therefore the total annual collection of information burden for advisers to file and complete the revised Form ADV (Parts 1 and 2), including the initial burden for both existing and anticipated new registrants plus the burden associated with amendments to the form, is estimated to be approximately 100,976 hours per year.[239] In addition to these estimated burdens, under this collection of information there is also a burden of 11,971 hours associated with advisers' obligations to deliver to clients copies of their adviser codes of ethics.[240] Thus, the estimated revised total annual hourly burden under this

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237 This estimate is based on IARD system data regarding the number of filings of Form ADV amendments.

238 11,817 advisers x 1.5 amendments per year = 17,725.5 amendments per year. 17,725.5 amendments x 0.75 hours = 13,294.125 hours.

239 13,294 hours per year attributable to amendments + (1,000 new registrants each year x 7.42 hours) + (10,817 currently-registered advisers x 7.42 hours) = 13,294 hours + 7,420 hours + 80,262.14 hours = 100,976.14 hours.

240 See Code of Ethics Adopting Release, above note 78. The current approval of this collection estimates that ten percent of an adviser's clients would make such requests, however, subsequently obtained information based on discussions with the industry regarding actual practice indicates that such requests occur significantly less frequently than previously estimated, thus, we have modified our estimate. We now estimate that only one percent of an adviser's clients actually request a copy the adviser's code of ethics. 0.01 x 1,013 (the estimated average number of clients per adviser) = 10.13 requests per registrant. See note 258 below regarding the estimated average number of clients. We continue to estimate that responding to each such request involves a burden

collection of information would be 112,947 hours.[241] This represents an increase of 3,269 hours per year from the currently approved burden.[242]

2. Rule 206(4)-4

Rule 206(4)-4 currently requires advisers to disclose certain disciplinary and financial information to clients. We are proposing to rescind rule 206(4)-4 and to incorporate its substantive provisions into Part 2A of Form ADV. The collection of information burden associated with the requirements of rule 206(4)-4 has been incorporated into the collection of information requirements for Form ADV, discussed above. Thus, the currently approved burden estimate for Form ADV already includes an estimate of the burdens associated with the disclosure of disciplinary and financial information connected with proposed Part 2.

B. Rule 204-2

This requirement is found at 17 CFR 275.204-2 and is mandatory. The Commission staff uses the collection of information in its examination and oversight program, and the information generally is kept confidential.[243] The likely respondents to

of 0.10 hours, amounting to an annual burden of 1.013 hours for each adviser stemming from the obligation to deliver copies of their codes of ethics to clients. 10.13 requests per adviser x 0.10 hours = 1.013 hours/adviser. This obligation applies to both currently-registered (10,817 respondents) and newly-registered advisers (1,000 respondents), for a total annual burden of 11,971 hours. 11,817 respondents x 1.013 hours = 11,970.621 hours.

241 11,971 hours + 100,976 hours = 112,947 hours.

242 Revised burden 112,947 hours - currently approved burden of 109,678 hours = 3,269 hours. As discussed above, the currently approved burden includes the estimated paperwork burdens associated with all the revisions to Form ADV that were proposed in 2000.

243 See section 210(b) of the Advisers Act (15 U.S.C. 80b-10(b)).

this collection of information requirement are all of the approximately 10,817 advisers currently registered with the Commission.

Under section 204 of the Advisers Act, investment advisers required to register with the Commission must make and keep certain records for prescribed periods, generally for a period of at least five years, and must make and disseminate certain reports. Rule 204-2 sets forth the requirements for maintaining and preserving specified books and records.

The amendments to rule 204-2 that we are proposing today would require SEC-registered advisers to prepare and preserve a memorandum describing any legal or disciplinary event listed in Item 9 in Part 2A and Item 3 in Part 2B of Form ADV, if the event is not disclosed in the adviser's brochure or the relevant brochure supplement. This revision is the same as originally proposed. Additionally, the amendments would also require SEC-registered investment advisers to prepare and preserve documentation of the method they use to compute managed assets for purposes of Item 4.E. in Part 2 of Form ADV, if that method differs from the method used to calculate "assets under management" in Part 1A of Form ADV. These records would be required to be maintained in the same manner, and for the same period of time, as other books and records required to be maintained under rule 204-2(a).

As discussed in the Proposing Release, Commission staff had estimated that the proposed amendments to rule 204-2 would result in a burden increase of four hours for each of the then estimated 110 Commission-registered advisers that would be required to prepare and preserve additional records as a result of the amendments. We continue to

believe that the proposed amendments to rule 204-2 will result in an increased burden of four hours for each adviser subject to the additional requirements.[244]

We estimate that 325 advisers will use a method for computing managed assets in Part 2 that differs from the method used to compute assets under management in Part 1A and thus would be required to prepare and preserve documentation describing the method used in Part 2.[245] We also estimate that 162 advisers will conclude that the materiality presumption in Part 2 is overcome with respect to a legal or disciplinary event, will determine not to disclose that event, and therefore would be required to prepare and preserve a memorandum describing the event.[246]

As discussed earlier, in the Proposing Release Commission staff had estimated that 110 advisers would have to prepare and preserve additional records in accordance with the amendments to rule 204-2. However, we now estimate that a total of 487 advisers will have to prepare and preserve additional records in accordance with

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244 The proposed rule did not require documentation for Item 4.E computations that differed from Part 1A, Item 5.F of Form ADV. We estimate that the additional recordkeeping requirement applicable to advisers who use an alternative method of asset calculation will take approximately the same amount of time (4.0 hrs) as that required by advisers who compose memoranda with respect to undisclosed legal/disciplinary events.

245 Based on the Commission staff's conversations with industry professionals, we anticipate that approximately three percent of the 10,817 advisers registered with us as of September 30, 2007 will use a method for computing managed assets in Part 2 of Form ADV that differs from the method used to compute assets under management in Part 1A of Form ADV. 10,817 advisers x 0.03 = 324.51 advisers.

246 Approximately 1,620 advisers registered with the Commission report disciplinary information in Part 1A of their Form ADV as of September 30, 2007. We anticipate that most of these advisers will include all disciplinary information in their brochures and supplements, but that approximately 10 percent of these advisers, or 162, will need to prepare and preserve a memorandum explaining their basis for not disclosing a legal or disciplinary event listed in Part 2 that is not disclosed in their brochures and supplements. 1,620 advisers x 0.10 = 162 advisers.

amendments to rule 204-2.[247] Only 110 of these are already accounted for in the currently approved burden estimate. We estimate that the additional 377 advisers whom we anticipate will be subject to the amended provisions of rule 204-2, will yield a 1,508 hour burden increase under rule.[248]

The approved annual aggregate burden for rule 204-2 is currently 1,762,267 hours based on an estimate of 9,728 registered advisers, or 181.15 per registered adviser.[249] Taking into account the estimated increased burden of 1,508 hours as discussed above, as well as an increase of 1,089 registered advisers,[250] the revised annual aggregate burden for all respondents to the recordkeeping requirements under rule 204-2 is therefore estimated to be 1,961,048 total hours.[251]

We further estimate that some advisers may incur a one-time cost including outside legal fees in connection with preparation of a memorandum explaining their basis for not disclosing a legal event listed in Part 2 in their brochures or supplements. We estimate this one-time cost would include fees for approximately three hours of outside

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247 325 advisers that we estimate would prepare memoranda regarding alternative method for calculating assets under management + 162 advisers that we estimate would prepare memoranda regarding unreported nonmaterial disciplinary events = 487 advisers.

248 487 advisers – 110 advisers = 377 advisers. 377 advisers x 4.0 hours = 1,508 hours.

249 1,762,267 hours / 9,728 registered advisers = 181.15 hours per adviser.

250 As stated above, our IARD data show that as of September 30, 2007 there were 10,817 advisers registered with the SEC. 10,817 – 9,728 = 1,089.

251 1,762,267 current burden hours + 1,508 hours due to an increase in the estimated number of registered advisers subject to additional recordkeeping under the amendments + (1,089 due to an increase of total number of registered advisers x 181.15 hours per adviser) = 1,961,048. The annual average burden per SEC-registered adviser is therefore 181.29 hours. 1,961,048 total hours / 10,817 advisers = 181.29 hours per adviser.

legal review and would amount on average to approximately $1,200 per adviser.[252] We believe that approximately 80 percent of the advisers preparing such memoranda would likely to engage outside legal services to assist in their preparation. Thus, we estimate that approximately 130 advisers, will incur these costs, for a total cost among all respondents of $156,000.[253]

C. Rule 204-3

Rule 204-3 contains a collection of information requirement. This collection of information is found at 17 CFR 275.204-3 and is mandatory. Responses are not kept confidential. The likely respondents to this information collection are the approximately 10,817 investment advisers registered with the Commission.

Rule 204-3 currently requires an investment adviser to deliver to clients, at the start of an advisory relationship, a copy of Part 2 of Form ADV or a written document containing at least the information required by Part 2 of Form ADV. The rule currently requires no further brochure delivery unless the client accepts the adviser's required annual offer. The brochure assists the client in determining whether to hire or retain an adviser.

The amendments to rule 204-3 would require advisers registered with us to deliver their brochures and brochure supplements at the start of an advisory relationship and to deliver their firm brochure annually thereafter.[254] The amendments also would require

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[252] Outside legal fees are in addition to the projected hourly per adviser burden discussed above. $400 per hour for legal services x 3 hours per adviser = $1,200. The hourly cost estimate is based on our consultation with advisers and law firms who regularly assist them in compliance matters.

[253] 162 advisers x 0.80 = 129.6. $1,200 x 130 = $156,000.

[254] Proposed rule 204-3(b).

that advisers deliver updates of the brochure and brochure supplements to clients only when disciplinary information in the brochure or supplements becomes materially inaccurate.[255] The updates could take the form of a revised brochure (or supplement) or a "sticker" containing the updated information. This represents a departure from the originally proposed requirements which would have required an ongoing obligation to deliver updates involving any material information in the brochure or supplement, not just disciplinary information.

The total annual burden currently approved by OMB for rule 204-3 is 6,902,278 hours and is based on the requirements of the rule as proposed in 2000.[256] This currently approved burden is based on each adviser having, on average, an estimated 670 clients.[257] Our records now currently indicate that the 10,817 advisers registered with the Commission have, on average, 1,013 clients.[258] These changes, along with our proposal

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[255] Proposed rule 204-3(e). We received comments that were critical of that proposal and that also suggested alternative approaches. In response to those comments, we are now proposing a narrower scope of the updating requirement.

[256] Following issuance of the Proposing Release, OMB approved a burden of 411,075 hours. That estimate assumed, in part, that approximately 8,100 advisers were registered with us and that each adviser had, on average, 49 clients. OMB subsequently approved an increase in the annual burden to 6,902,278 hours to reflect assumptions regarding an increased number of SEC-registered advisory firms and an increased estimate with respect to the average number of clients per adviser. This currently approved burden is based on the proposed delivery requirements (initial delivery plus interim stickering) and assumptions (an initial bulk mailing at 0.25 hours and 2 stickers per year for each SEC-registered firm at 0.5 hours per sticker) that were discussed in the Proposing Release.

[257] This average was based on advisers' responses to Item 5.C of Part 1A of Form ADV as of October 5, 2001.

[258] This average is based on advisers' responses to Item 5.C of Part 1A of Form ADV as of September 30, 2007, excluding the two advisers that reported the largest number of clients. Those advisers account for over 43 percent of all advisory clients of SEC registrants and not excluding them would raise the average client count to 1,778 clients. These two firms provide advisory services primarily over the Internet and currently meet their brochure obligations electronically, thus essentially entirely eliminating for these advisers any PRA burden associated with delivery under this rule. Therefore, we believe

to require annual brochure delivery along with interim delivery only of brochure and supplement updates that involve disciplinary information (in lieu of the originally proposed ongoing delivery obligation) alter the collection of information burden from that currently approved.

We expect that advisers will send their brochures annually in a "bulk mailing" to clients. We estimate that, with a bulk mailing, an adviser will require no more than 0.25 hours to send the adviser's firm brochure to each client, or an annual burden of 253.25 hours per adviser.[259] Thus, we estimate the total burden hours for 10,817 advisers to distribute their firm brochure to existing clients initially and annually thereafter to be 2,739,405 hours per year.[260]

Advisers also will be required to distribute interim updates disclosing new or revised disciplinary information in their brochure or supplements. We anticipate that in any given year, the number of such interim updates that advisers will be required to

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that it is appropriate to exclude these firms from our calculations. Even removing these advisers discussed above, the "typical" adviser registered with the Commission, has far fewer clients than suggested by this average. The average is still heavily weighted by the responses received from the few largest advisers. We note that the next five advisory firms with the largest numbers of clients account for more than an additional 15 percent of all clients. In contrast, the majority (over 60 percent) of advisers registered with us have 100 or fewer clients, and the vast majority (over 90 percent) have 500 or fewer. Based on a median, we estimate that the "typical" adviser registered with us has approximately 63 clients – that is, half of Commission-registered advisers have more than 63 clients and half have fewer. This median is consistent with advisers' modal response (the most common response) to Item 5.C of Part 1A, which was "26 to 100 clients."

259 (0.25 hours per client x 1,013 clients per adviser) = 253.25 hours per adviser. This is the same estimate we made in the 2000 proposal and for which we received no comment. We note that the burden for preparing brochures is already incorporated into the burden estimate for Form ADV discussed above. We anticipate that most advisers will make their annual delivery of their brochure as part of the annual bulk mailings they already make to clients.

260 (0.25 hours per client x 1,013 clients per adviser) x 10,817 advisers = 2,739,405.25 hours.

deliver is approximately 541.[261] We further estimate that an adviser will require no more than 0.5 hours per client for delivery of each such update.[262] This represents about 507 hours per interim update.[263] Thus, the aggregate annual hour burden for affected advisers to deliver interim updates to their brochures and supplements will be approximately 274,287 hours per year.[264]

Thus, the rule amendments requiring annual delivery and interim updating of advisers' brochures and supplements yields a total collection of information burden for rule 204-3 of 3,013,692 hours per year, or 279 hours per respondent.[265] This represents a decrease of 3,888,586 hours from the currently approved PRA burden.[266] The reduced burden results primarily from our proposal to replace the originally proposed requirement to deliver brochure and supplement updates on an ongoing basis, with a requirement to only deliver brochure updates once annually and interim amendments to brochures and supplements only when such updates involve disciplinary information. This change thus

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[261] Just under fifteen percent of the advisers currently registered with the Commission report any disciplinary events at all on their Form ADVs (as of September 30, 2007, only 1,620 of all 10,817 registered advisers indicated at least one "yes" answer to a question related to disciplinary events in Form ADV, Part 1A, Item 11). Thus, we anticipate that a correspondingly small number of advisers will be required to disclose new or updated disciplinary information. The Commission staff estimates that in any given year, five percent of advisers, will be required to deliver a single interim update to each of their clients, resulting in a total of approximately 522 interim updates per year. 0.05 x 10,817 x 1 update = 540.85 updates.

[262] This burden estimate relates only to the amount of time it will take advisers to <u>deliver</u> interim updates to clients, as required by the rule amendments. The burden for <u>preparing</u> interim updates is already incorporated into the burden estimate for Form ADV discussed above.

[263] 0.5 hours per client x 1,013 clients per adviser = 506.5 hours per update.

[264] 541 updates x 507 hours = 274,287 hours.

[265] 2,739,405 hours (initial and annual delivery) + 274,287 hours (interim delivery of updates to disciplinary information) = 3,013,692 hours. 3,013,692 hours / 10,817 advisers = 278.61 hours per adviser.

[266] 6,902,278 hours - 3,013,692 hours = 3,888,586 hours.

significantly reduces the estimated total number of updates advisers will be required to deliver annually.[267]

D. Request for Comment

With respect to the above-described collections of information and pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to: (i) evaluate whether the proposed collections of information is necessary for the proper performance of the functions of the agency, including whether the information shall have practical utility; (ii) evaluate the accuracy of the Commission's estimates of the burdens of the proposed collections of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) evaluate whether there are ways to minimize the burdens of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons submitting comments on these collections of information requirements should direct them 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 also 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. S7-10-00. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, with reference to File No. S7-10-00, and be submitted to the Securities and

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[267] This reduction in hours is offset somewhat by the fact that we have increased the estimated number of clients per adviser who will receive brochures and supplements and interim updates to these.

Exchange Commission, Records Management, Office of Filings and Information Services, 100 F Street, NE, Washington, DC 20549-1090. As OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication.

VII. COST-BENEFIT ANALYSIS

A. Background

The Commission is sensitive to the costs and benefits of its rules. As proposed, this rulemaking would revise Part 2 of Form ADV to require advisers to prepare plain English narrative brochures discussing their business practices and conflicts of interest and to prepare brochure supplements discussing the background and disciplinary history of certain supervised persons who formulate investment advice or exercise investment discretion for clients. The revisions to the form would essentially move into the form itself existing rule provisions that require advisers to disclose certain disciplinary and financial information. In conjunction with these revisions the Commission is proposing to withdraw rule 206(4)-4 as duplicative.

The proposed rulemaking would require advisers to deliver the narrative brochures to clients at the outset of the advisory relationship and annually thereafter, and to deliver to each client an initial brochure supplement for each supervised person who provides advisory services to that client. Advisers would be required to deliver to clients interim updates to their brochure and brochure supplements that involve a change to certain disciplinary information required by Part 2. The rules would provide exceptions to the brochure and supplement delivery requirements for certain types of clients, and

would excuse the adviser from preparing a brochure or supplement if there is no client to whom it must be delivered. The proposed rule amendments would also require advisers to file their narrative brochures electronically through the IARD, and to keep certain records relating to the brochures and supplements.

We have identified certain costs and benefits, discussed below, that may result from the proposed rule and form amendments. In the Proposing Release,[268] we analyzed costs and benefits of the proposed amendments to Part 2 and the related rules and requested comment and data on the effect they would have on individual investment advisers and on the advisory industry as a whole. We are now able to make more detailed estimates of costs, based on data available through the IARD system, and we provide those below.[269] We request comment on the costs and benefits of the proposed amendments. We encourage commenters to identify, discuss, analyze, and supply relevant data regarding these or any additional costs and benefits.

B. Form ADV Part 2 and IARD Filing

As discussed above, the proposed revisions to Part 2 would require most advisers to prepare plain English narrative brochures.[270] Advisers would file their brochures electronically through the IARD in a process much like attaching a file to an email.

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[268] See above note 5.

[269] As discussed above in note 2 of this Release and unless otherwise noted, the IARD data cited below is based on advisers' responses to questions on Part 1A of Form ADV as of September 30, 2007.

[270] Under the amendments, advisers that are not required to deliver a brochure to clients would not be required to prepare one. Advisers that provide only impersonal advice costing less than $500 per year per client, and advisers only to registered investment companies, would therefore not be required to prepare a brochure. We estimate, based on information filed with us on Form ADV, that approximately 295 advisers provide their services only to registered investment companies and therefore would not need to

The new narrative brochures and electronic filing would provide substantial benefits to advisory clients. The brochures would present clients with critically important information they need to determine whether to hire or continue the services of a particular adviser. This information would be presented in a format easy for most investors to understand. Investors searching for an adviser would be able to access the firm's brochures through our public disclosure Web site even before contacting the firm, and thus would be in a better position to know whether they wish to inquire further about the services the firm is offering. We believe these benefits to advisory clients will be a significant enhancement to the adviser disclosure regime. These benefits, while substantial, are difficult to quantify. Most commenters strongly supported the narrative, plain English format, and viewed it as an improvement over the current form. They agreed that the new brochures would greatly benefit clients by requiring advisers to present important information about their firms in a clear and more meaningful way. They observed that the enhanced disclosure required by the revised form would benefit clients by better equipping them with the knowledge to make informed decisions about whether to hire or retain a particular adviser.

Advisers themselves would also benefit from the flexibility the new narrative brochures would give them. Advisers would be able to organize their brochures in the manner that they believe best communicates the required disclosure to their clients. Advisers would also only be required to respond to items that apply to their business, thus

prepare a brochure. Based on Form ADV filings, we estimate that less than 10 advisers offer advisory services only by publishing periodicals and newsletters; we estimate that approximately half of these charge less than $500 per year per client and would not need to prepare a brochure. Moreover, because advisers need not deliver supplements to clients that do not receive a brochure, these advisers would also be excused from preparing any brochure supplements.

substantially enhancing the efficiency and minimizing the costs of preparing brochures and supplements. Moreover, the new amendments provide significant guidance to advisers in terms of highlighting the types of disclosures they, as fiduciaries, are already required to make. We believe the flexibility created by the revisions, as well as the enhanced clarity the new form provides will yield substantial benefits for advisers.

We recognize, however, that revised Part 2 would also impose costs on advisers. Advisers would be required to replace their current Part 2 with the new narrative brochure and supplements, and would be required to file their brochures with us. In addition, the disclosure in the new brochure may be more complete than that existing Form ADV Part 2 currently requires. Thus, drafting the new narrative brochure will likely entail additional expenses. As discussed in the Proposing Release, we believe that most of the costs that advisers will incur in connection with preparation of the new narrative firm brochure and brochure supplements will be in the initial drafting of these documents.[271] We do not expect that revised Part 2 would result in a significant cost increase on a long-term basis.

The cost of preparing a narrative brochure likely would vary significantly among advisers, depending on the complexity of their operations and because Part 2 would give advisers considerable flexibility in structuring their disclosure. Some firms may choose to prepare multiple brochures for several different services. These firms likely would

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271 Proposing Release at Section III.B.2. We do not, however, expect advisers to face substantial costs in gathering the required disclosure. Advisers already are required to provide us and/or their clients with much of the information required in the new narrative brochure. In addition, much of the information needed for the brochure supplements can be found in an adviser's current Form ADV or an investment adviser representative's registration application (i.e., Form U-4) filed with state securities authorities.

face only incrementally higher drafting costs than an advisory firm that uses a single brochure to make the required disclosure about the services it provides.

Similarly, the costs of preparing brochure supplements would vary from one adviser to the next. Costs would vary most significantly depending on the number of supervised persons for whom an adviser must provide disclosure.[272] An adviser with very few supervised persons for whom a supplement must be prepared would incur lower costs than a large adviser. Costs associated with preparing supplements also would vary greatly depending on the amount of disciplinary information, if any, required to be disclosed about a particular supervised person. The preparation of brochure supplements would be most demanding for those few advisers whose supervised persons have lengthy disciplinary records that must be disclosed, and less taxing for the vast majority of advisers, whose supervised persons have no disciplinary records and whose supplements would therefore likely be a page or less in length.[273]

We expect that only a few advisers would incur substantial costs in preparing supplements. Although some commenters representing large advisers argued that the supplement proposal would unduly burden advisers that have "thousands" of employees, IARD data indicate that fewer than one third of one percent of advisers registered with us

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272 In response to comments we received, we narrowed the scope of supervised persons for whom a brochure supplement must be delivered. In addition, an adviser that is not required to deliver a brochure supplement for a particular supervised person is not required to prepare a supplement for that individual. See Section II.B of this Release.

273 IARD data indicate that in response to Item 11 in Part 1A of Form ADV, only 1,620, or just under 15 percent, of the 10,817 advisers registered with us report any disciplinary information about their firms or advisory affiliates, including their advisory employees.

have over 1,000 employees performing investment advisory functions on their behalf.[274] Indeed, less than five percent of our registrants have over 50 employees performing investment advisory functions. The vast majority of SEC-registered advisers – nearly 82 percent – have 10 or fewer employees performing advisory functions on their behalf. We believe most, if not all, of these firms may choose to incorporate required information about their supervised persons into their firm brochures instead of preparing separate brochure supplements, thus reducing costs of preparation. We request comment on the number of supplements that advisers of varying sizes would need to prepare, and how that number compares to the number of advisory employees at the firm.

For purposes of the Paperwork Reduction Act and taking into account the widely varying numbers of advisory employees among the thousands of different advisory firms registered with us, we have estimated the number of hours the average adviser would spend in the initial preparation of their brochures and supplements.[275] Based on those estimates, we estimate that advisers would incur costs of approximately $14,723,982 in drafting these documents in the first year.[276] Furthermore, for Paperwork Reduction Act purposes we also have estimated that advisers may incur approximately costs of $7,257,200 in connection with their use of outside legal services to assist in preparation of their Form ADV.

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274 Moreover, it may not be necessary to prepare a brochure supplement for all of these employees.

275 See Section VI.A of this Release.

276 We expect that this function will most likely be performed by compliance professionals. Data from SIFMA's Report on Office Salaries in the Securities Industry 2006, modified to account for an 1,800-hour work-year and multiplied by 2.93 to account for bonuses, firm size, employee benefits and overhead, suggest that cost for a Compliance Clerk is approximately $56 per hour. 262,928.25 hours x $56 per hour = $14,723,982.

Advisers would incur annual expenses in addition to the initial costs of preparing firm brochures and brochure supplements, but we believe these costs would be modest and similar to current costs. The rule amendments, similar to the current requirements, would require advisers to revise their disclosure documents promptly when any information in them becomes materially inaccurate, and would require advisers to update their brochures and brochure supplements each year at the time of their required annual updating amendment. For Paperwork Reduction Act purposes, we have estimated that advisers would need to prepare brochure amendments, on average, one and one half times per year, and spend three quarters of an hour on each amendment. We estimate that advisers would incur annual costs of $744,471 in meeting these requirements.[277]

Finally, advisers would incur some costs in filing their brochures with us through the IARD. Advisers would prepare their brochures on their own computers, and as noted earlier, the filing of a brochure would be similar to attaching a file to an email.[278] We believe conversion of an adviser's brochure to PDF format and filing of that brochure through the IARD would impose minimal costs on advisers.

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277 Similarly, we expect that amendments to Part 2 will also most likely be performed by compliance professionals at an estimated cost for a Compliance Clerk of $56 per hour. 17,725.5 amendments x 0.75 hours per amendment x $56 = $744,471.

278 We note that all advisers registered with the Commission currently file Form ADV electronically via the IARD system and that since implementation of the electronic filing requirements in 2000 no adviser has applied for a permanent hardship exemption available to advisers for whom filing electronically would constitute an undue hardship. See rule 203-3(b) [17 CFR 275.203-3(b)].

C. Brochure and Supplement Delivery

Advisers would be required to deliver their revised brochures to existing clients annually.[279] The amended rules would require that, between annual deliveries, advisers deliver brochure and supplement amendments to existing clients only if there is an addition or change to disciplinary disclosure. Advisers already are required to deliver a copy of Part 2 to new clients. Thus, this requirement should present no new costs to advisers. Moreover, we believe that because advisers must deliver brochures to new clients, the cost of delivering brochure supplements to new clients should increase the existing cost of delivery only incrementally. New clients would receive brochures and supplements that are current as of the time of delivery.

Annual brochure delivery would benefit advisory clients by ensuring that they are kept apprised of their advisers' business practices and procedures for managing conflicts and enable clients to make decisions with respect to the adviser with the most currently available information. Changes to disciplinary information disclosed in the brochure and supplement are of such importance to clients that we believe interim delivery of these amendments is necessary. Moreover, advisers currently are already required to make disclosures regarding disciplinary information under existing rule 206(4)-4. Based on the experiences of examination staff, we believe that most advisers likely already make these disclosures in writing so that they can demonstrate compliance with the requirements of rule 206(4)-4. Thus, we believe that it is unlikely that there will be any new costs associated with delivery of this information.

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279 Currently, an adviser must offer its brochure to clients annually, and must deliver a revised brochure only if the client accepts the adviser's offer.

As discussed above, delivery of the new narrative brochures would provide substantial benefits to advisory clients. The brochures would present clients with important information they need to determine whether to hire or continue the services of a particular adviser. Currently, advisers must annually offer to deliver their brochure to existing clients, however, clients who never request a brochure may not necessarily see important amendments. Under the proposed approach, each year clients would automatically receive advisers' brochures and the valuable in information contained therein. Although we believe these benefits to advisory clients will be substantial, they are difficult to quantify.

Although advisers are already currently required to deliver a revised brochure to clients upon request, advisers would incur additional delivery costs under the amended rule (particularly in connection with the initial and annual delivery obligations). We expect these additional costs, however, to be less than under the original proposal.[280] Certain commenters raised particular concerns about the scope of the brochure supplement and its delivery, and the costs associated with ensuring proper distribution of supplements. In response to comments, we have both proposed to narrow the group of supervised persons who would need a brochure supplement, and to eliminate the need to send supplements to certain institutional or sophisticated clients. For Paperwork Reduction Act Purposes, we have estimated that the total annual paperwork burden associated with annual and interim delivery of brochures and supplements is

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[280] We are proposing the annual brochure delivery requirement (and the requirement that advisers deliver any interim amendments that disclose additional or revised disciplinary information) in lieu of our original proposal, which would have required advisers to deliver all brochure and supplement updates to clients on a continuous basis whenever any information in their brochures or supplements became materially inaccurate.

approximately 3,013,692 hours. We estimate this would represent an annual cost of $168,766,752.[281]

Advisers may significantly minimize the costs associated with annual delivery of their brochures and supplements by arranging to deliver their brochures and supplements to some or all clients by electronic media.[282] Advisers also may minimize delivery costs by mailing their brochures and supplements along with quarterly statements or other routine mailings they already send to clients.[283] The extent to which advisers will take advantage of these and other techniques to reduce costs is difficult to predict but we believe it will be significant. We request comment about the percentage of clients to whom advisers are likely to make electronic delivery. We also request comment about the extent to which advisers may minimize delivery costs by mailing their brochures and supplements along with quarterly statements or other routine mailings.

D. Amendments to Rule 204-2

The proposed amendments to rule 204-2 would require SEC-registered advisers to retain certain records relating to brochures and supplements. One of the proposed revisions to the rule would require advisers to retain copies of brochures and supplements prepared as required by Part 2. This provision is designed to conform that rule to our proposed changes to Form ADV and generally would impose no additional costs because

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281 We expect that delivery of amendments to Part 2 will also most likely be performed by compliance professionals at an estimated cost for a Compliance Clerk of $56 per hour. 3,013,692 hours x $56 = $168,766,752.

282 Proposed Instruction 3 for Part 2A of Form ADV expressly notes that Commission interpretive guidance permits advisers to deliver their brochures electronically upon client consent.

283 As noted above, annual brochure delivery must be made within 120 days of the adviser's fiscal year end. We have designed this deadline so that advisers can include the brochure in a routine mailing to clients.

advisers are already currently required to retain records relating to materials they distribute to their clients. Other proposed revisions to the rule would require advisers to maintain certain records in the event they use an alternative method to calculate assets under management in response to Item 4.E of Part 2A and if they do not disclose in their brochure any legal or disciplinary event listed in Part 2. These provisions would benefit advisers by permitting them flexibility in drafting their firm brochures while providing for maintenance of records needed by our examination staff. Moreover, because we anticipate that only a relatively small number of advisers would be subject to these provisions we expect that the cost of maintaining these records will be relatively minimal.[284]

E. Total Estimated Costs and Benefits of this Rulemaking

As discussed above, the proposed rule and form amendments are expected to have both benefits and costs for investors and the advisory industry as a whole. We believe the benefits to advisory clients in the form of significant enhancements to the adviser disclosure regime will be quite substantial, but are difficult to quantify. Similarly difficult to quantify are the expected benefits to the advisory industry that we believe would result from the proposed rules in the form of enhanced flexibility with respect to their obligations to prepare and deliver brochures and supplements. Moreover, not all of the costs we anticipate to result from this rulemaking are quantifiable. Based on the

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[284] For Paperwork Reduction Act purposes we estimate that only 487 advisers would be required to prepare additional records in accordance with the amendment to rule 204-2 and that each adviser would spend approximately four hours to satisfy the obligation for a total burden of 1,948 hours per year.

figures discussed above, however, we estimate that the first year quantifiable costs related to this proposed rulemaking to be approximately $191,492,405.[285]

VIII. INITIAL REGULATORY FLEXIBILITY ANALYSIS

We have prepared this Initial Regulatory Flexibility Analysis (IRFA) in accordance with section 3(a) of the Regulatory Flexibility Act (RFA).[286] It relates to proposed amendments to rules 203-1, 204-1, 204-2, 204-3, and 206(4)-4, and Form ADV under the Advisers Act. The rule and form amendments are designed to improve the disclosure that investment advisers provide to their clients. These proposed amendments would also revise the instructions for updating and filing Form ADV (including adviser brochures). We also are proposing conforming rule amendments that would revise the recordkeeping requirements relating to Part 2 of Form ADV.

We prepared an IRFA in conjunction with the release proposing amendments to Part 2 of Form ADV in April 2000, and made it available to the public. A summary of that IRFA was published with the Proposing Release.[287] We received no comments specifically on that IRFA.

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[285] Estimated costs related to initial preparation of Form ADV (including Part 2) of $14,723,982 + estimated one-time outside legal costs associated with this initial preparation of $7,257,200 + estimated costs of $744,471 related to annual updating of Form ADV (including Part 2) + estimated costs associated with delivery of brochures and supplements of $168,766,752 = $191,492,405.

[286] 5 U.S.C. 603(a).

[287] See above note 5.

A. Need for the Rule and Form Amendments

The proposed rule and form amendments are necessary to improve the quality of disclosure that advisers provide to their clients.[288] Form ADV was adopted by the Commission in 1985[289] and advisers currently use it to register with the Commission (Part 1) and to provide clients disclosure about their advisory firm and personnel (Part 2). Over the years, however, experience has shown that the format and content of current Part 2 of Form ADV do not lend themselves to disclosure that is easy for clients to understand. Clients need clearer information about an adviser's services, fees, business practices, and conflicts of interests to be able to make an informed decision about whether to hire or retain that adviser.

B. Objectives and Legal Basis

The primary objective of the proposed form and rule amendments is to provide advisory clients and prospective clients with access to meaningful and up-to-date disclosure, as well as to provide for filing of this disclosure with the Commission.[290] By requiring advisers to provide current narrative brochures and brochure supplements written in plain English, the amendments are intended to improve the quality of information investors receive from advisers about their services, fees, business practices and conflicts of interest. Also, by requiring advisers to file their brochures (and any amendments) with the Commission electronically using IARD, the proposal would make

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288 Sections I through IV, above, of this Release, describe in more detail the reasons for the proposed amendments.

289 Uniform Investment Adviser Registration Application Form, Investment Advisers Act Release No. 991 (Oct. 15, 1985) [50 FR 42903 (Oct. 23, 1985)].

290 Sections I through IV, above, of this Release, describe in more detail the objectives of the proposed amendments.

full use of existing and new information technologies to aid the Commission staff in its oversight efforts and provide ready public access to advisers' brochures.

We are proposing these amendments under section 19(a) of the Securities Act of 1933 [15 U.S.C. 77s(a)], sections 23(a) and 28(e)(2) of the Securities Exchange Act of 1934 [15 U.S.C. 78w(a) and 78bb(e)(2)], section 319(a) of the Trust Indenture Act of 1939 [15 U.S.C. 77sss(a)], section 38(a) of the Investment Company Act of 1940 [15 U.S.C. 78a-37(a)], and sections 203(c)(1), 204, 206(4), and 211(a) of the Investment Advisers Act of 1940 [15 U.S.C. 80b-3(c)(1), 80b-4, 80b-6(4), and 80b-11(a)].

C. Small Entities Subject to the Rules

In developing the proposals, we have considered their potential impact on small entities that may be affected. The proposed rule and form amendments would affect all advisers registered with the Commission, including small entities. Under Commission rules, for purposes of the Regulatory Flexibility Act, an investment adviser generally is a small entity if it: (i) has assets under management having a total value of less than $25 million; (ii) did not have total assets of $5 million or more on the last day of its most recent fiscal year; and (iii) does not control, is not controlled by, and is not under common control with another investment adviser that has assets under management of $25 million or more, or any person (other than a natural person) that had $5 million or more on the last day of its most recent fiscal year.[291]

Our rule and form amendments would not affect most advisers that are small entities ("small advisers") because they are generally registered with one or more state securities authorities and not with us. Under section 203A of the Advisers Act, most

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[291] Rule 0-7 [17 CFR 275.0-7].

small advisers are prohibited from registering with the Commission and are regulated by state regulators.[292] Those small advisers that register with us are located in Wyoming (which does not have an investment adviser statute), or are eligible for an exemption that permits SEC registration. The Commission estimates that as of September 30, 2007, of the 10,449 registered with us, there were approximately 634 that were small entities that would be affected by the proposed amendments.[293] We request comment on the effect and costs of the proposed amendments on small entities.

D. Reporting, Recordkeeping, and Other Compliance Requirements

The proposed rule and form amendments would impose certain reporting and compliance requirements on small advisers, requiring them to create and update narrative brochures containing certain information regarding their advisory business. The amendments also would require advisers to deliver their brochures to clients and to file them electronically through the IARD. The proposals would also impose new recordkeeping requirements. These requirements and the burdens on small advisers are discussed below.[294]

1. Amendments to Part 2 of Form ADV

The amendments to Part 2, because they require registered advisers to prepare and disseminate narrative brochures, would impose additional costs on all registered advisers,

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292 National Securities Markets Improvement Act of 1996 (Pub. L. No. 104-290, 110 Stat. 3438) (1996) ("NSMIA"). As a result of NSMIA, advisers with less than $25 million of assets under management generally are regulated by one or more state securities authority, while the Commission generally regulates those advisers with at least $25 million of assets under management. See section 203A of the Advisers Act [15 USC 80b-3a].

293 This estimate is based on information advisers have filed with the Commission on Part 1A of Form ADV.

294 Sections I through IV, above, of this Release, describe these requirements in more detail.

including small advisers. We assume that all small advisers currently distribute Part 2 of Form ADV and would have to redraft their brochures completely to comply with the proposed new format, although some information in current Part 2 may be transferable to the new narrative brochures.

The costs associated with preparing the new brochures will depend on the size of the adviser, the complexity of its operations, and the extent to which its operations present conflicts of interest with clients. Many of the new items imposing the most rigorous disclosure requirements may not apply to certain small advisers because, for example, those advisers may not have soft dollar or directed brokerage arrangements, or may not have custody of client assets. To the extent that some of the new disclosure burdens would apply to small advisers, these advisers are already obligated to make the disclosures to clients under the Advisers Act's anti-fraud provisions, although the disclosure is not required to be in the firm's written brochure.

For the first time, advisers also would be required to prepare and disseminate brochure supplements for certain supervised persons of their firm. To reduce the burdens on small advisers, however, we have drafted the new supplement rules so that firms with few employees would be permitted to include supplement information in their firm brochures and avoid preparing and distributing separate brochure supplements. We believe many small advisers would take advantage of this option and reduce their compliance burden.

2. Updating and Delivery Requirements

The amended rules, like the current rules, would require advisers to update their brochures whenever information in them becomes materially inaccurate. The proposed

amendments would also implement the same updating requirements for supplements. In updating its brochure and supplements, an adviser may minimize its burden by using a "sticker" containing the updated information instead of reprinting its entire brochure and supplements.

The amendments would require advisers to deliver a current brochure to clients annually and to deliver interim updates of the brochure and supplements to clients to disclose new or revised disciplinary information. These delivery requirements would replace the current requirement that advisers offer clients a revised brochure annually. To minimize the burden of delivery, advisers would be permitted with client consent to deliver brochures and supplements, as well as updates, electronically. To the extent that small advisers are more likely to have fewer advisory clients (and fewer supervised persons) than larger advisers, the proposed delivery requirements should impose lower variable costs on small advisers than on larger firms.

3. Recordkeeping Requirements

The proposed amendments would impose new recordkeeping requirements on advisers, including small advisers. As under the current rules, advisers would be required to maintain copies of their brochures. The proposed amendments would also require all advisers to maintain copies of their brochure supplements. In addition, the proposed amendments would require advisers, including small advisers, to maintain certain records if they determine that a disciplinary event that is presumptively material does not have to be disclosed, or if they calculate their managed assets for purpose of their brochures differently than in Part 1A of Form ADV.

E. Duplicative, Overlapping, or Conflicting Federal Rules

The Commission believes that there are no rules that duplicate or conflict with the proposed rule.[295]

F. Significant Alternatives

We have considered various alternatives in connection with the proposed rule and form amendments that might minimize their effect on small advisers, including: (i) establishing different compliance or reporting requirements or timetables that take into account the resources available to small advisers; (ii) clarifying, consolidating, or simplifying compliance and reporting requirements under the proposed amendments for small advisers; (iii) using performance rather than design standards; and (iv) exempting small advisers from coverage of all or part of the proposed amendments.

Regarding the first alternative, the Commission believes that establishing different compliance or reporting requirements for small advisers would be inappropriate under these circumstances. The amendments are designed to improve the quality and timeliness of critically important disclosure that advisory clients receive from their advisers. To establish different disclosure requirements for small entities would diminish this investor protection for clients of small advisers. We note, however, that small advisers, by the nature of their business, likely would spend fewer resources in completing their brochures and any brochure supplements. Moreover, certain rule and form amendments were designed specifically to reduce the burden on small advisers. For example, the proposed Part 2 instructions would give advisers the flexibility to incorporate required information

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[295] As discussed above, the Commission is proposing to withdraw as duplicative current rule 206(4)-4.

about their supervised persons into their firm brochures rather than presenting it in separate brochure supplements, thereby saving additional printing and mailing costs.

Regarding the second alternative, the proposed amendments would clarify requirements for all advisers, including small advisers. The proposed Part 2 instructions are designed to present requirements for advisers' brochures and supplements clearly and simply to all advisers, including small entities.

Regarding the third alternative, the Commission believes that the proposed amendments already appropriately use performance rather than design standards in many instances. The amendments would permit advisers considerable flexibility in designing their brochures and supplements so as best to communicate the required information to clients. In preparing brochure supplements, advisers would also have the flexibility of adapting the format of the supplements to best suit their firm: an adviser may: (i) prepare a separate supplement for each supervised person; (ii) prepare a single supplement containing the required information for all of its supervised persons; (iii) prepare multiple supplements for groups of supervised persons (e.g., all supervised persons in a particular office or work group); or (iv) include all information about supervised persons in the firm brochure and prepare no separate supplements.[296] The proposed amendments clarify that advisers may, with client consent, deliver their brochures and supplements, along with any updates, to clients electronically.

Regarding the fourth alternative, it would be inconsistent with the purposes of the Advisers Act to exempt small advisers from the proposed rule and form amendments. The information in an adviser's brochure is necessary for the client to evaluate the

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296 See Section II.B of this Release.

adviser's services, fees, and business practices, and to apprise the client of potential conflicts of interest and, when necessary, of the adviser's financial condition. Since we view the protections of the Advisers Act to apply equally to clients of both large and small advisers, it would be inconsistent with the purposes of the Act to specify different requirements for small entities.

G. Solicitation of Comment

The Commission encourages the submission of comments on matters discussed in the IRFA. Comment is requested particularly on the number of small advisers that would be affected by the proposals, the burdens the proposals would impose on small advisers, and whether the effects of the proposed rule and form amendments on small advisers would be economically significant. Commenters are asked to describe the nature of any effect and provide empirical data supporting the extent of the effect. These comments will be placed in the same public comment file as comments on the proposals.

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, the Commission is also requesting information regarding the potential impact of the proposals on the economy on an annual basis. Commenters should provide empirical data to support their views.

IX. EFFICIENCY, COMPETITION, AND CAPITAL FORMATION

Section 202(c) of the Advisers 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.[297] Today the Commission is proposing amendments to Part 2 of Form ADV and related Advisers Act rules that would require investment advisers registered with us to deliver to clients and prospective clients, brochures and brochure supplements written in plain English.

The brochure rule and form amendments that we are proposing today would promote efficiency and competition in the marketplace by improving the disclosure that advisers must provide to clients.[298] These amendments are designed to require advisers to provide clients and prospective clients with clear, current, and more meaningful disclosure of the business practices, conflicts of interest, and background of investment advisers and their advisory personnel. Advisers would file their brochures with us electronically, and we would make them available to the public through our Web site. With the public availability of more thorough and current disclosure of advisers' services, fees, business practices and conflicts of interests, investors will be able to make more informed decisions about whether to hire or retain a particular adviser. A more informed investing public will create a more efficient marketplace and strengthen competition among advisers. Moreover, the electronic filing requirements are expected to expedite

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297 15 U.S.C. 80b-2(c).

298 Along with the proposed brochure amendments, the Commission also is proposing conforming amendments to the General Instructions and Glossary of Form ADV to include instructions regarding brochure filing requirements and to add glossary terms and definitions that are used in Part 2. Additionally, the Commission also is proposing conforming amendments to the Advisers Act books and records rule. These proposed amendments would require advisers to maintain copies of their brochures, supplements, and amendments, and are intended to update the books and records rule in light of our proposed changes to Part 2. None of these proposed conforming amendments are expected to have an independent impact on efficiency, competition, or capital formation. To the extent that they facilitate the purposes of the proposed brochure amendments, the conforming amendments may, however, contribute to the expected effects on efficiency, competition and capital formation that would stem from the proposed brochure amendments and which are discussed below.

and simplify the process of filing firm brochures and amendments for the advisory firms, thus further improving efficiency. We believe, however, that the proposed brochure amendments are unrelated to and will have little or no effect on capital formation.

The Commission requests comment whether the above proposals, if adopted, would promote efficiency, competition, and capital formation. Commenters are requested to provide empirical data to support their views.

X. STATUTORY AUTHORITY

We are proposing amendments to rule 203-1 under sections 203(c)(1), 204, and 211(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3(c)(1), 80b-4, and 80b-11(a)).

We are proposing amendments to rule 204-1 under sections 203(c)(1) and 204 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3(c)(1) and 80b-4).

We are proposing amendments to rule 204-2 under section 204 and 206(4) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-4 and 80b-6(4)).

We are proposing amendments to rule 204-3 under section 204, 206(4), and 211(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-4, 80b-6(4), and 80b-11(a)).

We are proposing amendments to rule 279.1, Form ADV, under section 19(a) of the Securities Act of 1933 (15 U.S.C. 77s(a)), sections 23(a) and 28(e)(2) of the Securities Exchange Act of 1934 (15 U.S.C. 78w(a) and 78bb(e)(2)), section 319(a) of the Trust Indenture Act of 1939 (15 U.S.C. 77sss(a)), section 38(a) of the Investment Company Act of 1940 (15 U.S.C. 78a-37(a)), and sections 203(c)(1), 204, and 211(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3(c)(1), 80b-4, and 80b-11(a)).

We are proposing to remove and reserve rule 206(4)-4 under section 206(4) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-6(4)).

List of Subjects in 17 CFR Parts 275 and 279

Reporting and recordkeeping requirements; Securities

TEXT OF RULE AND FORM AMENDMENTS

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

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

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

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

2. Section 275.203-1 is amended by revising paragraphs (a) and (b) to read as follows:

§ 275.203-1 Application for investment adviser registration.

(a) Electronic Filing of Form ADV. (1) To apply for registration with the Commission as an investment adviser, you must complete Form ADV (17 CFR 279.1) by following the instructions in the form and you must file Part 1A of Form ADV and the firm brochure(s) required by Part 2A of Form ADV electronically with the Investment Adviser Registration Depository (IARD) unless you have received a hardship exemption under § 275.203-3.

Note to paragraph (a)(1): Information on how to file with the IARD is available on the Commission's Web site at www.sec.gov/iard.

(2) After [INSERT DATE SIX MONTHS AFTER EFFECTIVE DATE OF RULES/FORM] the Commission will not accept any initial application for registration as an investment adviser that does not include a brochure that satisfies the requirements of Part 2A of Form ADV.

(b) Special rule for Part 2B. You are not required to file with the Commission the brochure supplements required by Part 2B of Form ADV.

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3. Section 275.204-1 is amended by removing the notes to paragraphs (a) and (c) and revising paragraphs (b) and (c) to read as follows:

§ 275.204-1 Amendments to application for registration.

* * * * *

(b) Electronic filing of amendments. (1) Subject to paragraph (b)(2) of this rule, you must file all amendments to Part 1A of your Form ADV and all your amended firm brochure(s) required by Part 2A of Form ADV electronically with the Investment Adviser Registration Depository (IARD), unless you have received a continuing hardship exemption under § 275.203-3.

(2) Transition to electronic filing. You must amend your Form ADV by electronically filing with the IARD one or more brochures that satisfy the requirements of Part 2A of Form ADV (as amended effective [INSERT EFFECTIVE DATE OF RULES/FORM]) as part of the next annual updating amendment you are required to file after [INSERT DATE SIX MONTHS AFTER EFFECTIVE DATE OF RULES/FORM].

Note to paragraphs (a) and (b): Information on how to file with the IARD is available on our Web site at www.sec.gov/iard.

(c) Special rule for Part 2B. You are not required to file with the Commission amendments to brochure supplements required by Part 2B of Form ADV.

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4. Section 275.204-2(a)(14) is revised to read as follows:

§ 275.204-2 Books and records to be maintained by investment advisers.

(a) * * *

(14)(i) A copy of each brochure and brochure supplement, and each amendment or revision to the brochure and brochure supplements, required by Part 2 of Form ADV (17 CFR 279.1); any summary of material changes that is required by Part 2 of Form ADV but is not contained in the brochure or brochure supplements; and a record of the dates that each brochure and brochure supplement, each amendment or revision thereto, and each summary of material changes was given to any client or to any prospective client who subsequently becomes a client.

(ii) Documentation describing the method used to compute managed assets for purposes of Item 4.E of Part 2A of Form ADV, if the method differs from the method used to compute assets under management in Item 5.F of Part 1A of Form ADV.

(iii) A memorandum describing any legal or disciplinary event listed in Item 9 of Part 2A or Item 3 of Part 2B of Form ADV (Disciplinary Information) and presumed to be material, if the event involved the investment adviser or any of its supervised persons and is not disclosed in the brochure or brochure supplements described in paragraph (a)(14)(i) of this section. The memorandum must explain the investment adviser's determination that the presumption of materiality is overcome, and must discuss the factors described in Item 9 of Part 2A or Item 3 of Part 2B of Form ADV.

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5. Section 275.204-3 is revised to read as follows:

§ 275.204-3 Delivery of firm brochures and brochure supplements.

(a) General requirements. If you are registered under the Act as an investment adviser, you must deliver a firm brochure and one or more supplements to each client or prospective client as required by this section. The brochure and supplement(s) must contain all information required by Part 2 of Form ADV (17 CFR 279.1).

(b) Delivery requirements. You (or a supervised person acting on your behalf) must deliver to a client or prospective client:

(1) Your current brochure before or at the time you enter into an investment advisory contract with the client and, after that, an updated brochure annually within 120 days after the end of your fiscal year;

(2) A current brochure supplement for a supervised person before or at the time that supervised person begins to provide advisory services to the client. For purposes of this section, a supervised person will provide advisory services to a client if that supervised person will:

(i) Formulate investment advice for the client and have direct client contact; or

(ii) Make discretionary investment decisions for the client, even if the supervised person will have no direct client contact.

(c) Exceptions to delivery requirements.

(1) You are not required to deliver a brochure to a client:

(i) that is an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1 to 80a-64) or a business development company as defined in that

Act, provided that the advisory contract with that client meets the requirements of section 15(c) of that Act (15 U.S.C. 80a-15(c)); or

(ii) who receives only impersonal investment advice for which you charge less than $500 per year.

(2) You are not required to deliver a brochure supplement to a client:

(i) to whom you are not required to deliver a brochure under subparagraph (c)(1) of this section;

(ii) who receives only impersonal investment advice;

(iii) who would be a "qualified purchaser" under section 2(a)(51)(A) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(51)(A)); or

(iv) who would be a "qualified client" of your firm under § 275.205-3(d)(1)(iii).

(d) Wrap fee program brochures.

(1) If you are a sponsor of a wrap fee program, then the brochure that paragraph (b)(1) of this section requires you to deliver to a client or prospective client of the wrap fee program must be a wrap fee brochure containing all information required by Part 2A Appendix 1 of Form ADV. Any additional information in a wrap fee brochure must be limited to information applicable to wrap fee programs that you sponsor.

(2) You do not have to deliver a wrap fee brochure if another sponsor of the wrap fee program delivers, to the client or prospective client of the wrap fee program, a wrap fee program brochure containing all the information your wrap fee program brochure must contain.

Note to paragraph (d): A wrap fee brochure does not take the place of any brochure supplements that you are required to deliver under paragraph (b)(2) of this section.

(e) Amendments. Section 275.204-1 and instructions to Form ADV contain instructions that you must follow to amend your brochure and brochure supplements. You must provide a current brochure and current brochure supplements to any new clients or prospective clients. If an amendment adds disclosure of an event, or materially revises information already disclosed about an event, in response to Item 9 of Part 2A or Item 3 of Part 2B of Form ADV (Disciplinary Information), then you must provide the current brochure or current brochure supplements (or the amendment), as applicable, to all existing clients to whom you are required to deliver a brochure or brochure supplement under this section.

(f) Multiple brochures. If you provide substantially different advisory services to different clients, you may provide them with different brochures, so long as each client receives all information about the services and fees that are applicable to that client. The brochure you deliver to a client may omit any information required by Part 2A of Form ADV if the information does not apply to the advisory services or fees that you will provide or charge, or that you propose to provide or charge, to that client.

(g) Other disclosure obligations. Delivering a brochure or supplement in compliance with this section does not relieve you of any other disclosure obligations you have to your advisory clients or prospective clients under any federal or state laws or regulations.

(h) Transition rule.

(1) Within 30 days after the date by which you are first required by § 275.204-1(b)(2) to electronically file your brochure with the Commission, you must deliver to each

of your existing clients your current brochure and all current brochure supplements as required by Part 2 of Form ADV.

(2) As of the date by which you are first required to electronically file your brochure with the Commission, you must begin using your current brochure and current brochure supplements as required by Part 2 of Form ADV to comply with the requirements of this section pertaining to initial delivery to new and prospective clients.

(i) Definitions. For purposes of this section:

(1) Impersonal investment advice means investment advisory services that do not purport to meet the objectives or needs of specific individuals or accounts.

(2) Current brochure and current brochure supplement mean the most recent revision of the brochure or brochure supplement, including all amendments to date.

(3) Sponsor of a wrap fee program means an investment adviser that is compensated under a wrap fee program for sponsoring, organizing, or administering the program, or for selecting, or providing advice to clients regarding the selection of, other investment advisers in the program.

(4) Supervised person means any of your officers, partners or directors (or other persons occupying a similar status or performing similar functions) or employees, or any other person who provides investment advice on your behalf.

(5) Wrap fee program means an advisory program under which a specified fee or fees not based directly upon transactions in a client's account is charged for investment advisory services (which may include portfolio management or advice concerning the selection of other investment advisers) and the execution of client transactions.

6. Section 275.206(4)-4 is removed and reserved.

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PART 279 -- FORMS PRESCRIBED UNDER THE INVESTMENT ADVISERS ACT OF 1940

7. The authority citation for Part 279 continues to read as follows:

Authority: 15 U.S.C. 80b-1, et seq.

8. Form ADV (referenced in § 279.1) is amended by:

a. In the instructions to the form, revising the section entitled "Form ADV: General Instructions." The revised version of Form ADV: General Instructions is attached as Appendix A;

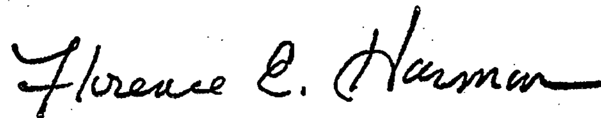
b. In the instructions to the form, revising the section entitled "Glossary of Terms." The revised version of Form ADV: Glossary of Terms is attached as Appendix B; and

c. Removing Form ADV, Part II, and adding Form ADV, Part 2. Form ADV, Part 2 is attached as Appendix C.

Note: The text of Form ADV does not and the amendments will not appear in the Code of Federal Regulations.

* * * * *

By the Commission.



Florence E. Harmon
Deputy Secretary

March 3, 2008

FORM ADV (Paper Version)
UNIFORM APPLICATION FOR INVESTMENT ADVISER REGISTRATION

Form ADV: General Instructions

Read these instructions carefully before filing Form ADV. Failure to follow these instructions, properly complete the form, and pay all required fees may result in your application being delayed or rejected.

In these instructions and in Form ADV, "you" means the investment adviser (i.e., the advisory firm) applying for registration or amending its registration. If you are a "separately identifiable department or division" (SID) of a bank, "you" means the SID, rather than your bank, unless the instructions or the form provide otherwise. Terms that appear in *italics* are defined in the Glossary of Terms to Form ADV.

1. Where can I get more information on Form ADV, electronic filing, and the IARD?

The SEC provides information about its rules and the Advisers Act on its website: <http://www.sec.gov/iard>.

NASAA provides information about state investment adviser laws and state rules, and how to contact a *state securities authority*, on its website: <http://www.nasaa.org>.

FINRA provides information about the IARD and electronic filing on the IARD website: <http://www.iard.com>.

2. What is Form ADV used for?

Investment advisers use Form ADV to:

- Register with the Securities and Exchange Commission
- Register with one or more *state securities authorities*
- Amend those registrations

3. How is Form ADV organized?

Form ADV contains four parts:

- Part 1A asks a number of questions about you, your business practices, the *persons* who own and *control* you, and the *persons* who provide investment advice on your behalf. All advisers registering with the SEC or any of the *state securities authorities* must complete Part 1A.

  Part 1A also contains several supplemental schedules. The items of Part 1A let you know which schedules you must complete.

- ◦ Schedule A asks for information about your direct owners and executive officers.
- ◦ Schedule B asks for information about your indirect owners.
- ◦ Schedule C is used by paper filers to update the information required by Schedules A and B (see Instruction 14).
- ◦ Schedule D asks for additional information for certain items in Part 1A.
- ◦ Disclosure Reporting Pages (or "DRPs") are schedules that ask for details about disciplinary events involving you or *persons* affiliated with you.

- Part 1B asks additional questions required by *state securities authorities*. Part 1B contains three additional DRPs. If you are applying for registration or are registered only with the SEC, you do not have to complete Part 1B. (If you are filing electronically and you do not have to complete Part 1B, you will not see Part 1B.)

- Part 2A requires advisers to create narrative *brochures* containing information about the advisory firm. The requirements in Part 2A apply to all investment advisers registered with or applying for registration with the SEC. If you are registered with or applying for registration with one or more of the *state securities authorities*, you should contact the appropriate *state securities authorities* to determine whether the requirements in Part 2A apply to you.

- Part 2B requires advisers to create *brochure supplements* containing information about certain *supervised persons*. The requirements in Part 2B apply to all investment advisers registered with or applying for registration with the SEC. If you are registered with or applying for registration with one or more of the *state securities authorities*, you should contact the appropriate *state securities authorities* to determine whether the requirements in Part 2B apply to you.

4. When am I required to update my Form ADV?

You must amend your Form ADV each year by filing an *annual updating amendment* within 90 days after the end of your fiscal year. When you submit your *annual updating amendment*, you must update your responses to all items.

In addition to your *annual updating amendment*, you must amend your Form ADV by filing additional amendments (other-than-annual amendments) promptly if:

- information you provided in response to Items 1, 3, 9, or 11 of Part 1A or Items 1, 2.A. through 2.F., or 2.I. of Part 1B, becomes inaccurate in any way;

- information you provided in response to Items 4, 8, or 10 of Part 1A or Item 2.G. of Part 1B becomes materially inaccurate; or

- information you provided in your brochure becomes materially inaccurate.

If you are submitting an other-than-annual amendment, you are not required to update your responses to Items 2, 5, 6, 7, or 12 of Part 1A or Items 2.H. or 2.J. of Part 1B, even if your responses to those items have become inaccurate.

Note: You must amend your *brochure supplements* (see Form ADV, Part 2B) promptly if any information in them becomes materially inaccurate.

- If you are an SEC-registered adviser, you are required to file your *brochure* amendments electronically through IARD. You are not required to file amendments to your *brochure supplements* with the SEC, but you must maintain a copy of them in your files.

- If you are a state-registered adviser, you may be required to file your *brochure* amendments and *brochure supplement* amendments with the appropriate *state securities authorities*. You should contact the appropriate *state securities authorities* to determine whether the states in which you have a filing obligation require filing of your *brochure* amendments and *brochure supplement* amendments, and if so, whether these should be filed electronically through IARD.

Failure to update your Form ADV, as required by this instruction, is a violation of SEC rule 204-1 or similar state rules and could lead to your registration being revoked.

5. Part 2 of Form ADV was amended recently. When do I have to comply with the new requirements?

If you are applying for registration with the SEC:

- Beginning [ ], your application for registration must include a narrative *brochure* prepared in accordance with the requirements of (amended) Part 2 of Form ADV. See SEC rule 203-1. After that date, the SEC will not accept any application that does not meet this requirement.

- Until that date, you may (but are not required to) include in your application a narrative *brochure* that meets the requirements of (amended) Part 2 of Form ADV. If you do not do this, you must comply with the requirements for preparing, delivering, and offering "old" Part II of Form ADV.

If you already are registered with or have submitted an application for registration with the SEC by [ ]:

- When you make the next annual updating amendment to your Form ADV after [ ], you must submit a narrative *brochure* that meets the requirements of (amended) Part 2 of Form ADV. See SEC Rule 204-1(b).

- Until that date, you may (but are not required to) submit a narrative *brochure* that meets the requirements of (amended) Part 2 of Form ADV. If you do not do this, you must comply with the requirements for preparing, delivering, and offering "old" Part II of Form ADV.

Note: Until the amendments to Part 2 are effective, you can satisfy the requirements related to "old" Part II by updating the information in your Part II whenever it becomes materially inaccurate. You must deliver Part II or a brochure containing at least the information contained in Part II to prospective *clients* and annually offer it to current *clients*. You are not required to file "old" Part II with the SEC, but you must keep a copy in your files, and provide it to the SEC staff upon request.

If you are applying for registration or are registered with one or more *state securities authorities*:

- Contact the appropriate *state securities authorities* for more information about the compliance transition schedule applicable to you.

6. Where do I sign my Form ADV application or amendment?

You must sign the appropriate Execution Page. There are three Execution Pages at the end of the form. Your initial application and all amendments to Form ADV must include at least one Execution Page.

- If you are applying for or are amending your SEC registration, you must sign and submit either a:
  - Domestic Investment Adviser Execution Page, if you (the advisory firm) are a resident of the United States; or
  - *Non-Resident* Investment Adviser Execution Page, if you (the advisory firm) are not a resident of the United States.
- If you are applying for or are amending your registration with a *state securities authority*, you must sign and submit the State-Registered Investment Adviser Execution Page.

7. Who must sign my Form ADV or amendment?

The individual who signs the form depends upon your form of organization:

- For a sole proprietorship, the sole proprietor.
- For a partnership, a general partner.
- For a corporation, an authorized principal officer.
- For a "separately identifiable department or division" (SID) of a bank, a principal officer of your bank who is directly engaged in the management, direction or supervision of your investment advisory activities.

- For all others, an authorized individual who participates in managing or directing your affairs.

The signature does not have to be notarized, and in the case of an electronic filing, should be a typed name.

8. How do I file my Form ADV?

Complete Form ADV electronically using the Investment Adviser Registration Depository (IARD) if:

- You are filing with the SEC (and submitting *notice filings* to any of the *state securities authorities*), or

- You are filing with a *state securities authority* that requires or permits advisers to submit Form ADV through the IARD.

  Note: SEC rules require advisers that are registered or applying for registration with the SEC to file electronically through the IARD system. See SEC rule 203-1. Check with the *state securities authorities* of each state in which you have a filing obligation to determine whether you can or must file Form ADV electronically through the IARD.

To file electronically, go to the IARD website (<www.iard.com>), which contains detailed instructions for advisers to follow when filing through the IARD.

Complete Form ADV (Paper Version) on paper if:

- You are filing with the SEC or a *state securities authority* that requires electronic filing, but you have been granted a continuing hardship exemption. Hardship exemptions are described in Instruction 14.

- You are filing with a *state securities authority* that permits (but does not require) electronic filing and you do not file electronically.

9. How do I get started filing electronically?

- First, get a copy of the IARD Entitlement Package from the following web site: <http://www.iard.com>. Second, request access to the IARD system for your firm by completing and submitting the IARD Entitlement Package. The IARD Entitlement Package must be submitted on paper. Mail the forms to: IARD Entitlement Requests, FINRA, P.O. Box 9495, Gaithersburg, MD 20898-9495.

- When FINRA receives your Entitlement Package, they will assign a *CRD* number (identification number for your firm) and a user I.D. code and password (identification number and system password for the individual(s) who will submit Form ADV filings for

your firm). Your firm may request an I.D. code and password for more than one individual. FINRA also will create a financial account for you from which the IARD will deduct filing fees and any state fees you are required to pay. If you already have a *CRD* account with FINRA, it will also serve as your IARD account; a separate account will not be established.

- Once you receive your *CRD* number, user I.D. code and password, and you have funded your account, you are ready to file electronically.

- Questions regarding the Entitlement Process should be addressed to FINRA at 240.386.4848.

10. If I am applying for registration with the SEC, or amending my SEC registration, how do I make *notice filings* with the *state securities authorities*?

If you are applying for registration with the SEC or are amending your SEC registration, one or more *state securities authorities* may require you to provide them with copies of your SEC filings. We call these filings "*notice filings*." Your *notice filings* will be sent electronically to the states that you check on Item 2.B. of Part 1A. The *state securities authorities* to which you send *notice filings* may charge fees, which will be deducted from the account you establish with FINRA. To determine which *state securities authorities* require SEC-registered advisers to submit *notice filings* and to pay fees, consult the relevant state investment adviser law or *state securities authority*. See General Instruction 1.

If you are granted a continuing hardship exemption to file Form ADV on paper, FINRA will enter your filing into the IARD and your *notice filings* will be sent electronically to the *state securities authorities* that you check on Item 2.B. of Part 1A.

11. I am registered with a state. When must I switch to SEC registration?

If you report on your *annual updating amendment* that your assets under management have increased to $30 million or more, you must register with the SEC within 90 days after you file that *annual updating amendment*. If your assets under management increase to $25 million or more but not $30 million, you may, but are not required to, register with the SEC (assuming you are not otherwise required to register with the SEC). Once you register with the SEC, you are subject to SEC regulation, regardless of whether you remain registered with one or more states. Each of your *investment adviser representatives*, however, may be subject to registration in those states in which the representative has a place of business. See SEC rule 203A-1(b). For additional information, consult the investment adviser laws or the *state securities authority* for the particular state in which you are "doing business." See General Instruction 1.

12. I am registered with the SEC. When must I switch to registration with a *state securities authority*?

If you report on your *annual updating amendment* that you have assets under management of less than $25 million and you are not otherwise eligible to register with the SEC, you must withdraw from SEC registration within 180 days after the end of your fiscal year by filing Form ADV-W. You should consult state law in the states that you are doing business to determine if you are required to register in these states. See General Instruction 1. Until you file your Form ADV-W with the SEC, you will remain subject to SEC regulation, and you also will be subject to regulation in any states where you register. See SEC rule 203A-1(b).

13. Are there filing fees?

Yes. These fees go to support and maintain the IARD. The IARD filing fees are in addition to any registration or other fee that may be required by state law. You must pay an IARD filing fee for your initial application and each *annual updating amendment*. There is no filing fee for an other-than-annual amendment or Form ADV-W. The IARD filing fee schedule is published at <http://www.sec.gov/iard>; <http://www.nasaa.org>; and <http://www.iard.com>.

If you are submitting a paper filing under a continuing hardship exemption (see Instruction 14), you are required to pay an additional fee. The amount of the additional fee depends on whether you are filing Form ADV or Form ADV-W. (There is no additional fee for filings made on Form ADV-W.) The hardship filing fee schedule is available by contacting FINRA at 240.386.4848.

14. What if I am not able to file electronically?

If you are required to file electronically but cannot do so, you may be eligible for one of two types of hardship exemptions from the electronic filing requirements.

- A **temporary hardship exemption** is available if you file electronically, but you encounter unexpected difficulties that prevent you from making a timely filing with the IARD, such as a computer malfunction or electrical outage. This exemption does not permit you to file on paper; instead, it extends the deadline for an electronic filing for seven business days. See SEC rule 203-3(a).

- A **continuing hardship exemption** may be granted if you are a small business and you can demonstrate that filing electronically would impose an undue hardship. You are a small business, and may be eligible for a continuing hardship exemption, if you are required to answer Item 12 of Part 1A (because you have assets under management of less than $25 million) and you are able to respond "no" to each question in Item 12. See SEC rule 0-7.

  If you have been granted a continuing hardship exemption, you must complete and submit the paper version of Form ADV to FINRA. FINRA will enter your responses into the

IARD. As discussed in General Instruction 13, FINRA will charge you a fee to reimburse it for the expense of data entry.

Before applying for a continuing hardship exemption, consider engaging a firm that assists investment advisers in making filings with the IARD. Check the SEC's web site (<http://www.sec.gov/iard>) to obtain a list of firms that provide these services.

15. I am eligible to file on paper. How do I make a paper filing?

When filing on paper, you must:

- Type all of your responses.
- Include your name (the same name you provide in response to Item 1.A. of Part 1A) and the date on every page.
- If you are amending your Form ADV:
  - complete page 1 and circle the number of any item for which you are changing your response.
  - include your SEC 801-number (if you have one) and your *CRD* number (if you have one) on every page.
  - complete the amended item in full and circle the number of the item for which you are changing your response.
  - to amend Schedule A or Schedule B, complete and submit Schedule C.

Where you submit your paper filing depends on why you are eligible to file on paper:

- If you are filing on paper because you have been granted a continuing hardship exemption, submit one manually signed Form ADV and one copy to: IARD Document Processing, FINRA, P.O. Box 9495, Gaithersburg, MD 20898-9495.

  If you complete Form ADV on paper and submit it to FINRA but you do not have a continuing hardship exemption, the submission will be returned to you.

- If you are filing on paper because a state in which you are registered or in which you are applying for registration allows you to submit paper instead of electronic filings, submit one manually signed Form ADV and one copy to the appropriate *state securities authorities*.

16. Who is required to file Form ADV-NR?

Every *non-resident* general partner and *managing agent* of all SEC-registered advisers, whether or not the adviser is resident in the United States, must file Form ADV-NR in connection with the adviser's initial application. A general partner or *managing agent* of an SEC-registered adviser who becomes a *non-resident* after the adviser's initial application has been submitted must file Form ADV-NR within 30 days. Form ADV-NR must be filed on paper (it cannot be filed electronically).

Submit Form ADV-NR to the SEC at the following address:

> Securities and Exchange Commission, 100 F Street, NE, Mail Stop 8031, Washington, DC 20549; Attn: The Registrations Branch

Failure to file Form ADV-NR promptly may delay SEC consideration of your initial application.

Federal Information Law and Requirements

Sections 203(c) and 204 of the Advisers Act [15 U.S.C. §§ 80b-3(c) and 80b-4] authorize the SEC to collect the information required by Form ADV. The SEC collects the information for regulatory purposes, such as deciding whether to grant registration. Filing Form ADV is mandatory for advisers who are required to register with the SEC. The SEC maintains the information submitted on this form and makes it publicly available. The SEC may return forms that do not include required information. Intentional misstatements or omissions constitute federal criminal violations under 18 U.S.C. § 1001 and 15 U.S.C. § 80b-17.

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. The Advisers Act authorizes the SEC to collect the information on Form ADV from applicants. See 15 U.S.C. §§ 80b-3(c)(1) and 80b-4. Filing the form is mandatory.

The main purpose of this form is to enable the SEC to register investment advisers. Every applicant for registration with the SEC as an adviser must file the form. See 17 C.F.R. § 275.203-1. By accepting a form, however, the SEC does not make a finding that it has been completed or submitted correctly. The form is filed annually by every adviser, no later than 90 days after the end of its fiscal year, to amend its registration. It is also filed promptly during the year to reflect material changes. See 17 C.F.R. § 275.204-1. The SEC maintains the information on the form and makes it publicly available through the IARD.

Anyone may send the SEC comments on the accuracy of the burden estimate on page 1 of the form, as well as suggestions for reducing the burden. The Office of Management and Budget has reviewed this collection of information under 44 U.S.C. § 3507.

The information contained in the form is part of a system of records subject to the Privacy Act of 1974, as amended. The SEC has published in the Federal Register the Privacy Act System of Records Notice for these records.

Appendix B

GLOSSARY OF TERMS

1. **Advisory Affiliate:** Your advisory affiliates are (1) all of your officers, partners, or directors (or any ***person*** performing similar functions); (2) all ***persons*** directly or indirectly ***controlling*** or ***controlled*** by you; and (3) all of your current ***employees*** (other than ***employees*** performing only clerical, administrative, support or similar functions).

   If you are a "separately identifiable department or division" (SID) of a bank, your ***advisory affiliates*** are: (1) all of your bank's ***employees*** who perform your investment advisory activities (other than clerical or administrative ***employees***); (2) all ***persons*** designated by your bank's board of directors as responsible for the day-to-day conduct of your investment advisory activities (including supervising the ***employees*** who perform investment advisory activities); (3) all ***persons*** who directly or indirectly ***control*** your bank, and all ***persons*** whom you ***control*** in connection with your investment advisory activities; and (4) all other ***persons*** who directly manage any of your investment advisory activities (including directing, supervising or performing your advisory activities), all ***persons*** who directly or indirectly ***control*** those management functions, and all ***persons*** whom you ***control*** in connection with those management functions. *[Used in: Part 1A, Item 11; Part 1B, Item 2]*

2. **Annual Updating Amendment:** Within 90 days after your firm's fiscal year end, your firm must file an "annual updating amendment," which is an amendment to your firm's Form ADV that reaffirms the eligibility information contained in Item 2 of Part 1A and updates the responses to any other item for which the information is no longer accurate. *[Used in: General Instructions; Part 1A Instructions, Introductory Text, Item 2; Part 2A, Instructions, Appendix 1 Instructions; Part 2B, Instructions]*

3. **Brochure:** A written disclosure statement that your firm is required to provide to ***clients*** and prospective ***clients***. See SEC rule 204-3; Form ADV, Part 2A. *[Used in: General Instructions; Used throughout Part 2 General Instructions; Part 2A, Instructions, Appendix 1 Instructions; Part 2B, Instructions]*

4. **Brochure Supplement:** A written disclosure statement containing information about certain of your supervised persons that your firm is required by Part 2B of Form ADV to provide to clients and prospective clients. See SEC rule 204-3; Form ADV, Part 2B. *[Used in: General Instructions; Used throughout Part 2 General Instructions; Part 2A, Instructions, Appendix 1 Instructions; Part 2B, Instructions]*

5. **Charged:** Being accused of a crime in a formal complaint, information, or indictment (or equivalent formal charge). *[Used in: Part 1A, Item 11; DRPs]*

6. **Client:** Any of your firm's investment advisory clients. This term includes clients from which your firm receives no compensation, such as members of your family. If your firm also

provides other services (e.g., accounting services), this term does not include clients that are not investment advisory clients. *[Used throughout Form ADV and Form ADV-W]*

7. **Control:** Control means the power, directly or indirectly, to direct the management or policies of a ***person***, whether through ownership of securities, by contract, or otherwise.

   - Each of your firm's officers, partners, or directors exercising executive responsibility (or ***persons*** having similar status or functions) is presumed to control your firm.

   - A ***person*** is presumed to control a corporation if the ***person***: (i) directly or indirectly has the right to vote 25 percent or more of a class of the corporation's voting securities; or (ii) has the power to sell or direct the sale of 25 percent or more of a class of the corporation's voting securities.

   - A ***person*** is presumed to control a partnership if the ***person*** has the right to receive upon dissolution, or has contributed, 25 percent or more of the capital of the partnership.

   - A ***person*** is presumed to control a limited liability company ("LLC") if the ***person***: (i) directly or indirectly has the right to vote 25 percent or more of a class of the interests of the LLC; (ii) has the right to receive upon dissolution, or has contributed, 25 percent or more of the capital of the LLC; or (iii) is an elected manager of the LLC.

   - A ***person*** is presumed to control a trust if the ***person*** is a trustee or ***managing agent*** of the trust.

   [Used in: General Instructions; Part 1A, Instructions, Items 2, 7, 10, 11, 12, Schedules A, B, C, D; Regulatory DRP]

8. **Custody:** Your firm has custody if it directly or indirectly holds ***client*** funds or securities, has any authority to obtain possession of them, or has the ability to appropriate them. Your firm has custody, for example, if it has a general power of attorney over a ***client's*** account or signatory power over a ***client's*** checking account. See SEC rule 206(4)-2. *[Used in: Part 1A, Item 9; Part 1B, Instructions, Item 2; Part 2A, Items 15, 18]*

9. **Discretionary Authority or Discretionary Basis:** Your firm has discretionary authority or manages assets on a discretionary basis if it has the authority to decide which securities to purchase and sell for the ***client***. Your firm also has discretionary authority if it has the authority to decide which investment advisers to retain on behalf of the ***client***. *[Used in: Part 1A, Instructions, Item 8; Part 1B, Instructions; Part 2A, Items 4, 16, 18; Part 2B, Instructions]*

10. **Employee:** This term includes an independent contractor who performs advisory functions on your behalf. *[Used in: Part 1A, Instructions, Items 1, 5, 7, 11]*

11. **Enjoined:** This term includes being subject to a mandatory injunction, prohibitory injunction, preliminary injunction, or a temporary restraining ***order***. *[Used in: Part 1A, Item 11; DRPs]*

12. **Felony:** For jurisdictions that do not differentiate between a felony and a ***misdemeanor***, a felony is an offense punishable by a sentence of at least one year imprisonment and/or a fine of at least $1,000. The term also includes a general court martial. *[Used in: Part 1A, Item 11; DRPs; Part 2A, Item 9; Part 2B, Item 3]*

13. **FINRA CRD** or **CRD:** The Web Central Registration Depository ("CRD") system operated by FINRA for the registration of broker-dealers and broker-dealer representatives. *[Used in: Part 1A, Item 1; Form ADV-W, Item 1]*

14. **Foreign Financial Regulatory Authority:** This term includes (1) a foreign securities authority; (2) another governmental body or foreign equivalent of a ***self-regulatory organization*** empowered by a foreign government to administer or enforce its laws relating to the regulation of ***investment-related*** activities; and (3) a foreign membership organization, a function of which is to regulate the participation of its members in the activities listed above. *[Used in: Part 1A, Items 1, 11; DRPs; Part 2A, Item 9; Part 2B, Item 3]*

15. **Found:** This term includes adverse final actions, including consent decrees in which the respondent has neither admitted nor denied the findings, but does not include agreements, deficiency letters, examination reports, memoranda of understanding, letters of caution, admonishments, and similar informal resolutions of matters. *[Used in: Part 1A, Item 11; Part 1B, Item 2; Part 2A, Item 9; Part 2B, Item 3]*

16. **Government Entity:** Any state or political subdivision of a state, including (i) any agency, authority, or instrumentality of the state or political subdivision; (ii) a plan or pool of assets ***controlled*** by the state or political subdivision or any agency, authority or instrumentality thereof; and (iii) any officer, agent, or employee of the state or political subdivision or any agency, authority or instrumentality thereof, acting in their official capacity. *[Used in: Part 1A, Item 5]*

17. **High Net Worth Individual:** An individual with at least $750,000 managed by you, or whose net worth your firm reasonably believes exceeds $1,500,000, or who is a "qualified purchaser" as defined in section 2(a)(51)(A) of the Investment Company Act of 1940. The net worth of an individual may include assets held jointly with his or her spouse. *[Used in: Part 1A, Item 5]*

18. **Home State:** If your firm is registered with a ***state securities authority***, your firm's "home state" is the state where it maintains its ***principal office and place of business***. *[Used in: Part 1B, Instructions]*

19. **Impersonal Investment Advice:** Investment advisory services that do not purport to meet the objectives or needs of specific individuals or accounts. *[Used in: Part 1A, Instructions; Part 2A, Instructions; Part 2B, Instructions]*

20. **Investment Adviser Representative:** Investment adviser representatives of SEC-registered advisers are subject to state registration in each state in which they have a ***place of business.*** Any of your firm's ***supervised persons*** (except those that provide only ***impersonal investment advice***) is an investment adviser representative, if --

    - the ***supervised person*** regularly solicits, meets with, or otherwise communicates with your firm's ***clients***,
    - the ***supervised person*** has more than five ***clients*** who are natural persons and not ***high net worth individuals***, and
    - more than ten percent of the ***supervised person's*** clients are natural persons and not ***high net worth individuals.***

    NOTE: If your firm is registered with the ***state securities authorities*** and not the SEC, your firm may be subject to a different state definition of "investment adviser representative."

[Used in: Part 2, General Instructions; Part 2A, Item 14; Part 2B, Item 1]

21. **Investment-Related:** Activities that pertain to securities, commodities, banking, insurance, or real estate (including, but not limited to, acting as or being associated with an investment adviser, broker-dealer, municipal securities dealer, government securities broker or dealer, issuer, investment company, futures sponsor, bank, or savings association). *[Used in: Part 1A, Item 11; DRPs; Part 1B, Item 2; Part 2A, Item 9; Part 2B, Item 3]*

22. **Involved:** Engaging in any act or omission, aiding, abetting, counseling, commanding, inducing, conspiring with or failing reasonably to supervise another in doing an act. *[Used in: Part 1A, Item 11; Part 2A, Item 9; Part 2B, Item 3]*

23. **Management Persons:** Anyone with the power to exercise, directly or indirectly, a ***controlling*** influence over your firm's management or policies, or to determine the general investment advice given to the ***clients*** of your firm.

Generally, all of the following are management persons:

- Your firm's principal executive officers, such as your chief executive officer, chief financial officer, chief operations officer, chief legal officer, and chief compliance officer; your directors, general partners, or trustees; and other individuals with similar status or performing similar functions;
- The members of your firm's investment committee or group that determines general investment advice to be given to ***clients***; and
- If your firm does not have an investment committee or group, the individuals who determine general investment advice provided to ***clients*** (if there are more than five people, you may limit your firm's response to their supervisors).

[Used in: Part 1B, Item 2; Part 2A, Items 9, 10]

24. **Managing Agent:** A managing agent of an investment adviser is any ***person***, including a trustee, who directs or manages (or who participates in directing or managing) the affairs of any unincorporated organization or association that is not a partnership. *[Used in: General Instructions; Form ADV-NR]*

25. **Minor Rule Violation:** A violation of a ***self-regulatory organization*** rule that has been designated as "minor" pursuant to a plan approved by the SEC. A rule violation may be designated as "minor" under a plan if the sanction imposed consists of a fine of $2,500 or less, and if the sanctioned ***person*** does not contest the fine. (Check with the appropriate ***self-regulatory organization*** to determine if a particular rule violation has been designated as "minor" for these purposes.) *[Used in: Part 1A, Item 11]*

26. **Misdemeanor:** For jurisdictions that do not differentiate between a ***felony*** and a misdemeanor, a misdemeanor is an offense punishable by a sentence of less than one year imprisonment and/or a fine of less than $1,000. The term also includes a special court martial. *[Used in: General Instructions; Part 1A, Item 11; DRPs; Part 2A, Item 9; Part 2B, Item 3]*

27. **Non-Resident:** (a) an individual who resides in any place not subject to the jurisdiction of the United States; (b) a corporation incorporated in or having its ***principal office and place of business*** in any place not subject to the jurisdiction of the United States; and (c) a partnership or other unincorporated organization or association that has its ***principal office and place of business*** in any place not subject to the jurisdiction of the United States. *[Used in: General Instructions; Form ADV-NR]*

28. **Notice Filing:** SEC-registered advisers may have to provide ***state securities authorities*** with copies of documents that are filed with the SEC. These filings are referred to as "notice filings." *[Used in: General Instructions; Part 1A, Item 2; Execution Page(s); Form ADV-W]*

29. **Order:** A written directive issued pursuant to statutory authority and procedures, including an order of denial, exemption, suspension, or revocation. Unless included in an order, this term does not include special stipulations, undertakings, or agreements relating to payments, limitations on activity or other restrictions. *[Used in: Part 1A, Items 2 and 11; Schedule D; DRPs; Part 2A, Item 9; Part 2B, Item 3]*

30. **Performance-Based Fee:** An investment advisory fee based on a share of capital gains on, or capital appreciation of, ***client*** assets. A fee that is based upon a percentage of assets that you manage is not a performance-based fee. *[Used in: Part 1A, Item 5]*

31. **Person:** A natural person (an individual) or a company. A company includes any partnership, corporation, trust, limited liability company ("LLC"), limited liability partnership ("LLP"), or other organization. *[Used throughout Form ADV and Form ADV-W]*

32. **Principal Place of Business** or **Principal Office and Place of Business:** Your firm's executive office from which your firm's officers, partners, or managers direct, ***control***, and coordinate the activities of your firm. *[Used in: Part 1A, Instructions, Items 1 and 2; Schedule D; Form ADV-W, Item 1]*

33. **Proceeding:** This term includes a formal administrative or civil action initiated by a governmental agency, ***self-regulatory organization*** or ***foreign financial regulatory authority***; a ***felony*** criminal indictment or information (or equivalent formal charge); or a ***misdemeanor*** criminal information (or equivalent formal charge). This term does not include other civil litigation, investigations, or arrests or similar charges effected in the absence of a formal criminal indictment or information (or equivalent formal charge). *[Used in: Part 1A, Item 11; DRPs; Part 1B, Item 2; Part 2A, Item 9; Part 2B, Item 3]*

34. **Related Person:** Any ***advisory affiliate*** and any ***person*** that is under common ***control*** with your firm. *[Used in: Part 1A, Items 7, 8, 9; Schedule D; Form ADV-W, Item 3; Part 2A, Instructions, Items 5, 10, 11, 12, 14, 15]*

35. **Self-Regulatory Organization** or **SRO:** Any national securities or commodities exchange, registered securities association, or registered clearing agency. For example, the Chicago Board of Trade ("CBOT"), FINRA and New York Stock Exchange ("NYSE") are self-regulatory organizations. *[Used in: Part 1A, Item 11; DRPs; Part 1B, Item 2; Part 2A, Item 9; Part 2B, Item 3]*

36. **Sponsor:** A sponsor of a ***wrap fee program*** sponsors, organizes, or administers the program or selects, or provides advice to ***clients*** regarding the selection of, other investment advisers in the program. *[Used in: Part 1A, Item 5; Schedule D; Part 2A, Instructions, Appendix 1 Instructions]*

37. **State Securities Authority:** The securities commission (or any agency or office performing like functions) of any state of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, or any other possession of the United States. *[Used throughout Form ADV]*

38. **Supervised Person:** Any of your officers, partners, directors (or other ***persons*** occupying a similar status or performing similar functions), or ***employees***, or any other ***person*** who provides investment advice on your behalf and is subject to your supervision or ***control***. *[Used in: Part 2, General Instructions; Part 2A, Item 6; Used throughout Part 2B]*

39. **Wrap Brochure** or **Wrap Fee Program Brochure:** The written disclosure statement that ***sponsors*** of ***wrap fee programs*** are required to provide to each of their ***wrap fee program clients***. *[Used in: Part 2, General Instructions; Used throughout Part 2A, Appendix 1]*

40. **Wrap Fee Program:** Any advisory program under which a specified fee or fees not based directly upon transactions in a ***client's*** account is charged for investment advisory services (which may include portfolio management or advice concerning the selection of other investment advisers) and the execution of ***client*** transactions. *[Used in: Part 1, Item 5; Schedule D; Part 2A, Instructions, Item 4, used throughout Appendix 1; Part 2B, Instructions]*

Appendix C

FORM ADV (Paper Version)
UNIFORM APPLICATION FOR INVESTMENT ADVISER REGISTRATION

PART 2: Uniform Requirements for Investment Adviser *Brochure* and *Brochure Supplements*

General Instructions for Part 2 of Form ADV

Under SEC and similar state rules, you are required to deliver to *clients* and prospective *clients* a *brochure* disclosing information about your firm. You also may be required to deliver a *brochure supplement* disclosing information about one or more of your *supervised persons*. Part 2 of Form ADV sets out the minimum required disclosure that your *brochure* (Part 2A for a firm *brochure*, or Appendix 1 for a *wrap fee program brochure*) and *brochure supplements* (Part 2B) must contain.

1. Narrative Format. Part 2 of Form ADV consists of a series of items that contain disclosure requirements for preparing your firm's *brochure* and any required supplements. The items require narrative responses. You may omit responses to the items that do not apply to your business. You do not have to provide responses in the same order as the items appear, and you should not repeat the items themselves in the *brochure* or the supplements. A *brochure* would not need to repeat information simply because the information is responsive to more than one item.

2. Plain English. The items in Part 2 of Form ADV are designed to promote effective communication between you and your *clients*. Write your *brochure* and supplements in plain English, taking into consideration your *clients*' level of financial sophistication. Your *brochure* should be concise and direct. In drafting your *brochure* and *brochure supplements*, you should: (i) use short sentences; (ii) use definite, concrete, everyday words; (iii) use active voice; (iv) use tables or bullet lists for complex material, whenever possible; (v) avoid legal jargon or highly technical business terms unless you explain them or you believe that your *clients* will understand them; and (vi) avoid multiple negatives. Consider providing examples to illustrate a description of your practices or policies.

   Note: The SEC's Office of Investor Education and Advocacy has published A Plain English Handbook. You may find the handbook helpful in writing your *brochure* and supplements. For a copy of this handbook, visit the SEC's web site at<www.sec.gov/news/extra/handbook.htm> or call 1-800-SEC-0330.

3. Full Disclosure of All Conflicts of Interest. Under federal and state law, you are a fiduciary required to make full disclosure to your *clients* of all material facts, including conflicts of interest between you and your *client* and any other material information that could affect the advisory relationship. You therefore may have to disclose to *clients* information not specifically required by Part 2 of Form ADV. You may disclose this additional information to *clients* in your *brochure* or by some other means.

4. Full and Truthful Disclosure. All information in your *brochure* and *brochure supplements* must be true and may not omit any material facts.

5. Filing. You must file your *brochure(s)* (and amendments) through the IARD system. See SEC rules 203-1 and 204-1 and similar state rules. If you are registered or are registering with the SEC, you are not required to file your *brochure supplements* through the IARD or otherwise. You must, however, preserve a copy of the supplements and make them available to SEC staff upon request. See SEC rule 204-2(a)(14). If you are registered or are registering with one or more of the *state securities authorities*, you must file a copy of the *brochure supplement* for each *supervised person* and each *investment adviser representative* doing business in that state. You should contact the appropriate *state securities authorities* to determine if this filing should be made electronically through the IARD or by a paper filing with the state.

Instructions for Part 2A of Form ADV: Preparing Your Firm *Brochure*

1. To whom must we deliver a firm *brochure*? You must give a firm *brochure* to each *client*. You must deliver the *brochure* even if your advisory agreement with the *client* is oral. See SEC rule 204-3(b)(1) and similar state rules.

   For SEC-registered advisers: You are not required to deliver your *brochure* to either (i) *clients* who receive only *impersonal investment advice* from you and who will pay you less than $500 per year or (ii) *clients* that are SEC-registered investment companies or business development companies (the *client* must be registered under the Investment Company Act of 1940 or be a business development company as defined in that Act, and the advisory contract must meet requirements of section 15(c) of that Act). See SEC rule 204-3(c).

   Note: Even if you are not required to give a *brochure* to a *client*, as a fiduciary you may still be required to provide your *clients* with similar information, particularly material information about your conflicts of interest and about your disciplinary information. If you are not required to give a *client* a *brochure*, you may make any required disclosures to that *client* by delivery of your *brochure* or through some other means.

2. When must we deliver a *brochure* to *clients*?
   - You must give a firm *brochure* to each *client* before or at the time you enter into an advisory agreement with that *client*. See SEC rule 204-3(b)(1) and similar state rules.
   - Each year you must deliver to each *client* a free updated *brochure* within 120 days of the end of your fiscal year. See SEC rule 204-3(b)(1) and similar state rules.
   - You do not have to deliver an interim amendment to *clients* unless the amendment includes information in response to Item 9 of Part 2A (disciplinary information). An interim amendment can be in the form of a "sticker" that identifies the information that has become inaccurate and provides the new information and the date of the sticker. See SEC rules 204-1 and 204-3(e) and similar state rules.

   Note: As a fiduciary, you have an ongoing obligation to inform your *clients* of any material information that could affect the advisory relationship. As a result, between *annual updating amendments* you must disclose material changes to *clients* even if those changes do not trigger delivery of an interim amendment. See General Instructions for Part 2 of Form ADV, Instruction 3.

3. May we deliver our *brochure* electronically? Yes. The SEC has published interpretive guidance on delivering documents electronically, which you can find at <www.sec.gov/rules/concept/33-7288.txt>.

4. When must we update our *brochure*? You must update your *brochure*: (i) each year at the time you file your *annual updating amendment*; and (ii) promptly whenever any information in the *brochure* becomes materially inaccurate. You are not generally required to update your *brochure* between annual amendments solely because the amount of *client* assets you manage has changed or because your fee schedule has changed. However, if you are updating your *brochure* for a separate reason in between annual amendments, and the amount of *client* assets you manage listed in response to Item 4.E or your fee schedule listed in response to Item 5.A has become materially inaccurate, you should update that item(s) as part of the interim amendment. All updates to your *brochure* must be filed through the IARD system and maintained in your files. See SEC rules 204-1 and 204-2(a)(14) and similar state rules.

5. We have determined that we have no *clients* to whom we must deliver a *brochure*. Must we prepare one? No.

6. We offer several advisory services. May we prepare multiple firm *brochures*? Yes. If you offer substantially different types of advisory services, you may opt to prepare separate *brochures* so long as each *client* receives all applicable information about services and fees. Each *brochure* may omit information that does not apply to the advisory services and fees it describes. For example, your firm *brochure* that describes one advisory service can omit the fee schedule for a different advisory service that is not discussed in the *brochure*. See SEC rule

204-3(f) and similar state rules. If you prepare separate *brochures* you must file each *brochure* (and any amendments) through the IARD system as required in SEC rules 203-1 and 204-1 and similar state rules.

7. We *sponsor* a *wrap fee program*. Is there a different *brochure* that we need to deliver to our wrap fee *clients*? Yes. If you *sponsor* a *wrap fee program*, you must deliver a *wrap fee program brochure* to your wrap fee *clients*. The disclosure requirements for preparing a *wrap fee program brochure* (also called a *wrap brochure*) appear in Part 2A Appendix 1 of Form ADV. If your entire advisory business is *sponsoring wrap fee programs*, you do not need to prepare a firm *brochure* separate from your *wrap brochure(s)*. See SEC rule 204-3(d).

8. We provide portfolio management services to *clients* in *wrap fee programs* that we do not *sponsor*. Which *brochure* must we deliver to these *clients*? You must deliver your firm *brochure* to your wrap fee *clients*. You also must deliver to these *clients* any *brochure supplements* required by Part 2B of Form ADV.

9. May we include information not required by an item in our *brochure*? Yes. If you include information not required by an item, however, you may not include so much additional information that the required information is obscured.

10. Item 18 requires us to give our *clients* an audited balance sheet. May any public accountant perform the audit? Your auditor must be independent. Article 2 of SEC Regulation S-X sets out the general rules for auditor independence. Please note that these requirements may be different from the rules of professional organizations.

11. We are a new firm. Do we need a *brochure*? Yes. Respond to items in Part 2A of Form ADV based on the advisory services you propose to provide and the practices, policies and procedures you propose to adopt.

12. We are a "separately identifiable department or division" (SID) of a bank. Must our *brochure* discuss our bank's general business practices? No. Information you include in your firm *brochure* (or in *brochure supplements*) should be information about you, the SID, and your business practices, rather than general information about your bank.

Part 2A of Form ADV: Firm *Brochure*

Item 1 Cover Page

A. The cover page of your *brochure* must state your name, business address, telephone number, Web site address (if you have one), and the date of the *brochure*.

Note: If you primarily conduct advisory business under a name different from your full legal name, and you have disclosed your business name in Item 1.B of Part 1A of Form ADV, then you may use your business name throughout your *brochure*.

B. Display on the cover page of your *brochure* the following (or other clear and concise language conveying the same information):

This brochure provides information about the qualifications and business practices of [your name]. If you have any questions about the contents of this brochure, please contact [name and telephone number of service center or name and/or title and telephone number of contact person]. The information in this brochure has not been approved or verified by the United States Securities and Exchange Commission or by any state securities authority.

Additional information about [your name] also is available on the Internet at www.adviserinfo.sec.gov.

C. If you refer to yourself as a "registered investment adviser" or describe yourself as being "registered," include a statement that registration does not imply a certain level of skill or training.

Item 2 Material Changes

If your *brochure* contains material changes from its last annual update, identify those changes on the cover page of the *brochure* or on the page immediately following the cover page, or in a separate communication accompanying the *brochure*. You must state clearly that you are discussing only material changes since the last annual update of your *brochure*, and you must provide the date of the last annual update of your *brochure*.

Note: You do not have to provide this information to a *client* or prospective *client* who has not received a previous version of your *brochure*.

Item 3 Table of Contents

Provide a table of contents to your *brochure*.

Note: Your table of contents must be detailed enough so that your *clients* can locate topics easily. However, your *brochure* is not required to follow the same order as the items listed in Part 2.

Item 4 Advisory Business

A. Describe your advisory firm, including how long you have been in business. Identify your principal owner(s).

Notes: (1) For purposes of this item, your principal owners include the *persons* you list as owning 25% or more of your firm on Schedule A of Part 1A of Form ADV (Ownership Codes C, D or E). (2) If you are a publicly held company without a 25% shareholder, simply disclose that you are publicly held. (3) If an individual or company owns 25% or more of your firm through subsidiaries, you must identify the individual or parent company and intermediate subsidiaries. If you are a state-registered adviser, you must

identify all intermediate subsidiaries. If you are an SEC-registered adviser, you must identify intermediate subsidiaries that are publicly held, but not other intermediate subsidiaries.

B. Describe the types of advisory services you offer. If you hold yourself out as specializing in a particular type of advisory service, such as financial planning, quantitative analysis, or market timing, explain the nature of that service in greater detail. If you provide investment advice only with respect to limited types of investments, explain the type of investment advice you offer, and disclose that your advice is limited to those types of investments.

C. Explain whether (and, if so, how) you tailor your advisory services to the individual needs of *clients*. Explain whether *clients* may impose restrictions on investing in certain securities or types of securities.

D. If you participate in *wrap fee programs* by providing portfolio management services, (1) describe the differences, if any, between how you manage wrap fee accounts and how you manage other accounts, and (2) explain that you receive a portion of the wrap fee for your services.

E. If you manage *client* assets, disclose the amount of *client* assets you manage on a *discretionary basis* and the amount of *client* assets you manage on a non-*discretionary basis*. Disclose the date "as of" which you calculated the amounts.

Note: Your method for computing the amount of "*client* assets you manage" can be different from the method for computing "assets under management" required for Item 5.F in Part 1A. However, if you choose to use a different method to compute "*client* assets you manage," you must keep documentation describing the method you use. The amount you disclose may be rounded to the nearest $100,000. Your "as of" date must not be more than three months before the date you last updated your *brochure* in response to this Item 4.E.

Item 5 Fees and Compensation

A. Describe how you are compensated for your advisory services. Provide your fee schedule. Disclose whether the fees are negotiable.

B. Describe whether you deduct fees from *clients'* assets or bill *clients* for fees incurred. If *clients* may select either method, disclose this fact. Explain how often you bill *clients* or deduct your fees.

C. Describe any other types of fees or expenses *clients* may pay in connection with your advisory services, such as custodian fees or mutual fund expenses. Disclose that *clients* will incur brokerage and other transaction costs, and direct *clients* to the section(s) of your *brochure* that discuss brokerage.

D. If your *clients* either may or must pay your fees in advance, disclose this fact. Explain how a *client* may obtain a refund of a pre-paid fee if the advisory contract is terminated before the end of the billing period. Explain how you will determine the amount of the refund.

E. If you or any of your *supervised persons* accepts compensation for the sale of securities or other investment products, including distribution or service ("trail") fees from the sale of mutual funds, disclose this fact and respond to Items 5.E.1, 5.E.2, 5.E.3 and 5.E.4.

1. Explain that this practice presents a conflict of interest and gives you or your *supervised persons* an incentive to recommend investment products based on the compensation received, rather than on a *client's* needs. Describe generally how you address conflicts that arise, including your procedures for disclosing the conflicts to *clients*. If you primarily recommend mutual funds, disclose whether you will recommend "no-load" funds.

2. Explain that *clients* have the option to purchase investment products that you recommend through other brokers or agents that are not affiliated with you.

3. If more than 50% of your revenue from advisory *clients* results from commissions and other compensation for the sale of investment products you recommend to your *clients*, including trail fees from the sale of mutual funds, disclose that commissions provide your primary or, if applicable, your exclusive compensation.

4. If you charge advisory fees in addition to commissions, disclose whether you reduce your advisory fees to offset the commissions you accept.

Note: If you receive compensation in connection with the purchase or sale of securities, you should carefully consider the applicability of the broker-dealer registration requirements of the Securities Exchange Act of 1934 and any applicable state securities statutes.

Item 6 Performance Fees and Side-By-Side Management

If you or any of your *supervised persons* accepts "performance fees" – that is, fees based on a share of capital gains on or capital appreciation of the assets of a *client* (such as a *client* that is a hedge fund or other pooled investment vehicle) – disclose this fact. If you or any of your *supervised persons* manage both accounts that are charged a performance fee and accounts that are charged another type of fee, such as an hourly or flat fee, or an asset-based fee, disclose this fact. Explain the conflicts of interest that you or your *supervised persons* face by managing these accounts at the same time, including that you or your *supervised persons* have an incentive to favor accounts for which you or your *supervised persons* receive a performance fee, and describe generally how you address these conflicts.

Item 7 Types of *Clients*

Describe the types of *clients* to whom you generally provide investment advice, such as individuals, trusts, investment companies, or pension plans. If you have any requirements for opening or maintaining an account, such as a minimum account size, disclose the requirements.

Item 8 Methods of Analysis, Investment Strategies and Risk of Loss

A. Describe the methods of analysis and investment strategies you use in formulating investment advice or managing assets. Explain that investing in securities involves risk of loss that *clients* should be prepared to bear.

B. If you primarily use a particular method of analysis or strategy, explain the specific risks involved. If the method of analysis or strategy involves significant or unusual risks, discuss these risks in detail. If your primary strategy involves frequent trading of securities, explain how frequent trading can affect investment performance, particularly through increased brokerage and other transaction costs and taxes.

C. If you recommend primarily a particular type of security, explain the specific risks involved. If the type of security involves significant or unusual risks, discuss these risks in detail.

D. Discuss your practices regarding cash balances in *client* accounts, including whether you invest cash balances for temporary purposes and, if so, how.

Item 9 Disciplinary Information

If there are legal or disciplinary events that are material to a *client's* or prospective *client's* evaluation of your advisory business or the integrity of your management, disclose all material facts regarding those events.

Items 9.A, 9.B, and 9.C list specific legal and disciplinary events that you must presume are material for this Item. If your advisory firm or a *management person* has been *involved* in one of these events, you must disclose it under this Item for ten years following the date of the event, unless (1) the event was resolved in your or the *management person's* favor, or was reversed, suspended or vacated, or (2) the event is not material (see Note below). For purposes of calculating this ten-year period, the "date" of an event is the date that the final *order*, judgment, or decree was entered, or the date that any rights of appeal from preliminary *orders*, judgments or decrees lapsed.

Items 9.A, 9.B, and 9.C do not contain an exclusive list of material disciplinary events. If your advisory firm or a *management person* has been *involved* in a legal or disciplinary event that is not listed in Items 9.A, 9.B, or 9.C, but nonetheless is material to a *client's* or prospective *client's* evaluation of your advisory business or the integrity of its management, you must disclose the event. Similarly, even if more than ten years have passed since the date of the event, you must disclose the event if it is so serious that it remains currently material to a *client's* or prospective *client's* evaluation.

A. A criminal or civil action in a domestic, foreign or military court of competent jurisdiction in which your firm or a *management person*

1. was convicted of, or pled guilty or nolo contendere ("no contest") to (a) any *felony*; (b) a *misdemeanor* that *involved* investments or an *investment-related* business, fraud, false statements or omissions, wrongful taking of property, bribery, perjury, forgery, counterfeiting, or extortion; or (c) a conspiracy to commit any of these offenses;

2. is the named subject of a pending criminal *proceeding* that involves an *investment-related* business, fraud, false statements or omissions, wrongful taking of property, bribery, forgery, counterfeiting, extortion, or a conspiracy to commit any of these offenses;

3. was *found* to have been *involved* in a violation of an *investment-related* statute or regulation; or

4. was the subject of any *order*, judgment, or decree permanently or temporarily enjoining, or otherwise limiting, your firm or a *management person* from engaging in any *investment-related* activity, or from violating any *investment-related* statute, rule, or *order*.

B. An administrative *proceeding* before the SEC, any other federal regulatory agency, any state regulatory agency, or any *foreign financial regulatory authority* in which your firm or a *management person*

1. was *found* to have caused an *investment-related* business to lose its authorization to do business; or

2. was *found* to have been *involved* in a violation of an *investment-related* statute or regulation and was the subject of an *order* by the agency or authority

(a) denying, suspending, or revoking the authorization of your firm or a *management person* to act in an *investment-related* business;

(b) barring or suspending your firm's or a *management person's* association with an *investment-related* business;

(c) otherwise significantly limiting your firm's or a *management person's investment-related* activities; or

(d) imposing a civil money penalty of more than $2,500 on your firm or a *management person*.

C. A *self-regulatory organization* (*SRO*) *proceeding* in which your firm or a *management person*

1. was *found* to have caused an *investment-related* business to lose its authorization to do business; or

2. was *found* to have been *involved* in a violation of the *SRO's* rules and was: (i) barred or suspended from membership or from association with other members, or was expelled from membership; (ii) otherwise significantly limited from *investment-related* activities; or (iii) fined more than $2,500.

Note: Special circumstances may make an event immaterial (overcoming the materiality presumption). If an event is immaterial, you are not required to disclose it. When you review a legal or disciplinary event involving your firm or a *management person* for materiality, you should consider all of the following factors: (1) the proximity of the *person involved* in the disciplinary event to the advisory function; (2) the nature of the infraction that led to the disciplinary event; (3) the severity of the disciplinary sanction; and (4) the time elapsed since the date of the disciplinary event. If you conclude that the materiality presumption is overcome, you must prepare and maintain a file memorandum of your determination in your records. See SEC rule 204-2(a)(14)(iii).

Item 10 Other Financial Industry Activities and Affiliations

A. If you or any of your *management persons* are registered, or have an application pending to register, as a broker-dealer or a registered representative of a broker-dealer, disclose this fact.

B. If you or any of your *management persons* are registered, or have an application pending to register, as a futures commission merchant, commodity pool operator, a commodity trading advisor, or an associated person of the foregoing entities, disclose this fact.

C. Describe any relationship or arrangement that is material to your advisory business or to your *clients*, that you or any of your *management persons* have with any *related person* listed below. Identify the *related person* and if the relationship or arrangement creates a material conflict of interest with *clients*, describe the nature of the conflict and how you address it.

1. broker-dealer, municipal securities dealer, or government securities dealer or broker
2. investment company or other pooled investment vehicle (including a mutual fund, closed-end investment company, unit investment trust, private investment company or "hedge fund," and offshore fund)
3. other investment adviser or financial planner
4. futures commission merchant, commodity pool operator, or commodity trading advisor
5. banking or thrift institution
6. accountant or accounting firm
7. lawyer or law firm
8. insurance company or agency
9. pension consultant
10. real estate broker or dealer
11. sponsor or syndicator of limited partnerships.

D. If you recommend or select other investment advisers for your *clients* and you receive compensation directly or indirectly from those advisers, or you have other business relationships with those advisers, describe these practices and discuss the conflicts of interest these practices create and how you address them.

Item 11 Code of Ethics, Participation or Interest in *Client* Transactions and Personal Trading

A. If you are an SEC-registered adviser, briefly describe your code of ethics adopted pursuant to SEC rule 204A-1. Explain that you will provide a copy of your code of ethics to any *client* or prospective *client* upon request.

B. If you or a *related person* recommends to *clients*, or buys or sells for *client* accounts, securities in which you or a *related person* has a material financial interest (excluding an interest as a shareholder of an SEC-registered, open-end investment company), describe your practice and discuss the conflicts of interest it presents. Describe generally how you address conflicts that arise, including your procedures for disclosing the conflicts to *clients*. You do not need to repeat any information you provided in response to Item 5 of Part 2A.

Examples: (1) You or a *related person*, as principal, buys securities from (or sells securities to) your *clients*; (2) you or a *related person* acts as general partner in a partnership in which you solicit *client* investments; or (3) you or a *related person* acts as investment adviser to an investment company that you recommend to *clients*.

C. If you or a *related person* invests in the same securities (or related securities, *e.g.*, warrants, options or futures) that you or a *related person* recommends to *clients*, describe your practice and discuss the conflicts of interest this presents and generally how you address the conflicts that arise in connection with personal trading.

D. If you or a *related person* recommends securities to *clients,* or buys or sells securities for *client* accounts, at or about the same time that you or a *related person* buys or sells the same securities for your own (or the *related person's* own) account, describe your practice and discuss the conflicts of interest it presents. Describe generally how you address conflicts that arise.

Note: The description required by Item 11.A may include information responsive to Item 11.B, C or D. If so, it is not necessary to make repeated disclosures of the same information.

Item 12 Brokerage Practices

A. Describe the factors that you consider in selecting or recommending broker-dealers for *client* transactions and determining the reasonableness of their compensation (*e.g.*, commissions).

1. Research and Other Soft Dollar Benefits. If you receive research or other products or services other than execution from a broker-dealer or a third party in connection with *client* securities transactions ("soft dollar benefits"), disclose your practices and discuss the conflicts of interest they create.

Note: Your disclosure and discussion must include all soft dollar benefits you receive, including, in the case of research, both proprietary research (created or developed by the broker-dealer) and research created or developed by a third party.

a. Explain that when you use *client* brokerage commissions (or markups or markdowns) to obtain research or other products or services, you receive a benefit because you do not have to produce or pay for the research, products or services.

b. Disclose that you may have an incentive to select or recommend a broker-dealer based on your interest in receiving the research or other products or services, rather than on your *clients*' interest in receiving best execution.

c. If you may cause *clients* to pay commissions (or markups or markdowns) higher than those charged by other broker-dealers in return for soft dollar benefits (known as paying-up), disclose this fact.

d. Disclose whether you use soft dollar benefits to service all of your *clients*' accounts or only those that paid for the benefits. Disclose whether you seek to allocate soft dollar benefits to *client* accounts proportionately to the soft dollar credits the accounts generate.

e. Describe the types of products and services you or any of your *related persons* acquired with *client* brokerage commissions (or markups or markdowns) within your last fiscal year.

Note: This description must be specific enough for your *clients* to understand the types of products or services that you are acquiring and to permit them to evaluate possible conflicts of interest. Your description must be more detailed for products or services that do not qualify for the safe harbor in section 28(e) of the Securities Exchange Act of 1934, such as those services that do not aid in investment decision-making or trade execution. Merely disclosing that you obtain various research reports and products is not specific enough.

f. Explain the procedures you used during your last fiscal year to direct *client* transactions to a particular broker-dealer in return for soft dollar benefits you received.

2. Brokerage for *Client* Referrals. If you consider, in selecting or recommending broker-dealers, whether you or a *related person* receives *client* referrals from a broker-dealer or third party, disclose this practice and discuss the conflicts of interest it creates.

a. Disclose that you may have an incentive to select or recommend a broker-dealer based on your interest in receiving *client* referrals, rather than on your *clients*' interest in receiving best execution.

b. Explain the procedures you used during your last fiscal year to direct *client* transactions to a particular broker-dealer in return for *client* referrals.

3. Directed Brokerage.

a. If you routinely recommend, request or require that a *client* direct you to execute transactions through a specified broker-dealer, describe your practice or policy. Explain that not all advisers require their *clients* to direct brokerage. If you and the broker-dealer are affiliates or have another economic relationship that creates a material conflict of interest, describe the relationship and discuss the conflicts of interest it presents. Explain that by directing brokerage you may be unable to achieve best execution of *client* transactions, and that this practice may cost *clients* more money.

b. If you permit a *client* to direct brokerage, describe your practice. If applicable, explain that you may be unable to achieve best execution of *client* transactions. Explain that directing brokerage may cost *clients* more money. For example, in a directed brokerage account, the *client* may pay higher brokerage commissions because you may not be able to aggregate orders to reduce transaction costs, or the *client* may receive less favorable prices.

Note: If you only permit *clients* to direct brokerage subject to best execution, you do not need to respond to Item 12.A.3.b.

B. Discuss whether and under what conditions you aggregate the purchase or sale of securities for various *client* accounts in quantities sufficient to obtain reduced transaction costs (known as bunching). If you do

not bunch orders when you have the opportunity to do so, explain your practice and describe the costs to *clients* of not bunching.

Item 13 Review of Accounts

A. Indicate whether you periodically review *client* accounts or financial plans. If you do, describe the frequency and nature of the review, and the titles of the *employees* who conduct the review.

B. If you review *client* accounts on other than a periodic basis, describe the factors that trigger a review.

C. Describe the content and indicate the frequency of regular reports you provide to *clients* regarding their accounts. State whether these reports are written.

Item 14 Payment for *Client* Referrals

A. If someone who is not a *client* provides an economic benefit to you for providing investment advice or other advisory services to your *clients*, generally describe the arrangement. For purposes of this Item, economic benefits include any sales awards or other prizes. You do not need to repeat any information you provided in response to Item 5 of Part 2A.

B. If you or a *related person* directly or indirectly compensates any *person* who is not your *employee* for *client* referrals, describe the arrangement and the compensation.

Note: If you compensate any *person* for *client* referrals, you should consider whether SEC rule 206(4)-3 or similar state rules regarding solicitation arrangements and/or state rules requiring registration of *investment adviser representatives* apply.

Item 15 *Custody*

A. If you have *custody* of *client* funds or securities and a qualified custodian as defined in SEC rule 206(4)-2 or similar state rules (for example, a broker-dealer or bank) does not send account statements with respect to those funds or securities directly to your *clients*, state that you have *custody* and explain the risks that *clients* will face because of this.

B. If you have *custody* of *client* funds or securities and a qualified custodian sends quarterly, or more frequent, account statements directly to your *clients*, explain that *clients* will receive account statements from the broker-dealer, bank or other qualified custodian and that *clients* should carefully review those statements.

Item 16 Investment Discretion

If you accept *discretionary authority* to manage securities accounts on behalf of *clients*, disclose this fact and describe any limitations *clients* may (or customarily do) place on this authority. Describe the procedures you follow before you assume this authority (*e.g.,* execution of a power of attorney).

Item 17 Voting *Client* Securities

A. If you have, or will accept, authority to vote *client* securities, briefly describe your voting policies and procedures, including those adopted pursuant to SEC rule 206(4)-6. Describe whether (and, if so, how) your *clients* can direct your vote in a particular solicitation. Describe how you address conflicts of interest between you and your *clients* with respect to voting their securities. Describe how *clients* may obtain information from you about how you voted their securities. Explain to *clients* that they may obtain a copy of your proxy voting policies and procedures upon request.

B. If you routinely rely on one or more third-party proxy voting services to advise you in connection with voting *client* securities, list the proxy voting services that you use, describe how you select the proxy voting services, and explain whether you permit *clients* to direct the use of a particular proxy voting service with respect to the securities held in their accounts. (You do not need to identify a proxy voting service that a *client* directs you to use unless you also use the service for the purpose of voting the securities of other *clients*). Describe whether you pay for proxy voting services with soft dollars or pass the cost on to your *clients* through a supplement to your advisory fee.

C. If you do not have authority to vote *client* securities, disclose this fact. Explain whether *clients* will receive their proxies or other solicitations directly from their custodian or a transfer agent or from you, and discuss whether (and, if so, how) *clients* can contact you with questions about a particular solicitation.

Item 18 Financial Information

A. If you require or solicit prepayment of more than $1,200 in fees per *client*, six months or more in advance, include a balance sheet for your most recent fiscal year.

1. The balance sheet must be prepared in accordance with generally accepted accounting principles, audited by an independent public accountant, and accompanied by a note stating the principles used to prepare it, the basis of securities included, and any other explanations required for clarity.

2. Show parenthetically the market or fair value of securities included at cost.

3. Qualifications and any accompanying independent accountant's report must conform to Article 2 of SEC Regulation S-X.

Note: If you are a sole proprietor, show investment advisory business assets and liabilities separate from other business and personal assets and liabilities. You may aggregate other business and personal assets unless advisory business liabilities exceed advisory business assets.

Note: If you have not completed your first fiscal year, include a balance sheet dated not more than 90 days prior to the date of your *brochure*.

Exception: You are not required to respond to Item 18.A of Part 2A if you also are: (i) a qualified custodian as defined in SEC rule 206(4)-2 or similar state rules; or (ii) an insurance company.

B. If you are an SEC-registered adviser and you have *discretionary authority* or *custody* of *client* funds or securities, or you require or solicit prepayment of more than $1,200 in fees per *client*, six months or more in advance, disclose any financial condition that is reasonably likely to impair your ability to meet contractual commitments to *clients*.

Note: With respect to Items 18.A and 18.B, if you are registered or are registering only with one or more of the *state securities authorities*, the dollar amount reporting threshold for including the required balance sheet and for making the required financial condition disclosures is more than $500 in fees per *client*, six months or more in advance.

C. If you have been the subject of a bankruptcy petition at any time during the past ten years, disclose this fact, the date the petition was first brought, and the current status.

Item 19 Index

The *brochure* you file with the SEC or *state securities authorities* must contain an index of the items required by this Part 2A, indicating where in the *brochure* you address each item (*e.g.*, Item 9 or "Disciplinary Information" on

page 12). If you do not include an item in the *brochure*, note that fact and the reason it is not included in the index (*e.g.*, Item 10 or "Other Financial Industry Activities and Affiliations" does not apply so it is not included). The *brochure* you provide to your *clients* does not need to include this index.

If you are registering or are registered with one or more *state securities authorities*, you must respond to the following additional Item.

Item 20 Requirements for State-Registered Advisers

A. Identify each of your principal executive officers and *management persons*, and describe their formal education and business background. If you have supplied this information elsewhere in your Form ADV, you do not need to repeat it in response to this Item.

B. Describe any business in which you are actively engaged (other than giving investment advice) and the approximate amount of time spent on that business. If you have supplied this information elsewhere in your Form ADV, you do not need to repeat it in response to this Item.

C. In addition to the description of your fees in response to Item 5 of Part 2A, if you or a *supervised person* are compensated for advisory services with *performance-based fees*, explain how these fees will be calculated. Disclose specifically that *performance-based compensation* may create an incentive for the adviser to recommend an investment that may carry a higher degree of risk to the *client*.

D. If you or a *management person* has been *involved* in one of the events listed below, disclose all material facts regarding the event.

1. An award or otherwise being *found* liable in an arbitration claim alleging damages in excess of $2,500, *involving* any of the following:

    (a) an investment or an *investment-related* business or activity;
    (b) fraud, false statement(s), or omissions;
    (c) theft, embezzlement, or other wrongful taking of property;
    (d) bribery, forgery, counterfeiting, or extortion; or
    (e) dishonest, unfair, or unethical practices.

2. An award or otherwise being *found* liable in a civil, *self-regulatory organization*, or administrative *proceeding involving* any of the following:

    (a) an investment or an *investment-related* business or activity;
    (b) fraud, false statement(s), or omissions;
    (c) theft, embezzlement, or other wrongful taking of property;
    (d) bribery, forgery, counterfeiting, or extortion; or
    (e) dishonest, unfair, or unethical practices.

E. In addition to any relationship or arrangement described in response to Item 10.C. of Part 2A, describe any relationship or arrangement that you or any of your *management persons* have with any issuer of securities that is not listed in Item 10.C. of Part 2A.

Instructions for Part 2A Appendix 1 of Form ADV: Preparing Your *Wrap Fee Program Brochure*

1. Who must deliver a *wrap fee program brochure*? If you *sponsor* a *wrap fee program*, you must give a *wrap brochure* to each *client* of the *wrap fee program*.

   However, if a *wrap fee program* that you *sponsor* has multiple *sponsors* and another *sponsor* creates and delivers to your *wrap fee program clients* a *wrap brochure* that includes all the information required in your *wrap brochure,* you do not have to create or deliver a separate *wrap brochure.*

   A *wrap brochure* takes the place of your advisory firm *brochure* required by Part 2A of Form ADV, but only for *clients* of *wrap fee programs* that you *sponsor*. See SEC rule 204-3(b)(1) and (f).

2. When must a *wrap fee program brochure* be delivered?

   - You must give a *wrap brochure* to each *client* of the *wrap fee program* before or at the time the *client* enters into a *wrap fee program* contract.
   - Each year you must deliver to each *client* an updated *wrap brochure* within 120 days of the end of your fiscal year.
   - You do not have to deliver an interim amendment to *clients* unless the amendment includes information in response to Item 9 of Part 2A (disciplinary information). An interim amendment can be in the form of a "sticker" that identifies the information that has become inaccurate and provides the new information and the date of the sticker. See SEC rule 204-3(b)(1), (f)(1), and (g).

   Note: As a fiduciary, you have a continuing obligation to inform your *clients* of any material information that could affect the advisory relationship. As a result, between *annual updating amendments* you must disclose to *clients* changes that are material to them even if those changes do not trigger delivery of an interim amendment.

3. When must we update our *wrap brochure*? You must update your *wrap brochure*: (i) each year at the time you file your *annual updating amendment*, and (ii) promptly whenever any information in the *wrap brochure* (other than information in response to Item 4.A of this Appendix (service fees/schedule)) becomes materially inaccurate. See SEC rules 204-1 and 204-2(a)(14)(i).

4. May we deliver our *wrap fee program brochure* electronically? Yes. You may deliver your *wrap brochure* using electronic media. The SEC has published interpretive guidance on delivering documents electronically, which you can find at <www.sec.gov/rules/concept/33-7288.txt>.

5. Must we also deliver *brochure supplements* to *wrap fee program clients*? Yes. A *wrap brochure* does not take the place of any supplements required by Part 2B of Form ADV.

6. What if we *sponsor* more than one *wrap fee program*? You may prepare a single *wrap brochure* describing all the *wrap fee programs* you *sponsor*, or you may prepare separate *wrap brochure*s that describe one or more of your *wrap fee programs*. If you prepare separate *brochures*, each *brochure* must state that you *sponsor* other *wrap fee programs* and must explain how the *client* can obtain *brochure*s for the other programs.

7. We provide portfolio management services under a *wrap fee program* that we *sponsor*. Must we deliver both our *wrap brochure* and our firm *brochure* to our *wrap fee program clients*? No, just the *wrap brochure*. If you or your *employees* provide portfolio management services under a *wrap fee program* that you also *sponsor*, your *wrap brochure* must describe the investments and investment strategies you (or your *employees*) will use as portfolio managers. This requirement appears in Item 6.B of this Appendix.

8. We provide other advisory services outside of our *wrap fee programs*. May we combine our *wrap brochure* into our firm *brochure* for *clients* receiving these other services? No. Your *wrap brochure* must address only the *wrap fee program*s you *sponsor*. See SEC rule 204-3(d)(1).

Part 2A Appendix 1 of Form ADV: ***Wrap Fee Program Brochure***

Item 1 Cover Page

A. The cover page of your *wrap fee program brochure* must state your name, business address, telephone number, Web site address (if you have one), and the date of the *wrap brochure*.

Note: If you primarily conduct advisory business under a name different from your full legal name, and you have disclosed your business name in Item 1.B of Part 1A of Form ADV, then you may use your business name throughout your *wrap brochure*.

B. Display on the cover page of your *wrap brochure* the following (or other clear and concise language conveying the same information):

This brochure provides information about the qualifications and business practices of [your name]. If you have any questions about the contents of this brochure, please contact [name and telephone number of service center or name and/or title and telephone number of contact person]. The information in this brochure has not been approved or verified by the United States Securities and Exchange Commission or by any state securities authority.

Additional information about [your name] also is available on the Internet at www.adviserinfo.sec.gov.

C. If you refer to yourself as a "registered investment adviser" or describe yourself as being "registered," include a statement that registration does not imply a certain level of skill or training.

Item 2 Material Changes

If your *wrap brochure* contains material changes from its last annual update, identify those changes on the page immediately following the cover page of the *wrap brochure* or in a separate letter accompanying the *wrap brochure*. You must clearly state that you are discussing only material changes since the last annual update of the *wrap brochure*, and must provide the date of the last annual update to the *wrap brochure*.

Note: You do not have to provide this information to a *client* or prospective *client* who has not received a previous version of your *wrap brochure*.

Item 3 Table of Contents

Provide a table of contents to your *wrap brochure*.

Note: Your table of contents must be detailed enough so that your *clients* can locate topics easily.

Item 4 Services, Fees and Compensation

A. Describe the services, including the types of portfolio management services, provided under each program. Indicate the wrap fee charged for each program or, if fees vary according to a schedule, provide your fee schedule. Indicate whether fees are negotiable and identify the portion of the total fee, or the range of fees, paid to portfolio managers.

B. Explain that the program may cost the *client* more or less than purchasing such services separately and describe the factors that bear upon the relative cost of the program, such as the cost of the services if provided separately and the trading activity in the *client's* account.

C. Describe any fees that the *client* may pay in addition to the wrap fee, and describe the circumstances under which *clients* may pay these fees, including, if applicable, mutual fund expenses and mark-ups, mark-downs, or spreads paid to market makers.

D. If the *person* recommending the *wrap fee program* to the *client* receives compensation as a result of the *client's* participation in the program, disclose this fact. Explain, if applicable, that the amount of this compensation may be more than what the *person* would receive if the *client* participated in your other programs or paid separately for investment advice, brokerage, and other services. Explain that the *person*, therefore, may have a financial incentive to recommend the *wrap fee program* over other programs or services.

Item 5 Account Requirements and Types of *Clients*

If a *wrap fee program* imposes any requirements to open or maintain an account, such as a minimum account size, disclose these requirements. If there is a minimum amount for assets placed with each portfolio manager as well as a minimum account size for participation in the *wrap fee program*, disclose and explain these requirements. To the extent applicable to your *wrap fee program clients*, describe the types of *clients* to whom you generally provide investment advice, such as individuals, trusts, investment companies, or pension plans.

Item 6 Portfolio Manager Selection and Evaluation

A. Describe how you select and review portfolio managers, your basis for recommending or selecting portfolio managers for particular *clients*, and your criteria for replacing or recommending the replacement of portfolio managers for the program and for particular *clients*.

1. Describe any standards you use to calculate portfolio manager performance, such as industry standards or standards used solely by you.

2. Indicate whether you review, or whether any third-party reviews, performance information to determine or verify its accuracy or its compliance with presentation standards. If so, briefly describe the nature of the review and the name of any third party conducting the review.

3. If applicable, explain that neither you nor a third-party reviews portfolio manager performance information, and/or that performance information may not be calculated on a uniform and consistent basis.

B. Disclose whether any of your *related persons* act as a portfolio manager for a *wrap fee program* described in the *wrap fee program brochure*. Explain the conflicts of interest that you face because of this arrangement and describe how you address these conflicts of interest. Disclose whether *related person* portfolio managers are subject to the same selection and review as the other portfolio managers that participate in the *wrap fee program*. If they are not, describe how you select and review *related person* portfolio managers.

C. If you, or any of your *employees* covered under your investment adviser registration, act as portfolio manager for a *wrap fee program* described in the *wrap brochure*, respond to Items 4.B, 4.C, 4.D (Advisory Business), 6 (Performance Fees and Side-By-Side Management), 8.A (Methods of Analysis, Investment Strategies and Risk of Loss) and 17 (Voting *Client* Securities) of Part 2A of Form ADV.

Item 7 *Client* Information Provided to Portfolio Managers

Describe the information about *clients* that you communicate to the *clients*' portfolio managers, and how often or under what circumstances you provide updated information.

Item 8 *Client* Contact with Portfolio Managers

Explain any restrictions placed on *clients*' ability to contact and consult with their portfolio managers.

Item 9 Additional Information

A. Respond to Item 9 (Disciplinary Information) and Item 10 (Other Financial Industry Activities and Affiliations) of Part 2A of Form ADV.

B. Respond to Items 11 (Code of Ethics, Participation or Interest in *Client* Transactions and Personal Trading), 13 (Review of Accounts), 14 (Payment for *Client* Referrals), and 18 (Financial Information) of Part 2A of Form ADV, as applicable to your wrap fee *clients*.

Item 10 Index

The *wrap brochure* you file with the SEC or *state securities authorities* must contain (or be accompanied by) an index of the items required by this Appendix, indicating where in the *wrap brochure* you address each item. The *wrap brochure* you provide to your *clients* does not need to include this index.

If you are registering or are registered with one or more *state securities authorities*, you must respond to the following additional Item.

Item 11 Requirements for State-Registered Advisers

Respond to Item 20.E of Part 2A of Form ADV.

Instructions for Part 2B of Form ADV: Preparing a *Brochure Supplement*

1. For which *supervised persons* must we prepare a *brochure supplement*? As an initial matter, if you have no *clients* to whom you must deliver a *brochure supplement* (see Instruction 2 below), then you need not prepare any *brochure supplements*. Otherwise, you must prepare a *brochure supplement* for the following *supervised persons*:

   (i) Any *supervised person* who formulates investment advice for a *client* and has direct *client* contact; and

   (ii) Any *supervised person* who has *discretionary authority* over a *client's* assets, even if the *supervised person* has no direct *client* contact. See SEC rule 204-3(b)(2) and similar state rules.

   Note: No supplement is required for a *supervised person* who has no direct *client* contact and has *discretionary authority* over a *client*'s assets only as part of a team.

2. To whom must we deliver *brochure supplements*? Are there any exceptions?

   You must deliver to a *client* the *brochure supplements* for each *supervised person* who provides advisory services to that *client*. However, there are four categories of *clients* to whom you are not required to deliver *supplements*. See SEC rule 204-3(c) and similar state rules.

   First, you are not required to deliver supplements to *clients* to whom you are not required to deliver a firm *brochure* (or a *wrap fee program brochure*).

   Second, you are not required to deliver supplements to *clients* who receive only *impersonal investment advice*, even if they receive a firm *brochure*.

   Third, you are not required to deliver supplements to *clients* who are "qualified purchasers" – a term defined in section 2(a)(51)(A) of the Investment Company Act of 1940. A "qualified purchaser" generally includes:

   (i) Any individual who owns not less than $5 million in investments;

   (ii) Any company that owns not less than $5 million in investments and that is owned by or for 2 or more natural persons who are related (*i.e.*, siblings or spouses, direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, or foundations, charitable organizations, or trusts established by or for the benefit of such persons); and

   (iii) Any *person* who owns or invests on a *discretionary basis* (for his own account or for the accounts of other qualified purchasers) not less than $25,000,000 in investments.

   Fourth, you are not required to deliver supplements to *clients* who are individuals who would be "qualified clients" of your firm under SEC rule 205-3(d)(1)(iii). Those persons are:

   (i) Any executive officers, directors, trustees, general partners, or persons serving in a similar capacity, of your firm; and

   (ii) Any employees of your firm (other than employees performing solely clerical, secretarial or administrative functions) who, in connection with their regular functions or duties, participate in the investment activities of your firm and have been performing such functions or duties for at least 12 months.

3. When must we deliver a supplement to a *client*?

- You must deliver the supplement for a *supervised person* before or at the time that *supervised person* begins to provide advisory services to a *client*.

- You also must deliver to *clients* any update to the supplement that amends information in response to Item 3 of Part 2B (disciplinary information). Such an amendment can be in the form of a "sticker" that identifies the information that has become inaccurate and provides the new information and the date of the sticker.

  Note: As a fiduciary, you have a continuing obligation to inform your *clients* of any material information that could affect the advisory relationship. As a result, between *annual updating amendments* you must disclose material changes to *clients* even if those changes do not trigger delivery of an updated supplement.

You may have a *supervised person* deliver supplements (including his own) on your behalf. Furthermore, you are not required to file *brochure supplements* or updates, but you must maintain copies of them. See Instruction 5 of SEC General Instructions for Part 2 of Form ADV.

4. When must we update *brochure supplements*? You must update *brochure supplements* promptly whenever any information in them becomes materially inaccurate.

5. May we deliver *brochure supplements* electronically? Yes. You may deliver supplements using electronic media. The SEC has published interpretive guidance on delivering documents electronically, which you can find at <www.sec.gov/rules/concept/33-7288.txt>.

6. Must *brochure supplements* be separate documents? No. If your firm *brochure* includes all the information required in a *brochure supplement*, you do not need a separate supplement. Smaller firms with just a few *supervised persons* may find it easier to include all supplement information in their firm *brochure*, while larger firms may prefer to use a firm *brochure* and separate supplements.

   If your firm *brochure* includes some (but not all) supplement information about a *supervised person*, the supplement can refer the reader to the appropriate section(s) of your firm *brochure* and describe the type of information being referred to instead of repeating that information in the supplement.

   You may prepare supplements for groups of *supervised persons*. A group supplement, or a firm *brochure* presenting supplement information about *supervised persons*, must present information in a separate section for each *supervised person*.

7. Must an adviser who is a sole proprietor provide his own *brochure supplement* to *clients*? No, if that information is included in the firm *brochure*.

8. May we include information not required by an item in a *brochure supplement*? Yes. If you include information not required by an item, however, you may not include so much additional information that the required information is obscured.

Part 2B of Form ADV: *Brochure Supplement*

Item 1 Cover Page

A. Include the following on the cover page of the supplement:

1. The *supervised person's* name, business address and telephone number (if different from yours).
2. Your firm's name, business address and telephone number. If your firm *brochure* uses a business name for your firm, use the same business name for the firm in the supplement.
3. The date of the supplement.

B. Display on the cover page statements containing the following or other clear and concise language conveying the same information:

This supplement provides information about [name of *supervised person*] that supplements the [name of advisory firm] brochure. You should have received a copy of that brochure. Please contact [service center or name and/or title of your contact *person*] if you did not receive [name of advisory firm]'s brochure or if you have any questions about the contents of this supplement.

Additional information about [name of *supervised person*] is available on the Internet at <u>www.adviserinfo.sec.gov</u>.

Note: You do not have to include this statement directing *clients* to the public website until such time that information about *investment adviser representatives* is available through the Investment Adviser Public Disclosure System. In addition, you do not have to include this statement directing *clients* to the public website unless the *supervised person* is an *investment adviser representative* required to register with *state securities authorities*.

Item 2 Educational Background and Business Experience

Disclose the *supervised person's* name, age (or year of birth), formal education after high school, and business background for the preceding five years. If the *supervised person* either has no formal education after high school or has no business background, disclose this fact.

Item 3 Disciplinary Information

If there are legal or disciplinary events material to a *client's* or prospective *client's* evaluation of the *supervised person*, disclose all material facts regarding those events.

Items 3.A, 3.B, 3.C, and 3.D below list specific legal and disciplinary events that you must presume are material for this Item. If the *supervised person* has been *involved* in one of these events, you must disclose it under this Item for ten years following the date of the event, unless (1) the event was resolved in the *supervised person's* favor, or was reversed, suspended or vacated, or (2) the event is not material (see Note below). For purposes of calculating this ten-year period, the "date" of an event is the date the final *order*, judgment, or decree was entered, or the date any rights of appeal from preliminary *order*s, judgments or decrees lapsed.

Items 3.A, 3.B, 3.C, and 3.D do not contain an exclusive list of material disciplinary events. If the *supervised person* has been *involved* in a legal or disciplinary event that is <u>not</u> listed in Items 3.A, 3.B, 3.C, or 3.D but <u>is</u> material to a *client's* or prospective *client's* evaluation of the *supervised person's* integrity, you must disclose the event. Similarly, even if more than ten years have passed since the date of the event, you must disclose the event if it is so serious that it remains currently material to a *client's* or prospective *client's* evaluation.

A. A criminal or civil action in a domestic, foreign or military court of competent jurisdiction in which the *supervised person*

1. was convicted of, or pled guilty or nolo contendere ("no contest") to (a) any *felony*; (b) a *misdemeanor* that *involved* investments or an *investment-related* business, fraud, false statements or omissions, wrongful taking of property, bribery, perjury, forgery, counterfeiting, or extortion; or (c) a conspiracy to commit any of these offenses;

2. is the named subject of a pending criminal *proceeding* that involves an *investment-related* business, fraud, false statements or omissions, wrongful taking of property, bribery, forgery, counterfeiting, extortion, or a conspiracy to commit any of these offenses;

3. was *found* to have been *involved* in a violation of an *investment-related* statute or regulation; or

4. was the subject of any *order*, judgment, or decree permanently or temporarily enjoining, or otherwise limiting, the *supervised person* from engaging in any *investment-related* activity, or from violating any *investment-related* statute, rule, or *order*.

B. An administrative *proceeding* before the SEC, any other federal regulatory agency, any state regulatory agency, or any *foreign financial regulatory authority* in which the *supervised person*

1. was *found* to have caused an *investment-related* business to lose its authorization to do business; or

2. was *found* to have been *involved* in a violation of an *investment-related* statute or regulation and was the subject of an *order* by the agency or authority

   (a) denying, suspending, or revoking the authorization of the *supervised person* to act in an *investment-related* business;

   (b) barring or suspending the *supervised person's* association with an *investment-related* business;

   (c) otherwise significantly limiting the *supervised person's investment-related* activities; or

   (d) imposing a civil money penalty of more than $2,500 on the *supervised person*.

C. A *self-regulatory organization* (*SRO*) *proceeding* in which the *supervised person*

1. was *found* to have caused an *investment-related* business to lose its authorization to do business; or

2. was *found* to have been *involved* in a violation of the *SRO's* rules and was: (i) barred or suspended from membership or from association with other members, or was expelled from membership; (ii) otherwise significantly limited from *investment-related* activities; or (iii) fined more than $2,500.

D. Any other *proceeding* in which a professional attainment, designation, or license of the *supervised person* was revoked or suspended because of a violation of rules relating to professional conduct. If the *supervised person* resigned (or otherwise relinquished his attainment, designation, or license) in anticipation of such a *proceeding*, disclose the event.

Note: Special circumstances may make an event immaterial (overcoming the materiality presumption). If an event is immaterial, you are not required to disclose it. When you review a legal or disciplinary event involving the *supervised person* for materiality, you should consider all of the following factors: (1) the proximity of the *supervised person* to the advisory function; (2) the nature of the infraction that led to the disciplinary event; (3) the severity of the disciplinary sanction; and (4) the time elapsed since the date of the disciplinary event. If you

conclude that the materiality presumption is overcome, you must prepare and maintain a file memorandum of your determination in your records.

Item 4 Other Business Activities

A. If the *supervised person* is actively engaged in any *investment-related* business or occupation, including if the *supervised person* is registered, or has an application pending to register, as a broker-dealer, registered representative of a broker-dealer, futures commission merchant ("FCM"), commodity pool operator ("CPO"), commodity trading advisor ("CTA"), or an associated person of an FCM, CPO, or CTA, disclose this fact and describe the business relationship, if any, between the advisory business and the other business.

1. If a relationship between the advisory business and the *supervised person's* other financial industry activities creates a material conflict of interest with *clients*, describe the nature of the conflict and generally how you address it.

2. If the *supervised person* receives commissions, bonuses or other compensation based on the sale of securities or other investment products, including as a broker-dealer or registered representative, and including distribution or service ("trail") fees from the sale of mutual funds, disclose this fact. If this compensation is not cash, explain what type of compensation the *supervised person* receives. Explain that this practice gives the *supervised person* an incentive to recommend investment products based on the compensation received, rather than on the *client's* needs.

B. If the *supervised person* is actively engaged in any business or occupation for compensation not discussed in response to Item 4.A, above, and the other business activity or activities provide a substantial source of the *supervised person's* income or involve a substantial amount of the *supervised person's* time, disclose this fact and describe the nature of that business.

Item 5 Additional Compensation

If someone who is not a *client* provides an economic benefit to the *supervised person* for providing advisory services, generally describe the arrangement. For purposes of this Item, economic benefits include sales awards and other prizes, but do not include the *supervised person's* regular salary. Any bonus that is based, at least in part, on the number or amount of sales, *client* referrals, or new accounts should be considered an economic benefit, but other regular bonuses should not.

Item 6 Supervision

Explain how you *supervise* the *supervised person*, including how you monitor the advice the *supervised person* provides to *clients*. Provide the name, title and telephone number of the *person* responsible for supervising the *supervised person's* advisory activities on behalf of your firm.

If you are registering or are registered with one or more *state securities authorities*, you must respond to the following additional Item.

Item 7 Requirements for State-Registered Advisers

A. In addition to the events listed in Item 3 of Part 2B, if the *supervised person* has been *involved* in one of the events listed below, disclose all material facts regarding the event.

1. An award or otherwise being *found* liable in an arbitration claim alleging damages in excess of $2,500, *involving* any of the following:

(a) an investment or an *investment-related* business or activity;
(b) fraud, false statement(s), or omissions;
(c) theft, embezzlement, or other wrongful taking of property;
(d) bribery, forgery, counterfeiting, or extortion; or
(e) dishonest, unfair, or unethical practices.

2. An award or otherwise being *found* liable in a civil, *self-regulatory organization*, or administrative *proceeding involving* any of the following:

(a) an investment or an *investment-related* business or activity;
(b) fraud, false statement(s), or omissions;
(c) theft, embezzlement, or other wrongful taking of property;
(d) bribery, forgery, counterfeiting, or extortion; or
(e) dishonest, unfair, or unethical practices.

B. If the *supervised person* has been the subject of a bankruptcy petition, disclose that fact, the date the petition was first brought, and the current status.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 57428 / March 4, 2008

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2794 / March 4, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12974

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

I.

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

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

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

II.

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

III.

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

A. Fresia, age 52, is and has been a certified public accountant holding an inactive license to practice in the State of Colorado. Fresia served as the chief financial officer of the Expanets, Inc. ("Expanets") subsidiary of NorthWestern Corporation ("NorthWestern") from April 2002 through May 2003.

B. NorthWestern was, at all relevant times, a Delaware corporation with its principal place of business in Sioux Falls, South Dakota. NorthWestern operates a regulated utility business in South Dakota, Nebraska and Montana. During the period of conduct described herein, NorthWestern consolidated the financial results of Expanets. At all relevant times, NorthWestern's common stock was registered with the Commission pursuant to Section 12(b) of the Securities Exchange Act of 1934 ("Exchange Act"), and traded on the New York Stock Exchange.

C. Expanets, formerly headquartered in Englewood, Colorado, provided networked telecommunications equipment and services to medium-sized businesses nationwide. Expanets was comprised of approximately 26 small telecommunications equipment resellers and a former sales division of Lucent Technologies. NorthWestern wrote off substantially all of its investment in Expanets in its 2002 Form 10-K and announced its intent to sell Expanets in April 2003. In the second quarter of 2003, Expanets' operations were discontinued, and in May 2004, Expanets filed for bankruptcy. Proceeds from the sale of Expanets' assets were distributed in bankruptcy.

D. On July 23, 2007, the Commission filed a complaint against Fresia in Securities and Exchange Commission v. Richard E. Fresia, Civil Action Number 1:07-CV-01549-JKL-BNB in the United States District Court for the District of Colorado. On February 22, 2008 the court entered a final judgment permanently enjoining Fresia, by consent, from future violations of Section 13(b)(5) of the Exchange Act and Rule 13b2-1 thereunder, and aiding and abetting violations of Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-11 and 13a-13 thereunder. Fresia was also ordered to pay a $20,000 civil money penalty.

E. The Commission's Complaint alleged, among other things, that during the second and third quarters of 2002, Respondent participated in concealing from the public Expanets' ongoing operational problems and poor financial performance. First, the Complaint alleged that Respondent knew that Expanets improperly accounted for accounts receivable and adjustments to customers' bills, causing overstatements of NorthWestern's reported income from continuing operations of 90% and 109% in the second and third quarters of 2002, respectively. Second, the Commission's Complaint alleged that Respondent knew that NorthWestern had not disclosed the nature of Expanets' reported income during the second and third quarters of 2002, including the magnitude of Expanets' reserve reductions and its receipt of unusual non-compete payments. Finally, the Commission's Complaint alleged that the misstatement of Expanets' and NorthWestern's financial results facilitated more than $800 million in securities offerings by NorthWestern in September and October 2002, including an $87.5 million equity offering that raised badly needed operating capital for the company.

IV.

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

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

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

B. After three 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

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 57426 / March 4, 2008

Admin. Proc. File No. 3-12599

In the Matter of the Application of

ROBERT E. STRONG
105 Pinehurst Avenue
New York, New York 10033

For Review of Disciplinary Action Taken by

NASD

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION -- REVIEW OF DISCIPLINARY PROCEEDINGS

Violation of Conduct Rules

Failure to Supervise

Incomplete and Inaccurate Disclosures in Research Reports

Untimely Filing of Required Attestation

Conduct Inconsistent With Just and Equitable Principles of Trade

Chief Compliance Officer of member of registered securities association failed to supervise research analyst whose personal securities trading violated association rules. Chief Compliance Officer also allowed incomplete and inaccurate disclosures in research reports and failed to file timely attestation of procedures. Held, association's findings of violations and sanctions it imposed are sustained.

3 of 35

APPEARANCES:

Robert E. Strong, pro se.

Marc Menchel, Alan B. Lawhead, and Jennifer C. Brooks, for NASD.

Appeal filed: March 23, 2007
Last brief received: August 1, 2007

I.

Robert E. Strong, former Chief Compliance Officer of NASD member Jesup & Lamont Securities Corp. ("J&L" or the "Firm"), appeals from NASD disciplinary action. 1/ NASD found that Strong failed to supervise the personal trading of Gary B. Davis, 2/ a J&L research analyst, in violation of NASD Conduct Rules 3010 and 2110. 3/ NASD also found that Strong violated NASD Conduct Rules 2711 and 2110 by failing to enforce NASD disclosure requirements in connection with various research reports issued by the Firm and by failing to file within the time

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1/ On July 26, 2007, the Commission approved a proposed rule change filed by NASD to amend NASD's Restated Certificate of Incorporation to reflect its name change to Financial Industry Regulatory Authority, Inc., or FINRA, in connection with the consolidation of NASD and the member-regulation, enforcement and arbitration functions of the New York Stock Exchange. See Securities Exchange Act Rel. No. 56146 (July 26, 2007), 91 SEC Docket 517 (Aug. 1, 2007). Because the disciplinary action here was taken before that date, we continue to use the designation NASD.

2/ In a separate proceeding, Davis submitted a Letter of Acceptance, Waiver and Consent, in which he agreed to pay a fine of $130,000, of which approximately $116,000 represented disgorgement of trading profits related to the allegations in this proceeding, serve a six-month suspension from association with any NASD member in any capacity, and serve an eighteen-month suspension from association with any NASD member as a research analyst. J&L, which was charged with Strong in this proceeding, agreed to a censure and payment of a $75,000 fine in settlement of the charges against it.

3/ NASD Conduct Rule 3010(a) imposes supervisory requirements on NASD members. NASD Conduct Rule 2110 requires NASD members to "observe high standards of commercial honor and just and equitable principles of trade."

specified a required annual attestation of related procedures. 4/ NASD fined Strong $10,000 and imposed $3,723.54 in costs. We base our findings on an independent review of the record.

II.

a. This case concerns Strong's role in overseeing J&L's compliance with NASD Conduct Rule 2711. Among other things, Rule 2711 imposes restrictions on personal trading by research analysts and requires that research reports contain certain disclosures. The rule, which was approved in May 2002 and took effect beginning in July 2002, 5/ was intended "to improve the objectivity of research and provide investors with more useful and reliable information when making decisions." 6/

Strong was hired by J&L's Co-President William Moreno as the Firm's Chief Compliance Officer in July 2002. Moreno testified that the Firm, which had recently been formed from the merger of Broadmark Capital Corp. and J&L, had "a lot going on" with respect to, among other things, the newly effective Rule 2711, and that he hired Strong to "keep [J&L] compliant . . . keep [it] up to date on what the rules and regs were and make sure [it] followed them."

On July 31, 2002, soon after joining the Firm, Strong wrote a memorandum to the research staff and the Firm's senior management attaching a copy of Rule 2711 and describing its requirements. Among other things, Strong's memorandum explained that Rule 2711 forbids research analysts from "purchas[ing] or sell[ing] any security . . . in a manner inconsistent with the research analyst's recommendation as reflected in the most recent research report published by the [NASD] member [firm]." 7/ During the time of the alleged misconduct, the rule defined a

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4/ NASD Conduct Rule 2711(h) requires that members include specified disclosures in all research reports. At the time of the charged conduct, NASD Conduct Rule 2711(i) required NASD members to "adopt and implement written supervisory procedures reasonably designed to ensure that the member and its employees comply with the provisions of [NASD Conduct Rule 2711] and a senior officer of such a member must attest annually to NASD that it has adopted and implemented those procedures."

5/ Order Approving NASD Proposed Rule Change Regarding Research Analyst Conflicts of Interest, Exchange Act Rel. No. 45908 (May 10, 2002), 77 SEC Docket 1945.

6/ NASD Notice to Members 02-39, Research Analysts and Research Reports (July 2002) at 353.

7/ Rule 2711(g)(3). As discussed below, Rule 2711(g)(4) permits "legal or compliance personnel [to] authorize a transaction otherwise prohibited . . . based on an unanticipated significant change in the personal financial circumstance of the analyst." This exception to Rule 2711(g)(3) is available provided that, among other things, "legal or compliance

(continued...)

"research report" as any "written or electronic communication which includes an analysis of equity securities of individual companies or industries, and which provides information reasonably sufficient upon which to base an investment decision and includes a recommendation." 8/ The rule also provides that "[n]o research analyst account 9/ may purchase or sell any security issued by a company that the research analyst follows . . . for a period beginning 30 calendar days before and ending five days after the publication of a research report concerning the company . . . ." 10/ Strong testified that he had an informal conversation with Davis about the new rule but never made a formal presentation to the Firm's staff on the rule or its application to personal trading by the Firm's research analysts. Davis testified that he recalled discussing the rule with Strong "a little bit" and that he read Strong's memorandum about the rule but "to what extent, I don't remember." 11/

7/ (...continued)
personnel authorize the transaction before it is entered . . . ."

8/ As discussed below, in March 2004, six months after the end of the period at issue here, NASD excluded from the definition of "research report" any communication "distributed to fewer than 15 persons." NASD Notice to Members 04-18, Research Analysts and Research Reports (Mar. 2004) at 228. NASD also subsequently deleted from the definition the requirement that research reports include a recommendation.

9/ Rule 2711(a)(6) defined a "research analyst account" as "any account in which a research analyst . . . has a financial interest, or over which such analyst has discretion or control, other than an investment company registered under the Investment Company Act of 1940." NASD Notice to Members 02-39 at 355.

10/ Rule 2711(g)(2). Also as discussed below, Rule 2711(g)(2)(B) authorizes a firm to "permit a research analyst account to purchase or sell any security issued by a subject company within 30 calendar days before the publication of a research report . . . due to significant news or a significant event concerning the subject company provided that legal or compliance personnel pre-approve the research report . . . ."

11/ In addition to his July 2002 memorandum summarizing Rule 2711, the record contains six other memoranda from Strong addressing issues related to research activities. These include his memorandum of February 3, 2003, which is a "reminder" to the analysts that research reports must contain specific disclosures and provides some information that must be included among those disclosures. The first of two memoranda dated April 14, 2003 reminds analysts to give Strong ten days' notice before the issuance of a research report, and the other discusses proposed new rules governing research analysts.

On April 16, 2003, Strong issued a memorandum announcing the effectiveness of the Commission's Regulation AC, 17 C.F.R. §§ 242.500 - .505, which, as discussed below,
(continued...)

During his first months at the Firm, and at Moreno's direction, Strong produced a revised version of the Firm's "Written Supervisory Procedures" (the "Procedures"), which was implemented in October 2002. Strong drafted some of the provisions himself and adapted others for use by J&L. The Procedures closely tracked Rule 2711, stating that "[a]nalysts are not permitted to purchase or sell any security . . . in a manner inconsistent with the research analyst's recommendation as reflected in the most recent research report." In accordance with Rule 2711, the Procedures required further that "[n]o analyst may purchase or sell any security issued by a company that the analyst follows . . . for a period beginning 30 calendar days before and ending five days after the publication of a research report concerning the company . . . ."

The Procedures prepared by Strong also provided a mechanism to detect and prevent such prohibited trading practices by assigning the "Compliance Officer" ("CO"), i.e., Strong, responsibility for giving prior approval to "[t]ransactions in the accounts of research personnel." 12/ The Procedures further required the CO to retain "evidence of securities ownership [by research personnel] and review [research personnel's] trading activity to ensure compliance with holding requirements" and to retain "evidence of the review and note any action taken." Thus Strong assigned himself responsibility for J&L's monitoring of its research analysts' trading practices.

However, while the Procedures required Strong to pre-approve all personal trades by analysts, he failed to do so. Davis routinely and repeatedly executed personal trades at the Firm without the prior approval of Strong or any other Firm official. Indeed, Strong readily admits that he was unaware of Davis' trading activity and did not even begin reviewing Davis' monthly account statements until, according to Strong, "some time in the second quarter of 2003," i.e., no earlier than April 2003. Nor is there evidence that Strong reviewed other Firm trading data, such as the trade blotter, to monitor trading by Firm research personnel. 13/ Moreover, the evidence indicates that Strong took no other action, such as discussing the pre-approval requirement with

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11/ (...continued)
defines "research report" differently than Rule 2711 did at the time. Strong's July 30 and August 16, 2003 memoranda provided analysts an update on rules barring their interaction with investment banking activities and identifying related conflicts of interest.

12/ The Procedures refer variously to the "Compliance Officer" ("CO") and "Chief Compliance Officer" ("CCO"): it is undisputed that all such references refer to Strong. The Procedures name Strong as "Chief Compliance Officer" in the list of "Officers, Designated Principals, and Their Responsibilities." Strong also prepared an updated version of the Firm's Written Supervisory Procedures that became effective in August 2003, which explicitly identified Strong as responsible for "Research Activity."

13/ When asked about the Firm's trade blotter, Strong testified: "there probably was one available. It wasn't something I looked at."

the Firm's trading desk or providing internal training on this aspect of the Firm's Procedures, to verify that the Firm's staff understood and were following them.

The Procedures further gave Strong not only responsibility for overseeing trading by Firm personnel, but also authority to respond to trading that conflicted with the Procedures or regulatory requirements. For example, the Procedures required Strong, as part of his duty to maintain and publish the Firm's "Restricted List" of securities in which Firm employees were not permitted to trade freely, to "monitor daily trading to identify transactions in securities . . . on the Restricted List and take action as necessary, which may include . . . canceling transactions; or taking other appropriate action." 14/ The Procedures also required Strong to address trading issues brought to his attention by other supervisors, such as trades involving penny stocks, and possible violations of state "blue sky" laws. In handling such issues, Strong, according to the Procedures, was authorized to "take corrective action including canceling transactions or offering rescission." While these provisions do not expressly describe Strong's power to act to prevent trading that conflicted with Rule 2711, they do reflect that Strong had authority in general to address trading by Firm personnel that conflicted with the compliance requirements Strong was responsible for enforcing.

At the hearing, Moreno confirmed Strong's authority. Moreno testified that he delegated the supervision of J&L's research department to Strong and expected Strong to be responsible for the Firm's compliance with Rule 2711. Moreno further testified that he did not review trading activity by Davis or other research personnel for compliance purposes but understood that such review was being carried out by Strong. While Moreno testified that Strong also had authority, after consultation with Moreno, to discipline employees for compliance violations, he stated that whether Strong's disciplinary authority included the authority to fire an employee for compliance violations never arose, because Strong "never made the case" for firing an employee.

b. Between January 2, 2002 and July 22, 2003, Davis, as a J&L analyst, prepared the following reports published by the Firm:

Date	**Covered Company**	**Recommendation (comment)**
1/2/02	Discovery Laboratories, Inc. ("Discovery")	STRONG BUY (reiteration)
3/2/02	Nastech Pharm. Co. ("Nastech")	STRONG BUY (reiteration)

14/ With respect to the contents of the Restricted List, the Procedures provide that, in addition to securities subject to underwriting restrictions and those as to which J&L had material non-public information, the Restricted List could include securities subject to "[o]ther restrictions determined by the CO . . . ." Therefore, it appears that Strong could have added the securities covered by the Firm's research analysts to the Restricted List. Strong did not do so.

Date	Covered Company	Recommendation (comment)
4/23/02	Med-Design Corp. ("Med-Design")	STRONG BUY (reiteration)
6/4/02	Emisphere Technologies, Inc. ("Emisphere")	STRONG BUY (reiteration)
12/17/02	AVI Biopharma, Inc. ("AVI")	BUY (reiteration)
2/19/03	Med-Design	STRONG BUY (reiteration)
2/27/03	Collagenex Pharm., Inc. ("Collagenex")	STRONG BUY (reiteration)
3/21/03	Nastech	STRONG BUY (reiteration)
4/16/03	InKine Pharm., Inc. ("InKine")	BUY (initiating coverage)
7/22/03	Discovery	STRONG BUY (reiteration)

Each report met NASD's then-current definition of "research report" at the time J&L issued it; the reports included an "analysis of equity securities" and provided information "reasonably sufficient upon which to base an investment decision and include[d] a recommendation." 15/ While the extent of the reports' distribution is not entirely clear from the record, Davis testified that the Firm routinely made approximately 100 copies of each report. Davis claimed at one point during the hearing that he sent his reports only to four or five clients and to management of the covered companies and that, while the reports were made available to other Firm personnel, only two or three Firm salespersons used them. At another point in the hearing, he stated that a "majority" of the reports went to "less than 10 people." Although Strong claims that the research reports received very limited distribution, he admitted that J&L distributed as many as fifteen copies of Davis' reports on two occasions.

c. It is undisputed that between July 2, 2002 and September 30, 2003, Davis executed, without notice to or pre-approval from Strong, approximately 178 trades (112 in stocks he was covering and sixty-six in other companies), among which were forty-one sales of stock that he had most recently recommended in research reports as "buys" or "strong buys." In total, Davis sold 207,357 shares of stock that he had most recently recommended as buys in forty-one trades, earning approximately $116,000 in profits. 16/ Davis testified that he did not know during the period at issue that Strong was required to pre-approve his personal trades.

Davis was an active trader. In May 2003, for example, Davis sold 56,000 shares of securities that he had recommended as "buys" or "strong buys" and in August of 2003 sold 38,000 more shares similarly recommended. Between January and August 2003, Davis sold all

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15/ See supra note 8 and accompanying text.

16/ See supra note 2. These trades are listed in the attached Appendix.

of his shares in AVI and InKine. Davis was especially active in trading AVI. From a position of 23,500 shares on December 30, 2002, Davis sold his position down to zero by June 24, 2003. Then, after subsequently accumulating additional AVI stock, he sold all 28,000 shares he owned over two days, on August 25 and 26, 2003.

It is also undisputed that on four occasions Davis bought stock in companies he covered within thirty days before J&L issued a report authored by Davis on the covered company. On December 13, 2002, Davis purchased 100 shares of AVI, and on December 17, 2002, J&L issued his report on AVI. Davis sent Strong an apology for making this trade during the blackout period, but Strong did not take any action in connection with this violation of Rule 2711 and J&L's Procedures and did not increase his monitoring of Davis' trades. On February 4, 2003, Davis purchased 2,000 shares of Collagenex, and on February 27, 2003, J&L issued his report on Collagenex. On March 18, 2003, Davis purchased 4,000 shares of Nastech in two trades, and on March 21, 2003, J&L issued his report on Nastech. There is no evidence that Strong and Davis ever discussed the latter three trades or that Davis was aware of them.

As mentioned, Strong admittedly took no action to monitor Davis' trading until April 2003 at the earliest. At that point, according to Strong, he began reviewing Davis' account statements and finally discovered that Davis was trading without prior approval. Despite this belated discovery, however, Strong failed to discuss the matter with Davis, or address Davis' misconduct in some other way, until August 2003, when Strong finally "asked him to go to [Strong] for prior approval." It does not appear that they discussed Davis' repeated violations of Rule 2711. Strong took no other action, such as discussing Davis' improper trading with the trading desk or Moreno, and Davis' misconduct continued for roughly another month.

NASD discovered Davis' improper trading during an examination of J&L in October 2003, during which NASD reviewed, among other things, the Firm's compliance with Rule 2711. There is no evidence that Strong alerted NASD to Davis' misconduct. This proceeding developed from the October 2003 examination..

III.

NASD found that Strong failed to supervise the personal trading of Davis. NASD rules require that NASD members "establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with the Rules of [NASD]." 17/ Strong established a supervisory system with respect to analyst trading through the Procedures implemented by J&L in October 2002. The Procedures placed responsibility for monitoring analysts' trading squarely with Strong.

17/ NASD Conduct Rule 3010(a).

Strong does not deny that Davis engaged in misconduct, but argues that he, Strong, should not be held accountable for any failure to supervise Davis on account of that misconduct. First, Strong contends that his role at the Firm and the authority he had been given were too limited to make him responsible for Davis' actions. He asserts, in support, that he "did not have the 'power' to cancel inappropriate trades or prevent the trading desk from executing Davis' trades." He further notes that NASD found that Strong was not Davis' "line supervisor," and suggests that Moreno, whom Davis viewed as his supervisor for administrative purposes, was generally responsible for Davis' supervision. 18/

We agree with NASD that Strong failed to enforce the Procedures, thereby violating NASD Conduct Rule 3010. In particular, he failed, from at least October 2002 through March 2003, to monitor Davis' account for compliance with the pre-approval requirement and, from around April 2003, when he finally began reviewing Davis' account statements, until August 2003, failed to address Davis' misconduct in any way – and never in an effective manner – despite overwhelming evidence of that misconduct contained in Davis' account statements.

We have held that Firm officials can be held liable for supervisory failures where, as here, the officials have the "responsibility, ability, or authority to affect the . . . conduct" of Firm personnel. 19/ We believe that the evidence establishes that Strong had the requisite responsibility and authority. As discussed, J&L's Procedures unequivocally placed supervisory responsibility for the Firm's research department with Strong. The Procedures also gave him authority to cancel trades when those trades conflicted with the Procedures or regulatory requirements. In addition, Moreno testified that he delegated to Strong supervisory responsibility for research personnel and that Strong had the authority, after consultation with Moreno, to discipline personnel for compliance violations. 20/ While evidence indicates that Moreno also played a role in Davis' supervision, that role did not relieve Strong of the express responsibilities conferred on him by the Procedures. 21/

18/ It appears that Moreno acted as Davis' line supervisor, although the record is unclear on this point. Although Davis viewed Moreno as his supervisor for administrative purposes, he stated that he would approach Strong when he had questions about research matters. For example, Davis reported his purchase of AVI stock in December 2002 to Strong.

19/ Conrad C. Lysiak, 51 S.E.C. 841, 844 n.13 (1993) (holding compliance director responsible for failure to establish procedures to monitor branch-office correspondence), aff'd, 47 F.3d 1175 (9th Cir. 1995) (Table).

20/ As discussed, when Moreno was asked whether Strong had the authority to fire personnel, he answered that the matter was never discussed because Strong never sought to take such action.

21/ Steven P. Sanders, 53 S.E.C. 889, 904 (1998) (holding that "even where supervisory

(continued...)

Strong next complains that NASD "failed to conduct an inquiry into the reasonableness of" his actions and contends that, if NASD had done so, it could not have found Strong liable because he acted "reasonably" under the circumstances. Strong argues that his exclusive reliance on after-the-fact review of Davis' trading was reasonable given what he claims was a lack of "red flags" with respect to Davis' trading activity. Strong asserts that, aside from a single trade that Davis admitted to him, 22/ Strong "had no reason to believe that Davis was trading in covered securities." According to Strong, until Strong began receiving Davis' account statements, "the indications were that Mr. Davis understood the procedures and was following them."

The evidence contradicts Strong's claim that he acted reasonably. Strong testified that, notwithstanding the responsibility he had given himself to monitor Davis' trading activity, he did not begin to review Davis' account statements until April 2003 at the earliest, well after Strong became the Firm's compliance officer, eight months after the trading restrictions of Rule 2711 took effect in July 2002, six months after Strong had given himself authority to monitor compliance with Rule 2711, and six months after Davis began violating that rule, as well as the Procedures. Moreover, Strong failed to utilize, for at least a portion of the period at issue, readily available reports, including the Firm's trade blotter, to inform himself about the personal trading of J&L's analysts. Such trading data would have given an almost immediate view of Davis' unapproved trading activities and would have allowed Strong to detect and, presumably, address those activities soon after they began in October 2002.

Moreover, even Strong's very belated and fairly minimal efforts to monitor Davis' trading did not result in effective action. Despite the fact that Strong began to review Davis' account statements around April 2003 and the account statements showed that Davis was repeatedly violating NASD rules and the Procedures, Strong took no action for roughly four months after

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21/ (...continued)
responsibility is shared between firm executives, each can be held liable for supervisory failures"). Moreover, while Moreno monitored the Firm's trading blotter and generally reviewed the Firm's trading activity, he did not do so for purposes of determining compliance with the analyst rules. Although Strong testified that Moreno reviewed the daily order tickets and confirmations, Moreno testified, when asked if he "handle[d] any compliance issues" after Mr. Strong began at J&L, "[n]o I did not."

22/ As mentioned earlier, this trade was a purchase of 100 shares of AVI on December 13, 2002, four days before J&L issued a Davis-authored report on AVI on December 17, 2002. Davis told Strong that he, Davis, had traded in violation of the blackout provisions, and Strong had Davis put a memo in the file to that effect. While Strong states that this incident gave Strong confidence that Davis understood the blackout rule, we believe it should have caused Strong to reconsider the appropriateness of relying on Davis to comply on his own, because Davis had not obtained Strong's prior approval of the trade.

finally reviewing those statements. 23/ Although Strong eventually, in August 2003, discussed with Davis his failure to obtain pre-approval for his trades, Davis continued to trade without prior approval and in violation of Rule 2711 for another month. Moreover, there is no evidence that Strong ever took any other action to address Davis' misconduct or even discussed it with other Firm officials. Strong's response to Davis' actions was inadequate, and unreasonable, under the circumstances. 24/

Twenty-five of Davis' forty-one violative trades occurred between October 2002 and April 2003. Strong asserts that when, around April 2003, he finally became aware of Davis' "trading in securities he was covering," Strong began "a review of Mr. Davis' trades." Strong contends that, at the time, he thought Davis' trading since October 2002 had not necessarily been violative because Davis continued to hold large blocks of the recommended companies' stock and his sales were small compared to his holdings and were motivated, in most cases, by personal financial circumstances, not a loss of confidence in the stocks. 25/ However, because Rule 2711, by its own terms, prohibits "any" purchase or sale that is inconsistent with the most recent recommendation, absent prior approval by a firm under limited circumstances, Strong now

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23/ Even when one of Davis' inconsistent trades was brought to Strong's attention, he did not take the opportunity to address violations of Rule 2711 and the Procedures. In May 2003, a sale by Davis of his entire position in InKine to one of his clients prompted an inquiry by the trading desk to Strong. Strong asserts that this trade was done for the benefit of the client and was the "only time Mr. Strong was aware of one of Mr. Davis' trades on a real-time basis." Strong approved the trade, a sale of all of Davis' stock in a company he had most recently recommended as a "buy," determining that "the question [was] not necessarily whether the [trade] was a violation of [] Rule [2711] but whether it was reasonable to place the interests of the client above a strict adherence to the Rule." Although Davis had liquidated his entire position in a stock he was recommending as a buy, Strong again did not increase his supervision of Davis' trading activity.

24/ Bradford John Titus, 52 S.E.C. 1154, 1160 n.24 (1996) ("We have emphasized that 'there must be adequate follow-up and review when a firm's own procedures detect irregularities or unusual trading activity.'") (quoting Rita H. Malm, 52 S.E.C. 64, 70 (1996)). See generally Richard F. Kresge, Exchange Act Rel. No. 55988 (June 29, 2007), 90 SEC Docket 3072, 3088 (holding compliance officer responsible who "turned a blind eye to the activity that occurred" at broker-dealer); Quest Capital Strategies, 55 S.E.C. 362, 371 (2001) (holding a supervisor accountable for not acting on violations of firm policies because "supervisors must act decisively to detect and prevent violations of the securities laws when an indication of irregularity is brought to their attention"); John A. Chepak, 54 S.E.C. 502, 512 n.23 (2000) (holding that a compliance officer can be held accountable for unreasonable passivity with respect to employee misconduct).

25/ Strong admitted that he never asked NASD to confirm his understanding of the way Rule 2711 operated, despite asking NASD for guidance on other research-related issues.

concedes that his interpretation of Rule 2711 was incorrect. Moreover, Strong's factual premise is incorrect. Of the seven stocks that Davis sold inconsistently with his most recent "buy" or "strong buy" recommendations, Strong admits that Davis completely sold out his positions in AVI in June and August 2003 and InKine in May 2003. 26/ Most important, however, Strong misperceives the issue before us. By delaying his monitoring of Davis' trading and by allowing Davis to make dozens of trades in violation of the Firm's prior-approval requirement without any intervention, Strong demonstrated a significant failure of supervision.

Strong contends that certain of Davis' violative trades were within the scope of two exceptions contained in Rule 2711: Rule 2711(g)(2)(B), permitting analysts to trade during a blackout period if the report creating the blackout period was prompted by "significant news or a significant event" that required reporting; and Rule 2711(g)(4), permitting analysts to trade in a manner that would ordinarily violate Rule 2711 "based on an unanticipated significant change in the [analyst's] personal financial circumstances." 27/ We find Strong's argument unpersuasive because each exception requires that the analyst obtain prior approval for the otherwise violative trading activity from the firm's compliance department. Because Davis did not seek, and was not given, prior approval for the trades at issue, the exceptions do not apply to his actions.

Strong further asserts that he reasonably believed at the time that the reports at issue were not necessarily covered by Rule 2711 because of their limited distribution. During the relevant period, Rule 2711's definition of "research report" did not exclude reports based on limited distribution. Strong notes, however, that the February 27, 2003 adopting release for a related Commission regulation, Regulation AC, which took effect April 14, 2003, excluded communications distributed to fewer than fifteen persons from its own definition of research reports. 28/ Strong further notes that, in a letter dated July 2003, NASD informed the

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26/ The record reflects that Davis also sold all of his shares in Emisphere and Med-Design, but NASD did not make any findings with respect to those trades.

27/ Strong also argues that certain of Davis' trades were not truly inconsistent with the most recent published recommendation because the contingencies upon which the recommendation had been based did not occur, and the report was, consequently, "stale" and its recommendation no longer operative. Strong cites Davis' sale of his entire position in AVI. According to Strong, the contingencies identified in the most recent AVI research report did not occur, and, therefore, the report's positive recommendation was no longer supported. Strong argues that "[a]n important point is that NASD Rule 2711 did not at the time require that a written report be issued to clients when the recommendation is changed." Whether or not the Firm was required to issue a revised recommendation, such trading violated the Rule and was not covered by any of its exceptions.

28/ Securities Act Rel. No. 8193 (Feb. 27, 2003), 79 SEC Docket 2451. Regulation AC (continued...)

Commission that, in light of Regulation AC, it would exempt a communication to fewer than fifteen recipients from the definition of "research report" applicable to Rule 2711. However, NASD did not issue its notice to members announcing that change until March 2004, six months after the events at issue here. 29/ In any event, Strong readily admits that two of the research reports involved were distributed to at least fifteen of Davis' clients, thereby coming within the revised definition of research reports.

Strong, thus, has provided no basis for questioning NASD's finding of supervisory failure. In sum, the evidence establishes that Strong's unreasonable inaction effectively nullified the supervisory system related to the Firm's compliance with Rule 2711 that he himself had designed and was responsible for enforcing. Consequently, we find that Strong violated NASD Conduct Rule 3010 and that, because a violation of any NASD Conduct Rule is also a violation of NASD Conduct Rule 2110, Strong also violated NASD Conduct Rule 2110. 30/

IV.

NASD further found that Strong was responsible for the failure of various of the Firm's research reports to include required disclosures and for the inclusion of inaccurate disclosures, in violation of Rule 2711(h). During the period at issue, J&L issued thirty-five research reports. The Procedures required Strong to review "research reports to ensure compliance with NASD Rule 2711." Each report at issue in this proceeding met the definition of "research report" in

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28/ (...continued)
addresses issues related to the certification of research analysts. The Commission's adopting release for that regulation states that "[t]he following communications would generally not be research reports even if they recommend or rate individual securities or companies: . . . [a]n analysis prepared for a specific person or a limited group of fewer than fifteen persons." 79 SEC Docket at 2454. Strong asserts that, given the small number of Davis' clients and the definition of "research report" contained in Regulation AC, the "applicability of NASD Rule 2711 to Mr. Davis was the subject of numerous discussions within the firm." Strong does not say, and the record does not establish, with whom Strong held these alleged discussions, or otherwise contain any details about them.

29/ NASD Notice to Members 04-18, Research Analysts and Research Reports (Mar. 2004) at 228. While Strong states that the July 2003 letter between NASD and Commission staff "was available on-line prior" to the issuance of NASD's authoritative interpretation in March 2004, he does not state precisely when the letter was made public, and the record contains no evidence on this question. However, even assuming that he had access to the letter shortly after it was sent, in late July or early August, this would be after much of the misconduct at issue occurred. Indeed, it was in August that Strong, belatedly, began to focus on the problem and talked to Davis about it.

30/ See, e.g., Stephen J. Gluckman, 54 S.E.C. 175, 185 (1999).

effect at the time the report was issued. 31/ NASD concluded that Strong committed a direct violation of Rule 2711 based on the role he played in reviewing the research reports, not that he failed to supervise Davis' compliance with the Rule.

Rule 2711(h) required that these reports contain various disclosures. Rule 2711(h)(1)(A) required that they disclose whether the analyst owned a financial interest in the covered company and, if so, the nature of that interest. Rule 2711(h)(4) required that a research report define terms, such as "buy," used in making a recommendation. Rule 2711(h)(6) required research reports to present "a line graph of the security's daily closing prices for the period the member has assigned any rating or for a three-year period whichever is shorter." Rule 2711(h)(7) required reports to disclose "the valuation methods used to determine a price target . . . accompanied by a disclosure concerning the risks that may impede achievement of the price target." Rule 2711(h)(8) required research reports to disclose whether the issuing firm made a market in the covered company's stock. The same requirements are included in the Procedures which, as discussed, were prepared by Strong. The reports at issue in this proceeding and their respective violations are summarized in the following chart.

		Rule 2711 Violations				
Date	**Name of Company**	**(h)(1)(A)**	**(h)(4)**	**(h)(6)**	**(h)(7)**	**(h)(8)**
12/17/02	AVI			✓	✓	
2/19/03	Med-Design		✓		✓	
2/27/03	Collagenex	✓			✓	
3/21/03	Nastech		✓	✓	✓	
4/16/03	InKine				✓	✓
4/30/03	Curative Health Svcs., Inc.					✓
7/16/03	Providian Financial Corp. 32/				✓	
7/22/03	Discovery		✓	✓	✓	

31/ The reports published after July 2002 discussed in Section II, supra, and those at issue here are, with the exception of two reports authored by analysts other than Davis, the same.

32/ The reports on Curative Health Services, Inc. and Providian Financial Corp. were prepared by J&L analysts other than Davis.

Strong does not deny that these research reports contained misstatements and also omitted required disclosures. Indeed, Strong conceded that certain of the defective disclosures occurred because the item was "something that I missed" or "thought [the disclosure] didn't need to be there." 33/ The reports at issue misstated that Davis had no interest in Collagenex, failed to define key terms such as "strong buy," provided incomplete historical price data, and failed to disclose the Firm's market-maker status in InKine and Curative Health Services, Inc. stock. These misstatements and omissions violated Rules 2711(h)(1)(A), (h)(4), (h)(6), and (h)(8) respectively.

Strong argues generally, however, that his role as compliance officer of the Firm was so limited that he should not be held responsible for these violations. 34/ Strong argues that, given the many demands on his time, he reasonably relied on Davis to make the disclosures required by Rule 2711 completely and accurately and further relied on Moreno to review those disclosures. Strong then reviewed certain disclosures that were generally made on a separate page attached to the end of each report. According to Strong, to do more, in advance of any indication that more supervision was necessary, would have taken time away from other, more critical, compliance tasks. Strong further asserts "that the number of errors were de [minimis] in number relative to the number of disclosures required in the reports . . . ."

Strong construes his responsibilities with respect to disclosure too narrowly. The Procedures provided a direct role for Strong in the review process, stating that "the CCO [Strong] will review research reports to ensure compliance with NASD Rule 2711" and that "[a]ll research reports will be reviewed and initialed to demonstrate approval by the CCO and COO [Moreno] . . . ." Strong played an integral role and, by his own admission, "proactively inserted himself" into the preparation of the reports for publication "to see that the newly required disclosures were being made." 35/ According to his and Moreno's testimony, Strong reviewed each draft report (including its attached disclosures) and, after directing that any necessary changes be made, initialed it. Although Moreno also reviewed the reports, that review did not

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33/ We note that Strong's memorandum of February 3, 2003, reminding the analysts that Rule 2711 required specific disclosures preceded the Firm's issuance of reports, reviewed and approved by Strong, that omit some of the disclosures Strong mentioned in the memorandum. See supra note 11.

34/ As he does with respect to the findings that Davis' trading was inconsistent with his recommendations, Strong argues that the research reports at issue here were not subject to Rule 2711 because of their limited distribution. We find, however, as discussed, that the reports were subject to the rule as adopted, before NASD issued an interpretation limiting its application. See supra text accompanying note 29.

35/ For example, in a 2003 internal memorandum to the research staff, Strong reminded the analyst that he needed to be notified at least ten days before the release of a report so he could "ensure that the proper disclosures are made."

permit Strong to neglect his responsibility to verify that the reports satisfied disclosure requirements. 36/

In our view, Strong did not employ reasonable diligence to perform the verification function required by the Procedures he prepared. The burden of reviewing these reports, during the period at issue, does not appear to have been great. During this time, the Firm issued only thirty-five reports, averaging four pages each. Strong was, thus, required to review an average of fewer than three reports per month. Moreover, verification of the presence and accuracy of the disclosures required by Rule 2711 required no more than reasonable diligence. Nonetheless, the reports exhibited the disclosure violations described above. We find that, in failing to carry out his responsibility to review these reports, Strong violated Rules 2711(h)(1)(A), (4), (6), (8), and 2110. 37/

Strong makes somewhat different arguments regarding NASD's findings concerning Rule 2711(h)(7), i.e., that he was responsible for the reports' failure to disclose the valuation method used by the analyst and the associated risk factors. Strong first asserts that the requisite "[r]isk factors were disclosed" and that "NASD has never identified what additional risk factors it

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36/ Moreno's testimony as to his own role in the report review process varied. In his investigative testimony, Moreno stated that he would just "look at [a report] quickly . . . once he [Strong] has signed off on it . . . ." At the hearing, however, Moreno stated that he did not receive copies of the reports after Strong reviewed them, although he did admit that he reviewed research reports when Strong was absent from the office. Moreno believed that Strong was reviewing the reports "for the proper disclosures." For his part, Davis testified consistently that both Moreno and Strong reviewed his work. In his investigative testimony, he stated that "they [Moreno and Strong] both sign off on my reports." At the hearing he stated that his reports "would have to be signed off by [Strong] and [Moreno]." As discussed, Moreno's role in approving the reports did not relieve Strong of the express responsibilities conferred on him by the Procedures. See supra note 21.

37/ Although these rules impose disclosure requirements on NASD "members," those requirements also apply to associated persons of members where, as here, the associated person has responsibility for the member's compliance with the requirements. See NASD General Provision 0115(a) ("[p]ersons associated with a member shall have the same duties and obligations as a member under these [NASD] Rules."); see, e.g., Richard F. Kresge, Exchange Act Rel. No. 55988 (June 29, 2007), 90SEC Docket 3072, 3090-91 (holding compliance officer liable for firm's failure to report customer complaints, in violation of NASD Conduct Rule 3070(c), where compliance officer was given responsibility for such reporting); Pac. On-Line Trading & Sec., 56 S.E.C. 1111, 1116-17 (2003) (holding firm president responsible for firm's failure to file its initial advertisement in violation of NASD Conduct Rule 2210(c)(4)(A) where president was responsible for advertising compliance).

believes are required." According to Strong, "[a] comparison of Mr. Davis' reports with those issued by other firms shows that similar risk factors were identified" in the reports at issue.

Contrary to Strong's assertion, however, NASD presented testimony by one of its examiners who stated that Davis' reports "did not have the same . . . content, disclosures and risks that were contained in other reports" published by other firms. Our comparison of the reports at issue here with similar reports published by other firms, which Strong introduced before NASD as evidence of industry practice, is consistent with the views expressed by the NASD examiner. For example, a report by a firm other than J&L on Collagenex, an issuer recommended in one of the J&L reports at issue here, describes the analyst's valuation model explicitly and contains a separate section entitled "Impediments," which introduces an eight-item list of risk factors and states that "[t]he following impediments may cause our price objective to go unrealized." Similarly, three reports also introduced by Strong from another firm on Discovery, AVI, and InKine each describe the applicable valuation model and provide a separate section detailing risks that may impede the achievement of the report's price target. As indicated, the J&L reports at issue do not provide a comparable discussion of the valuation method used or the relevant risk factors. 38/

The J&L research reports at issue provide no explicit disclosure of risk factors, relying instead upon discussions of various contingencies, the occurrence of which, according to the reports, could enhance the value of the covered stock. For example, the February 27, 2003 report on Collagenex disclosed possible new product acquisitions and anticipated releases of favorable scientific data supporting new uses for an existing product, each of which would be a positive development for Collagenex stock. The report, however, did not mention any risk factors. Similarly, the March 21, 2003 report on Nastech discloses increased sales of an existing product, the beginning of marketing for a newly approved product, and the reporting of data from product tests and describes the positive outcomes that could be expected from each event. This report also does not identify any risks.

Strong further claims that, although he "provided guidance and information on the disclosure requirements to both Mr. Davis and Mr. Moreno, consistent with his role as the compliance officer," he actually "was not qualified to review the reports . . . for compliance with Rule 2711(h)(7)." Instead, according to Strong, he believed that Moreno was reviewing the reports to ensure that the proper disclosures were made.

However, in the Procedures, Strong assigned himself responsibility for verifying that Firm research reports contained the appropriate disclosures. Moreno testified that he looked to Strong to ensure the research reports complied with NASD Rule 2711. Whatever role Moreno played in the reviewing process was supplemental to Strong's and, as discussed, did not relieve Strong of compliance responsibility. As to Strong's arguments that he was not able to judge the

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38/ In any event, we do not believe that industry practice establishes the standard by which compliance with NASD Rule 2711(h) is measured.

adequacy of the disclosures related to valuation and investment risk, we believe he should have been able to notice their absence from the reports. 39/ In any event, given his position and the Firm's reliance on him to achieve compliance, Strong could not rely on the belief someone else at the Firm would cover for his own claimed inability to assess the adequacy of those disclosures. We therefore find that Strong violated NASD Conduct Rules 2711(h)(7) and 2110.

V.

NASD found that Strong violated Rule 2711(i) because an attestation regarding the Procedures was filed late. Rule 2711(i) requires that members "adopt and implement written supervisory procedures reasonably designed to ensure that the member and its employees comply with the provisions of [NASD Conduct Rule 2711] and a senior officer of such a member must attest annually to NASD that it has adopted and implemented those procedures." Strong does not contest that it was his responsibility to prepare and file with NASD the Firm's attestation under Rule 2711(i). At the time of the charged conduct, the deadline for filing the attestation was December 31, 2002. Strong admittedly filed J&L's attestation on February 27, 2003, roughly two months late. As a result, we find that Strong violated NASD Conduct Rules 2711(i) and 2110.

VI.

Following the settlement of the proceedings NASD brought against Davis, NASD issued a press release stating that "NASD has also charged [J&L], a New York City broker-dealer, and its chief compliance officer, Robert Strong, with failing to adequately supervise Davis." 40/ Strong asserts that the press release falsely stated or implied that he was involved in fraudulent misconduct and that the press release was an unfair punitive measure. We find that the press release accurately depicted the nature of the complaint against Strong and noted that Strong could respond to the complaint and request a hearing on the charges against him.

39/ If Strong did not feel competent to judge the adequacy of those disclosures, he should have acted to see that another Firm official was exercising responsibility for review of that information. Of course, any such delegation should have included an appropriate amendment of the Procedures to reflect the new delegation of responsibility. Kirk Montgomery, 55 S.E.C. 485, 496 (2001); Sanders, 53 S.E.C. at 904 (holding accountable for violations person identified in compliance manual as responsible for ensuring regulatory compliance).

40/ Press Release, FINRA, "NASD Fines Former Jesup & Lamont Research Analyst for Trading Contrary to His Own Recommendations" (February 23, 2005) (available online at http://www.finra.org/PressRoom/NewsReleases/2005NewsReleases/P013410).

Strong relies on a statement from Industrial Safety Equipment Ass'n v. EPA for the proposition that false publicity by a government agency can be considered a sanction. 41/ That case is inapposite. It requires that a government agency or actor generate the publicity and that the agency have an intent to punish the subject of the publicity. 42/ NASD, however, is not a governmental actor. 43/ Nor is there evidence of any punitive intent by NASD. We find that the press release issued by NASD was not a sanction subject to review in this proceeding.

VII.

Section 19(e)(2) of the Exchange Act governs our consideration of the sanctions imposed by NASD. 44/ Section 19(e)(2) directs us to sustain NASD's sanctions unless we find, having due regard for the public interest and the protection of investors, that the sanctions are excessive or oppressive or impose an unnecessary or inappropriate burden on competition. 45/ Strong argues that Davis' clients, the target audience of his reports, were financial institutions who were more sophisticated than the typical retail client and that, despite his occasional sales, Davis' buy recommendations represented his honest beliefs about the favorable prospects for the stocks he covered. Strong contends that the sanctions, fines totaling $10,000, are "punitive rather than remedial" and should be reduced or set aside. 46/ We disagree with Strong's characterization and find the sanctions satisfy the statutory standard.

In sustaining these sanctions, we note that NASD's National Adjudicatory Council ("NAC"), which considered Strong's appeal from NASD's hearing panel, reduced the sanctions

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41/ 837 F.2d 1115, 1119 (D.C. Cir. 1988) (noting that "Congress itself did note that in certain circumstances adverse publicity [from a government agency] might operate as a sanction").

42/ Id.

43/ See, e.g., Rooney A. Sahai, Exchange Act Rel. No. 55046 (Jan. 5, 2007), 89 SEC Docket 2402, 2408 (holding that NASD's authority "to discipline its members and . . . impose remedial sanctions does not convert it into a state actor").

44/ 15 U.S.C. § 78s(e)(2).

45/ Strong does not claim, and the record does not show, that NASD's action imposed an unnecessary or inappropriate burden on competition.

46/ The NAC assessed a $5,000 fine for Strong's supervisory violations and the late filing of the attestation under Rule 2711(i), and a $5,000 fine for the violations of Rule 2711(h). Strong also complains that, as a result of the proceeding, he has not been able to find comparable securities-industry employment and has gone into debt. Strong was also assessed costs of $3,723.54.

from the nine-month supervisory suspension and $15,000 fine imposed by the hearing panel. In reducing the sanctions, the NAC noted that it did "not find Strong's violations to be egregious" as had the hearing panel. The NAC considered "the circumstances under which Strong was operating," finding that Strong was "the sole compliance person in a 40-person firm that had previously neglected compliance." The NAC also considered, as mitigating, that the misconduct at issue occurred "within months of Strong's joining the Firm and when Strong was attempting to fulfill the broad-based compliance responsibilities put upon him." According to the NAC, "Strong was overwhelmed by the enormity of the responsibilities [and] . . . not equipped to undertake the responsibilities required of him at the Firm." In addition, the NAC found that Strong did not "personally benefit in any way" from his misconduct. Based on those considerations, the NAC determined that "the minimum sanction suggested in the Guidelines for the supervisory and disclosure violations" was "appropriate."

While NASD recognized the presence of various mitigating circumstances, it nevertheless also observed that its decision regarding sanctions "should not be read to indicate that supervisory violations or violations of the research analyst rules warrant light sanctions." We agree that the rules at issue serve important policy objectives related to investor protection. Rule 2711(g) is intended to ensure that research reports reflect the independent and honest opinions of the responsible analysts and are not compromised by personal financial interest. 47/ Similarly, the disclosure requirements of Rule 2711(h) seek to ensure that the reports contain a minimal level of information relevant to an investor's assessment of the reports' assertions.

NASD's Sanction Guidelines provide for a range of fines between $5,000 and $50,000 for the misconduct at issue here as well as suspensions of varying lengths, and, in egregious cases, also provide for bars from association with NASD members. 48/ Among the considerations identified by the Guidelines for evaluation of the proper sanctions for supervisory cases are: whether the respondent ignored "red flags" or other warnings that should have resulted in additional supervisory scrutiny; the "nature, extent, and character of the underlying misconduct;" and the "[q]uality and degree of the supervisor's implementation of the firm's supervisory

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47/ Strong claims that NASD failed to consider that Davis' trading practices resulted in no harm "to individual customers or to the investing public." We are unwilling to say, on this record, whether or not the misconduct at issue resulted in no harm. In any event, a showing of harm is not required under Rule 2711, since the rule is intended to serve a prophylactic purpose.

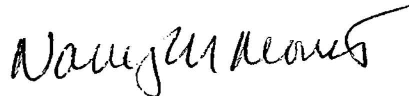
48/ FINRA Sanction Guidelines 1 (2006 ed.) (available on line at http://www.finra.org/web/groups/enforcement/documents/enforcement/p011038.pdf). The Sanction Guidelines have been promulgated by NASD in an effort to achieve greater consistency, uniformity, and fairness in the sanctions that are imposed for violations. See Perpetual Sec., Inc., Exchange Act Rel. No. 56613 (Oct. 4, 2007), 90 SEC Docket 2489, 2506 n.56 (describing function of Sanction Guidelines).

procedures and controls." 49/ Similarly, the Guidelines list the following considerations for evaluation of the proper sanctions for defective disclosure cases: whether the misconduct resulted from negligence or intentional behavior; whether the misconduct resulted in "publication of research reports that omitted material information or contained misleading information;" and whether there was evidence of "systemic problems or widespread abuse in the firm."

NASD considered these factors in assessing sanctions against Strong, as do we. 50/ Strong's supervisory failures reflect a troubling inattention to the responsibilities given to him by J&L's management and the Procedures. Although Strong revised the Firm's supervisory system, he failed effectively to implement that system and, as time went on, ignored indications of misconduct by Davis. Similarly, the disclosure violations, attributable to Strong's inattention, resulted in the publication of reports that omitted and misstated important information. While we, like NASD, do not consider Strong's conduct egregious, we believe that the sanctions imposed by NASD serve the public interest by encouraging future compliance with the rules at issue here, by Strong and by others in the industry who have been given similar responsibilities. As such, these sanctions are remedial and not punitive and satisfy the statutory standard in that they are neither excessive nor oppressive.

An appropriate order will issue. 51/

By the Commission (Chairman COX and Commissioners ATKINS and CASEY)



Nancy M. Morris
Secretary

49/ FINRA Sanction Guidelines at 108.

50/ We note that a fine can be an adequate sanction when the violative conduct does not warrant a bar or suspension. See, e.g., James S. Pritula, 53 S.E.C. 968, 977 (1998).

51/ We have considered all of the arguments advanced by the parties. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

Appendix
Stock Sales That Conflicted With Recommendations

Settlement Date	Company	No. of Shares	Position	Recommendation
10/8/02	NASTECH	2,600	55,255	Strong Buy
10/18/02	MED-DESIGN	2,500	1,200	Strong Buy
12/30/02	AVI	1,500	22,000	Buy
1/2/03	MED-DESIGN	1,200	0	Strong Buy
1/7/03	NASTECH	1,755	55,000	Strong Buy
1/30/03	NASTECH	1,755	55,621	Strong Buy
2/3/03	NASTECH	1,576	54,045	Strong Buy
2/5/03	NASTECH	800	55,000	Strong Buy
2/27/03	AVI	3,000	23,700	Buy
3/10/03	EMISPHERE	10,000	28,400	Strong Buy
3/11/03	EMISPHERE	10,000	18,400	Strong Buy
3/14/03	EMISPHERE	10,000	8,400	Strong Buy
3/18/03	AVI	10,000	26,700	Buy
3/18/03	EMISPHERE	2,000	6,400	Strong Buy
3/19/03	COLLAGENEX	671	33,500	Strong Buy
3/20/03	EMISPHERE	6,400	0	Strong Buy
4/1/03	COLLAGENEX	5,000	35,500	Strong Buy
4/23/03	DISCOVERY	5,000	100,377	Strong Buy
4/23/03	NASTECH	4,000	63,000	Strong Buy
4/28/03	MED-DESIGN	4,000	0	Strong Buy
5/1/03	AVI	15,000	12,900	Buy
5/6/03	AVI	10,000	2,900	Buy
5/8/03	INKINE	20,000	0	Buy
5/13/03	AVI	8,000	2,900	Buy

Settlement Date	Company	No. of Shares	Position	Recommendation
5/19/03	AVI	300	4,600	Buy
6/3/03	NASTECH	4,000	68,000	Strong Buy
6/3/03	COLLAGENEX	2,500	35,500	Strong Buy
6/16/03	AVI	1,700	2,900	Buy
6/24/03	AVI	2,900	0	Buy
6/26/03	NASTECH	1,200	66,800	Strong Buy
6/26/03	COLLAGENEX	1,000	34,500	Strong Buy
7/17/03	COLLAGENEX	6,500	28,000	Strong Buy
7/24/03	NASTECH	1,800	65,000	Strong Buy
7/24/03	COLLAGENEX	1,000	27,000	Strong Buy
8/1/03	COLLAGENEX	5,000	22,000	Strong Buy
8/1/03	COLLAGENEX	5,000	17,000	Strong Buy
8/25/03	AVI	20,000	8,000	Buy
8/25/03	AVI	3,000	5,000	Buy
8/26/03	AVI	5,000	0	Buy
9/9/03	DISCOVERY	10,000	161,134	Strong Buy
9/17/03	DISCOVERY	8,000	153,134	Strong Buy

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 57426 / March 4, 2008

Admin. Proc. File No. 3-12599

In the Matter of the Application of

ROBERT E. STRONG
105 Pinehurst Avenue
New York, New York 10033

For Review of Disciplinary Action Taken by

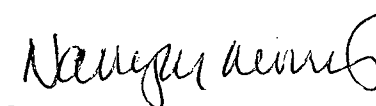
NASD

ORDER SUSTAINING DISCIPLINARY ACTION TAKEN BY REGISTERED SECURITIES ASSOCIATION

On the basis of the Commission's opinion issued this day, it is

ORDERED that the disciplinary action taken by NASD against Robert E. Strong, and NASD's assessment of costs, be, and they hereby are, sustained.

By the Commission.



Nancy M. Morris
Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR PART 248

Release Nos. 34-57427; IC-28178; IA-2712; File No. S7-06-08

RIN 3235-AK08

Part 248 – Regulation S-P: Privacy of Consumer Financial Information and Safeguarding Personal Information

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission ("Commission") is proposing amendments to Regulation S-P, which implements certain provisions of the Gramm-Leach-Bliley Act ("GLBA") and the Fair Credit Reporting Act ("FCRA") for entities regulated by the Commission. The proposed amendments would set forth more specific requirements for safeguarding information and responding to information security breaches, and broaden the scope of the information covered by Regulation S-P's safeguarding and disposal provisions. They also would extend the application of the disposal provisions to natural persons associated with brokers, dealers, investment advisers registered with the Commission ("registered investment advisers") and transfer agents registered with the Commission ("registered transfer agents"), and would extend the application of the safeguarding provisions to registered transfer agents. Finally, the proposed amendments would permit a limited transfer of information to a nonaffiliated third party without the required notice and opt out when personnel move from one broker-dealer or registered investment adviser to another.

DATES: Comments must be received on or before [insert date 60 days after publication in Federal Register].

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

4835

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 S7-06-08 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 S7-06-08. 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, on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Catherine McGuire, Chief Counsel, or Brice Prince, Special Counsel, Office of the Chief Counsel, Division of Trading and Markets, (202) 551-5550; or Penelope Saltzman, Acting Assistant Director, or Vincent Meehan, Senior Counsel, Office of Regulatory Policy, Division of Investment Management, (202) 551-6792, Securities

and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: The Commission today is proposing amendments to Regulation S-P[1] under Title V of the GLBA,[2] the FCRA,[3] the Securities Exchange Act of 1934 (the "Exchange Act"),[4] the Investment Company Act of 1940 (the "Investment Company Act"),[5] and the Investment Advisers Act of 1940 (the "Investment Advisers Act").[6]

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1 17 CFR Part 248. Unless otherwise noted, all references to rules under Regulation S-P will be to Part 248 of the Code of Federal Regulations (17 CFR 248).

2 15 U.S.C. 6801-6827.

3 15 U.S.C. 1681w.

4 15 U.S.C. 78a.

5 15 U.S.C. 80a.

6 15 U.S.C. 80b.

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I. BACKGROUND

A. Statutory Requirements and Current Regulation S-P Mandates

Subtitle A of Title V of the GLBA requires every financial institution to inform its customers about its privacy policies and practices, and limits the circumstances in which a financial institution may disclose nonpublic personal information about a consumer to a nonaffiliated third party without first giving the consumer an opportunity to opt out of the disclosure.[7] In enacting the legislation, Congress also specifically directed the Commission and other federal financial regulators to establish and implement information safeguarding standards requiring financial institutions subject to their jurisdiction to adopt administrative, technical and physical information safeguards.[8] The GLBA specified that these standards were to "insure the security and confidentiality of customer records and information," "protect against any anticipated threats or hazards to the security or integrity" of those records, and protect against unauthorized access to or use of those records or information, which "could result in substantial

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7 See 15 U.S.C. 6802(a) and (b). The GLBA and Regulation S-P draw a distinction between "consumers" and "customers." A "consumer" is defined in Section 3(g)(1) of Regulation S-P to mean an individual who obtains a financial product or service that is to be used primarily for personal, family, or household purposes. See 17 CFR 248.3(g)(1). A "customer" is defined in Section 3(j) of Regulation S-P as a consumer who has a continuing relationship with the financial institution. See 17 CFR 248.3(j). The distinction between customer and consumer determines the notices that a financial institution must provide. Pursuant to Sections 4 and 5 of Regulation S-P, a financial institution must provide customers with an initial notice describing the institution's privacy policies when a customer relationship is formed and at least annually throughout the customer relationship. In contrast, if a consumer is not a customer, a financial institution must only provide a notice if it intends to share nonpublic personal information about the consumer with a nonaffiliated third party (outside of certain exceptions). See 17 CFR 248.4 and 248.5.

8 The GLBA directed the Commission, the Federal Trade Commission ("FTC") and state insurance authorities to implement the safeguarding standards by rule. See 15 U.S.C. 6805(b)(2). The GLBA directed the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation ("FDIC") and the Office of Thrift Supervision (collectively, the "Banking Agencies") and the National Credit Union Administration ("NCUA") to implement the safeguarding standards by regulation or by guidelines. See 15 U.S.C. 6805(b)(1).

harm or inconvenience to any customer."[9]

In response to these directives, we adopted Regulation S-P in 2000.[10] Section 30(a) of Regulation S-P (the "safeguards rule") requires institutions to safeguard customer records and information,[11] while other sections of the regulation implement the notice and opt out provisions

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9 15 U.S.C. 6801(b).

10 See Privacy of Consumer Financial Information (Regulation S-P), Exchange Act Release No. 42974, Investment Company Act ("ICA") Release No. 24543, Investment Advisers Act ("IAA") Release No. 1883 (June 22, 2000), 65 FR 40334 (June 29, 2000). Pursuant to the GLBA directive, Regulation S-P is consistent with and comparable to the financial privacy rules adopted by other federal financial regulators in 2000. See FTC, Privacy of Consumer Financial Information, 65 FR 33646 (May 24, 2000); Banking Agencies, Privacy of Consumer Financial Information, 65 FR 35162 (June 1, 2000); and NCUA, Privacy of Consumer Financial Information; Requirements for Insurance, 65 FR 31722 (May 18, 2000). See also 15 U.S.C. 6804(a)(2) (directing federal financial regulators to consult and coordinate to assure, to the extent possible, that each agency's regulations are consistent and comparable with the regulations prescribed by the other agencies).

In 2001, we amended Regulation S-P to permit futures commission merchants and introducing brokers that are registered by notice as broker-dealers in order to conduct business in security futures products under Section 15(b)(11)(A) of the Exchange Act ("notice-registered broker-dealers") to comply with Regulation S-P by complying with financial privacy rules that the Commodity Futures Trading Commission ("CFTC") adopted that year. See 17 CFR 248.2(b); Registration of Broker-Dealers Pursuant to Section 15(b)(11) of the Securities Exchange Act of 1934, Exchange Act Release No. 44730 (Aug. 21, 2001), 66 FR 45138 (Aug. 27, 2001); see also CFTC, Privacy of Consumer Financial Information, 66 FR 21236 (Apr. 27, 2001).

11 17 CFR 248.30(a).

of the GLBA.[12] The safeguards rule currently requires institutions to adopt written policies and procedures for administrative, technical, and physical safeguards to protect customer records and information. The safeguards must be reasonably designed to meet the GLBA's objectives.[13] This approach provides flexibility for institutions to safeguard customer records and information in accordance with their own privacy policies and practices and business models. The safeguards rule and the notice and opt out provisions currently apply to brokers, dealers,

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[12] See 17 CFR 248.1-248.18. As described above, the GLBA and Regulation S-P require brokers, dealers, investment advisers registered with the Commission, and investment companies to provide an annual notice of their privacy policies and practices to their customers (and notice to consumers before sharing their nonpublic personal information with nonaffiliated third parties outside certain exceptions). See supra note 7; 15 U.S.C. 6803(a); 17 CFR 248.4; 17 CFR 248.5. In general, the privacy notices must describe the institutions' policies and practices with respect to disclosing nonpublic personal information about a consumer to both affiliated and nonaffiliated third parties. 15 U.S.C. 6803; 17 CFR 248.6. The notices also must provide a consumer a reasonable opportunity to direct the institution generally not to share nonpublic personal information about the consumer (that is, to "opt out") with nonaffiliated third parties. 15 U.S.C. 6802(b); 17 CFR 248.7. (The privacy notice also must provide, where applicable under the FCRA, a notice and an opportunity for a consumer to opt out of certain information sharing among affiliates.) Sections 13, 14, and 15 of Regulation S-P (17 CFR 248.13, 17 CFR 248.14, and 17 CFR 248.15) set out exceptions from these general notice and opt out requirements under the GLBA. Section 13 includes exceptions for sharing information with other financial institutions under joint marketing agreements and with certain service providers. Section 14 includes exceptions for sharing information for everyday business purposes, such as maintaining or servicing accounts. Section 15 includes exceptions for disclosures made with the consent or at the direction of a consumer, disclosures for particular purposes such as protecting against fraud, disclosures to consumer reporting agencies, and disclosures to law enforcement agencies. In March 2007, the Commission, together with the Banking Agencies, the CFTC, the FTC, and the NCUA, published for public comment in the Federal Register a proposed model privacy form that financial institutions could use for their privacy notices to consumers required by the GLBA. See Interagency Proposal for Model Privacy Form Under the Gramm-Leach-Bliley Act, Exchange Act Release No. 55497, IAA Release No. 2598, ICA Release No. 27755 (Mar. 20, 2007), 72 FR 14940 (Mar. 29, 2007) ("Interagency Model Privacy Form Proposal").

[13] Specifically, the safeguards must be reasonably designed to insure the security and confidentiality of customer records and information, protect against anticipated threats to the security or integrity of those records and information, and protect against unauthorized access to or use of such records or information that could result in substantial harm or inconvenience to any customer. See supra note 9 and accompanying text.

registered investment advisers, and investment companies.[14]

Pursuant to the Fair and Accurate Credit Transactions Act of 2003 ("FACT Act"), the Commission amended Regulation S-P in 2004 to protect against the improper disposal of consumer report information.[15] Section 30(b) of Regulation S-P (the "disposal rule") currently applies to the institutions subject to the other provisions of Regulation S-P, except that it excludes notice-registered broker-dealers and includes registered transfer agents.

B. Challenges Posed by Information Security Breaches

In recent years, we have become concerned with the increasing number of information security breaches that have come to light and the potential for identity theft and other misuse of personal financial information. Once seemingly confined mainly to commercial banks and

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[14] Regulation S-P applies to investment companies as the term is defined in Section 3 of the Investment Company Act (15 U.S.C. 80a-3), whether or not the investment company is registered with the Commission. See 17 CFR 248.3(r). Thus, a business development company, which is an investment company but is not required to register as such with the Commission, is subject to Regulation S-P. In this release, institutions to which Regulation S-P currently applies, or to which the proposed amendments would apply, are sometimes referred to as "covered institutions."

[15] 17 CFR 248.30(b). Section 216 of the FACT Act amended the FCRA by adding Section 628 (codified at 15 U.S.C. 1681w), which directed the Commission and other federal financial regulators to adopt regulations for the proper disposal of consumer information, and provides that any person who maintains or possesses consumer information or any compilation of consumer information derived from a consumer report for a business purpose must properly dispose of the information. See Disposal of Consumer Report Information, Exchange Act Release No. 50781, IAA Release No. 2332, ICA Release No. 26685 (Dec. 2, 2004), 69 FR 71322 (Dec. 8, 2004) ("Disposal Rule Adopting Release"). When we adopted the disposal rule, we also amended Regulation S-P to require that the policies and procedures institutions must adopt under the safeguards rule be in writing.

The disposal rule requires transfer agents registered with the Commission, as well as brokers and dealers other than notice-registered broker-dealers, investment advisers registered with the Commission, and investment companies that maintain or possess "consumer report information" for a business purpose, to take "reasonable measures to protect against unauthorized access to or use of the information in connection with its disposal."

In order to provide clarity, the Disposal Rule Adopting Release included five examples intended to provide guidance on disposal measures that would be deemed reasonable under the disposal rule. See Disposal Rule Adopting Release at section II.A.2.

retailers, this problem has spread throughout the business community, including the securities industry.[16]

In the last two years, we have seen a significant increase in information security breaches involving institutions we regulate. Perhaps most disturbing is the increase in incidents involving the takeover of online brokerage accounts, including the use of the accounts by foreign nationals as part of "pump-and-dump" schemes.[17] The financial services sector also is a popular target for online targeted attacks, and "phishing" attacks in which fraudsters set up an Internet site designed to mimic a legitimate site and induce random Internet users to disclose personal

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16 See Press Release, NASD, NASD Warns Investors to Protect Online Account Information, Brokerages Also Reminded of Obligation to Protect Customer Information from New Threats (July 28, 2005), http://www.finra.org/PressRoom/NewsReleases/2005NewsReleases/P014775 (last visited Nov. 6, 2007). See also In re NEXT Financial Group, Inc., Exchange Act Release No. 56316 (Aug. 24, 2007), http://www.sec.gov/litigation/admin/2007/34-56316.pdf, and Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 (Aug. 24, 2007) (alleging violations of the notice and opt out provisions of Regulation S-P and the safeguards rule in connection with recruiting registered representatives), http://www.sec.gov/litigation/admin/2007/34-56316-o.pdf.

17 While some account takeovers may have been facilitated by investors failing to take adequate precautions against security threats such as "keylogger" programs and "phishing" attacks, many online brokerage firms have successfully reduced their exposure to account takeovers by improving their authentication and monitoring procedures. The Commission has been active in this area, and has brought several enforcement cases involving defendants in foreign jurisdictions. See, e.g., Litigation Release No. 20037 (Mar. 12, 2007), available at http://www.sec.gov/litigation/litreleases/2007/lr20037.htm (three Indian nationals charged with participating in an alleged fraudulent scheme to manipulate the prices of at least fourteen securities through the unauthorized use of other people's online brokerage accounts); and Litigation Release No. 19949 (Dec. 19, 2006), available at http://www.sec.gov/litigation/litreleases/2006/lr19949.htm (emergency asset freeze obtained; complaint alleged an alleged Estonia-based account intrusion scheme that targeted online brokerage accounts in the U.S. to manipulate the markets).

information.[18] In other recent incidents, registered representatives of broker-dealers disposed of information and records about clients or prospective clients in accessible areas, from which journalists were able to remove them. Sensitive securities-related data also has been lost or stolen as a result of other incidents.[19]

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[18] In 2006, Symantec Corporation, a seller of information security and information management software, reported that in the first half of 2006, 84 percent of tracked phishing sites targeted the financial sector and 9 of the top 10 brands phished this period were from the financial sector. Because the financial services sector is a logical target for attackers increasingly motivated by financial gain, that sector was also the second most frequent target of Internet-based attacks (after home users). See Symantec, Symantec Internet Security Threat Report, Trends for January 06–June 06, at 9, 23 (Sept. 2006), http://www.symantec.com/specprog/threatreport/ent-whitepaper_symantec_internet_security_threat_report_x_09_2006.en-us.pdf (last visited Nov. 6, 2007) ("Symantec September 2006 Internet Security Threat Report"). Reportedly, employees of financial services firms "are increasingly being invited to visit Web sites or download programs by people pretending to be colleagues or peers," followed by attack programs on the sites or in downloads that "then open tunnels into the corporate network." More recently, although financial services-related spam reportedly "made up 21 percent of all spam in the first six months of 2007, making it the second most common type of spam during this period," there was a 30-percent decline in stock market "pump and dump" spam "due to a decline in spam touting penny stocks that was triggered by actions taken by the United States Securities and Exchange Commission, which limited the profitability of this type of spam by suspending trading of the stocks that are touted." See Symantec, Symantec Internet Security Threat Report, Trends for January–June 07, Volume XII, at 107 (Sept. 2007), http://eval.symantec.com/mktginfo/enterprise/white_papers/ent-whitepaper_internet_security_threat_report_xii_09_2007.en-us.pdf (last visited Nov. 6, 2007) (citing Commission Press Release 2007-34, SEC Suspends Trading Of 35 Companies Touted In Spam Email Campaigns (Mar. 8, 2007), available at http://www.sec.gov/news/press/2007/2007-34.htm).

[19] For example, in April 2005, a shipping company lost a computer backup tape containing account information for more than 200,000 broker-dealer customers. The broker-dealer voluntarily notified its affected customers, although the data was compressed and the tape was thought to have been destroyed. In December 2005, a laptop computer containing unencrypted information that included names and account numbers of 158,000 customers and the names and Social Security numbers of 68,000 adviser personnel was stolen from a registered investment adviser, and in March 2006, a laptop computer containing the names, addresses, Social Security numbers, dates of birth, and other employment-related information of as many as 196,000 retirement plan participants was stolen from a benefits plan administration subsidiary of a registered investment adviser. In both cases, the laptops were taken from vehicles by thieves who appear to have stolen them for their value as computer hardware rather than for the information contained on them. The registered investment adviser voluntarily notified the more than 200,000 clients and financial advisers whose information was compromised, while the benefits plan administrator voluntarily notified the nearly 200,000 retirement plan participants whose information was compromised, and offered to pay for a year of credit monitoring for each of them.

Many firms in the securities industry are aware of these problems and have appropriate safeguards in place to address them.[20] We are concerned, however, that some firms do not regularly reevaluate and update their safeguarding programs to deal with these increasingly sophisticated methods of attack.[21] For this reason, and in light of the increase in reported security breaches and the potential for identity theft among the institutions we regulate, we believe that our previous approach, requiring safeguards that must be reasonably designed to meet the GLBA's objectives, merits revisiting.[22]

We also are concerned that while the information protected under the safeguards rule and the disposal rule includes certain personal information, it does not include other information that could be used to access investors' financial information if obtained by an unauthorized user. Finally we want to address other issues under Regulation S-P that have come to our attention, including the application of the regulation to situations in which a representative of one broker-

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[20] Some institutions regulated by the Commission have already taken steps to strengthen their policies and procedures for safeguarding investors' information, such as by offering investors the use of password-generating tokens for online brokerage accounts. We also note that some firms have been sharing information about suspicious activity with one another for the purpose of combating identity theft. To the extent it might involve sharing nonpublic personal information about consumers of the firms, Regulation S-P does not prohibit such information sharing because Section 15(a)(2)(ii) of Regulation S-P permits firms to disclose nonpublic personal information to a nonaffiliated third party for the purpose of protecting against fraud without first giving consumers notice of and an opportunity to opt out of the disclosures.

[21] According to a September 2007 report from Deloitte Touche Tohmatsu, for example, 37 percent of 169 surveyed financial institutions do not have an information security strategy in place, and 33 percent of these institutions do not conduct vulnerability testing, or only do so on an ad hoc basis. See Deloitte Touche Tohmatsu, 2007 Global Security Survey, at 12, 36 (Sept. 2007), http://www.deloitte.com/dtt/cda/doc/content/dtt_gfsi_GlobalSecuritySurvey_20070901%281%29.pdf (last visited Nov. 6, 2007).

[22] In 2004 we sought comment on whether to revise our safeguards rule to require institutions to address certain elements in designating their safeguarding policies and procedures. See Disposal of Consumer Report Information, Exchange Act Release No. 50361, IAA Release No. 2293, ICA Release No. 20596 (Sept. 14, 2004), 69 FR 56304 (Sept. 20, 2004) ("Disposal Rule Proposing Release"), at section II.B. At that time we decided not to revise the safeguards rule, but noted we would consider the comments we received in the event we proposed any amendment to the rule. See Disposal Rule Adopting Release, supra note 15, at section II.B. See also infra note 31.

dealer or registered investment adviser moves to another firm. Accordingly, today we are proposing amendments to the safeguards and disposal rules that are designed to address these concerns.

II. Discussion

To help prevent and address security breaches in the securities industry and thereby better protect investor information, we propose to amend Regulation S-P in four principal ways. First, we propose to require more specific standards under the safeguards rule, including standards that would apply to data security breach incidents. Second, we propose to amend the scope of the information covered by the safeguards and disposal rules and to broaden the types of institutions and persons covered by the rules. Third, we propose to require institutions subject to the safeguards and disposal rules to maintain written records of their policies and procedures and their compliance with those policies and procedures. Finally, we are taking this opportunity to propose a new exception from Regulation S-P's notice and opt-out requirements to allow investors more easily to follow a representative who moves from one brokerage or advisory firm to another.

A. Information Security and Security Breach Response Requirements

To help prevent and address security breaches at the institutions we regulate, we propose to require more specific standards for safeguarding personal information, including standards for responding to data security breaches. When we adopted Regulation S-P in 2001, the safeguards rule simply required institutions to adopt policies and procedures to address the safeguarding objectives stated in the GLBA. Following our adoption of the rule, the FTC and the Banking Agencies issued regulations with more detailed standards for safeguarding customer records and

information applicable to the institutions they regulate.[23] We believe these standards include necessary elements that institutions should address when adopting and implementing safeguarding policies and procedures. We have therefore looked to the other agencies' standards in developing our proposal and tailored them, where appropriate, to develop proposed standards for the institutions we regulate.

1. Revised safeguarding policies and procedures

As noted above, the safeguards rule requires institutions to adopt written policies and procedures that address administrative, technical and physical safeguards to protect customer records and information. The proposed amendments would further develop this requirement by requiring each institution subject to the safeguards rule to develop, implement, and maintain a comprehensive "information security program," including written policies and procedures that

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[23] The Banking Agencies issued their guidelines for safeguarding customer records and information in 2001. See Interagency Guidelines Establishing Standards for Safeguarding Customer Information and Rescission of Year 2000 Standards for Safety and Soundness, 66 FR 8616 (Feb. 1, 2001) ("Banking Agencies' Security Guidelines"). The FTC adopted its safeguards rule in 2002. See Standards for Safeguarding Customer Information, 67 FR 36484 (May 23, 2002) ("FTC Safeguards Rule"). The Banking Agencies also have jointly issued guidance on responding to incidents of unauthorized access or use of customer information. See Interagency Guidance on Response Programs for Unauthorized Access to Customer Information and Customer Notice, 70 FR 15736 (Mar. 29, 2005) ("Banking Agencies' Incident Response Guidance"). More recently, through the Federal Financial Institutions Examination Council ("FFIEC"), the Banking Agencies jointly issued guidance on the authentication of customers in an Internet banking environment, and the Banking Agencies and the FTC jointly issued final rules and guidelines for identity theft "red flags" programs to detect, prevent, and mitigate identity theft in connection with the opening of certain accounts or certain existing accounts. See FFIEC, Authentication in an Internet Banking Environment (July 27, 2006), available at www.ffiec.gov/pdf/authentication_guidance.pdf ("Authentication Guidance"); Banking Agencies and FTC, Identity Theft Red Flags and Address Discrepancies under the Fair and Accurate Credit Transactions Act of 2003, 72 FR 63718 (Nov. 9, 2007) ("Final Red Flag Rules"). See also Banking Agencies and FTC, Identity Theft Red Flags and Address Discrepancies Under the Fair and Accurate Credit Transactions Act of 2003, 71 FR 40785 (July 18, 2006) ("Proposed Red Flag Guidelines"). In March of this year, the FTC also published a brochure on data security, Protecting Personal Information: A Guide for Business (available at http://www.ftc.gov/infosecurity/), and the FDIC issued a Supervisory Policy on Identity Theft, FIL-32-2007 (Apr. 11, 2007), available at http://www.fdic.gov/news/news/financial/2007/fil07032a.html.

provide administrative, technical, and physical safeguards for protecting personal information, and for responding to unauthorized access to or use of personal information.[24] This program would have to be appropriate to the institution's size and complexity, the nature and scope of its activities, and the sensitivity of any personal information at issue.[25] Consistent with current requirements for safeguarding policies and procedures, the information security program also would have to be reasonably designed to: (i) ensure the security and confidentiality of personal information; (ii) protect against any anticipated threats or hazards to the security or integrity of personal information; and (iii) protect against unauthorized access to or use of personal information that could result in substantial harm or inconvenience to any consumer, employee, investor or securityholder who is a natural person.[26] Although the term "substantial harm or inconvenience" is currently used in the safeguards rule, it is not defined. We propose to define the term to mean "personal injury, or more than trivial financial loss, expenditure of effort or loss of time."[27] This definition is intended to include harms other than identity theft that may result from failure to safeguard sensitive information about an individual. For example, a hacker could use confidential information about an individual for extortion by threatening to make the information public unless the individual agrees to the hacker's demands. "Substantial harm or

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[24] As amended, Section 30 would be titled, "Information security programs for personal information; records of compliance."

[25] See proposed paragraph (a)(1) of Section 30. The term "information security program" would mean the administrative, technical, or physical safeguards used to access, collect, distribute, process, protect, store, use, transmit, dispose of, or otherwise handle personal information. See proposed paragraph (d)(6) of Section 30.

[26] See proposed paragraph (a)(2) of Section 30. Compare 17 CFR 248.30(a)(1)-(3).

[27] See proposed paragraph (d)(12) of Section 30. "Substantial harm or inconvenience" would include theft, fraud, harassment, impersonation, intimidation, damaged reputation, impaired eligibility for credit, or the unauthorized use of the information identified with an individual to obtain a financial product or service, or to access, log into, effect a transaction in, or otherwise use the individual's account.

inconvenience" would not include "unintentional access to personal information by an unauthorized person that results only in trivial financial loss, expenditure of effort or loss of time," such as if use of the information results in an institution deciding to change the individual's account number or password.[28] The rule would provide an example of what would not constitute harm or inconvenience that rises to the level of "substantial," which should help clarify the scope of what would constitute "substantial harm or inconvenience."

The proposed amendments also would specify particular elements that a program meeting the requirements of Regulation S-P must include.[29] These elements are intended to provide firms in the securities industry with detailed standards for the policies and procedures that a well-designed information security program should include to address recent identity theft-related

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28 See proposed paragraph (d)(12)(ii) of Section 30. Thus, for example the proposed definition would not encompass a firm's occasional, unintentional delivery of an individual's account statement to an incorrect address if the institution determined that the information was highly unlikely to be misused. This determination would have to be made promptly after the institution becomes aware of an incident of unauthorized access to sensitive personal information, and documented in writing. See proposed paragraph (a)(4)(iii) of Section 30.

29 Many of these elements are addressed by widely accepted information security standards. See, e.g., National Institute of Standards and Technology ("NIST"), Special Publication 800 series (Computer Security), for example Generally Accepted Principals and Practices for Securing Information Technology Systems (SP 800-14) (Sept. 1996), Guide to Intrusion Detection and Prevention Systems (IDPS) (SP 800-94) (Feb. 2007), and Guide to Secure Web Services (SP 800-95) (Aug. 2007) (all available at http://csrc.nist.gov/publications/PubsSPs.html), and bulletins dealing with computer security published by the NIST's Information Technology Laboratory (ITL), for example Secure Web Servers: Protecting Web Sites That Are Accessed By The Public (ITL January 2008) (available at http://csrc.nist.gov/publications/PubsITLSB.html); Federal Information System Controls Audit Manual, General Accounting Office, Accounting and Information Management Division, Federal Information System Controls Audit Manual, GAO/AIMD-12.19.6 (known as "FISCAM") (Jan. 1999) (available at http://www.gao.gov/special.pubs/ai12.19.6.pdf); International Organization for Standardization, Code of Practice for Information Security Management (ISO/IEC 27002:2005) (known among information security professionals as the "British Standard," and formerly designated BS ISO/IEC 17799:2005 and BS 7799-1:2005) (available for purchase at http://www.standardsdirect.org/iso17799.htm and at http://www.bsi-global.com/en/Shop/Publication-Detail/?pid=000000000030166440); and Information Systems Audit and Control Association/IT Governance Institute, Control Objectives for Information and Related Technology (known as "COBIT") (last updated, and published as version 4.1, May 2007) (available at http://www.isaca.org).

incidents such as firms in the securities industry losing data tapes and laptop computers and failing to dispose properly of sensitive personal information, and hackers hijacking online brokerage accounts.[30] These elements also are intended to maintain consistency with information safeguarding guidelines and rules adopted by the Banking Agencies and FTC.[31] In addition, these elements are consistent with policies and procedures we understand many institutions in the securities industry have already adopted. We understand that large and complex organizations generally have written policies that address information safeguarding procedures at several layers, from an organization-wide policy statement to detailed procedures that address particular controls.[32]

Institutions subject to the rule would be required to:

(i) designate in writing an employee or employees to coordinate the information security program;[33]

(ii) identify in writing reasonably foreseeable security risks that could result in the

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30 See supra notes 16-19 and accompanying text.

31 See Banking Agencies' Security Guidelines and FTC Safeguards Rule, supra note 23. As noted above, we sought comment on whether to revise our safeguards rule in 2004. See supra note 22. At that time, several commenters noted that Rule 206(4)-7 under the Investment Advisers Act (17 CFR 275.206(4)-7) and Rule 38a-1 under the Investment Company Act (17 CFR 270.38a-1) require registered investment advisers and registered investment companies to have written policies and procedures reasonably designed to prevent violation of the federal securities laws, including safeguards for the protection of customer records and information under Regulation S-P. These rules also require registered investment advisers and funds to review, no less frequently than annually, the adequacy of these policies and procedures. See Comment Letter of the Investment Counsel Association of America (Oct. 20, 2004), at p. 3; Comment Letter of the Investment Company Institute (Oct. 20, 2004) at p. 2. Each of these letters is available at http://www.sec.gov/comments/s73304.shtml. We do not intend for the proposed amendments to alter or conflict with these requirements.

32 See Disposal Rule Proposing Release, supra note 22, at 69 FR 56308 & n.29.

33 See proposed paragraph (a)(3)(i) of Section 30. Of course, the employee or employees designated to coordinate an institution's information security program would need to have sufficient authority and access to the institution's managers, officers and directors to effectively implement the program and modify it as necessary.

program.[39]

The term "service provider" would mean any person or entity that receives, maintains, processes, or otherwise is permitted access to personal information through its provision of services directly to a person subject to the rule.[40] We understand that in large financial complexes, a particular affiliate may be responsible for providing a particular service for all affiliates in the complex. In that circumstance, each financial institution subject to Regulation S-P would be responsible for taking reasonable steps to ensure that the service provider is capable of maintaining appropriate safeguards and of overseeing the service provider's implementation, maintenance, evaluation, and modifications of appropriate safeguards for the institution's personal information. Under the proposed amendments, we anticipate that a covered institution's reasonable steps to evaluate the information safeguards of service providers could include the use of a third-party review of those safeguards such as a Statement of Auditing Standards No. 70 ("SAS 70") report, a SysTrust report, or a WebTrust report.[41]

We request comment on the proposed specific standards for safeguarding personal

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39 See proposed paragraph (a)(3)(vii) of Section 30. This requirement is similar to the requirement in the Banking Agencies' Security Guidelines that institutions covered by those guidelines monitor, evaluate, and adjust, as appropriate, their information security program in light of any relevant changes in technology, the sensitivity of their customer information, internal or external threats to information, and their own changing business arrangements, such as mergers and acquisitions, alliances and joint ventures, outsourcing arrangements, and changes to customer information systems. See supra note 23, Banking Agencies' Security Guidelines, 66 FR at 8634, 8635-36, 8637, 8639, 8641. The "material impact" standard in proposed paragraph (a)(3)(iii) is intended to require adjustment of a covered institution's information security program only when a reasonable coordinator of the program would consider adjusting the program important in light of changing circumstances.

40 See proposed paragraph (d)(11) of Section 30.

41 See Codification of Accounting Standards and Procedures, Statement on Auditing Standards No. 70, Reports on Processing of Transactions by Service Organizations (American Inst. of Certified Public Accountants). See also description and comparison of these reports at http://infotech.aicpa.org/Resources/System+Security+and+Reliability/System+Reliability/Principles+of+a+Reliable+System/SAS+No+70+SysTrust+and+WebTrust+A+Comparison.htm.

information.

- Would these standards provide sufficient direction to institutions? Are there particular standards that should be more or less prescriptive? For example, should institutions be required to designate an employee or employees to coordinate the information security program by name, or should institutions be permitted to make these designations by position or office?
- Would additional standards be appropriate or are certain standards unnecessary? Should the proposed standards be modified to more closely or less closely resemble standards prescribed by the Banking Agencies or the FTC? For the securities industry, are there any other standards that a well-designed information security program should address? Are there any other standards that would provide more flexibility to covered institutions?
- We also invite comment on the proposed requirement that entities assess the sufficiency of safeguards in place, to control reasonably foreseeable risks. Should the rules include more detailed standards and specifications for access controls? Should the requirement specify factors such as those identified in the Banking Agencies' guidance regarding authentication in an Internet banking environment or include policies and procedures such as those in the Banking Agencies and the FTC's proposed or final "red flag" requirements?[42] For example, should we require that covered institutions implement multifactor authentication, layered security, or other

[42] See Authentication Guidance, Proposed Red Flag Guidance, and Final Red Flag Rules, supra note 23. The Authentication Guidance has been credited with helping to curtail online banking fraud, but has been characterized as not adequately addressing authentication in the context of telephone banking. See Daniel Wolfe, How New Authentication Systems are Altering Fraud Picture, Amer. Banker (Dec. 26, 2007).

controls for high-risk transactions involving access to customer information or the movement of funds to third parties? Should we require that covered institutions include in their information security programs "red flag" elements that would be relevant to detecting, preventing and mitigating identity theft in connection with the opening of accounts or existing accounts, or in connection with particular types of accounts associated with a reasonably foreseeable risk of identity theft? Should we require that covered institutions adopt policies and procedures for evaluating changes of address followed closely by an account change or transaction, or for processing address discrepancy notices from consumer reporting agencies? If the rule were to include more detailed standards and specifications for access controls, how should these apply to business conducted by telephone?

- Commenters are invited to discuss the proposed definition of "substantial harm or inconvenience." Are there circumstances that commenters believe would create substantial harm or inconvenience to individuals that would not meet the proposed definition? If so, how should the definition be revised to address these circumstances?
- Commenters are invited to discuss the proposed requirements for written documentation of compliance with the proposed safeguarding provisions.
- Commenters are invited to discuss the proposed definition of "service provider." They also are invited to discuss whether, if the proposed amendments are adopted, they should include or be accompanied by guidance on the use of outside evaluations of third-party service providers. For example, should the Commission provide

guidance similar to that provided by the FFIEC on the appropriate use of SAS 70 reports in evaluating the information safeguards of service providers?[43]

2. Data security breach response

Because of the potential for harm or inconvenience to individuals when a data security breach occurs, we are proposing that information security programs include procedures for responding to incidents of unauthorized access to or use of personal information. These procedures would include notice to affected individuals if misuse of sensitive personal information has occurred or is reasonably possible. The procedures would also include notice to the Commission (or for certain broker-dealers, their designated examining authority[44]) under

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43 The FFIEC provided the following guidance on the use of SAS 70 reports in the oversight of third-party service providers ("TSPs") by financial institutions regulated by FFIEC member agencies:

> Financial institutions should ensure TSPs implement and maintain controls sufficient to appropriately mitigate risk. In higher-risk relationships the institution by contract may prescribe minimum control and reporting standards, obtain the right to require changes to standards as external and internal environments change, and obtain access to the TSP for institution or independent third-party evaluations of the TSP's performance against the standard. In lower risk relationships the institution may prescribe the use of standardized reports, such as trust services reports or a Statement of Auditing Standards 70 (SAS 70) report.
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> * * * * *
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> Financial institutions should carefully and critically evaluate whether a SAS 70 report adequately supports their oversight responsibilities. The report may not provide a thorough test of security controls and security monitoring unless requested by the TSP. It may not address the effectiveness of the security process in continually mitigating changing risks. Additionally, the SAS 70 report may not address whether the TSP is meeting the institution's specific risk mitigation requirements. Therefore, the contracting oversight exercised by financial institutions may require additional tests, evaluations, and reports to appropriately oversee the security program of the service provider.

FFIEC, FFIEC IT Examination Handbook, Information Security Booklet – July 2006, at 77, 78 (available at http://www.ffiec.gov/ffiecinfobase/booklets/information_security/information_security.pdf).

44 A broker-dealer's designated examining authority is the self-regulatory organization ("SRO") of which the broker-dealer is a member, or, if the broker-dealer is a member of more than one SRO, the SRO designated by the Commission pursuant to 17 CFR 240.17d-1 as responsible for examination of the member for compliance with applicable financial responsibility rules

circumstances in which an individual identified with the information has suffered substantial harm or inconvenience or an unauthorized person has intentionally obtained access to or used sensitive personal information. The proposed rules that would require prompt notice of information security breach incidents to individuals, as well as the Commission or designated examining authorities, are intended to facilitate swift and appropriate action to minimize the impact of the security breach.

The data security breach response provisions of the proposed amendments include elements intended to provide firms in the securities industry with detailed standards for responding to a breach so as to protect against unauthorized use of compromised data. The proposed standards would specify procedures a covered institution's information security program would need to include. These procedures would be required to be written to provide clarity for firm personnel and to facilitate Commission and SRO examination and inspection. The proposed standards are intended to ensure that covered institutions adopt plans for responding to an information security breach incident so as to minimize the risk of identity theft or other significant investor harm or inconvenience from the incident. These proposed procedures also are intended to consistent with security breach notification guidelines adopted by the Banking Agencies.[45]

Under the proposed amendments, institutions subject to the rule would be required to have written procedures to:

(i) assess any incident involving unauthorized access or use, and identify in writing what personal information systems and what types of personal information may

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(including the Commission's customer account protection rules at 17 CFR 240.15c3-3).

[45] See Banking Agencies' Incident Response Guidance, supra note 23.

have been compromised;[46]

(ii) take steps to contain and control the incident to prevent further unauthorized access or use and document all such steps taken in writing;[47]

(iii) promptly conduct a reasonable investigation and determine in writing the likelihood that the information has been or will be misused after the institution becomes aware of any unauthorized access to sensitive personal information;[48] and

(iv) notify individuals with whom the information is identified as soon as possible (and document the provision of such notification in writing) if the institution determines that misuse of the information has occurred or is reasonably possible.[49]

We propose to define the term, "sensitive personal information," to mean "any personal information, or any combination of components of personal information, that would allow an unauthorized person to use, log into, or access an individual's account, or to establish a new account using the individual's identifying information," including the individual's Social Security number, or any one of the individual's name, telephone number, street address, e-mail

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46 See proposed paragraph (a)(4)(i) of Section 30.

47 See proposed paragraph (a)(4)(ii) of Section 30.

48 See proposed paragraph (a)(4)(iii) of Section 30.

49 See proposed paragraph (a)(4)(iv) of Section 30. Notification could be delayed, however, if an appropriate law enforcement agency determines that notification will interfere with a criminal investigation and requests in writing a delay in notification. We propose to require notification of individuals only if misuse of the compromised information has occurred or is reasonably possible to avoid requiring notification in circumstances in which there is no significant risk of substantial harm or inconvenience. If covered institutions were required to notify individuals of every instance of unauthorized access or use, such as if an employee accidentally opened and quickly closed an electronic account record, individuals could receive an excessive number of data breach notifications and become desensitized to incidents that pose a real risk of identity theft.

address, or online user name, in combination with any one of the individual's account number, credit or debit card number, driver's license number, credit card expiration date or security code, mother's maiden name, password, personal identification number, biometric authentication record, or other authenticating information.[50] This definition is intended to cover the types of information that would be most useful to an identity thief, and to which unauthorized access would create a reasonable possibility of substantial harm or inconvenience to an affected individual.

The amendments also would require an institution to provide notice to the Commission as soon as possible after the institution becomes aware of any incident of unauthorized access to or use of personal information in which there is a significant risk that an individual identified with the information might suffer substantial harm or inconvenience, or in which an unauthorized person has intentionally obtained access to or used sensitive personal information.[51] This requirement would allow Commission and SRO investigators or examiners to review the notices to determine if an immediate investigative or examination response would be appropriate. In this regard, it is crucial that institutions respond promptly to any follow-up requests for records or information from our staff or the staff of the designated examining authority.[52] Under the proposed amendments, a prompt response in accordance with existing Commission guidance on the timely production of records would be particularly important in circumstances involving ongoing misuse of sensitive personal information.

The regulatory notification requirement in the Banking Agencies' guidance requires a

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50 See proposed paragraph (d)(10) of Section 30.

51 See proposed paragraph (a)(4)(v) of Section 30.

52 See generally 15 U.S.C. 21(a) (investigative requests); 17 CFR 240.17a-4(j) (examinations of broker-dealers); 17 CFR 275.204-2(g) (examinations of investment advisers).

report to the appropriate regulator as soon as possible after the institution becomes aware of an incident involving unauthorized access to or use of sensitive customer information.[53] Our proposed notice requirement differs from the Banking Agencies' approach in that it would require notice to the Commission (or a designated examining authority) when an incident of unauthorized access to or use of personal information poses a significant risk that an individual identified with the information might suffer substantial harm or inconvenience, or in which an unauthorized person has intentionally obtained access to or used sensitive personal information. The proposed notice requirement is intended to avoid notice to the Commission in every case of unauthorized access, and to focus scrutiny on information security breaches that present a greater potential likelihood for harm. We believe that this approach would help conserve institutions', as well as the Commission's, administrative resources by allowing minor incidents to be addressed in a way that is commensurate with the risk they present. The information to be included in the notice would allow the Commission or a broker-dealer's designated examining authority to evaluate whether any legal action against a would-be identity thief or other action is warranted in light of the circumstances. A broker-dealer, other than a notice-registered broker dealer, would be required to notify the appropriate designated examining authority on proposed Form SP-30. An investment company or registered investment adviser or transfer agent would be required to notify the Commission on proposed Form SP-30.[54]

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[53] See Banking Agencies' Incident Response Guidance, supra note 23, at 70 FR 15740-15741 (concluding that the Banking Agencies' standard for notification to regulators should provide an early warning to allow an institution's regulator to assess the effectiveness of an institution's response plan, and, where appropriate, to direct that notice be given to customers if the institution has not already done so).

[54] We anticipate that this form could be downloaded from our Web site and would be required to be filed electronically with the Registrations Branch in the Office of Compliance Inspections and Examinations. While broker-dealers generally would file the form with their designated examining authority rather than the Commission, investment advisers that are dually registered

Proposed Form SP-30 would require the institution to disclose information that the Commission (or the designated examining authority) needs to understand the nature of the unauthorized access or misuse of personal information and the institution's intended response to the incident.[55] Accordingly, in addition to identifying and contact information for the covered institution, the form would request a description of the incident, when it occurred and what offices or parts of the registrant's business were affected. The form also would require disclosure of any third-party service providers that were involved, the type of services provided and, if the service provider is an affiliate, the nature of the affiliation. This information would help examiners to assess the information security policies and procedures of the service provider. In addition, the form would require a description of any customer account losses.

Under the proposed amendments, if a covered institution determined that an unauthorized person had obtained access to or used sensitive personal information, and that misuse of the information had occurred or was reasonably possible, the institution also would be required to provide notification, in a clear and conspicuous manner, to each individual identified with the information.[56] The proposed requirements for notices to individuals are intended to give investors information that would help them protect themselves against identity theft. They also are intended to be consistent with similar requirements in the Banking Agencies' Incident

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with the Commission as broker-dealers also would file with the Commission and indicate their dual-registrant status on the form.

55 See proposed Form SP-30. Information submitted to the Commission on the form would be accorded confidential treatment to the extent permitted by law. See, e.g., 17 CFR 200.83. We realize that the full amount of losses may not be known at the time an information security breach is discovered, but we would expect covered institutions to make a good faith effort to complete the proposed form to the extent possible.

56 See proposed paragraph (a)(5) of Section 30.

Response Guidance.[57]

The notices to affected individuals that would be required by the proposed amendments would have to:

(i) describe the incident and the type of information that was compromised, and what was done to protect the individual's information from further unauthorized access or use;[58]

(ii) include a toll-free telephone number or other contact information for further information and assistance from the institution;[59]

(iii) recommend that the individual review account statements and immediately report any suspicious activity to the institution;[60] and

(iv) include information about FTC guidance regarding the steps an individual can take to protect against identity theft, a statement encouraging the individual to report any incidents of identity theft to the FTC, and the FTC's Web site address and toll-free telephone number for obtaining identity theft guidance and reporting suspected incidents of identity theft.[61]

We request comment on the proposed specific standards relating to incidents of unauthorized access to or misuse of personal information.

- Commenters are invited to discuss the proposed requirements for procedures for responding to incidents of unauthorized access to or use of personal information. Are

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[57] See Banking Agencies' Incident Response Guidance, supra note 23.

[58] See proposed paragraphs (a)(5)(i) and (a)(5)(ii) of Section 30.

[59] See proposed paragraph (a)(5)(iii) of Section 30.

[60] See proposed paragraphs (a)(5)(iv) and (a)(5)(v) of Section 30.

[61] See proposed paragraph (a)(5)(vi) of Section 30.

there any particular steps that may not be necessary, or not necessary in all situations? Are there any other steps that could be taken in response to a security breach that also should be required in some or all situations?

- We request comment on the proposed provisions regarding procedures for notifying the Commission (or a broker-dealer's designated examining authority) of incidents in which an individual identified with compromised information has suffered substantial harm or inconvenience, or an unauthorized person has intentionally obtained access to or used sensitive personal information.
- For example, should firms be required to provide notice only if the information compromised in an incident is identified with a certain number of individuals? Should the rule include a numerical or other threshold for when notice to the Commission (or to a broker-dealer's designated examining authority) is required? If so, how would a threshold work for smaller institutions that may be far more likely than larger institutions to meet the threshold? Will the proposed standard provide a sufficient early warning to the Commission, or should the Commission broaden the circumstances under which notices would be required to be provided to the Commission (or to a broker-dealer's designated examining authority), such as the standard adopted by the Banking Agencies? Commenters should explain their views.
- Is the proposed definition of "sensitive personal information" sufficient? Are there particular types of information that should or should not be included?
- We request comment on proposed Form SP-30. Is the form easy to understand and use? For example, is the form clear, or would additional guidance, such as instructions or further explanation of particular questions or terms be helpful? Would

it be easier or more cost-effective for firms if the rule specified the information they are required to provide rather than provide a form? Would the form be more useful if it were in a tabular format? Commenters should be specific regarding changes they believe should be made to the content or format of the proposed form.

- Similarly, we invite comment on the proposed provisions regarding procedures for notifying individuals of incidents of unauthorized use or access if an institution determines that an unauthorized person has obtained access to or used the information and that misuse of sensitive personal information has occurred or is reasonably possible. Is the information in the proposed notice to individuals appropriate? Is there additional information that institutions should include, or information, proposed to be included, that should be eliminated? Is the proposed threshold for notice appropriate? If not, are there alternative thresholds for notice to individuals that would be more appropriate? If so, commenters should explain their views.
- Commenters are invited to discuss the proposed requirements for written documentation of compliance with the proposed incident response provisions.

B. Scope of the Safeguards and Disposal Rules

1. Information covered by the safeguards and disposal rules

The Commission adopted the safeguards and disposal rules at different times under different statutes – respectively, the GLBA and the FACT Act – that differ in the scope of information they cover. As noted above, Regulation S-P implements the GLBA privacy provisions governing requirements for notice and opt out before an institution can share certain information with nonaffiliates and for safeguarding information. The regulation's notice and opt out provisions limit institutions from sharing "nonpublic personal information" about consumers

and customers as defined in the GLBA and in Regulation S-P, with nonaffiliated third parties.[62] As required under the GLBA, the safeguards rule requires covered institutions to maintain written policies and procedures to protect "customer records and information,"[63] which is not defined in the GLBA or in Regulation S-P. The disposal rule requires institutions to properly dispose of "consumer report information," a third term, which Regulation S-P defines consistent with the FACT Act provisions.[64] Each of these terms includes a different set of information, although the terms include some of the same information.[65] Each term also does not include some information that, if obtained by an unauthorized user, could permit access to personal financial information about an institution's customers. We preliminarily believe that in order to provide better protection against the unauthorized disclosure of this personal financial information, the scope of information protected by both the safeguards rule and the disposal rule should be broader. Broadening the scope of information covered by the safeguards and disposal rules would more appropriately implement Section 525 of the GLBA. Section 525 directs the Commission to revise its regulations as necessary to ensure that covered institutions have policies, procedures, and controls in place to prevent the unauthorized disclosure of "customer

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62 See 15 U.S.C. 6802(a), (b). "Nonpublic personal information" is generally defined in the GLBA and Regulation S-P as encompassing personally identifiable financial information, as well as any list, description, or other grouping of consumers (and publicly available information pertaining to them) derived using any personally identifiable financial information that is not publicly available, subject to certain exceptions. See 15 U.S.C. 6809(4); 17 CFR 248.3(t) and 248.3(u). See supra note 12 for a discussion of the notice and opt out provisions.

63 See 17 CFR 248.30; 15 U.S.C. 6801(b)(1).

64 17 CFR 248.30(b)(2). Section 628(a)(1) of the FCRA directed the Commission to adopt rules requiring the proper disposal of "consumer information, or any compilation of consumer information, derived from consumer reports for a business purpose." 15 U.S.C. 1681w(a)(1). Regulation S-P uses the term "consumer report information" and defines it to mean a record in any form about an individual "that is a consumer report or is derived from a consumer report." 17 CFR 248.30(b)(1)(ii). "Consumer report" has the same meaning as in Section 603(d) of the Fair Credit Reporting Act (15 U.S.C. 1681(d)). 17 CFR 248.30(b)(1)(i).

65 See Disposal Rule Adopting Release, supra note 15, at 69 FR 71323 n.13.

financial information." Section 521 of Title V of the GLBA prohibits persons from obtaining or requesting a person to obtain, customer information by making false or fraudulent statements to an officer, employee, agent, or customer of a financial institution.[66] In furtherance of these prohibitions, the GLBA directs the Commission and the other federal financial regulators to review their regulations and to revise them as necessary to ensure that financial institutions have policies, procedures and controls in place to prevent the unauthorized disclosure of "customer financial information" and to deter and detect the activity described in Section 521.[67] Applying both the safeguards and disposal rules to a consistent set of information also could reduce any burden that may have been created by the application of the safeguards and disposal rules to different information.[68]

Accordingly, we propose to amend the safeguards and disposal rules so that both protect "personal information," and to define that term to encompass any record containing either "nonpublic personal information" or "consumer report information."[69] As noted above, each of these terms is defined in Regulation S-P.[70] The term "consumer report information" would continue to mean any record about an individual, whether in paper, electronic or other form, that

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66 See 15 U.S.C. 6821(a), (b).

67 See 15 U.S.C. 6825.

68 See David Annecharico, Note, Online Transactions: Squaring the Gramm-Leach-Bliley Act Privacy Provisions With the FTC Fair Information Practice Principles, 6 N.C. Banking Inst. 637, 662 (2002), available at http://www.unc.edu/ncbank/Articles%20and%20Notes%20PDFs/Volume%206/DavidAnnecharico%5Bpp637-664%5D.pdf ("To require financial institutions to treat the security of consumer information on par with customer information may be cost effective and efficient. It could merely mean storing consumer information within the already mandated secure storage systems that are being used to store customer information.").

69 Proposed paragraph (d)(8) of Section 30.

70 See 17 CFR 248.3(t)(1) (definition of "nonpublic personal information"); 17 CFR 248.30(b)(ii) (definition of "consumer report information").

is a consumer report or is derived from a consumer report, as well as a compilation of such records, but not including information that does not identify individuals, such as aggregate information or blind data.[71] The proposed amendments would leave the meaning of the term "consumer report" unchanged from the definition set forth in Section 603(d) of the FCRA.[72] Section 603(d) defines "consumer report" in general as encompassing communications of information by a consumer reporting agency bearing on a consumer's creditworthiness, credit standing, reputation or particular other factors used in connection with establishing the consumer's eligibility for credit or insurance, or for employment purposes or other authorized purposes, subject to certain exclusions.[73]

In addition to nonpublic personal information and consumer report information, "personal information" also would include information identified with any consumer, or with any employee, investor, or securityholder who is a natural person,[74] in paper, electronic or other form, that is handled by the institution or maintained on the institution's behalf.[75] Thus, for example, the definition would include records of employee user names and passwords maintained by a brokerage firm, and records about securityholders maintained by a transfer agent. We believe safeguarding employee user names and passwords promotes information

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[71] See proposed paragraph (c)(4) of Section 30 and current paragraph (b)(ii) of Section 30 (definition governing current disposal requirements).

[72] See proposed paragraph (d)(3) of Section 30.

[73] See 15 U.S.C. 1681a(d).

[74] This element of the definition would exclude information identified only with persons other than natural persons, such as corporations. The GLBA limits the protections provided under subtitle A of the privacy provisions to "consumers," who are individuals who obtain from a financial institution financial products or services to be used for personal, family or household purposes. 15 U.S.C. 6809(9). The FACT Act defines a "consumer" to mean an individual. 15 U.S.C. 1681a(c).

[75] See proposed paragraph (d)(8) of Section 30.

security because unauthorized access to this information could facilitate unauthorized access to a firm's network and its clients' personal information.[76] Safeguarding information about investors and securityholders, such as maintained by registered transfer agents, is necessary to protect investors who may, directly or indirectly, do business with the Commission's regulated entities even though they may not be "consumers" or "customers" of those entities as those terms are defined for purposes of Regulation S-P.[77] We also propose to make a conforming change to the definition of "personally identifiable financial information" by including within the definition information that is handled or maintained by a covered institution or on its behalf, and that is identified with any consumer, or with any employee, investor, or securityholder who is a natural person.[78] We preliminarily believe that this change would be appropriate in the public interest and for the protection of investors because it would help protect information identified with an investor who may not be a "consumer" or "customer" of a covered institution.

To better protect investors' and securityholders' information from unauthorized disclosure, the proposed amendments would apply the safeguards and disposal rules to nonpublic personal information or consumer report information that is identified with any individual consumer, employee, investor or securityholder and handled or maintained by or on behalf of the institution. The proposal to include personal information and consumer report information about employees of covered institutions is intended to reduce the risk that a would-be identity thief could access investor information by impersonating an employee or employing "social

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[76] See supra note 17 and accompanying text.

[77] As discussed supra at note 7, Regulation S-P defines the terms "consumer" and "customer" at 17 CFR 248.3(g) and 248.3(j), respectively.

[78] See proposed new paragraph (u)(1)(iv) of Section 3. The proposed amendments also would include technical, conforming changes to references to Section 30 in Sections 1(b) and 2(b) of Regulation S-P.

engineering" techniques or bribery.

Including consumer report information within the definition of "personal information" (to which the safeguards rule would apply) would be consistent with the congressional intent behind making consumer report information subject to the disposal requirements set forth in the FACT Act.[79] Furthermore, the proposed scope of protection appears to be consistent with the practices of many covered institutions that currently protect employee information, consumer report information, and nonpublic personal information about consumers and customers in the same manner.[80]

We invite comment on the proposed definition of "personal information."

- Should the safeguards rule extend to consumer report information that is not nonpublic personal information?
- Should the disposal rule extend to nonpublic personal information that is not consumer report information?
- To what extent do institutions currently take the same measures in disposing of consumer report information, customer records and information, nonpublic personal information about consumers and customers, and information other than consumer report information that is identified with employees, investors, or securityholders who

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[79] The disposal rule was intended to reduce the risk of fraud or related crimes, including identity theft, by ensuring that records containing sensitive financial or personal information are appropriately redacted or destroyed before being discarded. See 108 Cong. Rec. S13,889 (Nov. 4, 2003) (statement of Sen. Nelson).

[80] Based on our staff's informal discussions with industry representatives about Regulation S-P issues, as well as the estimated costs and benefits of the proposed amendments we believe that many covered institutions currently protect both kinds of information in the same way out of prudence and for reasons of operational efficiency. See infra section V.B.

are not consumers or customers? To the extent that measures are different, what is the basis for those differences?

- Is the proposed definition of "personal information," which includes all records containing either consumer report information or nonpublic personal information, broad enough to encompass the information that needs to be protected? If not, how should we expand the definition? Are there any aspects of the proposed definition that, in the context of the information security requirements discussed below, may be over-inclusive with regard to particular types of entities? If so, how should we tailor the definition?
- The proposed definition of "personal information" encompasses information identified with any consumer, or with any employee, investor, or securityholder who is a natural person. Are there any other persons whose information should be protected under the safeguards rule, or should the safeguards rule cover only information identified with individuals who are customers of a financial institution?
- Should the proposed definition of "personal information" be expanded to include information identified with non-natural persons, such as corporate clients? Commenters should explain their views.

2. Institutions covered by the safeguards rule

As discussed above, the safeguards rule currently applies to brokers, dealers, registered investment advisers, and investment companies. The disposal rule currently applies to those entities as well as to registered transfer agents. We propose to extend the safeguards rule to

apply to registered transfer agents.[81] These institutions, like those currently subject to both the safeguards and disposal rules, may maintain personal information such as Social Security numbers, account numbers, passwords, account balances, and records of securities transactions and positions. Unauthorized access to or misuse of such information could result in substantial harm and inconvenience to the individuals identified with the information. The proposed amendments thus would require that covered institutions that may receive personal information in the course of effecting, processing or otherwise supporting securities transactions must protect that information by maintaining appropriate safeguards in addition to taking measures to properly dispose of the information.[82] Registered transfer agents may maintain sensitive personal information about investors, the unauthorized access to or use of which could cause investors substantial inconvenience or harm. Therefore, we preliminarily believe that extending the safeguards rule to registered transfer agents would be appropriate in the public interest and for the protection of investors.[83]

The proposed amendments also would limit the scope of broker-dealers covered by the safeguards rule to brokers or dealers other than those registered by notice with the Commission

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81 The term "transfer agent" would be defined by proposed paragraph (d)(14) of Section 30 to have the same meaning as in Section 3(a)(25) of the Exchange Act (15 U.S.C. 78c(a)(25)).

As discussed below, we also propose to extend the disposal rule to associated persons of broker-dealers, supervised persons of registered investment advisers, and associated persons of registered transfer agents.

82 The proposed definition of "personal information" would include information about individual investors maintained by registered transfer agents even though transfer agents typically do not have consumers or customers for purposes of Regulation S-P because their clients generally are not individuals, but are the companies in which investors, including individuals, hold shares.

83 Under Section 17A of the Exchange Act (15 U.S.C. 78q-1) the Commission has authority to prescribe rules and regulations for transfer agents as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of Title I of the Exchange Act.

under Section 15(b)(11) of the Exchange Act.[84] Notice-registered broker-dealers must comply with the privacy rules, including rules requiring the safeguarding of customer records and information, adopted by the CFTC.[85] Excluding notice-registered broker-dealers from the scope of the Commission's safeguards rule would clarify that both sets of rules do not apply to notice-registered broker-dealers, and that the CFTC would have primary responsibility for oversight of those broker-dealers in this area.

We seek comment on the proposed scope of the safeguards rule.

- Should registered transfer agents be subject to the safeguards rule? To what extent are registered transfer agents expected to possess, or lack, the type of information that could be used to commit identity theft or otherwise cause individuals substantial harm or inconvenience?[86] Are there special issues that registered transfer agents might have in implementing or meeting the requirements of the safeguards rule?

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84 Proposed paragraph (a)(1) of Section 30. See 15 U.S.C. 78o(b)(11). The Commodity Futures Modernization Act of 2000 established a system of notice registration under which trading facilities and intermediaries that are already registered with either the Commission or the CFTC may register with the other agency on an expedited basis for the limited purpose of trading security futures products. Under the substituted compliance provision in Section 2(b) of Regulation S-P (17 CFR 248.2(b)), CFTC-regulated futures commission merchants and introducing brokers that are registered by notice with the Commission and in compliance with the financial privacy rules of the CFTC are deemed to be in compliance with Regulation S-P, except with respect to Regulation S-P's disposal rule (currently 17 CFR 248.30(b)). Notice-registered broker-dealers are already excluded from the scope of the disposal rule.

85 See 17 CFR 160.30.

86 Such information could include address and account information used to disseminate shareholder communications and dividend and interest payments, as well as information collected pursuant to Rule 17Ad-17 under the Exchange Act (17 CFR 240.17Ad-17), which requires transfer agents registered with the Commission to use taxpayer identification numbers or names to search databases for addresses of lost securityholders.

- Should the Commission propose to extend the safeguards and disposal rules to self-regulatory organizations or other types of institutions in the securities industry? If so, which ones?
- Should notice-registered broker-dealers be excluded from the scope of the proposed amended safeguards rule? If not, why not?

3. Persons covered by the disposal rule

As noted above, the disposal rule currently applies to broker-dealers, investment companies, registered investment advisers and registered transfer agents. We propose to extend the disposal rule to apply to natural persons who are associated persons of a broker or dealer, supervised persons of a registered investment adviser, and associated persons of a registered transfer agent.[87] As noted above, we have become concerned that some of these persons, who may work in branches far from the registered entity's main office, may not dispose of sensitive personal financial information consistent with the registered entity's disposal policies. The proposal is intended to make persons associated with a covered institution directly responsible for properly disposing of personal information consistent with the institution's policies.

[87] See proposed paragraph (b)(1) of Section 30. The term "associated person of a broker or dealer" would be defined by proposed paragraph (d)(1) of Section 30 to have the same meaning as in Section 3(a)(18) of the Exchange Act (15 U.S.C. 78c(a)(18)). The term "supervised person of an investment adviser" would be defined by proposed paragraph (d)(13) of Section 30 to have the same meaning as in Section 202(a)(25) of the Investment Advisers Act of (15 U.S.C. 80b-2(a)(25)). We are proposing to include "supervised" persons of an investment adviser, rather than "associated" persons in order to include all employees, including clerical employees, of an investment adviser who may be responsible for disposing of personal information. See 15 U.S.C. 80b-2(a)(17) (defining term "person associated with an investment adviser" not to include associated persons whose functions are clerical or ministerial). This approach is intended to cover the same range of employees at investment advisers, broker-dealers, and registered transfer agents. The term "associated person of a transfer agent" would be defined by proposed paragraph (d)(2) of Section 30 to have the same meaning as in Section 3(a)(49) of the Exchange Act (15 U.S.C. 78c(a)(49).

An additional proposed extension to the scope of the disposal rule is discussed below. See infra section II.B.

- We request comment on the proposed extension of the scope of the disposal rule to apply to natural persons who are associated with broker-dealers, supervised persons of registered investment advisers, or who are associated persons of registered transfer agents.
- Are there alternative ways of helping to ensure that these persons would follow the covered institution's disposal policies and properly dispose of personal information?

C. Records of Compliance

We further propose to amend Regulation S-P to require institutions subject to the safeguards and disposal rules to make and preserve written records of their safeguards and disposal policies and procedures. We also propose to require that institutions document that they have complied with the elements required to develop, maintain and implement these policies and procedures for protecting and disposing of personal information, including procedures relating to incidents of unauthorized access to or misuse of personal information. These records would help institutions assess their policies and procedures internally, and help examiners to monitor compliance with the requirements of the amended rules. The periods of time for which the records would have to be preserved would vary by institution, because the requirements would be consistent with existing recordkeeping rules, beginning with when the records were made, and, for records of written policies and procedures, after any change in the policies or procedures they document.[88] Broker-dealers would have to preserve the records for a period of not less than three years, the first two years in an easily accessible place. Registered transfer agents would have to preserve the records for a period of not less than two years, the first year in an easily accessible place. Investment companies would have to preserve the records for a period not less

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[88] See proposed paragraph (c) of Section 30.

than six years, the first two years in an easily accessible place. Registered investment advisers would have to preserve the records for five years, the first two years in an appropriate office of the investment adviser. We believe that these proposed recordkeeping provisions, while varying among covered institutions, would all result in the maintenance of the proposed records for sufficiently long periods of time and in locations in which they would be useful to examiners. Moreover, we do not believe that shorter or longer maintenance periods would be warranted by any difference between the proposed records and other records that covered institutions currently must maintain for these lengths of time. We also believe that conforming the proposed retention periods to existing requirements would allow covered institutions to minimize their compliance costs by integrating the proposed requirements into their existing recordkeeping systems.[89]

We request comment on the proposed requirements for making and retaining records.

- Are the proposed periods of time for preserving the records appropriate, or should certain records be preserved for different periods of time?
- Would the costs associated with preserving records for periods of time consistent with covered institutions' other recordkeeping requirements be less than they would be if all institutions were required to keep these records for the same period of time?

D. Exception for Limited Information Disclosure When Personnel Leave Their Firms

Finally, we propose to amend Regulation S-P to add a new exception from the notice and opt out requirements to permit limited disclosures of investor information when a registered representative of a broker-dealer or a supervised person of a registered investment adviser moves from one brokerage or advisory firm to another. The proposed exception is intended to allow

[89] See 17 CFR 240.17a-4(b); 240.17Ad-7(b); 270.31a-2(a)(4)-(6); 275.204-2(e)(1).

firms with departing representatives to share limited customer information with the representatives' new firms that could be used to contact clients and offer them a choice about whether to follow a representative to the new firm. At many firms, representatives develop close professional and personal relationships with investors over time. Representatives at such firms likely remember the basic contact information for their clients or have recorded it in their own personal records. Some firms discourage departing representatives from soliciting clients to move to another firm, while others do not. At any firm, departing representatives may have a strong incentive to transfer as much customer information as possible to their new firms, and it has been brought to our attention that, at some firms, information may have been transferred without adequate supervision, in contradiction of privacy notices provided to customers, or potentially in violation of Regulation S-P.[90]

The proposed exception is designed to provide an orderly framework under which firms with departing representatives could share certain limited customer contact information and

90 See, e.g., In re NEXT Financial Group, Inc., supra note 16.

could supervise the information transfer.[91] The proposed exception would permit one firm to disclose to another only the following information: the customer's name, a general description of the type of account and products held by the customer, and contact information, including address, telephone number and e-mail information.[92] We propose to include this particular information as it would be useful for a representative seeking to maintain contact with investors, but appears unlikely to put an investor at serious risk of identity theft. It also is the type of information an investor would expect a representative to remember. Broker-dealers and registered investment advisers seeking to rely on the exception would have to require their departing representatives to provide to them, not later than the representative's separation from employment, a written record of the information that would be disclosed pursuant to the exception, and broker-dealers and registered investment advisers would be required to preserve

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91 In 2004, certain large broker-dealers entered into a protocol under which signatories agreed not to sue one another for recruiting one another's registered representatives, if the representatives take only limited client information to another participating firm. The initial signatories, Citigroup Global Markets/Smith Barney, Merrill Lynch, and UBS Financial Services, were joined more recently by Raymond James, Wachovia Securities and others.

We understand that, under the protocol, the information that a departing representative may take to another firm is limited to each client's name, address, a general description of the type of account and products held by the client, and the client's phone number and e-mail address. This information may be used at the representative's new firm only by the representative, and only for the purpose of soliciting the representative's former clients.

We further understand that there may be some confusion in the securities industry regarding what information may be disclosed to a departing representative's new firm consistent with the limitations in Regulation S-P, and that at times these limitations may cause inconvenience to investors. NASD (now consolidated into FINRA) issued guidance to its member firms regarding the permissible and impermissible use of "negative response letters" for bulk transfers of customer accounts and changes in the broker-dealer of record on certain types of accounts (see NASD NtM 04-72 (Oct. 2004); NtM 02-57 (Sept. 2002)). More recently, FINRA issued guidance relating to Regulation S-P in the context special considerations firms should use to supervise recommendations of newly associated registered representatives to replace mutual funds and variable products). See FINRA, Regulatory Notice 07-36, available at http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p036445.pdf. However, our staff reports that scenarios involving representatives moving from one firm to another continue to create uncertainty regarding firms' obligations under Regulation S-P.

92 See proposed paragraph (a)(8)(i) of Section 15.

such records consistent with the proposed recordkeeping provisions of Section 30.[93] This condition is intended to help ensure that firms relying on the exception are appropriately accounting for the information they are disclosing in connection with departures of their representatives.[94]

The exception would be subject to conditions that are designed to limit the potential that the information would result in identity theft or other abuses. The shared information could not include any customer's account number, Social Security number, or securities positions.[95] A representative would not need this type of information to contact investors, although it would be useful to an identity thief, and an investor probably would not expect a representative to remember it. In addition, a representative could solicit only an institution's customers that were the representative's clients. This condition recognizes that an investor might expect to be contacted by a representative with whom the investor has done business before, but not by another person at the representative's new firm.[96]

As noted above, the proposed exception is designed to facilitate the transfer of client contact information that would help broker-dealers and registered investment advisers offer

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93 See proposed paragraph (a)(8)(iii) of Section 15 and proposed paragraph (c) of Section 30. For purposes of the proposed exception, the term "representative" would be defined to mean a natural person associated with a broker or dealer registered with the Commission, who is registered or approved in compliance with 17 CFR 240.15b7-1, or a supervised person of an investment adviser as defined in Section 202(a)(25) of the Investment Advisers Act. See proposed paragraph (a)(8)(iv) of Section 15.

94 Most firms seeking to rely on the proposed exception would not need to revise their GLBA privacy notices because they already state in the notices that their disclosures of information not specifically described include disclosures permitted by law, which would include disclosures made pursuant to the proposed exception and the other exceptions provided in Section 15 of Regulation S-P.

95 See proposed paragraph (a)(8)(ii) of Section 15.

96 See proposed paragraph (a)(8)(i) of Section 15 (permitting a representative to solicit customers to whom the representative personally provided a financial product or service on behalf of the institution).

clients the choice of following a departing representative to a new firm. At firms that choose to rely on it, the proposed exception also should reduce potential incentives some representatives may have to take information with them secretly when they leave. By specifically limiting the types of information that could be disclosed to the representative's new firm, the proposed amendments are designed to help firms safeguard more sensitive client information. This limitation also would clarify that a firm may not require or expect a representative from another firm to bring more information than necessary for the representative to solicit former clients. Because the proposed exception is designed to promote investor choice, provide legal certainty, and reduce potential incentives for improper disclosures, we preliminarily believe that it would be necessary or appropriate in the public interest, and is consistent with the protection of investors.

The proposed exception would not limit the disclosure of additional information to a new firm pursuant to a customer's consent or direction.[97] It also would not preclude the disclosure of additional information required in connection with the transfer of a customer's account.[98] Depending on its business organization, its policies regarding departing representatives and the

[97] For example, if an investor chooses to move his or her business to the representative's new firm, he or she may consent to having the original firm disclose additional information about the customer's account to the representative's new firm without the firm first having to provide the customer with an opt out. See 17 CFR 248.15(a)(1).

[98] If an investor requests or authorizes the transfer of his or her account from the representative's old firm to the representative's new firm, the old firm may disclose additional information as necessary to effect the account transfer. See 17 CFR 248.14(a)(1) and 248.14(b)(2)(vi)(B). The exception also would not preclude the disclosure of additional information about the investor if the firm has provided the investor with a privacy notice describing the disclosure and given the investor a reasonable opportunity to opt out of the disclosure, and the customer has not opted out. See 17 CFR 248.10. Thus, covered institutions that wish to disclose an investor's nonpublic personal information to a departing representative's new firm without relying on the proposed new exception or without first obtaining consent from the investor to the disclosure or to an account transfer could revise their privacy notices to describe disclosures the firm would make in the context of a representative's move to another broker-dealer or registered investment adviser.

circumstances of a representative's departure, a firm could choose to rely on existing exceptions rather than the proposed new exception.[99] The proposed exception is designed to allow firms that choose to share limited contact information to do so. The proposed exception would not, however, affect firm policies that prohibit the transfer of any customer information other than at the customer's specific direction.

We have chosen to propose this approach as opposed to an alternative approach that would require all firms to include specific notice and opportunity to opt out of this information sharing in their initial and annual privacy notices. Under this alternative, a broker-dealer or registered investment adviser's privacy notice would have to provide specific disclosure regarding the circumstances under which the broker-dealer or adviser would share customer information with another firm when a registered representative or supervised person leaves. We have chosen this approach because, as indicated earlier, many representatives develop close professional and personal relationships with investors. They are likely to remember basic contact information for their clients or have recorded it in their own personal records, and investors would expect representatives to have this information. This type of limited contact information is unlikely to put investors at serious risk of identity theft. Also, we believe that a description of disclosures to a departing representative's new firm would be difficult to distinguish from the description of disclosures made for the purpose of third-party marketing and would further complicate already complex privacy notices.

- Commenters are invited to discuss the proposed new exception. Would it permit the transfer of contact information so as to promote investor choice and convenience? Would it foreclose the transfer of particularly sensitive information that, if misused,

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[99] See 17 CFR 248.14, 248.15.

could lead to identity theft? Should the transfer of customer contact information be conditioned on the broker-dealer or registered investment adviser receiving the information certifying to the sharing institution that it complies with the safeguards and disposal rules?

- We also invite commenters to share their views on the likely effect of the proposed new exception on competition in recruiting broker-dealer and investment adviser representatives. Are there alternative approaches that would both protect investor information and not unduly restrict the transfer of representatives from one firm to another?
- We seek comment on potential alternative approaches, including requiring specific disclosure. Are investors, particularly new clients to a firm, likely to understand disclosures about information that would be given to a departing representative's new firm in initial or annual privacy notices?[100] Should the availability of the proposed exemption be conditioned on providing investors with specific disclosure regarding whether a covered institution would disclose personal information in connection with a representative's departure?
- The proposed exception would permit broker-dealers and registered investment advisers to transfer limited information to other broker-dealers and registered investment advisers without first providing notice and opt out. Should we make the proposed exception available for information transferred to other types of financial

[100] We expect that if the Banking Agencies, the FTC and the Commission were to adopt the proposed model privacy form, see Interagency Model Privacy Form Proposal, supra note 12, the description of the disclosure to a nonaffiliated firm could be included on page 2 of the proposed form in the section defining nonaffiliates.

institutions where a departing representative may go? For example, should we permit broker-dealers and registered investment advisers to rely on the exception to share information with investment advisers that are not registered with the Commission?

- Commenters are invited to express their views on the proposed exemption's condition that a departing representative of a covered institution relying on this exemption could solicit only the institution's customers that were the representative's clients.

III. GENERAL REQUEST FOR COMMENTS

We request comment on all aspects of the proposed amendments to Regulation S-P. We particularly urge commenters to suggest other provisions or changes that could enhance the ways in which securities industry participants protect personal information. We encourage commenters to provide empirical data, if available, to support their views.

IV. PAPERWORK REDUCTION ACT

Certain provisions of the proposed amendments contain "collections of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[101] The Commission is submitting these amendments to the Office of Management and Budget ("OMB") for review and approval in accordance with the PRA.[102] The title for the collections of information is "Information security programs for personal information; records of compliance." The safeguards and disposal rules we propose to amend contain currently approved collections of information under OMB Control No. 3235-0610, the title of which is, "Rule 248.30, Procedures to safeguard customer records and information; disposal of consumer report information."[103]

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[101] 44 U.S.C. 3501-3520.

[102] 44 U.S.C. 3507(d) and 5 CFR 1320.11.

[103] The paperwork burden imposed by Regulation S-P's notice and opt-out requirements, 17 CFR 248.1 to 248.18, is currently approved under a separate OMB control number, OMB Control No.

The Commission is proposing to amend Regulation S-P's safeguards and disposal rules, 17 CFR 248.30(a) and (b), pursuant to Sections 501, 504, 505, and 504 of the GLBA,[104] Sections 17, 17A, 23, and 36 of the Exchange Act,[105] Sections 31(a) and 38 of the Investment Company Act,[106] and Sections 204 and 211 of the Investment Advisers Act.[107] Regulation S-P sets forth the Commission's safeguards rule for institutions covered by the regulation. Among other things, the safeguards rule requires covered institutions to adopt administrative, technical and physical information safeguards to protect customer records and information. Regulation S-P also contains the Commission's disposal rule, which requires institutions to properly dispose of consumer report information possessed for a business purpose by taking reasonable measures to protect against unauthorized access to or use of the information in connection with its disposal.

The proposed amendments are designed to ensure that covered institutions maintain a reasonable information security program that includes safeguarding policies and procedures that are more specific than those currently required, including policies and procedures for responding to data security breach incidents, for notifying individuals for whom the incidents pose a risk of identity theft, and for reporting certain incidents to the Commission (or to a broker-dealer's designated examining authority) on proposed Form SP-30. The amendments also would broaden the scope of information and the types of institutions and persons covered by the safeguards and disposal rules. Finally, the amendments would create a new exception from Regulation S-P's notice and opt out requirements for disclosures of limited information in connection with the

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3235-0537. The proposed amendments would not affect this collection of information.

104 15 U.S.C. 6801, 6804, 6805 and 6825.

105 15 U.S.C. 78q, 78q-1, 78w, and 78mm.

106 15 U.S.C. 80a-30(a), 80a-37.

107 15 U.S.C. 80b-4, 80b-11.

departure of a representative of a broker-dealer or registered investment adviser. Firms choosing to rely on the exception would be required to keep records of the information disclosed pursuant to it.

The hours and costs associated with these collections of information would consist of reviewing the proposed amendments, collecting and searching for existing policies and procedures, conducting a risk assessment, developing and recording information safeguards appropriate to address risks, training personnel, and adjusting written safeguards on an ongoing basis. Institutions would also have to respond appropriately to incidents of data security breach as may occur on an ongoing basis. If misuse of information has occurred or is reasonably possible, this would include notifying affected individuals. If there is a significant risk that an individual identified with the information might suffer substantial harm or inconvenience, or any unauthorized person has intentionally obtained access to or used sensitive personal information, this would also include notifying the Commission or an appropriate designated examining authority as soon as possible on proposed Form SP-30. Certain of these collections of information also would require disclosure, reporting, and recordkeeping burdens, as analyzed below.

An agency may not conduct or sponsor, and a person is not required to respond to a collection of information unless a currently valid OMB control number is displayed. Responses to these collections of information would not be kept confidential.[108] The collections of information would be mandatory, and would have to be maintained by broker-dealers for not less than three years, the first two years in an easily accessible place, by registered transfer agents for

[108] Information submitted to the Commission on proposed Form SP-30 would be kept confidential to the extent permitted by law. See supra note 55.

a period of not less than two years, the first year in an easily accessible place, by investment companies for a period not less than six years, the first two years in an easily accessible place, and registered investment advisers would have to preserve the records for five years, the first two years in an appropriate office of the investment adviser.

Information security and security breach response requirements

The proposed amendments contain collections of information requirements related to the more specific standards we are proposing for safeguarding personal information, including standards for responding to data security breaches. We believe these proposed collections of information are necessary to help prevent and address security breaches and designed to ensure that covered institutions maintain a reasonable information security program pursuant to the statutory requirements. Covered institutions would have to document in writing steps they would be required to take to develop, implement, and maintain a comprehensive information security program. We estimate that there would be 12,432 respondents to this information collection.[109] Of these covered institutions, we estimate that 5,862 are smaller institutions and 6,570 are larger institutions.[110]

Based on limited inquiries of covered institutions, the staff estimates that the amount of time smaller institutions would devote to initial compliance with the proposed amendments

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[109] This estimate includes 6,016 broker-dealers, 4,733 investment companies representing portions of 813 fund complexes, 77 business development companies, 9,860 registered investment advisers, and 501 registered transfer agents. As discussed in more detail in the cost-benefit analysis below, the staff estimates that 56 percent of these 17,267 institutions, or 9,670 institutions, have one or more affiliates. The staff estimates, for purposes of this analysis, that each of the affiliated institutions has one corporate affiliate. The staff estimates that these affiliated institutions are likely to bear these paperwork burdens on an organization-wide basis, rather than being incurred by each institution. Based on these estimates, the staff estimates there would be 12,432 respondents to this information collection. (17,267 – (9,670 ÷ 2) = 12,432) These estimates are discussed in more detail in the cost-benefit analysis, see infra note 149 and accompanying text.

[110] See infra note 154 and accompanying text.

would range from 2 to 80 hours with a midpoint of 41 hours.[111] This estimate reflects the following burden hours: 1 hour for the board of directors to designate an information security program coordinator; 1 hour for the program coordinator to review the amendments; 4 hours to assess risks and review procedures; 10 hours to review, revise and implement new safeguards (including any data breach notification procedures); 8 hours to test the effectiveness of the safeguards controls and procedures; 7 hours to train staff; and 10 hours to review service providers' policies and procedures and revise contracts as necessary to require them to maintain appropriate safeguards. The staff estimates that initially it would cost smaller institutions approximately $18,560 to comply with the proposed amendments.[112] Amortized over three years, the estimated annual hourly burden would be 14 hours at a cost of approximately $6,187.

The staff estimates that the amount of time larger institutions would devote to initial compliance with the proposed amendments would range from 40 hours to 400 hours with a

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111 The staff estimate uses the midpoint of the range of hours, although the average number of burden hours could be higher or lower. Our estimates are based on staff contacts with several institutions regarding their current safeguarding and disposal policies and procedures as well as the potential costs of the proposed amendments. Because the staff was able to discuss these issues with only a small number of very large institutions, and our estimates in this analysis are based largely on this information, our estimates may be much higher or lower than the range of actual current costs related to compliance with Regulation S-P and the range of potential costs associated with the proposed amendments.

112 This estimate is based on a cost of $2,000 for one hour of the board of directors' time (at $2,000/hour) and $16,560 for 40 hours of a program coordinators' time (at $414/hour). Staff believes that the program coordinator would be a senior executive of the institution, such as a chief compliance officer of an investment adviser. For purposes of this PRA analysis, the staff is using salaries for New York-based employees which tend to be higher than the salaries for comparable positions located outside of New York. This conservative approach is intended to capture unforeseen costs and to account for the possibility that a substantial portion of the work would be undertaken in New York. The salary information is derived from data compiled by the Securities Industry and Financial Markets Association. The Commission staff has modified this information to account for an 1,800-hour work year and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead. See Securities Industry and Financial Markets Association, Report on Management and Professional Earnings in the Securities Industry (2007); Securities Industry and Financial Markets Association, Report on Office Salaries in the Securities Industry ("SIFMA Earnings Reports").

midpoint of 220 hours.[113] This estimate reflects the following burden hours: 2 hours for the board of directors to designate an information security program coordinator; 2 hours for the program coordinator to review the amendments; 42 hours to assess risks and review procedures; 60 hours to review, revise and implement new safeguards (including any data breach notification procedures); 60 hours to test the effectiveness of the safeguards controls and procedures; 34 hours to train staff; and 20 hours to review service providers policies and procedures and revise contracts as necessary to require them to maintain appropriate safeguards. The staff estimates that larger institutions would spend approximately $172,732 to comply with the proposed amendments initially.[114] Amortized over three years, the estimated annual hourly burden would be 73 hours at a cost of approximately $57,577.

On an annual, ongoing basis the staff estimates that the amount of time smaller institutions would devote to ongoing compliance with the safeguards and disposal rules, as they are proposed to be amended, would range from 12 hours to 40 hours per year with a midpoint of 26 hours per year. This estimate reflects the following burden hour estimates: 5 hours to regularly test or monitor the safeguards' key controls, systems, and procedures; 3 hours to augment staff training; 3 hours to provide continued oversight of service providers; 3 hours to evaluate and adjust safeguards; 10 hours to respond appropriately to potential incidents of data security breach, including investigating the breach and, as necessary, notifying affected

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113 The staff estimate uses the midpoint of the range of hours, although the average number of burden hours could be higher or lower.

114 This estimate is based on a cost of $4,000 for 2 hours of board of directors' time (at $2,000/hour) and $168,732 for 218 hours of a group of compliance professionals' time (at $774/hour). The staff believes that this group of compliance professionals would include the program coordinator at a rate of $414 per hour, an in-house attorney at a rate of $295 per hour, and an administrative assistant at a rate of $65 per hour. See SIFMA Earnings Reports, supra note 112. In total, we estimate that this group of compliance professionals would cost the larger institution $758 per hour. $414 + $295 + $65 = $774.

individuals; and 2 hours to notify the Commission or a designated examining authority as soon as possible on proposed Form SP-30, in the event there is a significant risk that an individual identified with the information might suffer substantial harm or inconvenience or an unauthorized person has intentionally obtained access to or used sensitive personal information.[115] We believe that most institutions investigate data security breaches as a matter of good business practice to protect their business operations and the sensitive information they have about employees and clients. Nevertheless, we have estimated additional burden hours because the proposed rule specifies certain elements of the investigation and the notice to affected individuals. We also believe that an institution would have gathered all the information that would have to be disclosed in Form SP-30 in the course of these investigations of data security breaches. Thus, staff estimates for the Form SP-30 collection of information burden reflect only the time it would take to draft the information on the form. Staff estimates that smaller institutions would spend an additional $10,764 per institution per year in connection with these burdens.[116]

The staff also estimates that the amount of time larger institutions would devote to

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115 We estimate that each covered institution that has developed and adopted and is maintaining safeguarding policies and procedures will experience some form of breach of data security each year. See, e.g., Deloitte & Touche LLP and Ponemon Institute LLC, Enterprise@Risk: 2007 Privacy & Data Protection Survey (Dec. 2007), http://www.deloitte.com/dtt/cda/doc/content/us_risk_s%26P_2007%20Privacy10Dec2007final.pdf (last visited Dec. 19, 2007) (85% of surveyed privacy and security professionals experienced a reportable breach within the past 12 months). These data security breaches may range from minor breaches (such as an individual who accidentally sees data that he or she does not have authority to view) to more serious breaches. Accordingly, we have estimated that each of these institutions would experience a data security breach that would require notice to the Commission (or a designated examining authority) each year. We understand that the nature of security breaches will vary widely within and among institutions, and that this estimate may be much higher than the actual reporting that would be required under the proposed rule.

116 This estimate is based on the following calculation: 26 hours per smaller institution per year x $414 per hour = $10,764.

ongoing compliance with the proposed amendments would range from 32 hours to 100 hours with a midpoint of 66 hours per year. This estimate reflects the following burden hour estimates: 12 hours to regularly test or monitor the safeguards' key controls, systems, and procedures; 9 hours to augment staff training; 9 hours to provide continued oversight of service providers; 10 hours to evaluate and adjust safeguards; 20 hours to respond appropriately to potential incidents of data security breach, including investigating the breach and, as necessary, notifying affected individuals; and 6 hours to notify the Commission or a designated examining authority as soon as possible on proposed Form SP-30, in the event there is a significant risk that an individual identified with the information might suffer substantial harm or inconvenience or an unauthorized person has intentionally obtained access to or used sensitive personal information.[117] Staff believes that larger institutions are likely to have more complex business operations and data systems and may experience more sophisticated security attacks than smaller institutions. As a result, staff anticipates that larger institutions are more likely to conduct more complicated investigations that require more detailed explanations on proposed Form SP-30. Staff estimates therefore that larger institutions would take more time to perform investigations and to complete the questions on proposed Form SP-30.[118] The staff estimates that larger institutions would spend approximately an additional $51,084 per institution per year.[119]

Given the estimates set forth above, we estimate that the weighted average initial burden

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117 See supra note 115.

118 We recognize that the time it takes to perform an investigation of a data security breach and to complete Form SP-30 may vary significantly depending on the nature, size and complexity of an institution's business operations as well as the nature and size of the security breach. Accordingly, the actual time it may take a particular institution to investigate the breach and complete Form SP-30 may vary significantly from staff estimates.

119 This estimate is based on the following calculation: 66 hours x $774 = $51,084.

for each respondent would be approximately 136 hours[120] and $100,036.[121] We also estimate that the weighted average ongoing burden for each respondent would be approximately 47 hours[122] and $32,072.[123]

Scope of the safeguards and disposal rules

The amendments also would broaden the scope of information and of the entities covered by the safeguards and disposal rules. These amendments do not contain collections of information beyond those related to the information security and security breach response requirements, analyzed above.

Records of compliance

The proposed amendments would require that written records required under the disposal and safeguards rules be maintained and preserved by broker-dealers for not less than three years, the first two years in an easily accessible place, by registered transfer agents for a period of not less than two years, the first year in an easily accessible place, by investment companies for a period not less than six years, the first two years in an easily accessible place, and registered investment advisers would have to preserve the records for five years, the first two years in an appropriate office of the investment adviser. Covered institutions are already required pursuant to other Commission rules to maintain and preserve similar records in the same manner, and we do not believe that the currently approved collections of information for these rules would

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120 This estimate is based on the following calculation: ((5,862 smaller institutions x 41 hours) + (6,570 larger institutions x 220 hours) ÷ 12,432 total institutions = 135.60 hours.

121 This estimate is based on the following calculation: ((5,862 smaller institutions x $18,560) + (6,570 larger institutions x $172,732)) ÷ 12,432 total institutions = $100,036.03.

122 This estimate is based on the following calculation: ((5,862 smaller institutions x 26 hours) + (6,570 larger institutions x 66 hours)) ÷ 12,432 total institutions = 47.14 hours.

123 This estimate is based on the following calculation: ((5,862 smaller institutions x $10,764) + (6,570 larger institutions x $51,084)) ÷ 12,432 total institutions = $32,072.12.

change based on the proposed amendments.[124]

Exception for limited information disclosure when personnel leave their firms

The proposed amendments would create a new exception from Regulation S-P's notice and opt out requirements that would permit limited disclosures of investor information when a registered representative of a broker-dealer or supervised person of a registered investment adviser moves from one brokerage or advisory firm to another. This exception would require that the departing representative provide the broker, dealer, or registered investment adviser he or she is leaving with a written record of the permissible information that would be disclosed under this exception. Broker-dealers and registered investment advisers also would be required to retain a record of that information consistent with existing record retention requirements. All broker-dealers and registered investment advisers maintain records of their customers and clients, including relevant contact information and type of account. Thus, we estimate that allowing a departing representative to make a copy of this information and requiring the broker-dealer or registered investment adviser to retain a record of that information would not result in an additional measurable burden to the firm.

We request comment on whether these estimates are reasonable. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments in order to: (i) evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility; (ii) evaluate the accuracy of the Commission's estimate of the burden of the proposed collections of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) minimize the burden of the collections of information on

124 See 17 CFR 240.17a-4(b); 240.17Ad-7(b); 270.31a-2(a)(4)-(6); 275.204-2(e)(1).

those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Members of the public may direct to us any comments concerning the accuracy of these burden estimates and any suggestions for reducing these burden hours. Persons wishing to submit comments on the collection of information requirements of the proposed amendments should direct them to the Office of Management and Budget, Attention Desk Officer of the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 10102, New Executive Office Building, Washington, DC 20523, and should send a copy to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090 with reference to File No. S7-06-08. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this release; therefore a comment to OMB is best assured of having its full effect if OMB receives it within 30 days after the publication of this release. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-06-08, and be submitted to the Securities and Exchange Commission, Public Reference Room, 100 F Street, NE, Washington, DC 20549.

V. COST-BENEFIT ANALYSIS

The Commission is sensitive to the costs and benefits imposed by its rules. We have identified certain costs and benefits of the proposed amendments and request comment on all aspects of this cost-benefit analysis, including identification and assessment of any costs and benefits not discussed in this analysis. We seek comment and data on the value of the benefits identified. We also welcome comments on the accuracy of the cost estimates in each section of this analysis, and request that commenters provide data so we can improve these cost estimates. In addition, we seek estimates and views regarding these costs and benefits for particular covered

institutions, including registered transfer agents, as well as any other costs or benefits that may result from the adoption of these proposed amendments.

As discussed above, the proposed rule amendments are designed to enhance covered institutions' information security policies and procedures as well as their ability to protect personal information. Under Regulation S-P, covered institutions have been required to safeguard customer records and information since 2001 and to dispose properly of consumer report information since 2005. The proposed amendments would modify Regulation S-P's current safeguards and disposal rules to: (i) require more specific standards under the safeguards rule, including standards that would apply to data security breach incidents; (ii) broaden the scope of information and the types of institutions and persons covered by the rules; and (iii) require covered institutions to maintain written records of their policies and procedures and their compliance with those policies and procedures. The proposed amendments also would create a new exception from Regulation S-P's notice and opt-out requirements that would not unduly restrict the transfer of representatives from one broker-dealer or registered investment adviser to another while protecting customer information.

A. Costs and Benefits of More Specific Information Security and Security Breach Standards

As noted, since 2001 broker-dealers, investment companies, and registered investment advisers have been required to adopt policies and procedures reasonably designed to insure the security and confidentiality of customer records and information, protect against anticipated threats or hazards, and protect against unauthorized access to or use of customer records and information.[125] The proposed rule amendments would require more specific standards for

[125] See 15 U.S.C. 6801; 17 CFR 248.30(a). The Commission also required that safeguarding policies and procedures be in writing by July 1, 2005. See Disposal Rule Adopting Release, supra note

safeguarding personal information, including standards for responding to data security breaches. The amendments would require covered institutions to develop, implement, and maintain a comprehensive "information security program" for protecting personal information and for responding to unauthorized access to or use of personal information that would have to be appropriate to the institution's size and complexity, the nature and scope of its activities, and the sensitivity of the personal information involved. The information security program would have to include seven safeguarding elements, as described above in section II.A. Our proposed amendments also would specifically require that institutions' information security programs include procedures for responding to incidents of unauthorized access to or use of personal information. We believe that these proposed amendments would be consistent with safeguarding guidance and rules issued by the Banking Agencies and the FTC.[126]

1. Benefits of More Specific Information Security and Security Breach Standards

We anticipate that the proposed amendments would benefit covered institutions and investors by providing specific standards for policies and procedures to safeguard investor information, boosting investor confidence and mitigating losses due to security breach incidents, helping to ensure that information security programs are actively managed and regularly updated, and reducing the compliance burden for institutions in the event of a data security breach incident.

One benefit of the proposed information security and security breach standards would be to provide firms in the securities industry with detailed standards for the policies and procedures that a well-designed information security program should include. As already noted, a

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126 See supra note 23 and accompanying text.

significant increase in reported information security breaches involving covered institutions, including increasingly sophisticated identity theft attacks directed at the securities industry, have altered the risk environment and brought to our attention the vulnerability of certain of our institutions' information security policies and procedures.[127] We are concerned that some Commission-regulated institutions may not regularly reevaluate and update their safeguarding programs to deal with these increasingly sophisticated methods of attack. As a result, our staff has devoted increased attention to this area.

The current rule's reasonable design standard has permitted institutions flexibility to implement safeguarding policies and procedures tailored to their own privacy policies and practices and their varying business operations. While many institutions have appropriate safeguards in place, some institutions, including some smaller institutions, may have had difficulty keeping up with the changes in the threat environment. Setting out a more specific framework for institutions' continuing obligation to protect customer information, may ease institutions' burden in interpreting our expectations of safeguarding policies and procedures that are "reasonably designed," while retaining much of the current rule's flexibility.

We believe the proposed amendments would be consistent with the Commission's initial statutory mandate under the GLBA to adopt, in 2000, final financial privacy regulations that are consistent and comparable with those adopted by other federal financial regulators.[128] As noted above, after our adoption of Regulation S-P's safeguards rule, the FTC and the Banking Agencies issued regulations with more detailed standards applicable to the institutions they

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[127] See supra notes 16-19 and accompanying text.

[128] See Section 504(a) of the GLBA (15 U.S.C. 6804(a)).

regulate.[129] The Banking Agencies also issued guidance for their institutions on responding to incidents of unauthorized access to or use of customer information.[130] Our proposed amendments include safeguarding elements consistent with the regulatory provisions of these other agencies that Commission-regulated institutions would have to address in their safeguarding policies and procedures.[131]

Covered institutions would benefit from having specific standards that are consistent and comparable to those already adopted by the Banking Agencies and the FTC in other ways. For example, covered institutions that have banking affiliates may have already developed policies and procedures consistent with the Banking Agencies' guidance that are applied to all affiliates of the bank. If they do not have the same policies and procedures, these covered institutions would be able to apply the banking affiliate's policies and procedures to the securities businesses with few changes. More specific safeguarding standards also could increase investor confidence in institutions and help mitigate losses that can result from lax safeguarding policies and procedures. Incidents of identity theft have affected a large number of Americans and are

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129 See supra note 23 and accompanying text.

130 Id.

131 When the FTC adopted its safeguards rule, it stated that an entity that demonstrated compliance with the Banking Agencies' or NCUA's safeguarding standards also would satisfy the FTC rule. The FTC stated, however, that it would not automatically recognize an institution's compliance with other safeguards rules (including Regulation S-P) as satisfying the FTC Safeguards Rule. The FTC stated that it made this decision because "such other rules and law do not necessarily provide comparable protection in terms of the safeguards mandated, data covered, and range of circumstances to which protection apply." See Standards for Safeguarding Customer Information, 67 FR 36484 (May 23, 2003), at text accompanying and following nn.28-33. Compliance with other Regulation S-P provisions, however, currently satisfies other FTC privacy requirements. Thus, we expect that making the safeguarding provisions of Regulation S-P comparable to the FTC's requirements would benefit institutions by, for example, permitting state-registered investment advisers to satisfy the FTC standards by complying with the Commission's safeguards rule, which was drafted to address investment advisory business models.

difficult and expensive for victims to deal with and correct.[132] Moreover, there is at least anecdotal evidence that the wave of widely-reported incidents of data security breaches have played a role in discouraging a significant number of individuals from conducting business online.[133] The proposed amendments could benefit investors and increase their confidence by providing firms with detailed standards for the processes that a well-designed information security program should include. This could result in enhanced protection for the privacy of investor information, and could decrease incidents of identity theft, thereby mitigating losses due to identity theft and other misuses of sensitive information. We also believe that the increased protection that could result from the proposed amendments could benefit institutions, which frequently incur the costs of fraudulent activity.[134] Thus, if only a small number of security breach incidents were averted because the proposed amendments were adopted, there still could be a significant cost savings to individuals and institutions.[135]

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132 In 2003 the FTC reported that up to 10 million Americans had been victimized by identity theft over a 12-month period and that these thefts cost businesses and consumers over $52 billion. See FTC, Identity Theft Survey Report (Sept. 2003), available at http://www.ftc.gov/os/2003/09/synovatereport.pdf.

133 A July 2005 study found that 48 percent of consumers avoided making purchases on the Internet because they feared their personal information may be stolen. See Cyber Security Industry Alliance, Internet Voter Survey, at 9 (June 2005), https://www.csialliance.org/publications/surveys_and_polls/CSIA_Internet_Security_Survey_June_2005.pdf (last visited Nov. 6, 2007).

134 In most cases, financial institutions do not impose the losses associated with fraudulent activity on consumers. See, e.g., Testimony of Oliver I. Ireland, on Behalf of the Financial Services Coordinating Council, H.R. 3997, the "Financial Data Protection Act of 2005," Before the Subcomm. on Financial Institutions and Consumer Credit, House Comm. on Financial Services (Nov. 9, 2005), available at http://www.sia.com/testimony/2005/ireland11-9-05.html.

135 One research institution has estimated that the average cost of a data security breach incident per institution is $1.4 million. See Ponemon Institute, LLC, 2006 Annual Study: Cost of a Data Breach (Oct. 2006), http://download.pgp.com/pdfs/Ponemon2-Breach-Survey_061020_F.pdf (last visited Nov. 6, 2007). In addition, some investigations into data breach incidents have been reported to cost as much as $5 million. See Daniel Wolfe, Security Watch, Amer. Banker (Apr. 4, 2007).

As noted above, we are concerned that some institutions do not regularly reevaluate and update their safeguarding programs. Requiring covered institutions to designate in writing an employee or employees to coordinate their information security programs should foster clearer delegations of authority and responsibility, making it more likely that an institution's programs are regularly reevaluated and updated. Having an information security program coordinator also could contribute to an institution's ability to meet its affirmative and continuing obligation under the GLBA to safeguard customer information.[136] If, for example, elements of a covered institution's information security program were not maintained on a consolidated basis, but were dispersed throughout an institution, we believe having a responsible program coordinator or coordinators should facilitate the institution's awareness of these elements, as well as enable it to better manage and control risks and conduct ongoing evaluations.

We expect that the proposed framework for the initial and ongoing oversight of institutions' information security programs – in the form of formal risk assessments, periodic testing or monitoring of key controls, systems, and procedures, staff training, and relevant evaluations and adjustments – would help to ensure that information security programs are appropriately updated along with relevant changes in technology, new business arrangements, changes in the threat environment, and other circumstances. Finally, the proposed amendment that would require covered institutions to take reasonable steps to select and retain service providers that are capable of maintaining appropriate safeguards and would require service providers by contract to implement and maintain appropriate safeguards should help to ensure that sensitive personal information is protected when it leaves the institution's custody, while still permitting institutions the flexibility to select appropriate service providers.

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[136] See 15 U.S.C. 6801(a).

The proposed requirement that information security programs include specific procedures for responding to incidents of unauthorized access to or use of personal information is designed to benefit investors and institutions. The requirement would benefit investors who receive notice of an information security breach pursuant to an institution's incident response procedures by allowing those investors to take precautions to the extent they believe necessary.[137] The procedures also would benefit institutions by establishing a national data breach notification requirement for covered institutions.[138] Currently at least 39 states have enacted statutes requiring notification of individuals in the event of a data security breach.[139] This patchwork of overlapping and sometimes inconsistent regulation has created a difficult environment for financial institutions' compliance programs. However, many of the state statutes contain exemptions for entities regulated by federal data security breach regulations.[140] Accordingly, the proposed amendments could benefit covered institutions by significantly reducing the number of requirements with which covered institutions must comply.[141] As noted, the banking regulators

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[137] Often victims of identity theft are unaware of the crime until they are denied credit or employment, or are contacted by a debt collector for payment on a debt they did not incur. See Identity Theft Task Force, Combating Identity Theft, A Strategic Plan, p.3 (Apr. 2007), available at http://www.idtheft.gov/reports/StrategicPlan.pdf.

[138] Establishing national standards for data breach notification requirements was a recommendation of the Identity Theft Task Force. Id. at p. 35.

[139] See Government Accountability Office, Personal Information: Data Breaches Are Frequent, but Evidence of Resulting Identity Theft Is Limited; However, the Full Extent Is Unknown (Jun. 4, 2007) at p. 2, and National Conference of State Legislatures, State Security Breach Notification Laws (as of Dec. 1, 2007), http://www.ncsl.org/programs/lis/cip/priv/breachlaws.htm (last visited Dec. 10, 2007).

[140] See, e.g., Crowell & Moring LLP, State Laws Governing Security Breach Notification (last updated Apr. 2007), http://www.crowell.com/pdf/SecurityBreachTable.pdf (last visited Dec. 10, 2007).

[141] Under the proposed amendments, for example, using proposed Form SP-30 would satisfy an institution's obligations to notify the Commission or the appropriate designated examining authority. Because many state laws have exceptions from breach notification requirements for institutions subject to federal breach notification requirements, this would streamline institutions'

published similar data breach notification guidance in 2005.[142]

We request comment on available metrics to quantify these benefits and any other benefits the commenter may identify. In particular, we request comment reflecting institutions' experiences in safeguarding customer information and addressing the security breach incidents discussed above. Commenters are also requested to identify sources of empirical data that could be used for the metrics they propose.

2. Costs of More Specific Information Security and Security Breach Standards

Some institutions would likely incur additional costs in reviewing, implementing, and maintaining more specific information security and security breach standards. Institutions could incur additional costs in reviewing current safeguarding policies and procedures and designing and implementing new ones, if necessary, on an initial basis. Institutions also could incur additional costs on an ongoing basis to maintain up-to-date information security programs and to respond appropriately to any data security breach incidents.

According to Commission filings, approximately 6,016 broker-dealers, 4,733 investment

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current reporting obligations to numerous state authorities.

142 See Interagency Guidance on Response Programs for Unauthorized Access to Customer Information and Customer Notice, 70 FR 15736 (Mar. 29, 2005), available at http://www.occ.treas.gov/consumer/Customernoticeguidance.pdf. The guidance supplements the Interagency Guidelines Establishing Standards for Safeguarding Information which was renamed the Interagency Guidelines Establishing Information Security Standards.

companies comprising portions of 813 fund complexes,[143] 77 business development companies, 9,860 registered investment advisers, and 501 registered transfer agents, or 17,267 covered institutions, would be required to comply with the proposed amendments' more specific information security and security breach standards.[144] As noted, broker-dealers, investment companies, and registered investment advisers have been required to have reasonably designed safeguarding policies and procedures since 2001. In addition, transfer agents have been required to have information security safeguards since 2003, in accordance with the FTC Safeguards Rule.[145] We estimate that 56 percent of all covered institutions, or 9,670 institutions, have one or more financial affiliates (whether these institutions are regulated by the Commission or other federal financial regulators).[146] We estimate that each of the affiliated institutions has one corporate affiliate. Based on limited inquiries of covered institutions, we believe that these affiliated institutions are likely to have developed safeguarding policies and procedures on an organization-wide basis, rather than each affiliate developing policies and procedures on its

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143 Although the circumstances for every investment company vary, we believe that in general the costs of complying with the proposed rule amendments would be incurred on a per fund complex basis and not on a per fund basis because almost all investment companies are externally managed by affiliated organizations and independent contractors, who, if the proposals are adopted, are likely to review and implement the amended rules on behalf of all of the investment companies they manage. See, e.g., Investment Company Institute, A Guide to Understanding Mutual Funds, at 16, Sept. 2006, available at http://www.ici.org/pdf/bro_understanding_mfs_p.pdf (last visited Dec. 3, 2007). Thus, throughout this cost-benefit analysis we estimate the costs of compliance on a per fund complex basis.

144 This estimate is based on the following calculation: 6,016 + 813 + 77 + 9,860 + 501 = 17,267.

145 See supra note 23.

146 The estimate that 56 percent of registrants have an affiliate is based upon statistics reported as of December 3, 2007 on Form ADV, the Universal Application for Investment Adviser Regulation, which contains specific questions regarding affiliations between investment advisers and other persons in the financial industry. We estimate that other institutions subject to the safeguards rule would report a rate of affiliation similar to that reported by registered investment advisers. The estimate that 9,670 institutions have an affiliate is based on the following calculation: 17,267 x 0.56 = 9,669.52.

own.[147] We also believe that the affiliate that developed the affiliated organization's safeguarding policies and procedures is also responsible for maintaining these policies and procedures. We therefore estimate that one-half of the covered affiliated institutions, or 4,835 institutions, have developed, documented, and are maintaining safeguarding policies and procedures, while the other half instead use the policies and procedures developed, documented, and maintained by their affiliate.[148] Accordingly, we estimate that 12,432 covered institutions have developed and adopted safeguarding policies and procedures and are maintaining these policies and procedures in accordance with the current rule.[149]

We expect that these institutions' current costs to maintain safeguarding policies and procedures in compliance with the Commission's safeguards rule vary greatly depending upon the size of the institution, its customer base, the complexity of its business operations, and the extent to which the institution engages in information sharing. Thus, for example, we estimate that small investment advisers with fewer than 10 employees require more limited safeguarding policies and procedures to address a limited scope of information transfer, storage, and disposal. We believe that larger broker-dealers or fund complexes, by contrast, are more likely to have and maintain a more extensive set of information safeguarding policies and procedures, corresponding to these institutions' more complex business activities and information sharing practices.

Of the covered institutions, we estimate that 7,030 registered investment advisers have 10

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[147] See supra note 109.

[148] This estimate is based on the following calculation: $9,670 \div 2 = 4,835$.

[149] This estimate is based on the following calculation: $(17,267 - 9,670) + 4,835 = 12,432$.

or fewer employees.[150] We estimate that 942 broker-dealers and investment company complexes are small institutions, and are likely to have no more than 10 employees.[151] Based on Commission filings, we also estimate that 170 transfer agents are smaller institutions that are likely to have no more than 10 employees. We therefore estimate that 8,142 institutions, out of 17,267 covered institutions, are smaller institutions that are likely to have no more than 10 employees.[152] We believe that the institutions that have developed and adopted safeguarding policies and procedures are as likely to be smaller institutions with no more than 10 employees as the total population of covered institutions.[153] Therefore, of 12,432 covered institutions that we estimate have developed and adopted and are maintaining safeguarding policies and procedures, we estimate for purposes of this analysis that 5,862 institutions are smaller institutions, while 6,570 institutions are larger institutions.[154]

Based on conversations with representatives of covered institutions, and information collected from limited inquiries of covered institutions, we estimate that smaller institutions are currently spending between $5,000 and $1,000,000 per year to comply with the safeguards and disposal rules.[155] We also estimate that larger institutions are spending between $200,000 and $10,000,000 per year to comply with the safeguards and disposal rules. These estimates include costs for dedicated personnel, maintaining up-to-date policies and procedures, enforcing various

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150 See Investment Adviser Association, Evolution Revolution, A Profile of the Investment Adviser Profession (2006), available at http://www.nrs-inc.com/ICAA/EvRev06.pdf.

151 As noted below, 915 broker-dealers and 238 investment companies, representing 27 fund complexes, are small entities.

152 This estimate is based on the following calculation: 7,030 + 942 + 170 = 8,142 smaller institutions.

153 8,142 ÷ 17,267 = 0.4715.

154 12,432 x 0.4715 = 5,861.88; 12,432 - 5,862 = 6,570.

155 See supra note 111.

safeguarding requirements (such as "clean desk" requirements), hiring contractors to properly dispose of sensitive information, developing and enforcing access procedures, ongoing staff training, monitoring and reviewing compliance with safeguarding standards, and computer encryption. These estimates also include current spending to comply with state data security breach statutes.[156]

We expect that most covered institutions have information security programs in place that would be consistent with the proposed amendments.[157] We do not have a reliable basis for estimating the number of institutions that would incur additional costs or the extent to which those institutions would have to enhance their policies and procedures, including documentation of the information safeguard program and its elements. Accordingly, we have estimated the range of additional costs that individual firms could incur. We seek comment on the number of firms that have information safeguard programs that would satisfy the proposed amendments, the number of firms that would have to enhance their programs, the extent of those enhancements, and the costs of enhancement.

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[156] These estimates also include transfer agents' current spending to comply with the FTC Safeguards Rule. As noted, the proposed amendments would apply to every broker or dealer other than a notice-registered broker or dealer, every investment company, and every investment adviser or transfer agent registered with the Commission. See proposed paragraph (a)(1) of Section 30.

[157] This belief is consistent with the analysis of the Office of the Comptroller of the Currency and Office of Thrift Supervision when they adopted the Banking Agencies Safeguard Guidelines in 2001. At that time they stated with respect to the institutions they regulated, that "most if not all institutions already have information security programs in place that are consistent with the Banking Agencies' Security Guidelines. In such cases, little or no modification to an institution's program will be required." See Banking Agencies' Security Guidelines, supra note 23. The statement was made in the analysis of whether the Guidelines would constitute "a significant regulatory action" for purposes of Executive Order 12866, which includes an action that would have an annual effect on the economy of $100 million or more or adversely affect in a material way the economy, a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local, or tribal governments or communities. The Board and the FDIC did not prepare an analysis under Executive Order 12866.

If the proposed amendments were adopted, covered institutions could incur costs to supplement their current information security programs in some or all of the following ways. First, the institution would be required to review and, as appropriate, revise its current safeguarding policies and procedures, including their data security breach procedures and disposal rule procedures, to comply with the more specific requirements of the proposed amendments. Initially this would require the institutions to: (i) designate an employee or employees as coordinator for the information security program; (ii) identify in writing reasonably foreseeable security risks that could result in the unauthorized or compromise of personal information or personal information systems; (iii) review existing or design new safeguards to control these risks; (iv) train staff to implement the safeguards; and (v) test the effectiveness of the safeguards' key controls, including access controls, controls to detect, prevent and respond to incidents of unauthorized access to or use of personal information. Second, an institution also would be required to review its service providers' information safeguards and determine whether its service providers are capable of maintaining appropriate safeguards for personal information, document this finding, and enter into contracts with the service providers to implement and maintain appropriate safeguards.

Third, an institution would be required to review existing safeguarding procedures relating to data security breach incidents. Initially, this could include: (i) assessing current policies and procedures for responding to data breach incidents; and (ii) designing and implementing written policies and procedures to assess, control, and investigate incidents of unauthorized access or use of sensitive personal information, as well as policies and procedures to notify individuals and the Commission or a broker-dealer's designated examining authority, if necessary.

Fourth, to comply with these amendments on an ongoing basis, institutions would be required to: (i) regularly test or monitor, and maintain a written record of the effectiveness of their safeguards' key controls, systems and procedures (including an assessment of personal information system access controls, controls designed to detect, prevent and respond to data security breach incidents, and controls related to employee training or supervision); (ii) train staff to implement their information security program; (iii) continue and document their oversight of service providers; and (iv) evaluate and adjust their information security programs in light of testing and monitoring, and changes in technology, business operations or arrangements, and other material circumstances.

Finally, an institution would be required to begin to respond to any data security breach incidents as may occur on an ongoing basis. This would include implementing and following written procedures to: (i) assess the nature and scope of the incident; (ii) take appropriate steps to contain and control it, and document those steps in writing; (iii) promptly conduct a reasonable investigation and make a written determination of the likelihood that sensitive personal information had been or would be misused; (iv) if misuse of information had occurred or were reasonably likely, notify affected individuals; and (v) if an individual identified with the information had suffered substantial harm or inconvenience, or any unauthorized person had intentionally obtained access to or used sensitive personal information, notify the Commission, or the appropriate designated examining authority as soon as possible on proposed Form SP-30.

We expect these estimated costs would vary significantly depending on the size of the institution, the adequacy of its existing safeguarding policies and procedures, and the nature of the institution's operations. The "reasonably designed" standard for information security programs in the proposed rule amendments is consistent with the current safeguards and disposal

rules. Thus, we believe it should be relatively straightforward for an institution that does not currently have policies and procedures that apply to specific elements of the proposed amendments to incorporate these elements into its current system of safeguarding policies and procedures. In addition, we estimate that little or no modification to an institution's safeguarding policies and procedures would be required in situations where a covered institution's affiliate developed its existing safeguarding policies and procedures in compliance with the Banking Agencies' safeguarding guidance or the FTC's rules.

In addition to an institution's size, the adequacy of its safeguards, and its operations, we expect that institutions' information security programs would vary considerably depending on the way in which each collects information, the number and types of entities to which each transfers information, and the ways in which each stores, transfers, and disposes of personal information. Based on conversations with representatives of covered institutions and information collected from limited inquiries of institutions, our staff estimates that the additional initial costs that an institution could incur to comply with the proposed amendments could range from 0 to 10 percent of its current costs of maintaining an information security program. Our staff also estimates that the additional costs an institution could incur for ongoing compliance with the proposed amendments could range from 0 to 5 percent of its current costs.[158] For purposes of the PRA, staff estimates that for a smaller institution, the initial costs could range from between $500 and $100,000, with an approximate cost of $18,560 per smaller institution.[159]

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158 While we estimate that additional initial and ongoing costs would vary significantly across wide ranges, we estimate that the average cost per institution would be concentrated in the lower end of those ranges because, as noted, we believe that most institutions have already developed and adopted safeguarding and disposal polices and procedures, and are maintaining these policies and procedures, in accordance (or substantially in accordance) with the proposed rule amendments.

159 See supra note 112 and accompanying text.

Staff also estimates that for a smaller institution, additional ongoing costs could range from between $250 and $50,000, with an approximate cost of $10,764 per smaller institution per year.[160] With respect to a larger institution, again for purposes of the PRA, staff estimates that initial costs could range from between $20,000 and $1 million, with an approximate cost of $172,732 per larger institution.[161] Staff further estimates that for a larger institution, additional ongoing costs could range from between $10,000 and $500,000 per year, with an approximate cost of $51,084 per larger institution per year.[162] We note that an institution that currently incurs the highest estimated costs for its information security program seems likely already to have a comprehensive information security program and therefore would be less likely to require program enhancements to comply with the rule. Accordingly, the high end of the range of estimated costs for institutions may be excessive.

We request comment on our estimated costs and our rationale underlying them, and any aspect of the estimates or other costs that we have not considered. We seek information about particular costs of compliance as well as information as to any overall percentage increase in costs that firms would likely incur as a result of the proposed amendments. We request comment accompanied with statistical or other quantitative information, and comment on the experiences of institutions in addressing the circumstances addressed above. Commenters should identify the metrics of any empirical data that support their cost estimates.

B. Costs and Benefits of Broadened Scope of Information and of Covered Institutions

The proposed rule amendments would broaden the scope of information covered by the

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160 See supra note 116 and accompanying text.

161 See supra note 114 and accompanying text.

162 See supra note 119 and accompanying text.

safeguards and disposal rules. From the perspective of ease of compliance, we anticipate that institutions would benefit from having a common set of rules that apply to both nonpublic personal information about customers and consumer report information. We also expect that investors would benefit from expanding the scope of information covered by the safeguards and disposal rules because both terms exclude some information that without protections could more easily be used to obtain unauthorized access to investors' personal financial information. Because we expect that this expansion of the scope of information covered by the safeguards and disposal rules would not require modification of institutions' current policies and procedures, or their systems and databases for implementing these policies and procedures, and because many firms currently protect nonpublic personal information about customers and consumer report information in the same way, we expect that the proposal would result in no significant, if any, additional costs to institutions.

The amendments also would expand the scope of the safeguards rule to include registered transfer agents, limit the scope of the safeguards rule to exclude notice-registered broker-dealers, and extend the disposal rule to apply to natural persons. As noted above, bringing registered transfer agents within the scope of our safeguards rule should benefit investors because these institutions maintain sensitive personal information. We included registered transfer agents in our estimate of the costs of the proposed information security and security breach procedures above.[163] Because transfer agents are currently subject to the FTC Safeguards Rule, which, if the proposed amendments were adopted, would be substantially similar to the Commission's safeguards and disposal rules, we do not anticipate that there would be any unique or unusual costs to transfer agents, beyond those discussed above. Similarly, we do not anticipate any costs

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163 See supra section V.A.2.

or benefits resulting from the proposal to exclude notice-registered broker-dealers from Regulation S-P because they would be subject to the CFTC's substantially similar safeguards rules. This proposal would simply clarify that notice-registered broker-dealers need not comply with both Regulation S-P and the CFTC's rules.

We expect that the proposal to include natural persons within the scope of the disposal rule would benefit investors by establishing a system designed to ensure that personal information is disposed of properly by employees, particularly those who may work in branches far from a covered institution's main office. We also believe that this proposal would benefit investors by requiring compliance by natural persons, associated with a covered institution, who are directly responsible for properly disposing of personal information consistent with the institution's policies. We do not expect that this proposal would result in costs to institutions beyond those that would be imposed by the more specific standards analyzed above in section V.A.2. Specifically, we believe that any changes that would be required to covered institutions' policies and procedures or training programs to make it clear that individuals (not just firms) would have responsibility for complying with the disposal rule are captured in our estimates above.

We request comment on these estimates of benefits and costs and our rationale underlying them, and any aspect of the estimates or other benefits or costs that we have not considered. In particular, we request comment accompanied with statistical or other quantitative evidence, and comment on the experiences of institutions in addressing the circumstances addressed above. Commenters should identify the metrics and sources of any empirical data that support their cost estimates.

C. Costs and Benefits of Maintaining Written Records

The proposed amendments would require covered institutions to maintain and preserve,

in an easily accessible place, written records of the safeguards and disposal policies and procedures. The amendments also would require that institutions document compliance with their policies and procedures, and that records would have to be maintained for a period consistent with current requirements for similar records. We expect that this proposal would benefit investors by enabling the Commission's examination staff to evaluate whether that institutions are in compliance with the requirements of the proposed amendments to the safeguards and disposal rules. We anticipate that institutions are unlikely to incur significant costs in maintaining records or documenting compliance to meet the requirements of this proposal because we would expect to establish a date for compliance with these amendments that would permit institutions to document and maintain these records in the normal course of ordinary business. Thus, we do not expect that this proposal would result in costs to institutions beyond those that would be imposed by the more specific standards analyzed above in section V.A.2.

We request comment on these estimates of benefits and costs and our rationale underlying them, and any aspect of the estimates or other benefits or costs that we have not considered. In particular, we request comment accompanied with statistical or other quantitative evidence, and comment on the experiences of institutions in addressing the circumstances addressed above. Commenters should identify the metrics and sources of any empirical data that support their cost estimates.

D. Costs and Benefits of Proposed New Exception

Our proposed amendments would create a new exception from Regulation S-P's notice and opt out requirements for disclosures of limited information in connection with the departure of a representative of a broker-dealer or investment adviser. The proposal should enhance information security by providing a clear framework for transferring limited information from

one firm to another in this context. At firms that choose to rely on it, the proposed exception also should reduce potential incentives some representatives may have to take information with them secretly when they leave. In addition, the amendment should promote investor choice regarding whether to follow a departing representative to another firm. Institutions that choose to rely on the proposed exception also should benefit from the greater legal certainty that it would provide. We expect that institutions would incur minimal costs in retaining a written record of the information that would be disclosed in connection with a representative's departure, and expect that for a number of firms such costs are incurred already in the ordinary course of business.[164] Institutions need not provide these disclosures. Thus we anticipate that only those that expect the potential benefits from the disclosure would justify any associated costs would make the disclosures.

We request comment on this cost estimate and our rationale underlying it, and any aspect of the estimates or other costs that we have not considered. In particular, we request comment accompanied with statistical or other quantitative evidence, and the experiences of institutions in addressing the circumstances addressed above. Commenters should identify the metrics and sources of any empirical data that support their cost estimates.

E. Request for comment

We request comment on all aspects of this cost-benefit analysis, including comment as to whether the estimates we have used in our analysis are reasonable. We welcome comment on any aspect of our analysis, the estimates we have made, and the assumptions we have described. In particular, we request comment as to any costs or benefits we may not have considered here that could result from the adoption of the proposed amendments. We also request comment on

[164] See supra note 91 and accompanying text.

the numerical estimates we have made here, and request comment and specific costs and benefits from covered institutions that have experienced any of the situations analyzed above.

VI. INITIAL REGULATORY FLEXIBILITY ANALYSIS

This Initial Regulatory Flexibility Analysis ("IRFA") has been prepared in accordance with 5 U.S.C. 603. It relates to proposed amendments to Regulation S-P that seek to strengthen the protections for safeguarding and disposing of sensitive personal information and provide a limited exception to notice and opt out requirements intended to augment investors' ability to choose whether to follow personnel who move from one broker-dealer or registered investment adviser to another. The proposed amendments would: (i) require covered institutions to adopt more specific standards under the safeguards rule, including standards that would apply to security breach incidents; (ii) broaden the scope of information and the types of institutions and persons covered by the rules; and (iii) require covered institutions to maintain written records of the policies and procedures and their ongoing compliance with those polices and procedures. The proposed amendments also would require covered institutions seeking to rely on the new exception related to departing representatives to maintain a record of the information disclosed under the exception to a representative's new firm.

A. Reasons for the Proposed Action

We have become concerned with the significant increase in the number of information security breaches that have come to light in recent years and the potential created by such breaches for misuse of personal financial information, including identity theft. We are concerned that some firms do not regularly reevaluate and update their safeguarding programs to deal with increasingly sophisticated methods of attack. To help prevent and address security breaches at covered institutions, we propose to require more specific standards for safeguarding

personal information, including standards for responding to data security breaches. In order to provide better protection against unauthorized disclosure of personal financial information, we believe that the scope of information covered by the current safeguards and disposal rules should be broader.

We also propose a new exception to Regulation S-P's notice and opt out requirements to permit limited disclosures of investor information when a registered representative of a broker-dealer or a supervised person of an investment adviser moves from one brokerage or advisory firm to another. The proposed exception should provide legal certainty to firms that choose to rely on it and reduce incentives some representatives may have to take information with them secretly when they leave. We believe this amendment also would help to augment investors' ability to choose whether or not to follow a departing representative to another firm.

B. Objectives of the Proposed Action

The overall objectives of the proposed amendments are to: (i) strengthen the protections for safeguarding and disposing of sensitive personal information; and (ii) provide a limited exception to Regulation S-P's notice and opt out requirements that would preserve investors' ability to choose whether to follow personnel who move from one broker-dealer or investment adviser to another. We believe that the proposed amendments would help to:

- Prevent and mitigate information security breach incidents;
- Ensure that sensitive financial information is not disposed of improperly;
- Ensure that firms regularly review and update their safeguarding policies and procedures;

- Ensure that the full range of appropriate information and all relevant types of institutions regulated by the Commission are covered by Regulation S-P's requirements; and
- Enhance information security at firms choosing to rely on a new exemption for disclosures of limited information when representatives move from one firm to another by providing a clear framework for such disclosures and promote investor choice regarding whether or not to follow a departing representative to another firm.

C. Legal Basis

The amendments to Regulation S-P are proposed pursuant to the authority set forth in Sections 501, 504, 505 and 525 of the GLBA, Section 628(a)(1) of the FCRA, Sections 17, 17A, 23, and 36 of the Exchange Act, Sections 31(a) and 38 of the Investment Company Act, and Sections 204 and 211 of the Investment Advisers Act.[165]

D. Small Entities Subject to the Proposed Rule Amendments

The proposed amendments to Regulation S-P would affect brokers, dealers, registered investment advisers, investment companies, and registered transfer agents, including entities that are considered to be a small business or small organization (collectively, "small entity") for purposes of the Regulatory Flexibility Act. For purposes of the Regulatory Flexibility Act, under the Exchange Act a broker or dealer is a small entity if it: (i) had total capital of less than $500,000 on the date in its prior fiscal year as of which its audited financial statements were prepared or, if not required to file audited financial statements, on the last business day of its

[165] 15 U.S.C. 6801, 6804, 6805 and 6825; 15 U.S.C. 1681w(a)(1); 15 U.S.C. 78q, 78q-1, 78w, and 78mm; 15 U.S.C. 80a-30(a), 80a-37; and 15 U.S.C. 80b-4, 80b-11.

prior fiscal year; and (ii) is not affiliated with any person that is not a small entity.[166] A registered transfer agent is a small entity if it: (i) received less than 500 items for transfer and less than 500 items for processing during the preceding six months; (ii) transferred items only of issuers that are small entities; (iii) 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; and (iv) is not affiliated with any person that is not a small entity.[167] Under the Investment Company Act, investment companies are considered small entities if they, together with other funds in the same group of related funds, have net assets of $50 million or less as of the end of its most recent fiscal year.[168] Under the Investment Advisers Act, a small entity is an investment adviser that: (i) manages less than $25 million in assets; (ii) has total assets of less than $5 million on the last day of its most recent fiscal year; and (iii) does not control, is not controlled by, and is not under common control with another investment adviser that manages $25 million or more in assets, or any person that has had total assets of $5 million or more on the last day of the most recent fiscal year.[169]

Based on Commission filings, we estimate that 894 broker-dealers, 153 registered transfer agents, 203 investment companies, and 760 registered investment advisers may be considered small entities.

E. Reporting, Recordkeeping, and Other Compliance Requirements

The proposed amendments to Regulation S-P would require more specific compliance

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166 17 CFR 240.0-10.

167 Id.

168 17 CFR 270.0-10.

169 17 CFR 275.0-7.

requirements and create new reporting requirements for institutions that experience a breach of information security. The proposed amendments also would introduce new mandatory recordkeeping requirements.

Under the proposed amendments to Regulation S-P, covered institutions would have to develop, implement, and maintain a comprehensive "information security program" for protecting personal information and responding to unauthorized access to or use of personal information. We expect that some covered institutions, including covered institutions that are small entities, would be required to supplement their current costs by the costs involved in reviewing and, as appropriate, revising their current safeguarding policies and procedures, including their data security breach response procedures and disposal rule procedures, to comply with the more specific requirements of the proposed amendments. Initially this would require institutions to: (i) designate an employee or employees as coordinator for their information security program; (ii) identify in writing reasonably foreseeable security risks that could result in the unauthorized or compromise of personal information or personal information systems; (iii) create a written record of their design and implementation of their safeguards to control identified risks; (iv) train staff to implement their information security program; and (v) oversee service providers and document that oversight in writing.

Institutions also would have to review existing safeguarding procedures relating to data security breach incidents. This would include: (i) assessing current policies and procedures for responding to data breach incidents; and (ii) designing and implementing written policies and procedures to assess, control, and investigate incidents of unauthorized access or use of sensitive personal information, as well as policies and procedures for, under certain conditions, notifying individuals and the Commission or, in the case of a broker-dealer, the appropriate designated

examining authority.

To comply with these amendments on an ongoing basis, institutions would have to implement procedures to: (i) regularly test or monitor, and maintain a written record of the effectiveness of their safeguards' key controls, systems and procedures (including access controls, controls related to data security breach incidents, and controls related to employee training and supervision); (ii) augment staff training as necessary; (iii) provide continued oversight of service providers; and (iv) regularly evaluate and adjust their information security program in light of their regular testing and monitoring, changes in technology, their business operations or arrangements, and other material circumstances.

Institutions also would have to respond appropriately to incidents of data security breach as may occur on an ongoing basis. This would include following their written procedures to: (i) assess the nature and scope of the incident; (ii) take appropriate steps to contain and control the incident; (iii) promptly conduct a reasonable investigation and make a written determination of the likelihood that sensitive personal information has been or will be misused; (iv) if misuse of information has occurred or is reasonably likely, notify affected individuals as soon as possible; and (v) if an individual identified with the information has suffered substantial harm or inconvenience, or any unauthorized person has intentionally obtained access to or used sensitive personal information, notify the Commission or an appropriate designated examining authority as soon as possible on proposed Form SP-30.

Overall, we expect there would be incremental costs associated with the proposed amendments to Regulation S-P. Some proportion of large or small institutions would be likely to experience some increase in costs to comply with the proposed amendments if they are adopted.

More specifically, we estimate that with respect to the more specific safeguarding

elements, covered institutions would incur one-time costs that could include the costs of assessment and revision of safeguarding standards, staff training, and reviewing and entering into contracts with service providers.[170] We also estimate that the ongoing, long-term costs associated with the proposed amendments could include costs of regularly testing or monitoring the safeguards, augmenting staff training, providing continued oversight of service providers, evaluating and adjusting safeguards, and responding appropriately to incidents of data security breach.[171]

We encourage written comments regarding this analysis. We solicit comments as to whether the proposed amendments could have an effect that we have not considered. We also request that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of the impact.

F. Duplicative, Overlapping, or Conflicting Federal Rules

As discussed above, the proposed amendments would impose requirements that covered institutions maintain and document a written information security program. The proposed amendments also would require reporting to individuals and appropriate regulators after certain serious data breach incidents. Covered institutions are subject to requirements elsewhere under the federal securities laws and rules of the self-regulatory organizations that require them to adopt written policies and procedures that may relate to some similar issues.[172] The proposed

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170 See supra section IV.A.3.

171 Id.

172 See, e.g., 15 U.S.C. 80b-4a (requiring each adviser registered with the Commission to have written policies and procedures reasonably designed to prevent misuse of material non-public information by the adviser or persons associated with the adviser); and NASD Rule 3010 (requiring each broker-dealer to establish and maintain written procedures to supervise the types of business it is engaged in and to supervise the activities of registered representatives and associated persons, which could include registered investment advisers).

amendments to Regulation S-P, however, would not require covered institutions to maintain duplicate copies of records covered by the rule, and an institution's information security program would not have to be maintained in a single location. Moreover, although the proposed amendments would require covered institutions to keep certain records that may be required under existing recordkeeping rules, the purposes of the requirements are different, and institutions need not maintain duplicates of the records themselves.[173] We believe, therefore, that any duplication of regulatory requirements would be limited and would not impose significant additional costs on covered institutions including small entities. We believe there are no other federal rules that duplicate, overlap, or conflict with the proposed reporting requirements.

G. Significant Alternatives

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 proposed amendments, we considered the following alternatives:

(i) establishing different compliance or reporting standards that take into account the resources available to small entities;

(ii) the clarification, consolidation, or simplification of the reporting and compliance requirements under the rule for small entities;

(iii) use of performance rather than design standards; and

(iv) exempting small entities from coverage of the rule, or any part of the rule.

With regard to the first alternative, we have proposed amendments to Regulation S-P that

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173 See, e.g., 17 CFR 240.17a-3 (requiring broker-dealers to make and keep, among other things, blotters or other records of original entry, securities position records, and order tickets) and 17 CFR 270.31a-1(b)(11) (requiring investment companies to maintain, among other things, minute books of directors' meetings and "files of all advisory material received from the investment adviser").

would continue to permit institutions substantial flexibility to design safeguarding policies and procedures appropriate for their size and complexity, the nature and scope of their activities, and the sensitivity of the personal information at issue. We nevertheless believe it necessary to provide a more specific framework of elements that every institution should consider and address, regardless of its size. The proposed amendments to Regulation S-P arise from our concern with the increasing number of information security breaches that have come to light in recent years, particularly those involving institutions regulated by the Commission. Establishing different compliance or reporting requirements for small entities could lead to less favorable protections for these entities' customers and compromise the effectiveness of the proposed amendments.

With regard to the second alternative, we believe that the proposed amendments should, by their operation, simplify reporting and compliance requirements for small entities. Small covered institutions are likely to maintain personal information on fewer individuals than large covered institutions, and they are likely to have relatively simple personal information systems. Under proposed paragraph (a)(1) of Section 30, the information security programs that would be required by the proposed amendments would have to be appropriate to a covered institution's size and complexity, and the nature and scope of its activities. Accordingly, we believe that the requirements of the proposed amendment already would be simplified for small entities. We also believe that the requirements of the proposed amendments could not be further simplified, or clarified or consolidated, without compromising the investor protection objectives the proposed amendments are designed to achieve.

With regard to the third alternative, the proposed amendments are for the most part performance based. Rather than specifying the types of policies and procedures or the

technologies that an institution would be required to use to safeguard personal information, the proposed amendments would require the institution to assess the types of risks that it is likely to face and to address those in the manner the institution believes most appropriate. With respect to the specific requirements regarding notifications in the event of a data security breach, we have proposed that institutions provide only the information that seems most relevant for the Commission, a self-regulatory organization, or a consumer to know in order to adequately assess the potential damage that could result from the breach and to develop an appropriate response.

Finally, with regard to alternative four, we believe that an exemption for small entities would not be appropriate. Small entities are as vulnerable as large ones to the types of data security breach incidents we are trying to address. We believe that the specific elements we have proposed must be considered and incorporated into the policies and procedures of all covered institutions, regardless of their size, to mitigate the potential for fraud or other substantial harm or inconvenience to investors. Exempting small entities from coverage of the proposed amendments or any part of the proposed amendments could compromise the effectiveness of the proposed amendments and harm investors by lowering standards for safeguarding investor information maintained by small covered institutions. Excluding small entities from requirements that would be applicable to larger covered institutions also could create competitive disparities between large and small entities, for example by undermining investor confidence in the security of information maintained by small covered institutions.

We request comment on whether it is feasible or necessary for small entities to have special requirements or timetables for, or exemptions from, compliance with the proposed amendments. In particular, could any of the proposed amendments be altered in order to ease the regulatory burden on small entities, without sacrificing the effectiveness of the proposed

amendments?

H. Request for Comments

We encourage the submission of comments with respect to any aspect of this IRFA. In particular, we request comments regarding: (i) the number of small entities that may be affected by the proposed amendments; (ii) the existence or nature of the potential impact of the proposed amendments on small entities discussed in the analysis; and (iii) how to quantify the impact of the proposed amendments. Commenters 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 amendments are adopted, and will be placed in the same public file as comments on the proposed amendments. Comments should be submitted to the Commission at the addresses previously indicated.

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

Exchange Act Section 23(a)(2) requires us, when adopting rules under the Exchange Act, to consider the impact any new rule would have on competition.[174] 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 Title I of the Exchange Act. The proposed amendments to Regulation S-P would: (i) require more specific standards under the safeguards rule, including standards that would apply to data security breach incidents; (ii) broaden the scope of information and the types of institutions and persons covered by the safeguards and disposal rules; and (iii) require covered institutions to maintain written records of their policies and procedures and their compliance with those policies and procedures. The proposed

[174] 15 U.S.C. 78w(a)(2).

amendments also would create a new exception from Regulation S-P's notice and opt-out requirements for firms to transfer limited investor information regarding clients of departing representatives to those representatives' new firms.

Other financial institutions are currently subject to substantially similar safeguarding and data breach response requirements under rules adopted by the Banking Agencies and the FTC. Under the proposed amendments, all financial institutions would have to bear similar costs in implementing substantially similar rules thus enhancing competition. We expect that the proposed amendment to create the new exception for firms to transfer limited investor information regarding clients of departing representatives to those representatives' new firms would not limit and might promote competition in the securities industry by providing legal certainty for firms that choose to rely on it and by facilitating the transition for customers who choose to follow a departing representative to a new firm.

In addition, Exchange Act Section 3(f), Investment Company Act Section 2(c), and Investment Advisers Act Section 202(c) 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.[175] Our analysis on competition is discussed above. As discussed above, the proposed amendments could result in additional costs for covered institutions, which could affect the efficiency of these institutions. On the other hand, the amendments could promote investor confidence and bring new investors to these institutions. In the long term, the proposed amendments also could help reduce covered institutions' costs by mitigating the frequency and consequences of information security breaches. We do not believe

[175] 15 U.S.C. 78c(f); 15 U.S.C. 80a-2(c); and 15 U.S.C. 80b-2(c).

the proposed amendments would have a significant effect on capital formation, although if the proposals lead to better information security practices at covered institutions, potential investors could feel more comfortable investing money in the capital markets. As a result, we expect that the potential additional expense of compliance with these proposed rule amendments would have little, if any, adverse effect on efficiency, competition, and capital formation.

We request comment as to whether our estimates of the burdens the proposed amendments would have on covered institutions are reasonable. We welcome comment on any aspect of this analysis, and specifically request comment on any effect the proposed amendments might have on the promotion of efficiency, competition, and capital formation that we have not considered. Would the proposed amendments or their resulting costs affect the efficiency, competition, and capital formation of covered institutions and their businesses? Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

VIII. SMALL BUSINESS REGULATORY ENFORCEMENT FAIRNESS ACT

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"[176] we must advise OMB as to whether the proposed regulation constitutes a "major" rule. Under SBREFA, a rule is considered "major" if, upon adoption, 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

[176] Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of titles 5 and 15 of the United States Code, and as a note to 5 U.S.C. 601).

- 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 regulation 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. STATUTORY AUTHORITY

The Commission is proposing to amend Regulation S-P pursuant to authority set forth in Sections 501, 504, 505 and 525 of the GLBA (15 U.S.C. 6801, 6804, 6805 and 6825), Section 628(a)(1) of the FCRA (15 U.S.C. 1681w(a)(1)), Sections 17, 17A, 23, and 36 of the Exchange Act (15 U.S.C. 78q, 78q-1, 78w, and 78mm), Sections 31(a) and 38 of the Investment Company Act (15 U.S.C. 80a-30(a) and 80a-37), and Sections 204 and 211 of the Investment Advisers Act (15 U.S.C. 80b-4 and 80b-11).

X. TEXT OF PROPOSED RULES AND RULE AMENDMENTS

List of Subjects in 17 CFR Part 248

Brokers, Dealers, Investment advisers, Investment companies, Privacy, Reporting and recordkeeping requirements, Transfer agents.

For the reasons set out in the preamble, the Commission proposes to amend 17 CFR part 248 as follows.

1. Revise the heading of part 248 to read as follows:

Part 248 – Regulation S-P: Privacy of Consumer Financial Information and Safeguarding Personal Information

2. Revise the authority citation for part 248 to read as follows: 15 U.S.C. 78q, 78q-1, 78w, 78mm, 80a-30(a), 80a-37, 80b-4, 80b-11, 1681w(a)(1), 6801-6809, and 6825.

3. Section 248.1(b) is amended by removing "(b)" from the reference to

"§ 248.30(b)" in the first sentence of the paragraph.

4. Section 248.2(b) is amended by removing "(b)" from the reference to "§ 248.30(b)" in the first sentence.

5. Section 248.3(u) is amended by:

a. Removing the period at the end of paragraph (u)(1)(iii) and in its place adding "; or";

b. Removing "or" at the end of paragraph (u)(1)(ii);

c. removing the period at the end of paragraph (u)(1)(iii) and in its place adding "; or"; and

d. adding paragraph (u)(1)(iv) to read as follows: "(iv) Handled or maintained by you or on your behalf that is identified with any consumer, or with any employee, investor, or securityholder who is a natural person."

6. Remove the heading of subpart A of part 248 and add in its place the following undesignated center heading: "Privacy and Opt Out Notices".

7. Remove the heading of subpart B of part 248 and add in its place the following undesignated center heading: "Limits on Disclosures".

8. Remove the heading of subpart C of part 248 and add in its place the following undesignated center heading: "Exceptions".

9. Section 248.15 is amended by:

a. Removing the word "or" at the end of paragraph (a)(6);

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

c. Adding paragraph (a)(8).

The addition reads as follows:

§ 248.15 Other exceptions to notice and opt out requirements.

(a) * * *

(8) To a broker, dealer, or investment adviser registered with the Commission in order to allow one of your representatives who leaves you to become the representative of another broker, dealer, or registered investment adviser to solicit customers to whom the representative personally provided a financial product or service on your behalf, provided:

(i) The information is limited to a customer's name, a general description of the type of account and products held by the customer, and the customer's contact information, including the customer's address, telephone number, and email information;

(ii) The information does not include any customer's account number, Social Security number, or securities positions; and

(iii) You require your departing representative to provide to you, not later than the representative's separation from employment with you, a written record of the information that will be disclosed pursuant to this exception, and you maintain and preserve such records under § 248.30(c).

(iv) For purposes of this section, representative means:

(A) A natural person associated with a broker or dealer registered with the Commission, who is registered or approved in compliance with § 240.15b7-1 of this chapter; or

(B) A supervised person of an investment adviser as defined in § 202(a)(25) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(25)).

10. Remove the heading of subpart D of part 248 and add in its place the following undesignated center heading: "Relation to Other Laws; Effective Date".

11. Amend part 248 by adding the undesignated center heading, "Information

Security Programs" before § 248.30, and revising § 248.30 to read as follows:

§ 248.30 Information security programs for personal information; records of compliance.

(a) Information security programs.

(1) General requirements. Every broker or dealer other than a notice-registered broker or dealer, every investment company, and every investment adviser or transfer agent registered with the Commission, must develop, implement, and maintain a comprehensive information security program. Your program must include written policies and procedures that provide administrative, technical, and physical safeguards for protecting personal information, and for responding to unauthorized access to or use of personal information. Your program also must be appropriate to your size and complexity, the nature and scope of your activities, and the sensitivity of any personal information at issue.

(2) Objectives. Your information security program must be reasonably designed to:

(i) Ensure the security and confidentiality of personal information;

(ii) Protect against any anticipated threats or hazards to the security or integrity of personal information; and

(iii) Protect against unauthorized access to or use of personal information that could result in substantial harm or inconvenience to any consumer, employee, investor or securityholder who is a natural person.

(3) Safeguards. In order to develop, implement, and maintain your information security program, you must:

(i) Designate in writing an employee or employees to coordinate your information security program;

(ii) Identify in writing reasonably foreseeable internal and external risks to the security, confidentiality, and integrity of personal information and personal information systems

that could result in the unauthorized disclosure, misuse, alteration, destruction or other compromise of such information or systems;

(iii) Design and implement safeguards to control the risks you identify, and maintain a written record of your design;

(iv) Regularly test or otherwise monitor, and maintain a written record of the effectiveness of the safeguards' key controls, systems, and procedures, including the effectiveness of:

(A) Access controls on personal information systems;

(B) Controls to detect, prevent and respond to incidents of unauthorized access to or use of personal information; and

(C) Employee training and supervision relating to your information security program.

(v) Train staff to implement your information security program;

(vi) Oversee service providers, and document in writing that in your oversight you are:

(A) Taking reasonable steps to select and retain service providers that are capable of maintaining appropriate safeguards for the personal information at issue; and

(B) Requiring your service providers by contract to implement and maintain appropriate safeguards; and

(vii) Evaluate and adjust your information security program accordingly in light of:

(A) The results of the testing and monitoring required by paragraph (a)(3)(iv) of this section;

(B) Relevant changes in technology;

(C) Any material changes to your operations or business arrangements; and

(D) Any other circumstances that you know or reasonably believe may have a material impact on your information security program.

(4) Procedures for responding to unauthorized access or use. At a minimum, your information security program must include written procedures to:

(i) Assess the nature and scope of any incident involving unauthorized access to or use of personal information, and maintain a written record of the personal information systems and types of personal information that may have been accessed or misused;

(ii) Take appropriate steps to contain and control the incident to prevent further unauthorized access to or use of personal information and maintain a written record of the steps you take;

(iii) After becoming aware of an incident of unauthorized access to sensitive personal information, promptly conduct a reasonable investigation, determine the likelihood that the information has been or will be misused, and maintain a written record of your determination;

(iv) If you determine that misuse of the information has occurred or is reasonably possible, notify each individual with whom the information is identified as soon as possible in accordance with paragraph (a)(5) of this section and maintain a written record that you provided notification; provided however that if an appropriate law enforcement agency determines that notification will interfere with a criminal investigation and requests in writing that you delay notification, you may delay notification until it no longer interferes with the criminal investigation; and

(v) If you are a broker or dealer other than a notice-registered broker or dealer, provide written notice on Form SP-30 to your designated examining authority (see 17 CFR 240.17d-1), and, if you are an investment company or an investment adviser or transfer agent

registered with the Commission, provide written notice on Form SP-30 to the principal office of the Commission, as soon as possible after you become aware of any incident of unauthorized access to or use of personal information in which:

(A) There is a significant risk that an individual identified with the information might suffer substantial harm or inconvenience; or

(B) An unauthorized person has intentionally obtained access to or used sensitive personal information.

(5) Notifying individuals of unauthorized access or use. If you determine that an unauthorized person has obtained access to or used sensitive personal information, and you determine that misuse of the information has occurred or is reasonably possible, you must notify each individual with whom the information is identified in a clear and conspicuous manner and by a means designed to ensure that the individual can reasonably be expected to receive it. The notice must:

(i) Describe in general terms the incident and the type of sensitive personal information that was the subject of unauthorized access or use;

(ii) Describe what you have done to protect the individual's information from further unauthorized access or use;

(iii) Include a toll-free telephone number to call, or if you do not have any toll-free number, include a telephone number to call and the address and the name of a specific office to write for further information and assistance;

(iv) If the individual has an account with you, recommend that the individual review account statements and immediately report any suspicious activity to you; and

(v) Include information about the availability of online guidance from the FTC

regarding steps an individual can take to protect against identity theft, a statement encouraging the individual to report any incidents of identity theft to the FTC, and the FTC's website address and toll-free telephone number that individuals may use to obtain the identity theft guidance and report suspected incidents of identity theft.

(b) Disposal of personal information.

(1) Standard. Every broker or dealer other than a notice-registered broker or dealer, every investment company, every investment adviser or transfer agent registered with the Commission, and every natural person who is an associated person of a broker or dealer, a supervised person of an investment adviser registered with the Commission, or an associated person of a transfer agent registered with the Commission, that maintains or otherwise possesses personal information for a business purpose must properly dispose of the information by taking reasonable measures to protect against unauthorized access to or use of the information in connection with its disposal.

(2) Written policies, procedures and records. Every broker or dealer, other than a notice-registered broker or dealer, every investment company, and every investment adviser and transfer agent registered with the Commission must:

(i) Adopt written policies and procedures that address the proper disposal of personal information according to the requirements of paragraph (b)(1) of this section; and

(ii) Document in writing its proper disposal of personal information in compliance with paragraph (b)(1).

(3) Relation to other laws. Nothing in this paragraph (b) shall be construed:

(i) To require any broker, dealer, investment company, investment adviser, transfer agent, associated person of a broker or dealer, supervised person of an investment adviser, or

associated person of a transfer agent, to maintain or destroy any record pertaining to an individual that is not imposed under other law; or

(ii) To alter or affect any requirement imposed under any other provision of law to maintain or destroy records.

(c) Recordkeeping.

(1) Every broker or dealer other than a notice-registered broker or dealer, every investment company, and every investment adviser or transfer agent registered with the Commission, must make and maintain the records and written policies and procedures required under paragraphs (a) and (b)(2) of this section. Every broker or dealer other than a notice-registered broker or dealer, and every investment adviser registered with the Commission seeking to rely on the exception in § 248.15(a)(8) must make and maintain the records required by § 248.15(a)(8)(iii).

(2) Starting from when the record was made, or from when the written policy or procedure was last modified, the records and written policies and procedures required under paragraphs (a) and (b)(2) of this section, and the records made pursuant to § 248.15(a)(8)(iii), must be preserved in accordance with:

(i) 17 CFR 240.17a-4(b) by a broker or dealer other than a notice-registered broker or dealer;

(ii) 240.17Ad-7(b) by a transfer agent registered with the Commission;

(iii) 270.31a-2(a)(4)-(6) by an investment company; and

(iv) 275.204-2(e)(1) by an investment adviser registered with the Commission.

(d) Definitions. As used in this § 248.30, unless the context otherwise requires:

(1) Associated person of a broker or dealer has the same meaning as in section

3(a)(18) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(18)).

(2) Associated person of a transfer agent has the same meaning as in section 3(a)(49) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(49)).

(3) Consumer report has the same meaning as in section 603(d) of the Fair Credit Reporting Act (15 U.S.C. 1681a(d)).

(4) Consumer report information means any record about an individual, whether in paper, electronic or other form, that is a consumer report or is derived from a consumer report. Consumer report information also means a compilation of such records. Consumer report information does not include information that does not identify individuals, such as aggregate information or blind data.

(5) Disposal means:

(i) The discarding or abandonment of personal information; or

(ii) The sale, donation, or transfer of any medium, including computer equipment, on which personal information is stored.

(6) Information security program means the administrative, technical, or physical safeguards you use to access, collect, distribute, process, protect, store, use, transmit, dispose of, or otherwise handle personal information.

(7) Notice-registered broker or dealer means a broker or dealer registered by notice with the Commission under section 15(b)(11) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(b)(11)).

(8) Personal information means any record containing consumer report information, or nonpublic personal information as defined in § 248.3(t), that is identified with any consumer, or with any employee, investor, or securityholder who is a natural person, whether in paper,

electronic, or other form, that is handled or maintained by you or on your behalf.

(9) Personal information system means any method used to access, collect, store, use, transmit, protect, or dispose of personal information.

(10) Sensitive personal information means personal information, or any combination of components of personal information, that would allow an unauthorized person to use, log into, or access an individual's account, or to establish a new account using the individual's identifying information, including the individual's:

(i) Social Security number; or

(ii) Name, telephone number, street address, e-mail address, or online user name, in combination with the individual's account number, credit or debit card number, driver's license number, credit card expiration date or security code, mother's maiden name, password, personal identification number, biometric record, or other authenticating information.

(11) Service provider means any person or entity that receives, maintains, processes, or otherwise is permitted access to personal information through its provision of services directly to a broker, dealer, investment company, or investment adviser or transfer agent registered with the Commission.

(12) (i) Substantial harm or inconvenience means personal injury, or more than trivial financial loss, expenditure of effort or loss of time, including theft, fraud, harassment, impersonation, intimidation, damaged reputation, impaired eligibility for credit, or the unauthorized use of information identified with an individual to obtain a financial product or service, or to access, log into, effect a transaction in, or otherwise use the individual's account.

(ii) Substantial harm or inconvenience does not include unintentional access to personal information by an unauthorized person that results only in trivial financial loss,

expenditure of effort or loss of time, such as if use of the information results only in your deciding to change the individual's account number or password.

(13) Supervised person of an investment adviser has the same meaning as in section 202(a)(25) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(25))

(14) Transfer agent has the same meaning as in section 3(a)(25) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(25)).

12. Redesignate Appendix A to part 248 as Appendix B to part 248, and revise its heading to read "Appendix B to Part 248 – Sample Clauses".

13. Add new Appendix A to part 248 to read as follows:

Appendix A to Part 248 – Forms

(1) Availability of Forms. Any person may obtain a copy of Form S-P or Form SP-30 prescribed for use in this part by written request to the Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549. Any person also may view the forms on the Commission Web site as follows:

(a) Form S-P at: [Web site URL];

(b) Form SP-30 at: [Web site URL].

(2) Form S-P. Use of Form S-P by brokers, dealers, and investment companies, and by investment advisers registered with the Commission, constitutes compliance with the notice content requirements of §§ 248.6 and 248.7.

(3) Form SP-30. Form SP-30 must be used pursuant to § 248.30(a)(4)(v) as the notice of an incident of unauthorized access to or use of personal information to be filed with the appropriate designated examining authority by brokers or dealers other than notice-registered brokers or dealers, and to be filed with the Commission by investment companies, and by investment advisers and transfer agents registered with the Commission.

14. Add Form SP-30 (referenced in paragraph (3) of Appendix A to part 248) to read as follows:

Note: The text of Form SP-30 does not, and this amendment will not, appear in the Code of Federal Regulations.

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington DC 20549

FORM SP-30

SECURITY INCIDENT REPORTING FORM

(Pursuant to § 248.30(a)(4)(v) of Regulation S-P (17 CFR 248.30(a)(4)(v)))

1. Provide identifying information (IARD/CRD number, CIK,* business name, principal business and mailing addresses, and telephone number).

* CIK stands for "Central Index Key," which is the unique number the Commission assigns to each entity that submits filings to it.

2. Provide contact employee (name, title, address, and telephone number).

3. Type of Institution:

   ___ Broker-Dealer

   ___ Investment Adviser

   ___ Investment Adviser/Broker-Dealer (Dual Registrant)

   ___ Investment Company

   ___ Transfer Agent

4. Describe the security incident (e.g., unauthorized use of your customers' online trading accounts, unauthorized use of your employee's password to access sensitive personal information maintained on one of your databases, or unauthorized access to your files on an investment company's shareholders):

   (a) Provide the date(s) of the incident;

   (b) List Registrant's offices, divisions or branches involved;

(c) Describe personal information system(s) compromised;

(d) Describe the incident and identify anyone you reasonably believe accessed or used personal information without authorization or compromised the personal information system(s).

5. Provide information on third-party service provider(s) involved:

   (a) Identify any third-party service provider involved;

   (b) Describe the services provided;

   (c) If the service provider is an affiliate, describe the affiliation;

   (d) Describe the involvement of the service provider(s) in the incident.

6. Describe steps taken or that you plan to take to assess the incident.

7. Provide the number of individuals whose information appears to have been compromised: __________

8. Describe steps you have taken or plan to take to prevent improper use of any personal information that was or may be compromised by the incident.

9. Do you intend to notify affected individuals?

   (a) If yes, when?

   (b) If no, why not?

10. Describe any steps you have taken or any plan to review your policies and procedures in light of this incident.

11. Describe Customer account losses (to the extent known)

   (a) Number of Customer Accounts Accessed: __________

   (b) Unauthorized Money Transfers

      (i) Initial Customer Losses from Actual or Attempted Unauthorized Transfers:

      $ __________

      (ii) Mitigation of Customer Losses from Firm's Efforts

(A) Surveillance / Investigative Intervention:

$ ________

(B) Recoveries from Receiving Parties:

$ ________

(C) Firm Compensation to Customers:

$ ________

(iii) Net Customer Losses:

$ ________

(c) Unauthorized Changes to Securities Portfolio (e.g., Pump and Dump Schemes)

(i) Initial Customer Losses from Actual or Attempted Unauthorized Trading

(A) Value of Accounts Before the Unauthorized Trading:

$ ________

(B) Value of Accounts After the Unauthorized Trading:

$ ________

(C) Initial Customer Losses / Gains:

$ ________

(ii) Did the firm return the affected customer accounts to their positions before the unauthorized trading?

Yes / No

(iii) Net Customer Losses / Gains:

$ ________

By the Commission.

Nancy M. Morris
Secretary

Dated: March 4, 2008

Chairman Cox
Not Participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 2713 / March 5, 2008

INVESTMENT COMPANY ACT OF 1940
Release No. 28185 / March 5, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12976

In the Matter of **FIDELITY MANAGEMENT & RESEARCH COMPANY and FMR CO., 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 Fidelity Management & Research Company ("FMR") and FMR Co., Inc. ("FMR Co.") (collectively "Respondents" or "Fidelity").

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 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

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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 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 as set forth below.

III.

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

A. RESPONDENTS

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

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

B. OTHER RELEVANT PARTIES[2]

3. **Scott E. DeSano**, age 47, lives in Boston, Massachusetts. He was associated with FMR Co. from 1991 to July 2005, and was its senior vice president in charge of global equity trading from 1996 until he was reassigned to an affiliate of FMR in July 2005. From at least January 2002 through October 2004, he supervised Fidelity's Boston domestic equity trading desk ("Equity Trading Desk") and other equity trading operations. In all, DeSano supervised more than

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

2 The persons identified by name below are respondents in other administrative and cease-and-desist proceedings instituted today. *See* In the Matter of Scott E. DeSano, Thomas H. Bruderman, Timothy J. Burnieika, Robert L. Burns, David K. Donovan, Edward S. Driscoll, Jeffrey D. Harris, Christopher J. Horan, Steven P. Pascucci, and Kirk C. Smith; In the Matter of Peter S. Lynch; In the Matter of Bart A. Grenier; and In the Matter of Marc C. Beran.

thirty equity traders.[3] He reported to a senior vice president of FMR Co. (Bart Grenier). He also appeared as a representative of Fidelity in public testimony before Congress, the Commission, and other regulatory bodies.

4. **Bart A. Grenier**, age 49, lives in Boston, Massachusetts. Aside from a four-month period in 1997, Grenier was associated with FMR Co. from 1991 until June 2005. During the Relevant Period,[4] he was a senior vice president of FMR Co. with supervisory responsibility for Fidelity's equity trading operations and several of its other business groups.

5. **Peter S. Lynch**, age 64, lives in Marblehead, Massachusetts. He has been associated with FMR and FMR Co. in various capacities since 1969, and was the portfolio manager of Fidelity's Magellan Fund from 1977 to 1990. Since retiring from Magellan, he has been the vice chairman and a director of FMR and FMR Co. He was an interested trustee of the Fidelity Funds from 1990 until February 2003, and has since served as a member of the Advisory Board of the Fidelity Funds.

6. **Marc C. Beran**, age 38, lives in Southborough, Massachusetts. He was a domestic equity trader at FMR Co. from 1997 until January 2005. During the Relevant Period, he was a sector trader specializing in energy and materials stocks.

7. **Thomas H. Bruderman**, age 39, lives in Boston, Massachusetts. He was a domestic equity trader at FMR Co. from 1998 until December 2004. During the Relevant Period, he was a sector trader specializing in healthcare and pharmaceuticals stocks.

8. **Timothy J. Burnieika**, age 38, lives in Cohasset, Massachusetts. He was a domestic equity trader at FMR Co. from 2000 until September 2005, when he was reassigned to other duties that do not involve trading. During the Relevant Period, he was a primary trader reporting to Steven Pascucci.

9. **Robert L. Burns**, age 46, lives in Brookline, Massachusetts. He was a domestic equity trader at FMR Co. from 1986 until December 2004. During the Relevant Period, he was a sector trader specializing in technology stocks and reporting to David Donovan.

10. **David K. Donovan**, age 45, lives in Marblehead, Massachusetts. He was a domestic equity trader at FMR Co. from 1992 until March 2005. During the Relevant Period, he was a sector trader specializing in technology stocks, and he was also a team leader of several sector traders, including Robert Burns, Jeffrey Harris and Kirk Smith.

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[3] As discussed below, the Equity Trading Desk included "primary" traders, who worked closely with certain Fidelity portfolio managers, and "sector" traders, who were responsible for trading equities in certain industries.

[4] The term "Relevant Period" means the time period of January 1, 2002 through October 31, 2004.

11. **Edward S. Driscoll**, age 42, lives in Scituate, Massachusetts. Aside from a ten-month stint at another firm, he was a domestic equity trader at FMR Co. from 1997 until March 2005. During the Relevant Period, he was a sector trader specializing in food and beverage, household items, materials, and capital goods stocks.

12. **Jeffrey D. Harris**, age 35, lives in Charlestown, Massachusetts. He was a domestic equity trader at FMR Co. from 1998 until July 2005. During the Relevant Period, he was a sector trader specializing in technology stocks and reporting to David Donovan.

13. **Christopher J. Horan**, age 37, lives in Boston, Massachusetts. He was a domestic equity trader at FMR Co. from 1999 until September 2005, when he was reassigned to other duties that do not involve trading. During the Relevant Period, he was a sector trader specializing in insurance, capital goods, and restaurant stocks.

14. **Steven P. Pascucci**, age 41, lives in Concord, Massachusetts. He was a domestic equity trader at FMR Co. from 1997 until September 2005, when he was reassigned to other duties that do not involve trading. During the Relevant Period, he was a primary trader, and from 1998 until early 2005, he was a team leader of the other primary traders, including Timothy Burnieika.

15. **Kirk C. Smith**, age 43, lives in Walpole, Massachusetts. He was a domestic equity trader at FMR Co. from 1997 until September 2005, when he was reassigned to other duties that do not involve trading. During the Relevant Period, he was a sector trader specializing in technology stocks and reporting to David Donovan.

C. FACTS

Summary

16. During the period from at least January 2002 through October 2004, two Fidelity senior executives (DeSano and Grenier) and ten Fidelity equity traders (Beran, Bruderman, Burnieika, Burns, Donovan, Driscoll, Harris, Horan, Pascucci and Smith) in aggregate accepted approximately $1.6 million worth of travel, entertainment and gifts from brokerage firms that sought and obtained orders to buy or sell securities on behalf of Fidelity's advisory clients.[5] In addition, Lynch requested and received tickets to events from two equity traders, who obtained those tickets from brokers. Those brokerage firms each received millions of dollars in commission revenue for handling orders from Fidelity's advisory clients' accounts. DeSano and the traders in aggregate accepted from brokers dozens of expensive trips, frequently by private jet, including

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[5] A significant portion of this figure consists of the cost of private jet travel, which was calculated based on the cost to brokerage firms of chartering aircraft.

excursions to the Super Bowl, family vacations to Bermuda, Nantucket and the Caribbean, golf outings at exclusive clubs in Florida and South Carolina, weekends in Las Vegas, lodging at fine hotels, and even an extravagant, three-day bachelor party for Bruderman in Miami. Brokers also provided the Fidelity executives and traders with gifts including premium tickets to the World Series, the U.S. Open, Wimbledon, Rolling Stones concerts, and dozens of other sporting events and concerts. In addition, certain traders accepted illegal drugs from brokers and one trader's illegal gambling was facilitated by a broker.[6]

17. The ten traders allowed the receipt of travel, entertainment and gifts to influence their selection of brokers to handle transactions for Fidelity's clients. As one trader commented to another, "Word is out that order flow is for sale." In addition, certain traders routinely sent transactions to brokers who were members of their families or brokers with whom they had a romantic relationship.[7]

18. DeSano, who supervised Fidelity's equity trading operations, personally accepted travel, entertainment and gifts from brokers who sought and obtained securities transactions for Fidelity's clients. He solicited tickets from brokers for himself and to satisfy requests from his supervisor, Grenier. He accompanied certain traders on several trips by private jet paid for by brokers, including attending part of Bruderman's bachelor party in Miami, and traders told him about some of the other private jet trips and tickets they received from brokers. He also knew that certain traders directed transactions to brokers who were members of their family or with whom they had a romantic relationship. Nevertheless, DeSano failed to monitor the traders' receipt of travel, entertainment and gifts in any systematic way and failed to take reasonable steps to ensure that they were seeking best execution or complying with Fidelity's policy concerning its employees' receipt of gifts and gratuities.

19. Under Section 17(e)(1) of the Investment Company Act, affiliated persons of a registered investment company, such as Fidelity executives and traders, are prohibited from accepting "from any source any compensation (other than a regular salary or wages from such registered company) for the purchase or sale of any property" of the investment company. The objective of Section 17(e)(1) is to prevent persons affiliated with registered investment companies from having conflicts of interest impair their judgment and loyalty. A violation of Section 17(e)(1) of the Investment Company Act is complete upon receipt of the compensation. During the Relevant Period, two Fidelity executives (DeSano and Grenier) and ten Fidelity traders (Beran, Bruderman, Burnieika, Burns, Donovan, Driscoll, Harris, Horan, Pascucci and Smith) received compensation in violation of Section 17(e)(1) of the Investment Company Act in the form of

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[6] The primary recipient of drugs was Bruderman, who received ecstasy pills and marijuana from brokers on a number of occasions.

[7] Two traders not named in this Order sent Fidelity business to brokers with whom they were having romantic relationships.

travel, entertainment and gifts paid for by brokers who sought and obtained from those traders securities transactions for Fidelity's clients. In addition, another Fidelity executive (Lynch) caused two Fidelity traders' violations of Section 17(e)(1). Fidelity failed to adopt and implement a system of controls sufficient to detect, deter, and prevent the receipt by these executives and traders of travel, entertainment and gifts paid for by brokers as described herein. As a result, Fidelity failed reasonably to supervise the executives and traders, within the meaning of Section 203(e)(6) of the Advisers Act, with a view to preventing their violations of Section 17(e)(1) of the Investment Company Act.

20. Under Section 206 of the Advisers Act, an investment adviser has a fiduciary duty to seek best execution for its clients' securities transactions – that is, to seek the most favorable terms reasonably available under the circumstances. In determining whether an adviser is seeking best execution, the key criterion is whether the adviser selects the transaction which "represents the best qualitative execution for the managed account."[8] During the Relevant Period, Fidelity allowed certain employees' receipt of travel, entertainment and gifts and certain employees' family or romantic relationships to enter into the selection of brokers. Accordingly, Fidelity willfully violated Section 206(2) of the Advisers Act, resulting in the substantial possibility of higher execution costs for Fidelity's advisory clients.[9]

21. Under Section 206 of the Advisers Act, an investment adviser has a fiduciary duty to disclose all material conflicts of interest to its advisory clients. During the Relevant Period, Fidelity failed to disclose to its advisory clients the conflicts of interest arising from the receipt by certain Fidelity executives and traders of travel, entertainment and gifts from, and certain traders' family and romantic relationships with, brokers who sought and obtained securities transactions for Fidelity's clients, and failed to disclose that such travel, entertainment, gifts and relationships became additional factors in the traders' selection of brokers. Accordingly, Fidelity willfully violated Section 206(2) of the Advisers Act.

22. Under Sections 204, 206 and 207 of the Advisers Act and Rule 204-1 thereunder and Section 34(b) of the Investment Company Act, an investment adviser may not make materially false and misleading statements in public disclosure documents, such as an

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[8] Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934, Exchange Act Rel. No. 23170, 1986 SEC LEXIS 1689, at *38 (Apr. 23, 1986) ("1986 Soft Dollar Release"); *see also* Market 2000 Report: Study V, Best Execution, 1994 SEC LEXIS 136, at *42 n.65 ("Market 2000 Report") ("[M]oney managers in fulfilling their duties of best execution . . . must evaluate periodically the performance of the broker-dealers that execute their transactions."); *Renberg Capital Management, Inc.*, Advisers Act Rel. No. 2064, 2002 WL 31174796, *2 (Oct. 1, 2002); *Portfolio Advisory Services, LLC*, Advisers Act Rel. No. 2038, 2002 WL 1343823, *2 (June 20, 2002).

[9] "Willfully" as used in this Order means intentionally committing the act that 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. *Id.*

investment adviser's Form ADV and a registered investment company's prospectus and statement of additional information ("SAI"). During the Relevant Period, Fidelity's Forms ADV and the SAIs which it prepared for the Fidelity Funds stated that Fidelity selected brokers for its clients' transactions based on an itemized list of factors but failed to include the additional significant factors considered by certain traders – their receipt of travel, entertainment and gifts from brokers and their family or romantic relationships with brokers. As a result, Fidelity willfully violated Sections 204, 206(2) and 207 of the Advisers Act and Rule 204-1 thereunder and Section 34(b) of the Investment Company Act.

23. On behalf of Fidelity, DeSano made presentations to committees of the trustees of the Fidelity Funds in which he too identified the factors that Fidelity used in selecting brokers. DeSano also told the trustees that Fidelity required brokers to compete for its brokerage business based on the quality of their trade execution. Those statements were false and misleading because DeSano failed to disclose (1) that certain Fidelity traders selected brokers for Fidelity's business based on additional significant factors of which he was aware – travel, entertainment and gifts from brokers and family or romantic relationships with brokers, and (2) that brokers competed for Fidelity's business based on those additional factors as well. As a result, Fidelity willfully violated Section 206(2) of the Advisers Act.

24. Under Section 204 of the Advisers Act and Rule 204-2 thereunder, an investment adviser is required to make and keep true, accurate and current books and records relating to its investment advisory business, including originals or copies of certain documents reflecting its communications with brokerage firms relating to the placing or execution of orders to purchase or sell securities. During the Relevant Period, Fidelity traders used an electronic messaging network supplied by Bloomberg L.P. ("Bloomberg") to communicate with brokers. Fidelity failed to make and keep true, accurate, and current originals or copies of such messages. As a result, Fidelity willfully violated Section 204 of the Advisers Act and Rules 204-2(a)(7)(iii) and 204-2(g) thereunder.

Background on Fidelity's Equity Trading Desk

25. Fidelity manages one of the largest mutual fund complexes in the United States. Fidelity equity traders buy and sell millions of shares of stock every day for the Fidelity Funds and other institutional clients. As an investment adviser, Fidelity has a fiduciary duty to seek best execution for its clients' securities transactions and to disclose to its clients all material facts concerning conflicts of interest.

26. The Fidelity Funds and certain of Fidelity's other institutional clients' accounts are managed by portfolio managers who make investment decisions on their behalf. The portfolio managers send their orders to equity traders, who are responsible for selecting brokers to handle the transactions. During the Relevant Period, the Equity Trading Desk bought and sold more than 73 billion shares of equity securities (nearly 26 billion shares per year) with a total principal of more than $1.4 trillion (nearly $500 billion per year). Fidelity's

equity trading generated more than $2.3 billion in commissions (over $800 million per year) paid to brokerage firms by Fidelity's clients, including the Fidelity Funds.

27. During the Relevant Period, FMR Co.'s equity trading operations employed nearly sixty people, including 33 traders (seven "primary" traders and 26 "sector" traders). Under DeSano's supervision, the traders had broad discretion to select brokerage firms to handle securities transactions. The primary limitation was that the traders could only select from a list of approximately 100 firms that had been formally approved by Fidelity.

Fidelity Executives and Traders Received Travel, Entertainment and Gifts from Brokers Seeking and Obtaining Securities Transactions for Fidelity's Clients

Overview

28. During the Relevant Period, two Fidelity senior executives (DeSano and Grenier) and ten Fidelity equity traders (Beran, Bruderman, Burnieika, Burns, Donovan, Driscoll, Harris, Horan, Pascucci and Smith) in aggregate accepted approximately $1.6 million worth of travel, entertainment and gifts from brokerage firms that sought and obtained orders to buy or sell securities on behalf of Fidelity's advisory clients.[10] In addition, Lynch requested and received tickets to events from two equity traders, who obtained those tickets from brokers. Brokers took DeSano and/or certain traders, sometimes in groups, on more than thirty trips to such destinations as the Super Bowl, Las Vegas, Florida, the Caribbean, and Nantucket. These excursions sometimes included travel by private jet, lodging at fancy resorts, entry to exclusive golf courses, tickets to major sporting events, limousine service, expensive dinners, other amenities such as spa services, and, for certain traders, adult entertainment and illegal drugs. Bruderman even organized, and brokers paid for, his own extravagant, three-day bachelor party in Miami, part of which DeSano attended and which cost brokers approximately $160,000.

29. One brokerage firm seeking and obtaining Fidelity's business, Jefferies & Co., Inc. ("Jefferies"), gave one of its brokers, Kevin W. Quinn, a travel and entertainment budget of $1.5 million per year. From that budget, Quinn entertained DeSano and several Fidelity traders, primarily by taking them on weekend excursions by private jet.[11] For example, Quinn organized

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[10] The cost to brokerage firms was approximately $3 million, primarily because they sent one or more brokerage firm employees on entertainment trips with Fidelity employees.

[11] Quinn signed an employment agreement with Jefferies in May 2002 and began working in the firm's Boston office on September 3, 2002. On December 1, 2006, the Commission instituted settled administrative proceedings against Jefferies, a Jefferies senior executive, and Quinn with respect to Quinn's provision of substantial travel, entertainment and gifts to DeSano and certain Fidelity traders. *See* Matter of Jefferies & Co., Inc. *et al.*, Release No. 34-54861 (Dec. 1, 2006), *and* Matter of Kevin W. Quinn, Release No. 34-54862 (Dec. 1, 2006).

an annual trip he called the "Fall Classic," which included private jet travel, exclusive golf outings, lodging at expensive resorts, and other activities. During the November 2002 Fall Classic, for example, Quinn took DeSano, Bruderman and Harris by private jet to Las Vegas. Quinn provided accommodations at the Bellagio Hotel, several thousand dollars worth of golf merchandise, a private band, meals, golf, and entertainment at a nearby strip club. The group continued by private jet to Cabo San Lucas, Mexico, where Quinn provided accommodations in villas at the Esperanza Hotel, meals, more golf, and other entertainment. Jefferies paid approximately $200,000 for the expenses incurred on this trip.

30. Brokers other than Quinn also took Fidelity traders on a variety of trips. For example, each year during the Relevant Period, various brokers took several Fidelity traders to the Super Bowl. Brokers often provided the traders with travel by private jet, lodging at expensive hotels, admission to exclusive pre-game parties, tickets to the Super Bowl, golf greens fees, limousines, and other lavish entertainment. Even when they did not provide private jets, brokers often took traders on trips to Las Vegas and on golf weekends to Florida and other warm-weather locations, usually paying for the traders' lodging and meals and sometimes paying for other travel expenses such as commercial airfare.

31. On more than twenty other occasions, brokers made a private jet available for personal use by DeSano and/or certain traders (and at times, their families), without accompanying the Fidelity employee on the trip. Some of the private jet trips were short (such as weekend excursions to Nantucket), but others were quite long (such as flights to Florida and the Caribbean) and cost brokers up to $50,000 or more per trip.

32. Besides the trips, brokers provided to the Fidelity employees identified herein a total of approximately 900 tickets for some of the best seats to more than 270 sporting events, concerts, and other events, none of which the broker attended with the recipient. The events included the World Series, prominent tennis tournaments (Wimbledon, the U.S. Open, and the French Open), Broadway shows, concerts by nationally-known performers (such as the Rolling Stones and Bruce Springsteen), and dozens of sporting events, including baseball, basketball, football and hockey playoff and regular season games.[12]

33. Most of the tickets were for premium or exclusive seats (such as luxury boxes or seats close to the stage, court or field). Brokers frequently provided multiple tickets to the event, so that the recipient could bring his family or friends. The tickets often cost the brokers hundreds of dollars each, and tickets to special events such as playoff games often cost them more than $1,000 each.

34. In addition, brokers sent certain traders expensive wine (including cases that cost

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[12] Most of the sporting events involved the Boston-area professional teams: the Bruins, Celtics, Patriots and Red Sox.

from $1,000 to $7,700 each delivered straight to their homes), and other costly items such as entry to a racing school (over $5,000) and a humidor filled with cigars (approximately $1,300).

The Individual Executives and Traders

35. DeSano received more than $145,000 worth of travel, entertainment and gifts from brokers during the Relevant Period. He received the personal use of Quinn's private jet for at least two trips, and he went on at least six private jet trips with brokers, primarily Quinn. The trips by private jet included the "Fall Classic" in Las Vegas and Mexico in November 2002, Bruderman's bachelor party in Miami in March 2003, and golf trips to locations such as Sea Island, Georgia, West Palm Beach, Florida, and the Winged Foot Golf Club in Mamaroneck, New York. Brokers also gave DeSano nearly fifty tickets to more than twenty events, including several Bruins, Celtics, Patriots and Red Sox playoff games.

36. Grenier received approximately $38,500 worth of tickets from brokers during the Relevant Period. The tickets were to approximately twenty events, including a Super Bowl ticket package worth approximately $9,000 and premium seats to numerous Celtics and Red Sox games. On several occasions, Grenier asked DeSano to get the tickets for him, and DeSano obliged him by procuring the tickets from brokers who sought and obtained securities transactions for Fidelity.

37. Lynch was the portfolio manager of Fidelity's Magellan Fund from 1977 to 1990. During the last five years of his tenure at Magellan, Burns was one of the traders assigned to handle transactions for the Magellan Fund. During the Relevant Period, Lynch periodically asked Burns to get him tickets to concerts, theater and sporting events – often to sold-out events. Lynch knew that Burns obtained the tickets from brokers handling securities transactions for Fidelity. (On one occasion, Lynch obtained tickets to a Santana concert from Harris, who had taken his call when Burns was out.) From 1999 through October 2004, Lynch received tickets worth approximately $15,948 that Burns or Harris had obtained from brokers, and he did not reimburse. He received 61 tickets to approximately one dozen sporting, theater and concert events, including fourteen, three-day passes to the Ryder Cup golf tournament in Brookline, Massachusetts in 1999, eleven tickets to a U2 concert, and at least six tickets to the Ryder Cup golf tournament in Michigan in 2004. In addition to Burns and Harris, at least seven other members of the Equity Trading Desk were aware during the Relevant Period that Lynch obtained tickets to events from brokers through the Equity Trading Desk. Each of those members of the Equity Trading Desk accepted gifts for themselves from brokers.

38. Beran received more than $11,000 worth of travel, entertainment and gifts from brokers during the Relevant Period. These included tickets to out-of-town theater and local professional sporting events that the brokers did not attend. Beran and his family also went on two trips to Bermuda with a broker who paid for the family's luxury hotel accommodations, associated expenses, and for one trip, their commercial airfare.

39. Bruderman received more than $450,000 worth of travel, entertainment and gifts from brokers during the Relevant Period.[13] One example was his bachelor party in Miami, Florida in March 2003. Bruderman solicited certain brokers to arrange and pay for the event, and the brokers complied – at a total cost of approximately $160,000. The festivities included private jet travel, luxury accommodations at the Breakers Hotel, a chartered yacht, golf, a limousine, and other entertainment such as expensive dinners and strip clubs. Brokers hired two women to entertain the attendees at the party and provided a bag filled with illegal drugs (ecstasy pills) to Bruderman.[14] DeSano, who attended the bachelor party and flew to Miami on the private jet with Bruderman, several brokers, and the two women, believed that the women hired by the brokers were prostitutes. In addition to his bachelor party and other wedding-related expenses, brokers paid all or part of Bruderman's share of approximately 25 other trips. Bruderman obtained private jet travel on more than twenty of those occasions. The trips included such destinations as the Super Bowl (twice), the Caribbean, and Cabo San Lucas, Mexico (on the November 2002 "Fall Classic"). On approximately ten of the trips, brokers were not present and simply provided Bruderman and/or his fiancée with the use of a private jet. These included trips to Puerto Rico, Florida, and his honeymoon in Los Angeles. Brokers also provided Bruderman with lodging on at least fourteen occasions, airfare on commercial jets on at least six occasions, and other gifts such as entry to a racing school (over $5,000), thousands of dollars worth of wine, a humidor with cigars ($1,300), and limousine service. Finally, brokers gave Bruderman at least thirty tickets to at least seven events, including the U.S. Open tennis tournament and front-row seats at a Dave Matthews concert. Bruderman failed to inform DeSano or any other Fidelity manager of his receipt of illegal drugs from brokers.

40. Burnieika received more than $55,000 worth of travel, entertainment and gifts from brokers during the Relevant Period, mostly consisting of premium tickets to professional sporting events. Indeed, brokers gave Burnieika approximately 175 tickets to more than fifty events that the brokers did not attend, including several Celtics and Red Sox playoff games, numerous other Celtics and Red Sox games, and concerts by the Rolling Stones and Bruce Springsteen.

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[13] One broker at a firm that provided Bruderman with extravagant trips and gifts expressed the firm's attitude as, "Whatever Brudy wants, Brudy gets."

[14] Brokers sometimes offered illegal drugs to Bruderman. For example, in February 2002, a broker through whom Bruderman executed securities transactions for Fidelity clients sent him an email asking, "U want beans." (Certain traders and brokers used slang such as "beans" and "Scooby snacks" to refer to ecstasy.) On other occasions, Bruderman solicited drugs from brokers. For example, in January 2004, he asked a broker, "Long any snacks?" The broker responded, "For the Superbowl??? I most likely will b able to take care of that." Bruderman replied, "I would like to order 10 if you have a guy?"

All communications among DeSano, traders and brokers cited in this Order are from the email network maintained by Bloomberg for Fidelity and are quoted with their original spelling and punctuation. Brackets are used to clarify abbreviations or other terms and to indicate where names have been omitted.

Burnieika also went on ten trips with brokers to such destinations as the Super Bowl, Las Vegas, and Aspen, Colorado. Four of the trips were by private jet, while the other six trips were by commercial jet with brokers who paid for some of his lodging and other travel and entertainment expenses.

41. Burns received more than $180,000 worth of travel, entertainment and gifts from brokers during the Relevant Period (not counting the tickets that he obtained for Lynch). Burns received more than 190 tickets to more than forty events that the brokers did not attend, plus fourteen tickets for Burns' friends to attend three events that Burns attended with brokers. Burns received at least $140,000 of tickets and other gifts from Quinn at Jefferies, and Quinn did not attend any of the events for which he provided tickets. For example, over a three-year period, Quinn spent more than $100,000 so that Burns could attend the Wimbledon tennis tournament. In 2002 and 2003, Quinn simply gave Burns tickets to the tournament. In 2004, he not only gave Burns tickets that cost more than $38,000, but he also paid for Burns and his friends to stay at the Lanesborough Hotel in London, at a cost of nearly $13,000. Quinn also had cases of expensive wine delivered to Burns' home as Christmas gifts – at a cost of more than $5,900 in December 2002 and more than $7,700 in December 2003.

42. Donovan received more than $270,000 worth of travel, entertainment and gifts from brokers during the Relevant Period, mostly consisting of trips by private jet to the Super Bowl, Las Vegas, the Bahamas, Florida, and other vacations. In total, brokers paid all or most of Donovan's expenses on 24 trips, including travel by private jet to at least sixteen destinations, first-class flights on the Concorde on at least two occasions, and lodging on eighteen occasions. For example, in June 2002, one broker took Donovan to Paris for the French Open tennis tournament and paid for his lodging at the Hotel George V, and in August 2003, the same broker took Donovan and his wife to London for the Wimbledon tennis tournament and paid for their lodging in the Ritz Hotel. On six occasions, the broker did not attend but simply provided Donovan with the use of a private jet for himself and sometimes his family. In addition, brokers gave Donovan a case of wine valued at approximately $1,000 on two separate occasions, as well as more than sixty tickets to more than twenty events.

43. Driscoll received more than $45,000 worth of travel, entertainment and gifts from brokers during the Relevant Period. This included the exclusive use of Quinn's private jet, as well as car service, for a family vacation to DisneyWorld in Florida, at a cost to Jefferies of approximately $25,000. Driscoll also went on four trips with brokers to the Super Bowl and Las Vegas, two of which included private jet travel and three of which included lodging. Brokers also gave Driscoll more than 55 tickets to at least sixteen events that the brokers did not attend, primarily Celtics games. In addition, one broker facilitated Driscoll's illegal gambling by delivering his bets to a bookie and even, at one point, by initially covering Driscoll's $10,000 debt to the bookie. Driscoll failed to inform DeSano or any other Fidelity manager of his illegal gambling through a broker.

44. Harris received more than $125,000 worth of travel, entertainment and gifts from brokers during the Relevant Period, including some or all of the costs associated with more than twenty trips. On three occasions, the brokers did not attend but simply provided Harris with the use of a private jet, such as a March 2004 trip with Horan to Turks & Caicos in the Caribbean. On eight other occasions, brokers took Harris by private jet on trips such as the "Fall Classic" in 2002 and 2003, the Super Bowl, various other golf trips, and vacations to places such as Nantucket and Florida. On nearly all the trips, brokers paid for his lodging and other expenses. In addition, brokers gave Harris more than thirty tickets to at least fourteen events, including several Patriots and Red Sox games and concerts by Santana and Fleetwood Mac.

45. Horan received more than $120,000 worth of travel, entertainment and gifts from brokers during the Relevant Period, including some or all of his lodging and other travel expenses on at least 24 trips. Eleven of the trips were by private jet, including excursions to the Super Bowl, one "Fall Classic" sponsored by Quinn, and trips to destinations such as Las Vegas, Martha's Vineyard, and the Pebble Beach golf course in California. On three occasions, the brokers did not attend but simply provided Horan with the use of a private jet. For example, Quinn provided a private jet for Horan and his girlfriend (as well as Harris) to return from a weekend in Florida in February 2003, and the flight cost Jefferies more than $56,000. In addition, brokers gave Horan more than seventy tickets to at least 25 events, including Super Bowl and several Celtics and Red Sox playoff games. In addition, Horan received over twenty gifts from brokers, including a case of wine valued at $400-$500 and other items such as gift certificates and clothing.

46. Pascucci received more than $50,000 worth of travel, entertainment and gifts from brokers during the Relevant Period, consisting primarily of more than 165 tickets to more than fifty events that the broker did not attend, including several Patriots and Red Sox playoff games, numerous Celtics and Red Sox regular season games, and a performance of "The Producers." Brokers also paid for some of Pascucci's lodging and other travel expenses on at least five trips, including one trip to Dallas involving a stay at the Four Seasons Hotel, attendance at a Dallas Cowboys football game, a meeting with Bill Parcells (then the Cowboys coach), a return flight to Boston on a broker's private jet, and limousine service to and from the airport.

47. Smith received more than $85,000 worth of travel, entertainment and gifts from brokers during the Relevant Period. In November 2003, Quinn provided Smith with the use of a private jet so that Smith and his wife could take a vacation in the Caribbean, and the trip cost Jefferies more than $46,000. In addition to paying some of Smith's lodging and other travel expenses on two other trips, brokers gave Smith more than 150 tickets to more than forty events that the broker did not attend, including several Celtics, Patriots and Red Sox playoff games, numerous other Patriots and Red Sox games, several college hockey games, and concerts by the Rolling Stones and Van Morrison.

Violation of Section 17(e)(1)
of the Investment Company Act

48. Under Section 17(e)(1) of the Investment Company Act, affiliated persons of a registered investment company, such as Fidelity executives and traders, are prohibited from accepting "from any source any compensation (other than a regular salary or wages from such registered company) for the purchase or sale of any property" of the investment company.

49. During the Relevant Period, two Fidelity executives (DeSano and Grenier) and ten Fidelity traders (Beran, Bruderman, Burnieika, Burns, Donovan, Driscoll, Harris, Horan, Pascucci and Smith) received compensation in violation of Section 17(e)(1) of the Investment Company Act in the form of travel, entertainment and gifts paid for by brokers who sought and obtained from the traders securities transactions for the Fidelity Funds. In addition, another Fidelity executive (Lynch) caused two Fidelity traders to receive compensation in violation of Section 17(e)(1) of the Investment Company Act.

Fidelity Failed Reasonably to Supervise its Employees' Receipt of Travel, Entertainment and Gifts from Brokers

The Executives' and Traders' Violations of Fidelity's Gifts and Gratuities Policy

50. During the Relevant Period, Fidelity had a gifts and gratuities policy for its employees. The policy stated that it was designed to avoid "any actual or apparent conflict of interest or impropriety."

a. The policy prohibited employees from "condition[ing] any business or other transaction on the giving or acceptance of any gift or favor," from "accept[ing] gifts or other gratuities with a value of more than $100 per calendar year to or from any Company or individual" doing business with Fidelity, and from "accept[ing] tickets valued at more than $100 per calendar year if the one giving does not attend the event with the recipient." Employees were required to submit written requests for approval to receive gifts beyond the $100 limit.

b. The policy prohibited employees from "soliciting any gift, favor or other form of preferential treatment" and from "accept[ing] transportation (other than local ground transportation), lodging or other travel-related expenses to attend an athletic, cultural, social or entertainment event with a current or prospective vendor, customer, or supplier" unless the employee reimbursed the giver. Further, this section of the policy required "[a]n employee invited to attend such an event (whether attending with the giver or not) [to] either pay his or her own way, or reimburse the vendor, customer or supplier for these expenses."

c. The policy permitted "[o]ccasional business entertainment (such as a meal or a recreational activity) where the giver attends the event with the recipient and the primary purpose is to discuss business or build a business relationship."

51. The three Fidelity executives and ten traders repeatedly violated Fidelity's gifts and gratuities policy when they accepted travel, entertainment and gifts paid for by brokers who sought and obtained securities transactions from Fidelity. For example:

a. Many of the travel and entertainment events and gifts that the Fidelity employees received from brokers were worth more than $100, yet none of the employees ever submitted a written request for approval.

b. The Fidelity employees frequently solicited brokers for tickets to a particular event. In fact, they sometimes asked for tickets so close to the date of the event that the brokers had to obtain the tickets from ticket agencies at exorbitant prices.

c. On many occasions, the traders did not reimburse the brokers for the private jets, lodging, and other travel expenses, in violation of Fidelity's gifts and gratuities policy. On some occasions, brokers refused to accept reimbursement checks from traders; and on other occasions, the broker accepted a check not intending to cash it and informed the trader the check was just for "paper trail" purposes.

DeSano's Failure to Supervise the Traders' Receipt of Travel, Entertainment and Gifts under Section 17(e)(1) of the Investment Company Act

52. As Fidelity's head of equity trading, DeSano's duties included supervision of the traders' compliance with applicable legal requirements and with Fidelity's policies and procedures, including its gifts and gratuities policy.

53. DeSano knew that some traders received travel, entertainment and gifts from brokers, in part because he accompanied them on several trips, in part because he communicated regularly with Bruderman and several other traders about trading desk matters, and in part because he made sporadic attempts to have the traders tell him about their upcoming trips with brokers. For example, each year he asked the traders about their plans for the Super Bowl.

54. DeSano took only limited and ineffective steps to police the traders' receipt of travel, entertainment and gifts from brokers. For example:

a. At one point, DeSano caused Fidelity to issue credit cards to the traders so they could pay for their own business entertainment, but the traders did not use the cards or submit expenses for approval, and he did not follow up. At another point, he suggested to senior management of Fidelity that Fidelity might consider adopting a formal policy concerning its employees' use of private jets provided by brokers and other vendors, but again he did not follow up.

b. In early May 2004 (after a weekend when brokers had taken Harris to Las Vegas and Burnieika and Horan to Florida), he announced that traders would have to notify him in advance about all trips with brokers. A month later, he announced that traders would have to pay their own way on all future events with brokers. However, he did not enforce these policies, and traders continued to go on trips without informing him in advance and without reimbursing the brokers. For example, Quinn took DeSano and Bruderman golfing on Nantucket in June 2004, providing them with hundreds of dollars worth of golf items and arranging for Bruderman to take a private jet home from Nantucket. Similarly, Quinn took DeSano, Harris and his wife, and Horan to a charity golf event on Nantucket in August 2004. Quinn provided lodging for the group at his home, and gave the Harrises and Horan the use of his private jet to return to Boston. There is no evidence that the Fidelity employees reimbursed Quinn for these trips.

c. DeSano instructed the traders to reimburse brokers for private jet travel at the rate for first-class commercial airfare to the same destination, but he did not require proof of reimbursement, and, as a result, the traders rarely made reimbursement to brokers for their trips on private jets.

55. Indeed, far from effectively supervising the traders' receipt of travel, entertainment and gifts from brokers, DeSano actually made matters worse, in several respects.

a. DeSano personally asked brokers for tickets or asked traders to ask brokers for tickets, sometimes for himself and sometimes for other senior Fidelity executives like Grenier, and he personally went on several trips paid for by brokers without reimbursing his full share of the expenses. His conduct sent the clear message that the traders could engage in similar activities, and because soliciting brokers for tickets and traveling at a broker's expense were violations of Fidelity's gifts and gratuities policy, his conduct also sent the message that the traders too could violate Fidelity's policy with impunity.

b. DeSano traveled frequently with Quinn, the most significant source of travel and gifts for the traders.[15] For example, DeSano attended both the November 2002 "Fall Classic" and part of Bruderman's bachelor party in March 2003 – two visible and extravagant excursions for which brokers picked up the tab. (Jefferies paid approximately $200,000 for the former, and several brokers including Quinn paid a total of approximately $160,000 for the latter.)

c. DeSano also took steps to conceal his and others' participation in the 2002 "Fall Classic." In an October 2002 email to Quinn, DeSano asked, "What happens when

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[15] The demoralizing effect for the trading desk of DeSano's travels with Quinn is apparent from Pascucci's comment to Smith in December 2003, "How can u enforce the no nepotism rule when SCD [DeSano] is such buddies with Quinn? It is absurd the one guy gets so [much] favored treatment from the head."

I get fired for this?" Quinn responded, "SEC rule first class plane fare and we are all set.[16] . . . Plus noone is allowed 2 say anything . . . Last yr never got out . . . If someone talks, we kill . . . That conversation happens first thing on the plane . . . Just a simple golf trip." DeSano then said, "Brudy [Bruderman] will be on a trip with [his fiancée]. You [Quinn] will be trying to qualify for a tourney somewhere down south. Harris has to make something up. And what I do is no one's G.D. business!" In a subsequent email, DeSano told Harris, "This needs to be excessively covert . . . Not even your desk can know. Make something else up." Harris responded, "I will, but when Brudy [Bruderman] and I are out and Kevin [Quinn] is out . . . people start talking. I am going to Seattle to see [my wife's] grandmother with her parents . . . That's my story and I am sticking to it." DeSano then gave Harris the cover stories for Bruderman and Quinn. Harris replied, "Sounds good."

56. DeSano failed to monitor the traders' receipt of travel, entertainment and gifts from brokers on any systematic basis, and he failed to take reasonable steps to enforce Fidelity's gifts and gratuities policy or to ensure that the traders did not receive compensation from brokers for purposes of Section 17(e)(1) of the Investment Company Act. Certain traders violated Section 17(e)(1) by receiving compensation in the form of gifts, travel, and entertainment from brokers. As a result, Fidelity, through DeSano as its head of equity trading, failed reasonably to supervise the traders, within the meaning of Section 203(e)(6) of the Advisers Act, with a view to preventing their violations of Section 17(e)(1) of the Investment Company Act.

Fidelity's Failure to Supervise its Executives' and Traders' Receipt of Travel, Entertainment and Gifts under Section 17(e)(1) of the Investment Company Act

57. As shown above, the practice of accepting travel, entertainment and gifts paid for by brokers was well established at Fidelity throughout the Relevant Period – not just by the ten traders named above, who handled more than 50% of Fidelity's equity trading, but also by three senior Fidelity executives with ties to the Equity Trading Desk.

58. At least nine members of Fidelity's Equity Trading Desk were aware that Lynch – vice chairman and a director of FMR and FMR Co., interested trustee of the Fidelity Funds and former portfolio manager – solicited tickets by calling the Equity Trading Desk, primarily Burns. All nine of those employees obtained gifts that violated Fidelity's policy. Lynch's conduct was the subject of comment between certain traders.

59. Likewise, Grenier and DeSano – the two senior officers with primary responsibility for equity trading – personally solicited and received tickets from brokers. In addition, DeSano personally went on numerous trips at a broker's expense, sometimes while accompanying traders

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16 There is no such SEC rule.

under his supervision.[17] In a January 2004 email, Pascucci wrote to Smith, ". . . The jet stuff bothers me but the big guy [DeSano] is OK with it all the way."

60. Despite the fact that brokers who sought and obtained securities transactions from Fidelity were providing certain executives and traders with travel, entertainment and gifts as described herein, Fidelity failed to adopt and implement procedures reasonably designed to detect and prevent its employees' receipt of travel, entertainment and gifts that violated Fidelity's gifts and gratuities policy and that constituted compensation for purposes of Section 17(e)(1) of the Investment Company Act.

61. Fidelity failed to supervise its employees' compliance with the gifts and gratuities policy. Fidelity did not provide adequate training concerning the gifts and gratuities policy. In addition, Fidelity had virtually no monitoring mechanisms in place. For example, the policy required employees to submit a written request for an exception to the $100 limit on gifts, but even though the three executives and ten traders repeatedly received travel, tickets and other gifts worth more (often much more) than $100, none of them ever submitted such a request – a clear sign that the policy was being ignored. Nevertheless, Fidelity did not take meaningful steps to curtail the receipt of gifts and entertainment by its executives or equity traders.

62. Fidelity thus failed to monitor its employees' receipt of travel, entertainment and gifts from brokers on any systematic basis, and it failed to take reasonable steps to ensure that its employees complied with its gifts and gratuities policy and did not receive compensation from brokers for purposes of Section 17(e)(1) of the Investment Company Act. As a result, Fidelity failed reasonably to supervise the three executives and ten traders named above, within the meaning of Section 203(e)(6) of the Advisers Act, with a view to preventing their violations of Section 17(e)(1) of the Investment Company Act.

Fidelity Failed to Seek Best Execution for its Clients' Securities Transactions Because the Traders Allowed the Receipt of Travel, Entertainment and Gifts from Brokers, and Familial and Romantic Relationships with Brokers, to Influence Their Selection of Brokers

The Traders Sent Securities Transactions to Brokers from Whom They Received Travel, Entertainment and Gifts

63. The receipt by ten equity traders, by DeSano (the traders' supervisor) and by Grenier (DeSano's supervisor) of travel, entertainment and gifts from brokers who sought and obtained securities transactions from Fidelity created a material conflict of interest that influenced the traders' selection of brokers to execute securities transactions on behalf of Fidelity's clients. In addition, Lynch (senior officer of FMR and FMR Co. and trustee of the

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[17] Traders gossiped about DeSano's frequent absences. In January 2003, for example, Pascucci commented to another trader that DeSano had been on his "129th golf junket of last year."

Fidelity Funds) solicited and received tickets to sporting and entertainment events from two members of the Fidelity Equity Trading Desk, who in turn solicited those tickets from brokers who sought and obtained securities transactions from Fidelity, resulting in a material conflict of interest that influenced those traders' selection of brokers to execute securities transactions on behalf of Fidelity's clients.

64. In their emails to each other and to brokers, DeSano and the traders acknowledged the connection between the traders' receipt of travel, entertainment and gifts from brokers and their direction of business to brokers. For example:

a. In January 2002, Bruderman asked DeSano not to approve a certain brokerage firm that wanted to handle some of Fidelity's securities transactions: "Please do not approve him and I am not going anywhere on his or his company's dime. That is the last guy in the world I want to feel indebted to."

b. In April 2002, Pascucci asked a broker, "Pls ask the ticketmaster if the firm's single biggest customer cud have 2 tix [to an Andreas Bocelli concert]. (They are for his madre.)" Pascucci received the tickets from the broker.

c. In October 2002, Pascucci told DeSano that a broker was offering two tickets to that night's Celtics game. DeSano replied, "[Name omitted] works there. Bad guy. I wouldn't want to feel obligated."

d. Also in October 2002, a broker made the following offer to Donovan, "SANM [Sanmina-Sci Corp.] – 500 k at 2.52. 500 trades away at 2.53. Plus 2 50-yard line seats to VA Tech-BC."

e. In January 2003, Pascucci forwarded to Smith an email he received from a broker, "Like 'build it they will come,' the sell side mantra of 'plan fun trip with clients and they will come' still rings true in these parts."

f. In February 2003, Quinn told Bruderman about plans for the upcoming bachelor party and added, "If I do the plane that I might do, you better load me up when it gets busy again."

g. In March 2003, Pascucci commented to Smith that the conflicts between DeSano, Bruderman, Quinn, and others were "a WSJ [*Wall Street Journal*] article ready for the front page."

h. In March 2003, Beran declined a broker's invitation to a golf trip, saying that he was already going on two trips in the next two months. He added that, although he had heard that the site of his second trip (a private golf club in Maryland) was "great," the "only

problem is that I have to trade w/ [the brokerage firm] after I go!" Also in March 2003, Beran told another trader, "I figure I owe [the broker] 3 orders to pay for my annual . . . golf shirt."

i. Also in March 2003, Burns had this email exchange with a broker:

Broker : . . . You must have a hankering to do a big CSCO [Cisco Systems] trade w/ me. At the very least, your prompt response will be rewarded w/ Celtic playoff seats. Thanks for caring.

Burns: No hankering here, and you can send the tickets over.

Broker : Our friendship has taken a significant step forward this AM. I could not be more pleased.

Burns: Thank you!!!!

Broker : Our friendship is boundless. Now, if you would please think of me next time a big situation appears on your desk, our friendship would be to the moon.

j. In April 2003, a broker told Burnieika, "Keep up the flow and I will get you and [another Fidelity trader] a car to the airport Fri." Two days later, the broker took Burnieika on a golf weekend in North Carolina.

k. In April 2003, a broker told Pascucci, "Nice sales in FBF [FleetBoston Financial], thanks for the bus today, talk to you in AM. If you need any seats for Celts thurs night, I've got 2 courtside if you want them."

l. In August 2003, Smith used an analogy to the team-building techniques of certain baseball teams to explain to Pascucci his theory of how brokers use their travel and entertainment budget to attract Fidelity's business:

> If you map out a strategy for "attacking FIDO [Fidelity]" to maximize commission $$, it seems there are 2 strategies. . . attack the generals, i.e. ingratiate yourself w/ the powerbrokers thru extensive use of the expense account (let's call them the Yankees) who curry favor w/ THB [Bruderman], DKD [Donovan], and SCD [DeSano] . . . or recruit youth early (let's call them the A's) by showering the youngsters w/ service and small $$ perks.

m. In April 2004, the broker told Burns that he was sending Red Sox tickets and added "ANDW [Andrew Corp.] 6 figs for sale." Burns thanked him. The broker replied,

"Thx for sending over the Sox tix or thx for sending over the ANDW INDI or thx for being such a great guy or all of the above?" Burns responded, "All of the above."

65. Indeed, some of the emails between traders and brokers reflect a shared perception that the job of a so-called "sell side" broker includes the provision of travel and tickets, and that one advantage of being a so-called "buy side" trader is the opportunity to receive such benefits. For example:

a. In May 2002, Burnieika told a broker that he was going to two upcoming Celtics playoff games. The broker commented, "Nice to be king!" Burnieika replied, "Right side of the street when U2 concerts and Celts playoff games come around."

b. In August 2002, Smith observed to Pascucci ". . . Golf, dinners, tickets, Super Bowl, trips. Everything is for sale." Two days later, Smith complained to Pascucci, "It's bad enough w/ SCD [DeSano], DKD [Donovan], and Brudy [Bruderman], but when Horan and JDH [Harris] start in on the exclusive golf dates, it's pathetic." Pascucci replied, "Agreed 500%."

c. In September 2002, Bruderman sent a broker an email concerning plans for his wedding. Bruderman told the broker, "As of this morning you and [a broker at another firm] and Quinn are paying for it." The broker replied, "Can't wait. Send me the bill." Later that day, Bruderman told Quinn, "Bad news. You and [another broker] have to pay for the wedding." Quinn replied, "Creative T&E. Again."

d. In May 2003, Pascucci asked a broker, "Who will be first guy on sell side to offer Green Monster seats?" The broker replied, "Me." (The "Green Monster" was a new area of expensive seats for Red Sox games at Fenway Park.)

e. In September 2003, Bruderman received and forwarded to several brokers an email that parodied a beer company's advertising campaign:

> Here's to you Mr. Institutional Sales Trader. Because you spend all day lying to people with MBA's from Ivy League schools, even though you failed Econ 101 at the Community College. And if the stock goes up or down, you don't care – as long as you get your nickel. Five cents a share! So crack open an ice cold Bud Light you overpaid sack of sh*t, because without you there would be a lot of buy side guys sitting in bad seats at the concert.

f. In October 2003, Bruderman complained to one broker that a broker at another firm had been unable to get him tickets to a Bare Naked Ladies concert: "Say he has

no tickets left. Gave em all to [name omitted] and his hedge fund pals. I think I am going to request a change in coverage."

g. In May 2004, a broker asked Burns, "Are you aware of a guy who delivers Yankee tix to your desk faster than me? Seller of good size CSCO."

h. Also in May 2004, Pascucci offered Driscoll this praise for a broker: "[Name of broker] has not had a misstep for 1 second in his [name of firm] career. Trading is first rate. Research effort is consistent and impactful, and he is 500 times the ticket broker [name omitted] from Friend St. is. The new sales trading model."

66. As reflected by the traders' conduct and their email communications with brokers and each other, the conflicts of interest were not merely theoretical, and the traders did in fact allow their receipt of travel, entertainment and gifts to influence their selection of brokers to handle securities transactions for Fidelity's clients. For example:

a. In January 2002, Driscoll told another trader that he was going to the Super Bowl in New Orleans with a certain broker and added, "The good news is, the TYC [Tyco] order paid for [the broker's] jet." That day, Driscoll sent orders to the broker's firm (including more than 8 million shares of Tyco stock) that generated more than $487,000 in commissions. Driscoll's Tyco trade did not go unnoticed on the Equity Trading Desk. Smith observed to Pascucci: "[P]oor broker selection. Superbowl trip should not affect judgment" and "7 million shares of TYC [actually, 8 million shares] buys you a seat on a private jet."

b. Also in January 2002, Bruderman told a broker, "This BSX [Boston Scientific] order works to 1 mill. That should get us part of the way to paying for the band. How much is it so I know what I need to do to pay for it?" The broker responded that the band (Counting Crows) would cost "3 bills + love."

c. In March 2002, Smith commented to Pascucci that Bruderman sent most of his business to Quinn and brokers at two other firms who took him on trips and asked "Who says Fido can't be bot?" Pascucci responded, "No comment on record. Off record, THB [Bruderman] has killed the integrity of this desk." Smith replied, "How that does not raise red flags, I do not know."

d. In April 2002, Pascucci complained to Smith, "Here's the truth. Image on street at all time low. We are VWAP[18] robots and gift whores."

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18 VWAP is "volume weighted average price." VWAP is one of the methods that Fidelity used to measure the execution quality of the Equity Trading Desk.

e. A broker told Burns in a May 2002 email, "For better or for worse, I am [a] liquidity provider of stocks and tickets. Please do not hesitate to knock on my door for either. My door is open to you 24 hours a day 7 days a week." Burns took him up on the offer. Indeed, that same month, after the broker provided Burns with tickets to a Celtics playoff game, Burns sent 1.2 million shares to the broker – his first orders to the firm all year. The trades generated more than $60,000 in commissions.

f. In June 2002, a broker offered Burnieika tickets to a Red Sox game for his parents. One hour later, Burnieika began sending orders to the broker. While Burnieika had traded the same security with that broker the prior two trading days, his total for the day exceeded 860,000 shares – his heaviest single trading day with the firm during the entire 2002-2004 period. The trades generated $43,000 in commissions.

g. In June 2002, a broker took Donovan to Paris for the French Open tennis tournament, and Donovan's expenses cost the broker more than $24,000. The day he returned, Donovan sent more than 1.8 million shares to the broker. The trades generated $90,750 in commissions.

h. In August 2002, Harris thanked a broker for their recent trip to the Red Tail resort in Toronto: "I owe you bro. Can't thank you enough for including me in such a special trip. Place is over the top!" That day, Harris sent trades involving more than two million shares to the broker's firm, and the trades generated $103,000 in commissions.

i. In September 2002, several brokers from the same firm took Smith for a weekend in Illinois and Michigan that included a Notre Dame-Michigan college football game. During the two weeks after the trip (ten trading days), Smith sent nearly 19.3 million shares to the brokers (more than 1.9 million shares per day). The trades generated nearly $456,000 in commissions.

j. In September 2002, Harris told Quinn that he might not be able to attend the upcoming "Fall Classic". Quinn complained, "Pls don't do this 2 me." Harris replied, "Bro, I may have to but I will make it up with a lot of shares."

k. In September 2002, Smith asked Pascucci, "2 guesses who is paying for BB's [Burns] Super Saturday [U.S.] Open tickets." Pascucci answered, "Jeff Reece [Jefferies]." Smith observed that Quinn had taken four months off after leaving another firm, and that Burns had greeted his arrival at Jefferies in September 2002 with a million-share order.

l. In September 2002, Quinn gave Burns tickets to the US Open tennis tournament. Two days before the event, Burns sent 2.1 million shares to Quinn. The next day, Burns sent another 2.8 million shares. The trades on these two days generated more than $160,000 in commissions.

m. In November 2002, a broker told Harris, "Thx for the order. Have some B's tix for tomorrow if interested."

n. In November 2002, Smith complained in an email that "Brudy and Jeff [Harris] load up Jeff [Jefferies] for 2 weeks before the trip [the "Fall Classic"]. THB [Bruderman] has clearly made it known that his order flow is for sale to the highest bidder, and nobody else in the room would get away w/ that sh1t."

o. Quinn provided a private jet to Driscoll for a family Disney World trip. In a November 2002 email, Driscoll asked Quinn, "You did not tell anyone about this, did you?" Later, Quinn responded, "By the way, I view private 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." Driscoll replied, "We are on the same page." Driscoll also rewarded Quinn for his generosity. In the two weeks (seven trading days) before the Disney World trip, Driscoll sent more than 8.9 million shares to Quinn (almost 1.3 million shares per day). The trades generated more than $445,000 in commissions.

p. In December 2002, Driscoll thanked a broker for a holiday gift certificate. The broker replied, "No. Thx u. Wish was for more. Wud be luggin furniture if not for u."

q. In January 2003, a broker offered Pascucci tickets to "Disney on Ice." Pascucci asked for five tickets for his brother and his children. The broker replied, "No problem. And Steve, don't EVER hesitate to ask for tix if u need 'em. That's one of the beni's of my job. U've done a lot for me, I am more than happy to help you out." On the two days after the event, Pascucci sent more than 1.1 million shares to the broker (more than 550,000 shares per day). The trades generated more than $44,000 in commissions.

r. In January 2003, Quinn offered Burns a package with first class airfare to Wimbledon, which Burns declined. The same day, Burns sent Jefferies a total of 2.2 million shares, which generated $70,000 in commissions, and told Quinn "I am totally committed to assisting you in your efforts."

s. In February 2003, Smith commented to a Fidelity trader about "the obvious pattern of loading up a broker, then disappearing on a golf trip, etc. It used to be Red Sox tickets and a dinner, now it's private jets to the Masters."

t. In April 2003, Bruderman told a broker, "I owe you money. Paying it today w/ SGP [Schering Plough]." That day, Bruderman asked the broker to sell 100,000 shares of SGP, generating a $5,000 commission.

u. In June 2003, Quinn told Bruderman, "You're welcome for the Sox tix by the way." Bruderman replied, "You're welcome for the house in Needham [the location of Quinn's residence]."

v. In June 2003, Smith asked a broker for tickets to a Van Morrison concert. The broker offered him two front-row seats. Smith responded. "Right on." Two minutes later, Smith wrote "Work 250m MSFT [Microsoft] for me."

w. Shortly after Quinn joined Jefferies, Quinn asked if Smith was upset with him. Smith replied, "Never have been. Just shocked how the red carpet has been rolled out to you. Your 'new' firm offers me nothing that I don't already get from every other firm in the Top 30, so I apologize if I don't drink the Kool-Aid." Indeed, from September 2002 until mid-October 2003, Smith traded with Jefferies very infrequently. In mid-October 2003, however, that changed. On or about October 20, 2003, Smith began exchanging emails with Quinn about a trip to the Caribbean that Smith was planning with his wife. During the course of that exchange, Quinn offered to provide Smith with a private jet for his vacation. On the day Quinn offered to supply the jet, Smith sent more than 1.5 million shares to Jefferies. The next day, Smith sent nearly 1.4 million shares. All told, Smith traded with Quinn on sixteen of the seventeen trading days between the day Quinn offered his private jet and the day Smith left for his vacation. Smith's heavy use of Jefferies continued after his return. Smith traded with Quinn on fourteen of the first sixteen trading days after the trip, including one day with nearly 1.2 million shares. The three days with orders totaling over 1 million shares were three of Smith's four heaviest trading days with Jefferies during the Relevant Period, and the trades on those days generated nearly $190,000 in commissions.

x. In December 2003, Pascucci asked a broker for courtside tickets to that night's Celtics game. The broker offered four tickets. Pascucci told him where to deliver the tickets and added, "Thks. Buy 50K."

y. In February 2004, brokers took several traders to see the New England Patriots play in the Super Bowl in Houston. On the day before he left, Burnieika sent more than 500,000 shares to the broker who took him – his second largest day with the firm in the entire 2002-2004 period – and the trades generated more than $25,000 in commissions.

z. In July 2004, Quinn provided tickets and a hotel for Burns to attend the Wimbledon tennis tournament in London at a cost of over $50,000. During the week after he returned (four trading days), Burns sent more than 7.6 million shares to Jefferies (more than 1.9 million shares per day). On one of the days, he sent 4 million shares – his second heaviest trading day with the firm in the entire 2002-2004 period. The trades on these four days generated $255,000 in commissions.

aa. After the broker who facilitated Driscoll's gambling changed firms in April 2004, Driscoll received the following request from the broker: "If you can find it in your

heart not to let me get shut out by the end of the day that would be greatly appreciated. Not a very good first impression. Have to go down to NY for the day tomorrow to meet all the traders." Driscoll forwarded the broker's message to Horan and commented, "How is it that we owe all these fuking millionaires something after we got them where they are?" Despite his griping, Driscoll began sending regular trades to the broker's new firm two days later.

67. The decision of Harris to start sending business to Jefferies after Quinn joined the firm reflects how the receipt of travel, entertainment and gifts influenced his selection of brokerage firms.

a. In May 2002, Harris learned that Quinn was moving to Jefferies after rejecting an offer from a major brokerage firm that handled a substantial amount of Fidelity business. Harris was unhappy about Quinn's choice and complained to Bruderman, "Between me and you, I am frustrated he put me in this situation. It compromises your position on the desk to do a lot of bus with a firm like Jeff [Jefferies]. [The other firm] is easy because you can justify it. The desk will be pissed, especially now that commission dollars are under a microscope . . ."[19]

b. Despite his misgivings, Harris began sending a substantial amount of business to Jefferies in September 2002 after Quinn started working there. In late November 2002, however, Harris complained to Quinn about his trade execution:

Harris:	Just went out back . . . You were my 3rd broker for the month and 30th on [Fidelity's trader performance measurement] and I was still number 3 on the desk . . . Guys wanted to know what Jeff[eries] was and why I was doing all the volume, hurting my [performance statistics] when I could have taken number 1. Reminds me of my [name of firm] numbers. [Harris named the firm where Quinn had worked before joining Jefferies.]
Quinn:	Pick up [the dedicated phone line between Fidelity and Jefferies].
Harris:	One of 2 things will change: 1. your volume will drop. 2. my numbers will go up.
Quinn:	You're right. It is all my fault.

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19 Harris was not the only trader to worry about Quinn's move to Jefferies. Beran observed to Pascucci, "Don't ask THB [Bruderman] about Jeffco . . . I think he is trying to figure out how he is going to justify laying all those orders into Quinn!"

c. Nevertheless, Harris continued trading – and traveling – with Quinn. In December 2002, Quinn and another Jefferies broker took Harris for a golf weekend in South Carolina. The week he returned (three trading days), Harris sent more than 2.6 million shares to the brokers (almost 870,000 shares per day). The trades generated more than $118,000 in commissions.

d. In two July 2003 emails, Harris again complained to Quinn about his performance. In the first, Harris "thank[ed]" Quinn "for all the crummy [trader performance statistics] for last year and this year." In the second, Harris warned Quinn that the "[t]ech guys in back are on to you. Brudy's [Bruderman] numbers suk with you too."

e. Despite his complaints, Harris's trading with Jefferies remained heavy throughout Quinn's employment at the firm. Harris sent nearly 142 million shares to Jefferies after Quinn arrived, and the trades generated more than $6.5 million in commissions.

68. During the Relevant Period, the ten traders each directed equity trading business generating millions of dollars in commissions to brokers from whom they received travel, entertainment and gifts. The influence of travel, entertainment and gifts on Fidelity's order flow is particularly apparent with respect to Jefferies:

a. In the second quarter of 2002 (before Quinn's arrival), Jefferies handled 12.9 million shares of securities for Fidelity. With this volume, Jefferies ranked 44th among the brokerage firms used by Fidelity. 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 12th. In the third quarter of 2004 (Quinn's final full quarter of employment), Jefferies handled 112.9 million shares of securities, and its volume ranking was 13th.

b. The brokerage commissions that Jefferies received from Fidelity increased in a similar fashion. In the first six months of 2002, just prior to Quinn's arrival, Jefferies received nearly $888,000 in commissions, ranking it 42nd among the firms used by Fidelity. By contrast, in the first nine months of 2004, Jefferies received $20.7 million in brokerage commissions from the Fidelity Funds, improving its ranking to 10th among the firms used by Fidelity. During the period of Quinn's employment, Jefferies received over $60 million in commissions from Fidelity's client accounts.

c. Most of the brokerage business that Jefferies received from Fidelity came from four traders (Bruderman, Donovan, Harris and Horan), who went on most of Quinn's golf and other excursions, and from a fifth trader (Burns), who received expensive wine and 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 alone sent trades generating approximately $39.4 million in commissions for Jefferies.

Certain Traders Sent Securities Transactions to Brokers with
<u>Whom They Had a Family or Romantic Relationship</u>

69. During the Relevant Period, five Fidelity traders sent securities transactions to brokers with whom they had a family or romantic relationship. In each instance, the trader sent millions of shares of transactions to the broker's firm, and the trades generated millions of dollars of commissions.

a. One of Donovan's family members was a broker who covered (*i.e.*, handled transactions for) several Fidelity traders, including Donovan himself. During the Relevant Period, Donovan sent more than 678 million shares to his family member's firm, and the trades generated more than $31 million in commissions.

b. A family member of Driscoll's was a broker who changed firms in January 2003 and thereafter covered several Fidelity traders. The family member did not cover Driscoll himself, but the family member's compensation depended in part on the firm's total commissions from Fidelity's business. Driscoll sent no trades to the new firm before his family member joined it, but from January 2003 through October 2004, he sent more than 56 million shares to the firm, and the trades generated more than $2.7 million in commissions.

c. A family member of Pascucci's was a broker who changed firms in late December 2002 and thereafter covered several Fidelity traders, including Pascucci himself. Pascucci did little business with the new firm before his family member joined it, but from late December 2002 through October 2004, he sent more than 138 million shares to the firm, and the trades generated more than $6.8 million in commissions.

d. In addition, two Fidelity traders not named in this Order were involved in romantic relationships with brokers to whom they sent trades generating, in aggregate, several million dollars in commissions.

e. In October 2003, Smith commented to Pascucci, "so 2 of our . . . [brokerage firms] are absolutely zero value-added on research and mkt intelligence, but loaded to the gills w/ nepotism, incestual relationships, and issues of conflict." Pascucci replied, "I cannot poke a hole in that."

<u>Fidelity's Violation of Section 206(2) of the Advisers Act</u>

70. As set forth above, DeSano was aware of significant conflicts of interest involving Fidelity's equity traders. He knew that some traders sent securities transactions to brokers from whom they received travel, entertainment and gifts. He also knew that some traders sent securities transactions to brokers with whom they had a family or romantic relationship. For example, he knew that one of Donovan's family members was a broker at one of the largest firms handling transactions for Fidelity. He also knew that a Fidelity

trader not named in this Order was romantically involved with a broker because the trader told him about the relationship and asked him for permission to continue sending business to the broker's firm, and he approved.

71. Section 206(2) of the Advisers Act provides that an investment adviser shall not "engage in any transactions, practice, or course of business which operates as a fraud or deceit upon any client or prospective client."[20] One aspect of an investment adviser's fiduciary duty under Section 206(2) of the Advisers Act is the duty to seek best execution for its clients' securities transactions – that is, to seek the most favorable terms reasonably available under the circumstances.

72. As set forth above, Fidelity traders allowed their receipt of travel, entertainment and gifts from brokers and their family or romantic relationships with brokers to influence their selection of brokers to handle Fidelity's securities transactions. As a result, Fidelity failed to seek best execution for its clients' securities transactions and thereby willfully violated Section 206(2) of the Advisers Act.

Fidelity Made Materially False and Misleading Public Disclosures about its Conflicts of Interest with Respect to its Selection of Brokers

Fidelity's Failure to Disclose Its Conflicts of Interest

73. Under Section 206(2) of the Advisers Act, an investment adviser has a fiduciary duty to disclose all material conflicts of interest to its advisory clients. During the Relevant Period, Fidelity failed to disclose to its clients, including the Fidelity Funds, the material conflicts of interest arising from the receipt by certain Fidelity executives and traders of travel, entertainment and gifts from brokers (including illegal drugs for Bruderman and the facilitation of illegal gambling for Driscoll) and certain traders' family and romantic relationships with brokers seeking and obtaining securities transactions for Fidelity's clients. As a result, Fidelity willfully violated Section 206(2) of the Advisers Act.

Material Misrepresentations and Omissions in Form ADV and Statements of Additional Information

74. Section 204 of the Advisers Act and Rule 204-1 thereunder require an investment adviser annually to amend and file with the Commission its Form ADV. Section 207 of the Advisers Act prohibits any person from willfully making any untrue statement of

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[20] A violation of Section 206(2) of the Advisers Act does not require a finding of scienter and may be established by a showing of negligence. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963); SEC v. Steadman, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992).

material fact or omitting to state any material fact required to be stated in any report filed with the Commission under Section 204.

75. Form ADV requires the disclosure of certain material information about the investment adviser. For an investment adviser like Fidelity with discretion to select brokers to execute its clients' securities transactions, Item 12.B of Part II of Form ADV requires a description of the factors that the adviser considers when selecting brokers.

76. Section 34(b) of the Investment Company Act prohibits any person from willfully making an untrue statement of material fact in any document filed with the Commission.

77. Fidelity provides copies of its Form ADV to the independent trustees acting on behalf of the Fidelity Funds and to other clients. As investment adviser to the Fidelity Funds, Fidelity prepares Statements of Additional Information ("SAIs") that supplement the Fidelity Funds' prospectuses and are made available to shareholders upon request.

78. During the Relevant Period, the Forms ADV and the SAIs prepared by Fidelity contained virtually identical language to the effect that Fidelity selected brokers for its clients' transactions "on the basis of professional capability and the value and quality of services." The Forms ADV and the SAIs also listed specific factors that Fidelity considered when selecting brokers, including: (a) price, size and type of transaction; (b) reasonableness of commissions; (c) speed and certainty of trade executions; (d) nature and character of the markets for the security; (e) liquidity and depth offered by a market center or market-maker; (f) reliability of the market center or broker; (g) the degree of anonymity that the broker or market center can provide; (h) the broker's execution services rendered on a continuing basis; and (i) the execution efficiency, settlement capability, and financial condition of the brokerage firm. The Forms ADV and the SAIs were materially misleading because they failed to disclose that, as set forth above, the traders' receipt of travel, entertainment and gifts (including illegal drugs for Bruderman and the facilitation of illegal gambling for Driscoll) and their family and romantic relationships were also factors in the traders' selection of brokers for Fidelity's clients' transactions, including transactions for the Fidelity Funds, and that Fidelity did not have a sufficient system of controls to detect, deter, and prevent such factors from entering into the selection of brokers. As a result, Fidelity willfully violated Sections 204 and 207 of the Advisers Act, and Rule 204-1 thereunder; and Section 34(b) of the Investment Company Act.

Material Misrepresentations and Omissions
by DeSano to the Fidelity Funds' Trustees

79. During the Relevant Period, DeSano made periodic presentations to the trustees of the Fidelity Funds concerning equity trading operations and the selection of brokers for the Fidelity Funds' transactions. For example:

a. On September 19, 2002, DeSano attended a meeting of the Brokerage Committee of the Fidelity Funds' trustees and presented Fidelity's annual report on equity trading and the use of brokerage commissions. DeSano's written report to the trustees stated that the "sole criterion" for broker selection was "execution capability" and that "brokers compete on [the] basis of execution quality."

b. On September 18, 2003, DeSano attended a meeting of the Shareholder Services, Brokerage and Distribution Committee of the Fidelity Funds' trustees and presented Fidelity's annual report on equity trading and the use of brokerage commissions. According to the minutes of the meeting:

> Mr. DeSano provided an overview of the equity trading process, stating that FMR's approach to trading is *to focus solely on execution quality, trade with the best brokers* and closely manage the impact of the funds' trades on the market. He stated that as a result of the "broker segmentation" program implemented over five years ago, FMR now trades with a relatively small number of core brokers, which reduces information leakage and *allows the brokers to compete based on the quality of their execution.* [Emphasis added]

c. On September 16, 2004, DeSano attended a meeting of the Shareholder Services, Brokerage and Distribution Committee of the Fidelity Funds' trustees and presented Fidelity's annual report on equity trading and the use of brokerage commissions. According to the minutes of the meeting:

> Mr. DeSano provided an overview of the equity trading process, stating that FMR's *highest priority in trading for the funds is execution quality.* He stated that FMR seeks to trade with the best brokers and closely manage the impact of the funds' trades on the market. He stated that as a result of broker segmentation program in place for the last six years, FMR trades with a relatively small number of core brokers, which reduces information leakage and *allows the brokers to compete based on the quality of their execution.* [Emphasis added]

80. Section 206(2) of the Advisers Act provides that an investment adviser shall not "engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." The statements by Fidelity, through DeSano, to the trustees of the Fidelity Funds were materially misleading because DeSano failed to disclose that, as set forth above, the traders' receipt of travel, entertainment and gifts and their family and romantic relationships were also factors in the selection of brokers for the Fidelity Funds' transactions, and brokers competed for Fidelity's business on the basis of travel, entertainment and gifts in

addition to execution performance. As a result, Fidelity, through DeSano, willfully violated Section 206(2) of the Advisers Act.

Fidelity Failed to Supervise Certain Employees and Officers

81. Under Section 17(e)(1) of the Investment Company Act, affiliated persons of a registered investment company are prohibited from accepting "from any source any compensation (other than a regular salary or wages from such registered company) for the purchase or sale of any property" of the investment company. During the Relevant Period, two Fidelity executives (DeSano and Grenier) and ten Fidelity traders (Beran, Bruderman, Burnieika, Burns, Donovan, Driscoll, Harris, Horan, Pascucci and Smith) each received compensation in violation of Section 17(e)(1) of the Investment Company Act in the form of travel, entertainment and gifts paid for by brokers who sought and obtained securities transactions for Fidelity's clients. In addition, another Fidelity executive (Lynch) caused two Fidelity traders' violations of Section 17(e)(1). Fidelity failed to adopt and implement a system of controls sufficient to detect, deter, and prevent the receipt by these executives and traders of travel, entertainment and gifts paid for by brokers as described herein. As a result, Fidelity failed reasonably to supervise the executives and traders, within the meaning of Section 203(e)(6) of the Advisers Act, with a view to preventing their violations of Section 17(e)(1) of the Investment Company Act.

Fidelity's Failure to Make and Keep True, Accurate and Current Copies of Certain Communications Concerning the Purchase or Sale of Securities for its Clients

82. Section 204 of the Advisers Act and Rule 204-2 thereunder require an investment adviser to make and keep true, accurate and current certain books and records relating to its investment advisory business, including originals or copies of certain documents reflecting its communications with brokerage firms relating to the placing or execution of orders to purchase or sell securities.

83. During the Relevant Period, Fidelity did not maintain a complete record of all its employees' communications with brokers regarding the placing or execution of orders to purchase or sell securities. Fidelity contracted with Bloomberg to retain copies of all communications sent through Bloomberg's email network between Fidelity's equity traders and the brokers who handled securities transactions for Fidelity. Those email records were incomplete and inaccurate because when retrieved they did not include the names of individual email users who had terminated their employment with either Fidelity or a brokerage firm, such that in certain messages those users' names would not be displayed.

84. Because, as set forth above, the emails maintained by Bloomberg on Fidelity's behalf were incomplete, Fidelity failed to make and keep true, accurate, and current originals or copies of its communications with brokers concerning the placing or execution of orders to

purchase or sell securities. As a result, Fidelity willfully violated Section 204 of the Advisers Act and Rules 204-2(a)(7)(iii) and 204-2(g) thereunder.

Fidelity's Breach of Fiduciary Duty Resulted in the
Substantial Possibility of Higher Execution Costs to its Advisory Clients

85. As set forth above, Fidelity breached its fiduciary duty to its advisory clients, including the Fidelity Funds, in several respects. First, as described herein Fidelity allowed certain executives' and traders' receipt of travel, entertainment and gifts from brokers and certain traders' family or romantic relationships with brokers to influence its selection of brokers to handle its clients' transactions, resulting in the substantial possibility of higher execution costs to Fidelity's advisory clients. Second, it failed to disclose to its clients the conflict of interest arising from its executives' and traders' receipt of travel, entertainment and gifts from brokers and certain traders' family or romantic relationships with brokers. Finally, it made materially false and misleading statements in public disclosure documents and to the Fidelity Funds' trustees about the factors considered in the selection of brokers.

86. After being informed that some equity traders had accepted travel, entertainment and gifts from some brokers, the independent trustees of the Fidelity Funds retained a former federal judge, then an attorney at a prominent national law firm, to conduct an independent assessment of the adverse impact on the Fidelity Funds, if any, resulting from trades initiated by some Fidelity traders in recognition of improper travel, entertainment and gifts. The attorney was assisted by a team of economic consultants. The attorney submitted his report to the independent trustees in November 2006. (A copy of the final report is available on the SEC Web site.)[21]

87. The report to the independent trustees concluded that "Fidelity clearly breached its duty to the Fidelity Funds to ensure that its traders acted solely for the benefit of the Funds." The report found that, while "it is impossible to 'prove' statistically that the traders' receipt of TEGG [travel, entertainment, gifts and gratuities] did or did not result in excessive execution costs for the Funds, ... both logic and contemporaneous evidence suggest that there is a substantial possibility that the traders' acceptance of TEGG could have resulted in higher execution costs for the Funds." The report further noted that "the question to be answered here is not whether the Funds were in fact harmed by the traders' receipt of TEGG, but how the Trustees should respond to the traders' breach of fiduciary duty that put the Funds in harm's way."

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[21] The following categories of information have been redacted from the final report: names of certain individuals and entities not otherwise referred to in this Order, commercially sensitive and/or proprietary information; and specific citations to sources.

88. The report recommended that the independent trustees seek payment from Fidelity to the Fidelity Funds in the amount of $40.7 million for potential harm to the Fidelity Funds in order "to ensure with reasonable confidence that the Funds do not end up being undercompensated for the improper conduct that indisputably took place." Using the same methodology, the report recommended that a payment of approximately $10.2 million for potential harm be made to non-Fund advisory clients of FMR LLC's affiliates. In addition, the report recommended that Fidelity pay $8.2 million for reimbursement of Fund expenses incurred in connection with the independent trustees' investigation, and $4.5 million of interest through November 30, 2006.

89. During the course of his 14-month investigation, the independent trustees monitored the work of the attorney, heard reports from him and his economic consultants and heard presentations from Fidelity and its economic consultant. After reviewing the attorney's final report, on December 14, 2006, the independent trustees issued their report and conclusions. (A copy of the independent trustees' report and conclusions is available on the SEC Web site.)

90. The independent trustees' report accepted the attorney's final report. The independent trustees' report concluded that, "in spite of the absence of proof that the Funds experienced diminished execution quality as a result of traders' receipt of improper TEGG, the conduct at issue was serious, is worthy of redress and, as [the attorney] concluded, any uncertainty should be resolved in favor of the Funds." The independent trustees determined that it would be "appropriate" for Fidelity to pay the Fidelity Funds $42 million plus interest and expenses.

91. On December 21, 2006, Fidelity's parent company, FMR LLC, disclosed the independent trustees' report on its public Web site and announced that Fidelity had agreed to make the payment to the Fidelity Funds requested by the independent trustees (see para. 90, above) and that it had committed to make comparable payments to institutional and other accounts that are advised by FMR LLC affiliates.

D. RESPONDENTS' REMEDIATION

92. Fidelity took several remedial actions after the Commission staff began its investigation:

a. Fidelity disciplined approximately two dozen equity traders and other employees based on written surveys, which were requested by the Commission staff, of the traders and other employees concerning their receipt of travel, entertainment and gifts received from brokers during the Relevant Period.

b. Fidelity changed several of its policies and procedures concerning conflicts of interest. First, Fidelity adopted supplemental standards of conduct applicable to all Fidelity

employees that required management approval of all private jet travel, clarified the rules on permissible business entertainment, and required employees to report to the ethics office all business entertainment exceeding $250 in value. Later, with input from the independent trustees and an ethics consultant retained by the independent trustees, Fidelity's parent company, FMR LLC revised its firm-wide business entertainment and workplace gifts policy. Subsequently, Fidelity also adopted a new relationship policy, requiring traders to notify their managers and the ethics office promptly if certain family members become employed in certain specified positions by any broker-dealer with which Fidelity does business.

c. Fidelity also reorganized the management of its equity trading operations. Among other changes, in February 2005, Fidelity established a new level of management oversight between the head of equity trading and the traders. Subsequently, Fidelity appointed a new manager for its equity trading operations.

d. Fidelity's parent company, FMR LLC, substantially increased its ethics office's funding for technology and personnel and hired a new management team to run the ethics office, including an employee whose sole responsibility is to manage compliance with FMR LLC's gifts and entertainment policies for Fidelity and other FMR LLC subsidiaries.

E. VIOLATIONS

93. As described above, Fidelity failed reasonably to supervise three Fidelity executives (DeSano, Grenier and Lynch) and ten Fidelity equity traders (Beran, Bruderman, Burnieika, Burns, Donovan, Driscoll, Harris, Horan, Pascucci and Smith), within the meaning of Section 203(e)(6) of the Advisers Act, with a view to preventing their committing and/or causing violations of Section 17(e)(1) of the Investment Company Act.

94. As described above, Fidelity failed to seek best execution for its clients' securities transactions by allowing its traders' receipt of travel, entertainment and gifts and the traders' family or romantic relationships to enter into their selection of brokers. Accordingly, Fidelity willfully violated Section 206(2) of the Advisers Act.

95. As described above, Fidelity willfully violated Section 206(2) of the Advisers Act, in that Fidelity failed to disclose to its clients, including the Fidelity Funds, the material conflict of interest arising from the receipt by certain Fidelity executives and traders of travel, entertainment and gifts (including illegal drugs for Bruderman and the facilitation of illegal gambling for Driscoll) from, and certain traders' family or romantic relationships with, brokers seeking and obtaining securities transactions for Fidelity's clients.

96. As described above, Fidelity willfully violated Sections 204, 206(2) and 207 of the Advisers Act and Rule 204-1 thereunder and Section 34(b) of the Investment Company Act, in that Fidelity made materially false and misleading statements and omissions in its Forms ADV and in Statements of Additional Information for the Fidelity Funds about its selection of brokers.

97. As described above, Fidelity willfully violated Section 206(2) of the Advisers Act, in that Fidelity, through DeSano, made materially false and misleading statements and omissions to the trustees of the Fidelity Funds concerning the factors considered in its selection of brokers and the bases upon which brokers competed for the Fidelity Funds' brokerage business.

98. As described above, Fidelity willfully violated Section 204 of the Advisers Act and Rules 204-2(a)(7)(iii) and 204-2(g) thereunder, in that Fidelity failed to make and keep true, accurate, and current originals or copies of certain communications with brokers concerning the placing or execution of orders to purchase or sell securities.

IV.

UNDERTAKINGS

Respondents have undertaken to:

A. Independent Compliance Consultant.

1. Within 30 days of the entry of the Order, Fidelity shall retain an Independent Compliance Consultant ("ICC") not unacceptable to the staff of the Commission and the independent trustees. The ICC's compensation and expenses shall be paid exclusively by Fidelity. Fidelity shall cause the ICC to conduct a comprehensive review of Fidelity's current policies and procedures designed to prevent and detect violations of Section 17(e)(1) of the Investment Company Act and Fidelity's securities trading with respect to the following: (i) remediation actions relating to its equity trading operations; (ii) gifts and gratuities policies and procedures; and (iii) other current policies and procedures designed to prevent undisclosed conflicts of interest. Fidelity shall cooperate fully with the ICC and comply with all of the ICC's reasonable requests for access to Fidelity's files, books, records, and personnel.

2. Fidelity 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 ICC shall submit a Report to Fidelity, the independent trustees, and to the staff of the Commission. Fidelity shall require the ICC 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 ICC's recommendations for changes in or improvements to Fidelity's policies and procedures for implementing the recommended changes in or improvements to Fidelity's policies and procedures.

3. Fidelity shall adopt all recommendations contained in the Report of the ICC; provided, however, that within 150 days from the date of the entry of this Order, Fidelity shall in writing advise the ICC, the independent trustees, and the staff of the Commission of any recommendations that it considers to be unnecessary or inappropriate. With respect to any

recommendation that Fidelity considers unnecessary or inappropriate, Fidelity 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.

4. As to any recommendation with respect to Fidelity's policies and procedures on which Fidelity and the ICC 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 Fidelity and the ICC are unable to agree on an alternative proposal acceptable to the staff of the Commission, Fidelity will abide by the determinations of the ICC.

5. Fidelity (i) shall not have the authority to terminate the ICC, without prior written approval of the staff of the Commission; (ii) shall compensate the ICC, and persons engaged to assist the ICC, 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 ICC and shall not seek to invoke the attorney-client or any other doctrine or privilege to prevent the ICC from transmitting any information, reports, or documents to the staff of the Commission.

6. Fidelity shall require the ICC 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 ICC shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with Fidelity, or with any of Fidelity's present or former affiliates, directors, officers, employees, or agents acting in such capacity. The agreement will also provide that the ICC 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 ICC in performance of his/her duties under this Order shall not, without prior written consent of the Commission staff, enter into any employment, consultant, attorney-client, auditing or other professional relationship with Fidelity, or with any of Fidelity's present or former affiliates, directors, officers, employees, or agents acting in such capacity for the period of the engagement and for a period of two years after the engagement.

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

C. Recordkeeping. Fidelity 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 Fidelity's compliance with the undertakings set forth in this section IV.

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

E **Other Obligations and Requirements.** Nothing in this Order shall relieve

Fidelity of any other applicable legal obligation or requirement, including any rule adopted by the Commission subsequent to this Order.

F. Payment of the penalty referenced in paragraph V.C, below, shall not reduce the amount Fidelity has committed, as set forth in paragraph 91 above, to pay to the Fidelity Funds and institutional and other accounts.

In determining whether to accept the Offer, the Commission has considered these undertakings and Fidelity's commitment to make payments to the Fidelity Funds and institutional and other accounts, as set forth in paragraph 91, above.

V.

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 203(e) and 203(k) of the Advisers Act, and Section 9(b) and 9(f) of the Investment Company Act, it is hereby ORDERED that:

A. Respondents FMR and FMR Co. cease and desist from committing or causing any violations and any future violations of Sections 204, 206(2) and 207 of the Advisers Act and Rules 204-1 and 204-2 thereunder and Section 34(b) of the Investment Company Act;

B. Respondents FMR and FMR Co. be, and hereby are, censured;

C. FMR (as parent of FMR Co.) shall, within 10 days of the date of entry of this Order, pay a civil money penalty in the amount of $8 million to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies FMR as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to David P. Bergers, Regional Director, Division of Enforcement, U.S. Securities and Exchange Commission, Boston Regional Office, 33 Arch Street, 23rd Floor, Boston, MA 02110; and

D. Respondents shall comply with the undertakings enumerated in Section IV above.

By the Commission.

Nancy M. Morris
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Chairman Cox
Not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
March 5, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12978

In the Matter of **SCOTT E. DeSANO,** **THOMAS H. BRUDERMAN,** **TIMOTHY J. BURNIEIKA,** **ROBERT L. BURNS,** **DAVID K. DONOVAN,** **EDWARD S. DRISCOLL,** **JEFFREY D. HARRIS,** **CHRISTOPHER J. HORAN,** **STEVEN P. PASCUCCI and** **KIRK C. SMITH** **Respondents.**	**CORRECTED ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS AND NOTICE OF HEARING PURSUANT TO SECTIONS 203(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940 AND SECTIONS 9(b) AND 9(f) OF THE INVESTMENT COMPANY ACT OF 1940**

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(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Investment Company Act") against the individual respondents identified below.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. **Scott E. DeSano** ("DeSano"), age 47, lives in Boston, Massachusetts. He was associated with the adviser to the Fidelity group of mutual funds, FMR Co., Inc. (FMR Co.), from 1991 to July 2005, and was its senior vice president in charge of global equity trading from 1996 until he was reassigned to employment with an affiliated entity in July 2005. DeSano resigned on July 25, 2007, and is currently not employed in the financial services industry. From at least January 1, 2002 through October 31, 2004 (the "Relevant Period"), DeSano supervised FMR Co.'s Boston domestic equity trading desk, ("Equity Trading Desk") and other equity trading operations.[1] DeSano supervised more than thirty equity traders during the Relevant Period. He reported to a senior vice president of FMR Co. (Bart Grenier). He also appeared as a representative of FMR Co. in public testimony before Congress, the Commission, and other regulatory bodies.

2. **Thomas H. Bruderman** ("Bruderman"), age 39, lives in Boston, Massachusetts. He was an equity trader at FMR Co. from 1998 until his resignation in December 2004. During the Relevant Period, he was a sector trader specializing in healthcare and pharmaceuticals stocks.

3. **Timothy J. Burnieika** ("Burnieika"), age 38, lives in Cohasset, Massachusetts. He was an equity trader at FMR Co. from 2000 until September 2005, when he was reassigned to other duties that do not involve trading. During the Relevant Period, he was a primary trader reporting to respondent Steven P. Pascucci.

4. **Robert L. Burns** ("Burns"), age 46, lives in Brookline, Massachusetts. He was an equity trader at FMR Co. from 1986 until his resignation in December 2004. During the Relevant Period, he was a sector trader specializing in technology stocks and reporting to respondent David K. Donovan.

5. **David K. Donovan** ("Donovan"), age 45, lives in Marblehead, Massachusetts. He was an equity trader at FMR Co. from 1992 until his resignation in March 2005. During the Relevant Period, he was a sector trader specializing in technology stocks, and he was also a team leader of several sector traders, including respondents Burns, Jeffrey D. Harris and Kirk C. Smith.

6. **Edward S. Driscoll** ("Driscoll"), age 42, lives in Scituate, Massachusetts. Aside from a ten-month stint at another firm, he was an equity trader at FMR Co. from 1997 until his

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[1] As discussed below, the Equity Trading Desk included "primary" traders, who worked closely with certain FMR Co., Inc. portfolio managers, and "sector" traders, who were responsible for trading equities in certain industries.

resignation in March 2005. During the Relevant Period, he was a sector trader specializing in food and beverage, household items, materials, and capital goods stocks.

7. **Jeffrey D. Harris** ("Harris"), age 35, lives in Charlestown, Massachusetts. He was an equity trader at FMR Co. from 1998 until his resignation in July 2005. During the Relevant Period, he was a sector trader specializing in technology stocks and reporting to respondent Donovan.

8. **Christopher J. Horan** ("Horan"), age 37, lives in Boston, Massachusetts. He was an equity trader at FMR Co. from 1999 until September 2005, when he was reassigned to other duties that do not involve trading. During the Relevant Period, he was a sector trader specializing in insurance, capital goods, and restaurant stocks.

9. **Steven P. Pascucci** ("Pascucci"), age 41, lives in Concord, Massachusetts. He was an equity trader at FMR Co. from 1997 until September 2005, when he was reassigned to other duties that do not involve trading. During the Relevant Period, he was a primary trader, and from 1998 until early 2005, he was a team leader of the other primary traders, including respondent Burnieika.

10. **Kirk C. Smith** ("Smith"), age 43, lives in Walpole, Massachusetts. He was an equity trader at FMR Co. from 1997 until September 2005, when he was reassigned to other duties that do not involve trading. During the Relevant Period, he was a sector trader specializing in technology stocks and reporting to respondent Donovan.

B. OTHER RELEVANT PARTIES[2]

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

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

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[2] The following related administrative proceedings were instituted today: In the Matter of Fidelity Management & Research Company and FMR Co., Inc.; In the Matter of Peter S. Lynch; In the Matter of Bart A. Grenier; and In the Matter of Marc C. Beran.

13. **Peter S. Lynch** ("Lynch"), age 64, lives in Marblehead, Massachusetts. He has been associated with FMR and FMR Co. in various capacities since 1969, and was the portfolio manager of Fidelity's Magellan Fund from 1977 to 1990. Since retiring from managing Magellan, respondent Lynch has been the vice chairman and a director of FMR and FMR Co. He was an interested trustee of the Fidelity family of mutual funds from 1990 until February 2003, and has since served as a member of the Advisory Board of the Fidelity family of mutual funds.

14. **Bart A. Grenier**, age 49, lives in Boston, Massachusetts. Aside from a four-month period in 1997, Grenier was associated with FMR Co. from 1991 until June 2005. During the Relevant Period, he was a senior vice president of FMR Co. with supervisory responsibility for FMR Co.'s equity trading operations and several of its other business groups.

15. **Marc C. Beran**, age 38, lives in Southborough, Massachusetts. He was an equity trader at FMR Co. from 1997 until his resignation in January 2005. During the Relevant Period, he was a sector trader specializing in energy and materials stocks.

C. FACTS

Summary

16. FMR and FMR Co. (collectively "Fidelity") manage one of the largest mutual fund complexes in the United States. Its equity trading desk buys and sells millions of shares of stock every day for the Fidelity Funds and other institutional clients. As an investment adviser, Fidelity has a fiduciary duty to seek best execution for its clients' securities transactions and to disclose to its clients all material conflicts of interest.

17. During the period from at least January 2002 through October 2004 ("the Relevant Period"), the respondents in aggregate accepted more than $1.5 million worth of travel, entertainment and gifts from brokerage firms that sought and obtained orders to buy or sell securities on behalf of Fidelity's advisory clients. Those brokerage firms each received millions of dollars in commission revenue for handling orders from Fidelity's advisory clients' accounts. The respondents in aggregate accepted from brokers dozens of expensive trips, frequently by private jet, including excursions to the Super Bowl, family vacations to Bermuda, Nantucket and the Caribbean, golf outings at exclusive clubs in Florida and South Carolina, weekends in Las Vegas, lodging at fine hotels, and even an extravagant, three-day bachelor party for Bruderman in Miami. Brokers also provided the respondents with gifts including premium tickets to the World Series, the U.S. Open, Wimbledon, Rolling Stones concerts, and dozens of other sporting events and concerts. In addition, Bruderman accepted illegal drugs from brokers, and Driscoll's illegal gambling was facilitated by a broker, but neither Bruderman nor Driscoll disclosed that information to any manager at Fidelity.

18. Under Section 17(e)(1) of the Investment Company Act, affiliated persons of a registered investment company, such as Fidelity executives and traders, are prohibited from accepting "from any source any compensation (other than a regular salary or wages from such

registered company) for the purchase or sale of any property" of the investment company. The objective of Section 17(e)(1) of the Investment Company Act is to prevent persons affiliated with registered investment companies from having conflicts of interest impair their judgment and loyalty. A violation of Section 17(e)(1) of the Investment Company Act is complete upon receipt of the compensation. During the Relevant Period, the respondents each received compensation within the meaning of Section 17(e)(1) of the Investment Company Act in the form of travel, entertainment and gifts paid for by brokers who sought and obtained transactions for Fidelity's clients. In addition, Burns and Harris each obtained tickets from brokers to satisfy requests from Lynch. As a result, the respondents each willfully violated Section 17(e)(1) of the Investment Company Act.

19. DeSano, who supervised Fidelity's equity trading operations, personally accompanied certain traders on several trips by private jet paid for by brokers, including attending part of Bruderman's bachelor party in Miami, and personally solicited tickets from brokers for himself and to satisfy requests from his supervisor, Grenier. Traders also told DeSano about some of the other private jet trips and tickets they received from brokers. Nevertheless, DeSano failed to monitor traders' receipt of travel, entertainment and gifts in any systematic way. As a result, DeSano failed reasonably to supervise ten traders (Beran, Bruderman, Burnieika, Burns, Donovan, Driscoll, Harris, Horan, Pascucci and Smith), within the meaning of Section 203(e)(6) of the Advisers Act, with a view to preventing their violations of Section 17(e)(1) of the Investment Company Act.[3]

20. Under Section 206 of the Advisers Act, an investment adviser has a fiduciary duty to seek best execution for its clients' securities transactions – that is, to seek the most favorable terms reasonably available under the circumstances. In determining whether an adviser is seeking best execution, the key criterion is whether the adviser selects the transaction which "represents the best qualitative execution for the managed account."[4] During the Relevant Period, the respondent traders (plus Beran) allowed the receipt of travel, entertainment and gifts to influence their selection of brokers to handle transactions for Fidelity's clients. As one trader commented to another, "Word is out that order flow is for sale."[5] In addition, certain traders

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[3] As set forth in a separate administrative proceeding instituted today, Beran willfully violated Section 17(e)(1) of the Investment Company Act through the receipt of compensation in the form of travel and gifts paid for by brokers handling transactions for Fidelity's clients.

[4] Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934, Exchange Act Rel. No. 23170, 1986 SEC LEXIS 1689, at *38 (Apr. 23, 1986) ("1986 Soft Dollar Release"); *see also* Market 2000 Report: Study V, Best Execution, 1994 SEC LEXIS 136, at *42 n.65 ("Market 2000 Report") ("[M]oney managers in fulfilling their duties of best execution . . . must evaluate periodically the performance of the broker-dealers that execute their transactions."); *Renberg Capital Management, Inc.*, Advisers Act Rel. No. 2064, 2002 WL 31174796, *2 (Oct. 1, 2002); *Portfolio Advisory Services, LLC*, Advisers Act Rel. No. 2038, 2002 WL 1343823, *2 (June 20, 2002).

[5] All communications among DeSano, traders and brokers cited in this Order are from an email network maintained by Bloomberg for Fidelity and are quoted with their original spelling and punctuation. Brackets are used to clarify abbreviations or other terms and to indicate where names have been omitted.

routinely sent transactions to brokers who were members of their families or brokers with whom they had a romantic relationship.[6] DeSano knew that certain traders directed transactions to brokers who provided them with travel, entertainment and gifts, and he also knew that certain traders directed transactions to brokers who were members of their family or with whom they had a romantic relationship. Nevertheless, DeSano failed to take reasonable steps to prevent such factors from entering into the traders' selection of brokers or to ensure that the traders were seeking best execution. Accordingly, DeSano was a cause of Fidelity's violation of Section 206(2) of the Advisers Act.[7]

21. Under Section 206 of the Advisers Act, an investment adviser has a fiduciary duty to disclose all material conflicts of interest to its advisory clients. During the Relevant Period, Fidelity failed to disclose to its advisory clients the conflicts of interest arising from the receipt by certain Fidelity executives and traders, as described herein, of travel, entertainment and gifts (including illegal drugs for Bruderman and the facilitation of illegal gambling for Driscoll) paid for by brokers, and certain traders' family and romantic relationships with brokers who sought and obtained securities transactions for Fidelity's clients, and failed to disclose that such travel, entertainment, gifts and relationships were additional factors in the traders' selection of brokers. Accordingly, DeSano, Bruderman and Driscoll were each a cause of Fidelity's violation of Section 206(2) of the Advisers Act.

22. Under Sections 204, 206 and 207 of the Advisers Act and Rule 204-1 thereunder, an investment adviser may not make materially false and misleading statements in public disclosure documents, such as an investment adviser's Form ADV. During the Relevant Period, Fidelity's Forms ADV stated that Fidelity selected brokers for its clients' transactions based on an itemized list of factors but failed to include the additional significant factors considered by certain traders – their receipt of travel, entertainment and gifts from brokers and their family or romantic relationships with brokers. DeSano was, at least, negligent in not knowing that Fidelity's Forms ADV contained misleading statements concerning the factors considered in selecting brokers. Moreover, DeSano's acceptance of TEGG from brokers caused Fidelity's disclosures to be false and misleading. As a result, DeSano caused Fidelity's violations of Sections 204, 206(2) and 207 of the Advisers Act and Rule 204-1 thereunder.

23. On behalf of Fidelity, DeSano made presentations to committees of the trustees of the Fidelity Funds in which he identified the factors that Fidelity used in selecting brokers. DeSano also told the trustees that Fidelity required brokers to compete for its brokerage business based on the quality of their trade execution. Those statements were false and misleading because DeSano failed to disclose: (1) that certain Fidelity traders selected brokers for Fidelity's business based on additional significant factors of which he was aware – travel,

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[6] Two traders not named in this Order sent Fidelity brokerage business to brokers with whom they were having romantic relationships.

[7] Fidelity's violations of Section 206 of the Advisers Act as identified in this paragraph and in paragraphs 21 and 22 is addressed in the separate administrative proceeding instituted today against FMR and FMR Co.

entertainment and gifts from brokers and family or romantic relationships with brokers – and (2) that brokers competed for Fidelity's business based on those additional factors as well. As a result, DeSano willfully aided and abetted and was a cause of Fidelity's violation of Section 206(1) of the Advisers Act.

Background on Fidelity's Equity Trading Desk

24. The Fidelity Funds and certain of Fidelity's other institutional clients' accounts are managed by portfolio managers who make investment decisions on their behalf. The portfolio managers send their orders to equity traders, who are responsible for selecting brokers to handle the transactions. During the Relevant Period, the Equity Trading Desk bought and sold more than 73 billion shares of equity securities (nearly 26 billion shares per year) with a total principal of more than $1.4 trillion (nearly $500 billion per year). Fidelity's equity trading generated more than $2.3 billion in commissions (over $800 million per year) paid to brokerage firms by Fidelity's clients, including the Fidelity Funds.

25. During the Relevant Period, FMR Co.'s equity trading operations employed nearly sixty people, including 33 traders (seven "primary" traders and 26 "sector" traders). Under DeSano's supervision, the traders had broad discretion to select brokerage firms to handle securities transactions. The primary limitation was that the traders could only select from a list of approximately 100 firms that had been formally approved by Fidelity.

DeSano and Traders Received Travel, Entertainment and Gifts Paid for Brokers Seeking and Obtaining Securities Transactions for Fidelity's Clients

Overview

26. During the Relevant Period, the respondents in aggregate accepted over $1.5 million worth of travel, entertainment and gifts from brokerage firms that sought and obtained orders to buy or sell securities on behalf of Fidelity's advisory clients.[8] Brokers took DeSano and certain traders, sometimes in groups, on more than thirty trips to such destinations as the Super Bowl, Las Vegas, Florida, the Caribbean, and Nantucket. These excursions sometimes included travel by private jet, lodging at fancy resorts, entry to exclusive golf courses, tickets to major sporting events, limousine service, expensive dinners, other amenities such as spa services, and, for certain traders, adult entertainment and illegal drugs. Bruderman even organized, and brokers paid for, his own extravagant, three-day bachelor party in Miami, part of which DeSano attended and which cost brokers approximately $160,000.

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[8] The aggregate cost to the brokerage firms was approximately $3 million, primarily because they sent one or more brokerage firm employee on entertainment trips with Fidelity employees.

27. One brokerage firm seeking and obtaining Fidelity's business, Jefferies & Co., Inc. ("Jefferies"), gave one of its brokers, Kevin W. Quinn, a travel and entertainment budget of $1.5 million per year. From that budget, Quinn entertained DeSano and several traders, primarily by taking them on weekend excursions by private jet.[9] For example, Quinn organized an annual trip he called the "Fall Classic," which included private jet travel, exclusive golf outings, lodging at expensive resorts, and other activities. During the November 2002 Fall Classic, for example, Quinn took DeSano, Bruderman and Harris by private jet to Las Vegas. Quinn provided accommodations at the Bellagio Hotel, several thousand dollars worth of golf merchandise, a private band, meals, golf, and entertainment at a nearby strip club. The group continued by private jet to Cabo San Lucas, Mexico, where Quinn provided accommodations in villas at the Esperanza Hotel, meals, more golf, and other entertainment. Jefferies paid approximately $200,000 for the expenses incurred on this trip.

28. Brokers other than Quinn also took Fidelity traders on a variety of trips. For example, during the Relevant Period, various brokers took several traders to Super Bowls. Brokers often provided the traders with travel by private jet, lodging at expensive hotels, admission to exclusive pre-game parties, tickets to the Super Bowl, golf greens fees, limousines, and other lavish entertainment. Even when they did not provide private jets, brokers often took traders on trips to Las Vegas and on golf weekends to Florida and other warm-weather locations, usually paying for the traders' lodging and meals and sometimes paying for other travel expenses such as commercial airfare.

29. On more than twenty other occasions, brokers made a private jet available for personal use by DeSano and/or certain traders (and at times, their families), without accompanying the Fidelity employee on the trip. Some of the private jet trips were short (such as weekend excursions to Nantucket), but others were quite long (such as flights to Florida and the Caribbean) and cost brokers up to $50,000 or more per trip.

30. Besides the trips, brokers gave the respondents a total of approximately 900 tickets for some of the best seats at more than 270 sporting events, concerts, and other events, none of which the broker attended with the recipient. The events included the World Series, prominent tennis tournaments (Wimbledon, the U.S. Open, and the French Open), Broadway shows, concerts by nationally-known performers (such as the Rolling Stones and Bruce Springsteen), and dozens of sporting events, including baseball, basketball, football and hockey playoff and regular season games.[10]

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[9] Quinn signed an employment agreement with Jefferies in May 2002 and began working in the firm's Boston office on September 3, 2002. On December 1, 2006, the Commission instituted settled administrative proceedings against Jefferies, a Jefferies senior executive, and Quinn with respect to Quinn's provision of approximately $2 million in travel, entertainment and gifts to DeSano and certain Fidelity traders. *See* Matter of Jefferies & Co., Inc. *et al.*, Release No. 34-54861 (Dec. 1, 2006), *and* Matter of Kevin W. Quinn, Release No. 34-54862 (Dec. 1, 2006).

[10] Most of the sporting events involved the Boston-area professional teams: the Bruins, Celtics, Patriots, and Red Sox.

31. Most of the tickets were for premium or exclusive seats (such as luxury boxes or seats close to the stage, court or field). Brokers frequently provided multiple tickets to the event, so that the recipient could bring his family or friends. The tickets often cost the brokers hundreds of dollars each, and tickets to special events such as playoff games often cost them more than $1,000 each.

32. In addition, brokers sent certain traders expensive wine (including cases that cost from $1,000 to $7,700 and were delivered straight to their homes), and other costly items such as entry to a racing school (over $5,000) and a humidor filled with cigars (approximately $1,300).

The Individual Respondents

33. DeSano received more than $145,000 worth of travel, entertainment and gifts from brokers during the Relevant Period. He received the personal use of Quinn's private jet for at least two trips, and he went on at least six private jet trips with brokers, primarily Quinn.[11] The trips by private jet included the "Fall Classic" in Las Vegas and Mexico in November 2002, Bruderman's bachelor party in Miami in March 2003, and golf trips to locations such as Sea Island, Georgia, West Palm Beach, Florida, and the Winged Foot Golf Club in Mamaroneck, New York. Brokers also gave DeSano nearly fifty tickets to more than twenty events, including several Bruins, Celtics, Patriots and Red Sox playoff games.

34. Bruderman received more than $450,000 worth of travel, entertainment and gifts from brokers during the Relevant Period.[12] One example was his bachelor party in Miami, Florida in March 2003. Bruderman solicited certain brokers to arrange and pay for the event, and the brokers complied – at a total cost of approximately $160,000. The festivities included private jet travel, luxury accommodations at the Delano Hotel, a chartered yacht, golf, a limousine, and other entertainment such as expensive dinners and strip clubs. Brokers hired two women to entertain the attendees at the party and provided a bag filled with illegal drugs (ecstasy pills) to Bruderman.[13] (DeSano, who attended the bachelor party and flew to Miami on the private jet with Bruderman, several brokers, and the two women, believed that the

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[11] DeSano's frequent absences from the trading desk, which earned him the nickname "The Owl," (short for "the spotted owl", as in something rarely seen), hindered his ability to supervise the equity traders. Traders gossiped about DeSano's frequent absences. In January 2003, for example, Pascucci commented to another trader that DeSano had been on his "129th golf junket of last year."

[12] One representative at a firm that provided Bruderman with extravagant trips and gifts expressed the firm's attitude as, "Whatever Brudy wants, Brudy gets."

[13] Brokers sometimes offered illegal drugs to Bruderman. For example, in February 2002, a broker through whom Bruderman executed securities transactions for Fidelity clients sent him an email asking, "U want beans." (Certain traders and brokers used slang such as "beans" and "Scooby snacks" to refer to ecstasy.) On other occasions, Bruderman solicited drugs from brokers. For example, in January 2004, he asked a broker, "Long any snacks?" The broker responded, "For the Superbowl??? I most likely will b able to take care of that." Bruderman replied, "I would like to order 10 if you have a guy?" Bruderman failed to inform anyone at Fidelity of the conflicts created by his receipt of illegal drugs from brokers.

women hired by the brokers were prostitutes.) In addition to his bachelor party and other wedding-related expenses, brokers paid all or part of Bruderman's share of approximately 25 other trips. Bruderman obtained private jet travel on more than twenty of those occasions. The trips included such destinations as the Super Bowl (twice), the Caribbean, and Cabo San Lucas, Mexico (on the November 2002 "Fall Classic"). On approximately ten of the trips, brokers were not present and simply provided Bruderman and/or his fiancée (later wife) with the use of a private jet. These included trips to Puerto Rico, Florida, and his honeymoon in Los Angeles. Brokers also provided Bruderman with lodging on at least fourteen occasions, airfare on commercial jets on at least six occasions, and other gifts such as entry to a racing school (over $5,000), thousands of dollars worth of wine, a humidor with cigars ($1,300), and limousine service. Finally, brokers gave Bruderman at least thirty tickets to at least seven events, including the U.S. Open tennis tournament and front-row seats at a Dave Matthews concert.

35. Burnieika received more than $55,000 worth of travel, entertainment and gifts from brokers during the Relevant Period, mostly consisting of premium tickets to professional sporting events. Indeed, brokers gave Burnieika approximately 175 tickets to more than fifty events that the brokers did not attend, including several Celtics and Red Sox playoff games, numerous other Celtics and Red Sox games, and concerts by the Rolling Stones and Bruce Springsteen. Burnieika also went on ten trips with brokers to such destinations as the Super Bowl, Las Vegas, and Aspen, Colorado. Four of the trips were by private jet, while the other six trips were by commercial jet with brokers who paid for some of his lodging and other travel and entertainment expenses.

36. Burns received more than $180,000 worth of travel, entertainment and gifts from brokers during the Relevant Period. Burns received more than 190 tickets to more than forty events that the brokers did not attend, plus fourteen tickets for Burns' friends to attend three events that Burns attended with brokers. Burns received at least $140,000 of tickets and other gifts from Quinn at Jefferies, and Quinn did not attend any of the events for which he provided tickets. For example, over a three-year period, Quinn spent more than $100,000 so that Burns could attend the Wimbledon tennis tournament. In 2002 and 2003, Quinn simply gave Burns tickets to the tournament. In 2004, he not only gave Burns tickets that cost more than $38,000, but he also paid for Burns and his friends to stay at the Lanesborough Hotel in London, at a cost of nearly $13,000. Quinn also had cases of expensive wine delivered to Burns' home as Christmas gifts – at a cost of more than $5,900 in December 2002 and more than $7,700 in December 2003. In addition, on certain occasions at Lynch's request, Burns solicited and obtained tickets to sporting and theater events from brokers doing business or seeking to do business with Fidelity.

37. Donovan received more than $270,000 worth of travel, entertainment and gifts from brokers during the Relevant Period, mostly consisting of trips by private jet to the Super Bowl, Las Vegas, the Bahamas, Florida, and other vacations. In total, brokers paid all or most of Donovan's expenses on 24 trips, including travel by private jet to at least sixteen destinations, first-class flights on the Concorde on at least two occasions, and lodging on eighteen occasions. For example, in June 2002, one broker took Donovan to Paris for the French Open tennis tournament and paid for his lodging at the Hotel George V, and in August 2003, the same broker took Donovan and his wife to London for the Wimbledon tennis tournament and paid for their lodging

at the Ritz Hotel. On six occasions, the broker did not attend but simply provided Donovan with the use of a private jet for himself and sometimes his family. In addition, brokers gave Donovan a case of wine valued at approximately $1,000 on two separate occasions, as well as more than sixty tickets to more than twenty events.

38. Driscoll received more than $45,000 worth of travel, entertainment and gifts from brokers during the Relevant Period. This included the exclusive use of Quinn's private jet, as well as car service, for a family vacation to DisneyWorld in Florida, at a cost to Jefferies of approximately $25,000. Driscoll also went on four trips with brokers to the Super Bowl and Las Vegas, two of which included private jet travel and three of which included lodging. Brokers also gave Driscoll more than 55 tickets to at least sixteen events that the brokers did not attend, primarily Celtics games.[14]

39. Harris received more than $125,000 worth of travel, entertainment and gifts from brokers during the Relevant Period, including some or all of the costs associated with more than twenty trips.[15] On three occasions, the brokers did not attend but simply provided Harris with the use of a private jet, such as a March 2004 trip with Horan to Turks & Caicos in the Caribbean. On eight other occasions, brokers took Harris by private jet on trips such as the "Fall Classic" in 2002 and 2003, the Super Bowl, various other golf trips, and vacations to places such as Nantucket and Florida. On nearly all the trips, brokers paid for his lodging and other expenses. In addition, brokers gave Harris more than thirty tickets to at least fourteen events, including several Patriots and Red Sox games and concerts by Santana and Fleetwood Mac. In addition, on at least one occasion at Lynch's request, Harris solicited and obtained tickets to a concert from a broker doing business or seeking to do business with Fidelity.

40. Horan received more than $120,000 worth of travel, entertainment and gifts from brokers during the Relevant Period, including some or all of his lodging and other travel expenses on at least 24 trips. Eleven of the trips were by private jet, including excursions to the Super Bowl, one "Fall Classic" sponsored by Quinn, and trips to destinations such as Las Vegas, Martha's Vineyard, and the Pebble Beach golf course in California. On three occasions, the brokers did not attend but simply provided Horan with the use of a private jet. For example, Quinn provided a private jet for Horan and his girlfriend (as well as Harris) to return from a weekend in Florida in February 2003, and the flight cost Jefferies more than $56,000. In addition, brokers gave Horan more than seventy tickets to at least 25 events, including Super Bowl and several Celtics and Red Sox playoff games. In addition, Horan received over twenty gifts from brokers, including a case of wine valued at $400-$500 and other items such as gift certificates and clothing.

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[14] In addition, one broker facilitated Driscoll's illegal gambling by delivering his bets to a bookie and even, at one point, by temporarily covering his $10,000 debt to the bookie. Driscoll failed to inform any Fidelity manager of that conduct.

[15] After Quinn took Harris on a golf trip to South Carolina, Harris offered in an email to split the greens fee and condominium rental. Quinn declined, replying "OPM [other people's money]."

41. Pascucci received more than $50,000 worth of travel, entertainment and gifts from brokers during the Relevant Period, consisting primarily of more than 165 tickets to more than fifty events that the broker did not attend, including several Patriots and Red Sox playoff games, numerous Celtics and Red Sox regular season games, and a performance of "The Producers." Brokers also paid for some of Pascucci's lodging and other travel expenses on at least five trips, including one trip to Dallas involving a stay at the Four Seasons Hotel, attendance at a Dallas Cowboys football game, a meeting with Bill Parcells (then the Cowboys coach), a return flight to Boston on a broker's private jet, and limousine service to and from the airport.

42. Smith received more than $85,000 worth of travel, entertainment and gifts from brokers during the Relevant Period. In November 2003, Quinn provided Smith with the use of a private jet so that Smith and his wife could take a vacation in the Caribbean, and the trip cost Jefferies more than $46,000. In addition to paying some of Smith's lodging and other travel expenses on two other trips, brokers gave Smith more than 150 tickets to more than forty events that the broker did not attend, including several Celtics, Patriots and Red Sox playoff games, numerous other Patriots and Red Sox games, several college hockey games, and concerts by the Rolling Stones and Van Morrison.

Violation of Section 17(e)(1) of the Investment Company Act

43. Under Section 17(e)(1) of the Investment Company Act, affiliated persons of a registered investment company, such as Fidelity executives and traders, are prohibited from accepting "from any source any compensation (other than a regular salary or wages from such registered company) for the purchase or sale of any property" of the investment company.

44. During the Relevant Period, each of the respondents received prohibited compensation within the meaning of Section 17(e)(1) of the Investment Company Act in the form of travel, entertainment and gifts paid for by brokers who sought and obtained from the traders securities transactions for the Fidelity Funds.[16]

DeSano Failed Reasonably to Supervise the Traders' Receipt of Travel, Entertainment and Gifts from Brokers

DeSano's and Traders' Violations of Fidelity's Gifts and Gratuities Policy

45. During the Relevant Period, Fidelity had a gifts and gratuities policy for its employees. The policy stated that it was designed to avoid "any actual or apparent conflict of interest or impropriety."

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[16] In addition, as set forth in the separate administrative proceedings instituted against them today, Grenier received approximately $38,500 worth of tickets from brokers during the Relevant Period, and Beran received more than $11,000 worth of travel, entertainment and gifts from brokers during the Relevant Period.

a. The policy prohibited employees from "condition[ing] any business or other transaction on the giving or acceptance of any gift or favor," from "accept[ing] gifts or other gratuities with a value of more than $100 per calendar year to or from any Company or individual" doing business with Fidelity and from "accept[ing] tickets valued at more than $100 per calendar year if the one giving does not attend the event with the recipient." Employees were required to submit written requests for approval to receive gifts beyond the $100 limit.

b. The policy prohibited employees from "soliciting any gift, favor or other form of preferential treatment" and from "accept[ing] transportation (other than local ground transportation), lodging or other travel-related expenses to attend an athletic, cultural, social or entertainment event with a current or prospective vendor, customer, or supplier" unless the employee reimbursed the giver. Further, this section of the policy required "[a]n employee invited to attend such an event (whether attending with the giver or not) [to] either pay his or her own way, or reimburse the vendor, customer or supplier for these expenses."

c. The policy permitted "[o]ccasional business entertainment (such as a meal or a recreational activity) where the giver attends the event with the recipient and the primary purpose is to discuss business or build a business relationship."

46. On an annual basis during the Relevant Period, the respondents were asked to acknowledge receipt of Fidelity's code of ethics and certify that they understood the policies that applied to them and conducted themselves in accordance with the policies. Accompanying the acknowledgement form was the actual code of ethics. It typically was an approximately 20-page document that primarily covered personal securities transactions. Each version of the code of ethics during the Relevant Period referred to Fidelity's gifts and gratuities policy by name, summarized its major requirements, and, in one instance, contained a hyperlink to the policy. The respondent traders each acknowledged receipt and compliance with Fidelity's code of ethics at least once during the Relevant Period.

47. On an annual basis, Fidelity's ethics office provided code of ethics training to employees, including presentation of a slide setting forth the major requirements of Fidelity's gifts and gratuities policy. Each of the respondent traders attended the code of ethics training at least once during the Relevant Period.

48. The respondents each violated Fidelity's gifts and gratuities policy when they accepted travel, entertainment and gifts from brokers who sought and obtained securities transactions from Fidelity. For example:

a. Many of the travel and entertainment events and gifts that the respondents received from brokers were worth more than $100, yet none of the employees ever submitted a written request for approval.

b. The traders frequently solicited brokers for tickets to a particular event. In fact, they sometimes asked for tickets so close to the date of the event that the brokers had to obtain the tickets from ticket agencies at prices well above face value.

c. On many occasions, the respondents did not reimburse the brokers for the private jets, lodging, and other travel expenses, in violation of Fidelity's gifts and gratuities policy. On some occasions, brokers refused to accept reimbursement checks from traders; and on other occasions, the broker accepted a check not intending to cash it and informed the trader the check was just for "paper trail" purposes.

DeSano's Failure to Supervise the Traders' Receipt of Travel, Entertainment and Gifts under Section 17(e)(1) of the Investment Company Act

49. As Fidelity's head of equity trading, DeSano's duties included supervision of the traders' compliance with applicable legal requirements and with Fidelity's policies and procedures, including its gifts and gratuities policy.

50. DeSano knew that some traders received travel, entertainment and gifts from brokers, in part because he accompanied them on several trips, in part because he communicated regularly with Bruderman and several other traders about trading desk matters, and in part because he made sporadic attempts to have the traders tell him about their upcoming trips with brokers. For example, each year he asked the traders about their plans for the Super Bowl.

51. DeSano took only limited and ineffective steps to police the traders' receipt of travel, entertainment and gifts from brokers. For example:

a. At one point, DeSano caused Fidelity to issue credit cards to the traders so they could pay for their own business entertainment, but the traders did not use the cards or submit expenses for approval, and he did not follow up. At another point, he suggested to senior management of Fidelity that Fidelity might consider adopting a formal policy concerning its employees' use of private jets provided by brokers and other vendors, but again he did not follow up.

b. In early May 2004 (after a weekend when brokers had taken Harris to Las Vegas and Burnieika and Horan to Florida), he announced that traders would have to notify him in advance about all trips with brokers. A month later, he announced that traders would have to pay their own way on all future events with brokers. However, he did not enforce these policies, and traders continued to go on trips without informing him in advance and without reimbursing the brokers. For example, Quinn took DeSano and Bruderman golfing on Nantucket in June 2004, providing them with hundreds of dollars worth of golf items and arranging for Bruderman to take a private jet home from Nantucket. Similarly, Quinn took DeSano, Harris and his wife, and Horan to a charity golf event on Nantucket in August 2004. Quinn provided lodging for the group at his home, and gave the Harrises and

Horan the use of his private jet to return to Boston. There is no evidence that the Fidelity employees reimbursed Quinn for these trips.

c. DeSano instructed the traders to reimburse brokers for private jet travel at the rate for first-class commercial airfare to the same destination, but he did not require proof of reimbursement, and, as a result, the traders rarely made reimbursement to brokers for their trips on private jets.

52. Indeed, far from effectively supervising the traders' receipt of travel, entertainment and gifts from brokers, DeSano actually made matters worse, in several respects.

a. DeSano personally asked brokers for tickets or asked traders to ask brokers for tickets, sometimes for himself and sometimes for other senior Fidelity executives like Grenier, and he personally went on several trips paid for by brokers without reimbursing his full share of the expenses. His conduct sent the clear message that the traders could engage in similar activities, and because soliciting brokers for tickets and traveling at a broker's expense were violations of Fidelity's gifts and gratuities policy, his conduct also sent the message that the traders too could violate Fidelity's policy with impunity.

b. DeSano traveled frequently with Quinn, the most significant source of travel and gifts for the traders.[17] For example, DeSano attended both the November 2002 "Fall Classic" and part of Bruderman's bachelor party in March 2003 – two visible and extravagant excursions for which brokers picked up the tab. (Jefferies paid approximately $200,000 for the former, and several brokers including Quinn paid a total of approximately $160,000 for the latter.)

c. DeSano also took steps to conceal his and others' participation in the 2002 "Fall Classic." In an October 2002 email to Quinn, DeSano asked, "What happens when I get fired for this?" Quinn responded, "SEC rule first class plane fare and we are all set.[18] . . . Plus no one is allowed 2 say anything . . . Last yr never got out . . . If someone talks, we kill . . . That conversation happens first thing on the plane . . . Just a simple golf trip." DeSano then said, "Brudy [Bruderman] will be on a trip with [his fiancée]. You [Quinn] will be trying to qualify for a tourney somewhere down south. Harris has to make something up. And what I do is no one's G.D. business!" In a subsequent email, DeSano told Harris, "This needs to be excessively covert . . . Not even your desk can know. Make something else up." Harris responded, "I will, but when Brudy [Bruderman] and I are out and Kevin [Quinn] is out . . . people start talking. I am going to Seattle to see [my wife's] grandmother with her parents . . . That's my story and I am sticking to it." DeSano then gave Harris the cover stories for Bruderman and Quinn. Harris replied, "Sounds good."

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17 The demoralizing effect for the trading desk of DeSano's travels with Quinn is apparent from Pascucci's comment to Smith in December 2003, "How can u enforce the no nepotism rule when SCD [DeSano] is such buddies with Quinn? It is absurd the one guy gets so [much] favored treatment from the head."

18 There is no such SEC rule.

53. DeSano failed to monitor traders' receipt of travel, entertainment and gifts from brokers on any systematic basis, and he failed to take reasonable steps to enforce Fidelity's gifts and gratuities policy or to ensure that traders did not receive compensation from brokers within the meaning of Section 17(e)(1) of the Investment Company Act. During the Relevant Period, the respondent traders willfully violated Section 17(e)(1) by receiving compensation in the form of gifts, travel, and entertainment from brokers. As a result, DeSano failed reasonably to supervise ten Fidelity traders (Beran, Bruderman, Burnieika, Burns, Donovan, Driscoll, Harris, Horan, Pascucci and Smith), within the meaning of Section 203(e)(6) of the Advisers Act, with a view to preventing their violations of Section 17(e)(1) of the Investment Company Act.

DeSano Was a Cause of Fidelity's Failure to Seek
Best Execution for its Clients' Securities Transactions

The Traders Sent Securities Transactions to Brokers from Whom They Received Travel, Entertainment and Gifts

54. The receipt by ten equity traders and DeSano (the traders' supervisor) of travel, entertainment and gifts from brokers who sought and obtained securities transactions from Fidelity created material conflicts of interest that influenced the traders' selection of brokers to execute securities transactions on behalf of Fidelity's clients.

55. In their emails to each other and to brokers, DeSano and the traders acknowledged the link between the traders' receipt of travel, entertainment and gifts from brokers and their direction of business to brokers. For example:

a. In January 2002, Bruderman asked DeSano not to approve a certain brokerage firm that wanted to handle some of Fidelity's securities transactions: "Please do not approve him and I am not going anywhere on his or his company's dime. That is the last guy in the world I want to feel indebted to."

b. In April 2002, Pascucci asked a broker, "Pls ask the ticketmaster if the firm's single biggest customer cud have 2 tix [to an Andreas Bocelli concert]. (They are for his madre.)" Pascucci received the tickets from the broker.

c. In September 2002, Pascucci complained to Smith about the trading desk, "Big picture thot [sic]. This room suks [sic]. Total country club. The number of people making golf plans, or ticket plans, or vacation plans during trading hours far outnumbers the number of people thinking about their names [i.e., stocks] or assuming any risk."

d. In October 2002, Pascucci told DeSano that a broker was offering two tickets to that night's Celtics game. DeSano replied, "[Name omitted] works there. Bad guy. I wouldn't want to feel obligated."

e. Also in October 2002, a broker made the following offer to Donovan, "SANM [Sanmina-Sci Corp.] – 500 k at 2.52. 500 trades away at 2.53. Plus 2 50-yard line seats to VA Tech-BC."

f. In January 2003, Pascucci forwarded to Smith an email he received from a broker, "Like 'build it they will come,' the sell side mantra of 'plan fun trip with clients and they will come' still rings true in these parts."

g. In February 2003, Quinn told Bruderman about plans for the upcoming bachelor party and added, "If I do the plane that I might do, you better load me up when it gets busy again."

h. In March 2003, Pascucci commented to Smith that the conflicts between DeSano, Bruderman, Quinn and others was "a WSJ [*Wall Street Journal*] article ready for the front page."

i. In March 2003, Beran declined a broker's invitation to a golf trip, saying that he was already going on two trips in the next two months. He added that, although he had heard that the site of his second trip (a private golf club in Maryland) was "great," the "only problem is that I have to trade w/ [the brokerage firm] after I go!" Also in March 2003, Beran told another trader, "I figure I owe [the broker] 3 orders to pay for my annual . . . golf shirt."

j. Also in March 2003, Burns had this email exchange with a broker:

Broker : You must have a hankering to do a big CSCO [Cisco Systems] trade w/ me. At the very least, your prompt response will be rewarded w/ Celtic playoff seats. Thanks for caring.

Burns: No hankering here, and you can send the tickets over.

Broker : Our friendship has taken a significant step forward this AM. I could not be more pleased.

Burns: Thank you!!!!

Broker : Our friendship is boundless. Now, if you would please think of me next time a big situation appears on your desk, our friendship would be to the moon.

k. In April 2003, a broker told Burnieika, "Keep up the flow and I will get you and [another Fidelity trader] a car to the airport Fri." Two days later, the broker took Burnieika on a golf weekend in North Carolina.

l. In April 2003, a broker told Pascucci, "Nice sales in FBF [FleetBoston Financial], thanks for the bus today, talk to you in AM. If you need any seats for Celts thurs night, I've got 2 courtside if you want them."

m. In August 2003, Smith used an analogy to the team-building techniques of certain baseball teams to explain to Pascucci his theory of how brokers use their travel and entertainment budget to attract Fidelity's business:

> If you map out a strategy for "attacking FIDO [Fidelity]" to maximize commission $$, it seems there are 2 strategies. . . attack the generals, i.e. ingratiate yourself w/ the powerbrokers thru extensive use of the expense account (let's call them the Yankees) who curry favor w/ THB [Bruderman], DKD [Donovan], and SCD [DeSano] . . . or recruit youth early (let's call them the A's) by showering the youngsters w/ service and small $$ perks.

n. In April 2004, the broker told Burns that he was sending Red Sox tickets and added "ANDW [Andrew Corp.] 6 figs for sale." Burns thanked him. The broker replied, "Thx for sending over the Sox tix or thx for sending over the ANDW INDI or thx for being such a great guy or all of the above?" Burns responded, "All of the above."

56. Indeed, some of the emails between traders and brokers reflect a shared perception that the job of a so-called "sell side" broker includes the provision of travel and tickets, and that one advantage of being a so-called "buy side" trader is the opportunity to receive such benefits. For example:

a. In May 2002, Burnieika told a broker that he was going to two upcoming Celtics playoff games. The broker commented, "Nice to be king!" Burnieika replied, "Right side of the street when U2 concerts and Celts playoff games come around."

b. In August 2002, Smith observed to Pascucci ". . . Golf, dinners, tickets, Super Bowl, trips. Everything is for sale." Two days later, Smith complained to Pascucci, "It's bad enough w/ SCD [DeSano], DKD [Donovan], and Brudy [Bruderman], but when Horan and JDH [Harris] start in on the exclusive golf dates, it's pathetic." Pascucci replied, "Agreed 500%."

c. In September 2002, Bruderman sent a broker an email concerning plans for his wedding. Bruderman told the broker, "As of this morning you and [a broker at another firm] and Quinn are paying for it." The broker replied, "Can't wait. Send me the bill." Later that day, Bruderman told Quinn, "Bad news. You and [another broker] have to pay for the wedding." Quinn replied, "Creative T&E. Again."

d. In May 2003, Pascucci asked several brokers, "Who will be first guy on sell side to offer Green Monster seats?" One broker replied, "Me." (The "Green Monster" was a new area of expensive seats for Red Sox games at Fenway Park.)

e. In September 2003, Bruderman received and forwarded an email that parodied a beer company's advertising campaign to several brokers:

> Here's to you Mr. Institutional Sales Trader. Because you spend all day lying to people with MBA's from Ivy League schools, even though you failed Econ 101 at the Community College. And if the stock goes up or down, you don't care – as long as you get your nickel. Five cents a share! So crack open an ice cold Bud Light you overpaid sack of sh*t, because without you there would be a lot of buy side guys sitting in bad seats at the concert.

f. In October 2003, Bruderman complained to one broker that a broker at another firm had been unable to get him tickets to a Bare Naked Ladies concert: "Say he has no tickets left. Gave em all to [name omitted] and his hedge fund pals. I think I am going to request a change in coverage."

g. In May 2004, a broker asked Burns, "Are you aware of a guy who delivers Yankee tix to your desk faster than me? Seller of good size CSCO."

h. Also in May 2004, Pascucci offered Driscoll this praise for a broker: "[Name of broker] has not had a misstep for 1 second in his [name of firm] career. Trading is first rate. Research effort is consistent and impactful, and he is 500 times the ticket broker [name omitted] from Friend St. is. The new sales trading model."

57. As reflected by the traders' conduct and their email communications with brokers and each other, the conflicts of interest were not merely theoretical, and the traders did in fact allow their receipt of travel, entertainment and gifts to influence their selection of brokers to handle securities transactions for Fidelity's clients. For example:

a. In January 2002, Driscoll told another trader that he was going to the Super Bowl in New Orleans with a certain broker and added, "The good news is, the TYC [Tyco] order paid for [the broker's] jet." That day, Driscoll sent orders to the broker's firm (including more than 8 million shares of Tyco stock) that generated more than $487,000 in commissions. Driscoll's Tyco trade did not go unnoticed on Fidelity trading desk. Smith observed to Pascucci: "[P]oor broker selection. Superbowl trip should not affect judgment" and "7 million shares of TYC [actually, 8 million shares] buys you a seat on a private jet."

b. Also in January 2002, Bruderman told a broker, "This BSX [Boston Scientific] order works to 1 mill. That should get us part of the way to paying for the band. How much is it so I know what I need to do to pay for it?" The broker responded that the band (Counting Crows) would cost "3 bills + love."

c. In March 2002, Smith commented to Pascucci that Bruderman sent most of his business to Quinn and brokers at two other firms who took him on trips and asked "Who says Fido can't be bot?" Pascucci responded, "No comment on record. Off record, THB [Bruderman] has killed the integrity of this desk." Smith replied, "How that does not raise red flags, I do not know."

d. In April 2002, Pascucci complained to Smith, "Here's the truth. Image on street at all time low. We are VWAP[19] robots and gift whores."

e. A broker told Burns in a May 2002 email, "For better or for worse, I am [a] liquidity provider of stocks and tickets. Please do not hesitate to knock on my door for either. My door is open to you 24 hours a day 7 days a week." Burns took him up on the offer. Indeed, that same month, after the broker provided Burns with tickets to a Celtics playoff game, Burns sent 1.2 million shares to the broker – his first orders to the firm all year. The trades generated more than $60,000 in commissions.

f. In June 2002, a broker offered Burnieika tickets to a Red Sox game for his parents. One hour later, Burnieika began sending orders to the broker. While Burnieika had traded the same security with that broker the prior two trading days, his total for the day exceeded 860,000 shares – his heaviest single trading day with the firm during the entire 2002-2004 period. The trades generated $43,000 in commissions.

g. In June 2002, a broker took Donovan to Paris for the French Open tennis tournament, and Donovan's expenses cost the broker more than $24,000. The day he returned, Donovan sent more than 1.8 million shares to the broker. The trades generated $90,750 in commissions.

h. In August 2002, Harris thanked a broker for their recent trip to the Red Tail resort in Toronto: "I owe you bro. Can't thank you enough for including me in such a special trip. Place is over the top!" That day, Harris sent trades involving more than two million shares to the broker's firm, and the trades generated $103,000 in commissions.

i. In September 2002, several brokers from the same firm took Smith for a weekend in Illinois and Indiana that included a Notre Dame-Michigan college football game. During the two weeks after the trip (ten trading days), Smith sent nearly 19.3 million shares to the brokers (more than 1.9 million shares per day). The trades generated nearly $456,000 in commissions.

j. In September 2002, Harris told Quinn that he might not be able to attend the upcoming "Fall Classic". Quinn complained, "Pls don't do this 2 me." Harris replied, "Bro, I may have to but I will make it up with a lot of shares."

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19 VWAP is "volume weighted average price."

k. In September 2002, Smith asked Pascucci, "2 guesses who is paying for BB's [Burns] Super Saturday [U.S.] Open tickets." Pascucci answered, "Jeff Reece [Jefferies]." Smith observed that Quinn had taken four months off after leaving another firm, and that Burns had greeted his arrival at Jefferies in September 2002 with a million-share order.

l. In September 2002, Quinn gave Burns tickets to the US Open tennis tournament. Two days before the event, Burns sent 2.1 million shares to Quinn. The next day, Burns sent another 2.8 million shares. The trades on these two days generated more than $160,000 in commissions.

m. In November 2002, a broker told Harris, "Thx for the order. Have some B's tix for tomorrow if interested."

n. In November 2002, Smith complained in an email that "Brudy and Jeff [Harris] load up Jeff [Jefferies] for 2 weeks before the trip [the "Fall Classic"]. THB [Bruderman] has clearly made it known that his order flow is for sale to the highest bidder, and nobody else in the room would get away w/ that sh1t."

o. Quinn provided a private jet to Driscoll for a family Disney World trip. In a November 2002 email, Quinn cautioned Driscoll, "You did not tell anyone about this, did you?" Then Quinn added, "By the way, I view private 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." Driscoll replied, "We are on the same page." Driscoll also rewarded Quinn for his generosity. In the two weeks (seven trading days) before the Disney World trip, Driscoll sent more than 8.9 million shares to Quinn (almost 1.3 million shares per day). The trades generated more than $445,000 in commissions.

p. In December 2002, Driscoll thanked a broker for a holiday gift certificate. The broker replied, "No. Thx u. Wish was for more. Wud be luggin furniture if not for u."

q. In January 2003, a broker offered Pascucci tickets to "Disney on Ice." Pascucci asked for five tickets for his brother and his children. The broker replied, "No problem. And Steve, don't EVER hesitate to ask for tix if u need 'em. That's one of the beni's of my job. U've done a lot for me, I am more than happy to help you out." On the two days after the event, Pascucci sent more than 1.1 million shares to the broker (more than 550,000 shares per day). The trades generated more than $44,000 in commissions.

r. In January 2003, Quinn offered Burns a package with first class airfare to Wimbledon, which Burns declined. The same day, Burns sent Jefferies a total of 2.2 million shares, which generated $70,000 in commissions, and told Quinn "I am totally committed to assisting you in your efforts."

s. In February 2003, Smith commented to a Fidelity trader about "the obvious pattern of loading up a broker, then disappearing on a golf trip, etc. It used to be Red Sox tickets and a dinner, now it's private jets to the Masters."

t. In April 2003, Bruderman told a broker, "I owe you money. Paying it today w/ SGP [Schering Plough]." That day, Bruderman asked the broker to sell 100,000 shares of SGP, generating a $5,000 commission.

u. In June 2003, Quinn told Bruderman, "You're welcome for the Sox tix by the way." Bruderman replied, "You're welcome for the house in Needham [the location of Quinn's residence]."

v. In June 2003, Smith asked a broker for tickets to a Van Morrison concert. The broker offered him two front-row seats. Smith responded. "Right on." Two minutes later, Smith wrote "Work 250m MSFT [Microsoft] for me."

w. Shortly after Quinn joined Jefferies, Quinn asked if Smith was upset with him. Smith replied, "Never have been. Just shocked how the red carpet has been rolled out to you. Your 'new' firm offers me nothing that I don't already get from every other firm in the Top 30, so I apologize if I don't drink the Kool-Aid." Indeed, from September 2002 until mid-October 2003, Smith traded with Jefferies very infrequently. In mid-October 2003, however, that changed. On or about October 20, 2003, Smith began exchanging emails with Quinn about a trip to the Caribbean that Smith was planning with his wife. During the course of that exchange, Quinn offered to provide Smith with a private jet for his vacation. On the day Quinn offered to supply the jet, Smith sent more than 1.5 million shares to Jefferies. The next day, Smith sent nearly 1.4 million shares. All told, Smith traded with Quinn on sixteen of the seventeen trading days between the day Quinn offered his private jet and the day Smith left for his vacation. Smith's heavy use of Jefferies continued after his return. Smith traded with Quinn on fourteen of the first sixteen trading days after the trip, including one day with nearly 1.2 million shares. The three days with orders totaling over 1 million shares were three of Smith's four heaviest trading days with Jefferies during the Relevant Period, and the trades on those three days alone generated nearly $190,000 in commissions.

x. In December 2003, Pascucci asked a broker for courtside tickets to that night's Celtics game. The broker offered four tickets. Pascucci told him where to deliver the tickets and added, "Thks. Buy 50K."

y. In February 2004, brokers took several traders to see the New England Patriots play in the Super Bowl in Houston. On the day before he left, Burnieika sent more than 500,000 shares to the broker who took him – his second largest day with the firm in the entire 2002-2004 period – and the trades generated more than $25,000 in commissions.

z. In July 2004, Quinn provided tickets and a hotel for Burns to attend the Wimbledon tennis tournament in London at a cost of over $50,000. During the week after he returned (four trading days), Burns sent more than 7.6 million shares to Jefferies (more than

1.9 million shares per day). On one of the days, he sent 4 million shares – his second heaviest trading day with the firm in the entire 2002-2004 period. The trades on these four days generated $255,000 in commissions.

aa. After the broker who facilitated Driscoll's gambling changed firms in April 2004, Driscoll received the following request from the broker: "If you can find it in your heart not to let me get shut out by the end of the day that would be greatly appreciated. Not a very good first impression. Have to go down to NY for the day tomorrow to meet all the traders." Driscoll forwarded the broker's message to Horan and commented, "How is it that we owe all these fuking millionaires something after we got them where they are?" Despite his griping, Driscoll began sending regular trades to the broker's new firm two days later.

58. The decision of Harris to start sending business to Jefferies after Quinn joined the firm reflects how the receipt of travel, entertainment and gifts influenced his selection of brokerage firms.

a. In May 2002, Harris learned that Quinn was moving to Jefferies after rejecting an offer from a major brokerage firm that handled a substantial amount of Fidelity business. Harris was unhappy about Quinn's choice and complained to Bruderman, "Between me and you, I am frustrated he put me in this situation. It compromises your position on the desk to do a lot of bus with a firm like Jeff [Jefferies]. [The other firm] is easy because you can justify it. The desk will be pissed, especially now that commission dollars are under a microscope . . ."[20]

b. Despite his misgivings, Harris began sending a substantial amount of business to Jefferies in September 2002 after Quinn started working there. In late November 2002, however, Harris complained to Quinn about his trade execution:

Harris: Just went out back . . . You were my 3rd broker for the month and 30th on [Fidelity's trader performance measurement] and I was still number 3 on the desk . . . Guys wanted to know what Jeff[eries] was and why I was doing all the volume, hurting my [performance statistics] when I could have taken number 1. Reminds me of my [name of firm] numbers. [Harris named the firm where Quinn had worked before joining Jefferies.]

Quinn: Pick up [the dedicated phone line between Fidelity and Jefferies].

Harris: One of 2 things will change: 1. your volume will drop. 2. my numbers will go up.

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[20] Harris was not the only trader to worry about Quinn's move to Jefferies. Beran observed to Pascucci, "Don't ask THB [Bruderman] about Jeffco . . . I think he is trying to figure out how he is going to justify laying all those orders into Quinn!"

Quinn: You're right. It is all my fault.

c. Nevertheless, Harris continued trading – and traveling – with Quinn. In December 2002, Quinn and another Jefferies broker took Harris for a golf weekend in South Carolina. The week he returned (three trading days), Harris sent more than 2.6 million shares to the brokers (almost 870,000 shares per day). The trades generated more than $118,000 in commissions.

d. In two July 2003 emails, Harris again complained to Quinn about his performance. In the first, Harris "thank[ed]" Quinn "for all the crummy [trader performance statistics] for last year and this year." In the second, Harris warned Quinn that the "[t]ech guys in back are on to you. Brudy's [Bruderman] numbers suk [sic] with you too."

e. Despite his complaints, Harris's trading with Jefferies remained heavy throughout Quinn's employment at the firm. Harris sent nearly 142 million shares to Jefferies after Quinn arrived, and the trades generated more than $6.5 million in commissions.

59. During the Relevant Period, the ten traders each directed equity trading business generating millions of dollars in commissions to brokers from whom they received travel, entertainment and gifts. The influence of travel, entertainment and gifts on Fidelity's order flow is particularly apparent with respect to Jefferies:

a. In the second quarter of 2002 (before Quinn's arrival), Jefferies handled 12.9 million shares of securities for Fidelity. With this volume, Jefferies ranked 44th among the brokerage firms used by Fidelity. 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 12th. In the third quarter of 2004 (Quinn's final full quarter of employment), Jefferies handled 112.9 million shares of securities, and its volume ranking was 13th.

b. The brokerage commissions that Jefferies received from Fidelity increased in a similar fashion. In the first six months of 2002, just prior to Quinn's arrival, Jefferies received nearly $888,000 in commissions, ranking it 42nd among the firms used by Fidelity. By contrast, in the first nine months of 2004, Jefferies received $20.7 million in brokerage commissions from the Fidelity Funds, improving its ranking to 10th among the firms used by Fidelity. During the period of Quinn's employment, Jefferies received over $60 million in commissions from Fidelity's client accounts.

c. Most of the brokerage business that Jefferies received from Fidelity came from four traders (Bruderman, Donovan, Harris and Horan), who went on most of Quinn's golf and other excursions, and from a fifth trader (Burns), who received expensive wine and 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 alone sent trades generating approximately $39.4 million in commissions for Jefferies.

Certain Traders Sent Securities Transactions to Brokers with Whom They Had a Family or Romantic Relationship

60. During the Relevant Period, five Fidelity traders sent securities transactions to brokers with whom they had a family or romantic relationship. In each instance, the trader sent millions of shares of transactions to the broker's firm, and the trades generated millions of dollars of commissions.

a. One of Donovan's family members was a broker who covered (*i.e.*, handled transactions for) several Fidelity traders, including Donovan himself. During the Relevant Period, Donovan sent more than 678 million shares to his family member's firm, and the trades generated more than $31 million in commissions.

b. One of Driscoll's family members was a broker who changed firms in January 2003 and thereafter covered several Fidelity traders. The family member did not cover Driscoll himself, but the family member's compensation depended in part on the firm's total commissions from Fidelity's business. Driscoll sent no trades to the new firm before his family member joined it, but from January 2003 through October 2004, he sent more than 56 million shares to the firm, and the trades generated more than $2.7 million in commissions.

c. One of Pascucci's family members was a broker who changed firms in late December 2002 and thereafter covered several Fidelity traders, including Pascucci himself. Pascucci did little business with the new firm before his family member joined it, but from late December 2002 through October 2004, he sent more than 138 million shares to the firm, and the trades generated more than $6.8 million in commissions.

d. In addition, two Fidelity traders not named in this Order were involved in romantic relationships with brokers to whom they sent trades generating, in aggregate, several million dollars in commissions.

e. In October 2003, Smith commented to Pascucci, "so 2 of our . . . [brokerage firms] are absolutely zero value-added on research and mkt intelligence, but loaded to the gills w/ nepotism, incestual relationships, and issues of conflict." Pascucci replied, "I cannot poke a hole in that."

DeSano Caused Fidelity's Failure to Seek Best Execution in Violation of Section 206(2) of the Advisers Act

61. As set forth above, DeSano was aware of significant conflicts of interest involving Fidelity's equity traders. He knew that some traders sent securities transactions to brokers from whom they received travel, entertainment and gifts. He also knew that some traders sent securities transactions to brokers with whom they had a family or romantic relationship. For example, he knew that one of Donovan's family members was a broker at one of the largest firms handling transactions for Fidelity. He also knew that a Fidelity trader not named in this Order was romantically involved with a broker because the trader told

him about the relationship and asked Desano for permission to continue sending business to the broker's firm, and he approved.

62. Section 206(2) of the Advisers Act provides that an investment adviser shall not "engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client."[21] One aspect of an investment adviser's fiduciary duty under Section 206 of the Advisers Act is the duty to seek best execution for its clients' securities transactions – that is, to seek the most favorable terms reasonably available under the circumstances.

63. As set forth above, Fidelity traders allowed their receipt of travel, entertainment and gifts from brokers and their family or romantic relationships with brokers to influence their selection of brokers to handle Fidelity's securities transactions. As a result, Fidelity willfully violated Section 206(2) of the Advisers Act, and DeSano was a cause of Fidelity's violation of Section 206(2) of the Advisers Act.

Materially False and Misleading Public Disclosures about Fidelity's Conflicts of Interest with Respect to its Selection of Brokers

Material Misrepresentations and Omissions by DeSano to the Fidelity Funds' Trustees

64. During the Relevant Period, DeSano made periodic presentations to the trustees of the Fidelity Funds concerning equity trading operations and the selection of brokers for the Fidelity Funds' transactions. For example:

a. On September 19, 2002, DeSano attended a meeting of the Brokerage Committee of the Fidelity Funds' trustees and presented Fidelity's annual report on equity trading and the use of brokerage commissions. DeSano's written report to the trustees stated that the "sole criterion" for broker selection was "execution capability" and that "brokers compete on [the] basis of execution quality."

b. On September 18, 2003, DeSano attended a meeting of the Shareholder Services, Brokerage and Distribution Committee of the Fidelity Funds' trustees and presented Fidelity's annual report on equity trading and the use of brokerage commissions. According to the minutes of the meeting:

> Mr. DeSano provided an overview of the equity trading process, stating that FMR's approach to trading is *to focus solely on execution quality, trade with the best brokers* and closely manage

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[21] A violation of Section 206(2) of the Advisers Act does not require a finding of scienter and may be established by a showing of negligence. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963); SEC v. Steadman, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992).

> the impact of the funds' trades on the market. He stated that as a result of the "broker segmentation" program implemented over five years ago, FMR now trades with a relatively small number of core brokers, which reduces information leakage and *allows the brokers to compete based on the quality of their execution.* [Emphasis added]

c. On September 16, 2004, DeSano attended a meeting of the Shareholder Services, Brokerage and Distribution Committee of the Fidelity Funds' trustees and presented Fidelity's annual report on equity trading and the use of brokerage commissions. According to the minutes of the meeting:

> Mr. DeSano provided an overview of the equity trading process, stating that FMR's *highest priority in trading for the funds is execution quality.* He stated that FMR seeks to trade with the best brokers and closely manage the impact of the funds' trades on the market. He stated that as a result of broker segmentation program in place for the last six years, FMR trades with a relatively small number of core brokers, which reduces information leakage and *allows the brokers to compete based on the quality of their execution.* [Emphasis added]

65. Section 206(1) of the Advisers Act provides that an investment adviser shall not "employ any device, scheme, or artifice to defraud any client or prospective client." The statements by Fidelity, through DeSano, to the trustees of the Fidelity Funds were materially misleading because DeSano failed to disclose that, as set forth above, the traders' receipt of travel, entertainment and gifts and their family and romantic relationships were also factors in the selection of brokers for the Fidelity Funds' transactions, and brokers competed for Fidelity's business on the basis of travel, entertainment and gifts in addition to execution performance. As a result, Fidelity, through DeSano, violated Section 206(1) of the Advisers Act, and DeSano willfully aided and abetted and was a cause of Fidelity's violation of Section 206(1) of the Advisers Act.

DeSano Caused Fidelity's Failure to Disclose Certain Conflicts of Interest

66. As set forth above, DeSano was aware of significant conflicts of interest involving Fidelity's equity traders. He knew that some traders sent securities transactions to brokers from whom they received travel, entertainment and gifts. He also knew that some traders sent securities transactions to brokers with whom they had a family or romantic relationship.

67. Under Section 206(2) of the Advisers Act, an investment adviser has a fiduciary duty to disclose all material conflicts of interest to its advisory clients. During the Relevant Period, Fidelity failed to disclose to its clients, including the Fidelity Funds, the material conflicts of interest arising from the receipt by certain Fidelity executives and traders, as

described herein, of travel, entertainment and gifts paid for by brokers and certain traders' family and romantic relationships with brokers seeking and obtaining securities transactions for Fidelity's clients. As a result, Fidelity willfully violated Section 206(2) of the Advisers Act, and DeSano was a cause of Fidelity's violation of Section 206(2) of the Advisers Act.

Material Misrepresentations and Omissions in Form ADV

68. Section 204 of the Advisers Act and Rule 204-1 thereunder require an investment adviser annually to amend and file with the Commission its Form ADV. Section 207 of the Advisers Act prohibits any person from willfully making any untrue statement of material fact or omitting to state any material fact required to be stated in any report filed with the Commission under Section 204.

69. Form ADV requires the disclosure of certain material information about the investment adviser. For an investment adviser like Fidelity with discretion to select brokers to execute its clients' securities transactions, Item 12.B of Part II of Form ADV requires a description of the factors that the adviser considers when selecting brokers. Fidelity provides copies of its Form ADV to the independent trustees acting on behalf of the Fidelity Funds and to other clients.

70. During the Relevant Period, the Forms ADV prepared by Fidelity contained language to the effect that Fidelity selected brokers for its clients' transactions "on the basis of professional capability and the value and quality of services." The Forms ADV also listed specific factors that Fidelity considered when selecting brokers, including: (a) price, size and type of transaction; (b) reasonableness of commissions; (c) speed and certainty of trade executions; (d) nature and character of the markets for the security; (e) liquidity and depth offered by a market center or market-maker; (f) reliability of the market center or broker; (g) the degree of anonymity that the broker or market center can provide; (h) the broker's execution services rendered on a continuing basis; and (i) the execution efficiency, settlement capability, and financial condition of the brokerage firm.

71. Annually, Fidelity's legal and compliance departments determine what, if any, changes to Fidelity's Form ADV were required. To that end, they submitted the relevant portion(s) of the Form ADV to each interested department at Fidelity, including DeSano's. On one occasion during March 2004, Fidelity's legal/compliance staff sent an e-mail to the equity trading desk's manager of operations, who reported to DeSano, that included the sections of Fidelity's Form ADV concerning broker selection and best execution and noted that it was important for the trading desk to review the disclosures. The operations manager forwarded the e-mail to DeSano and asked him if he had any comments. Despite his knowledge of the extensive receipt of gifts, travel, and entertainment by employees of the equity trading desk and the direction of Fidelity's brokerage business to immediate family members and a romantic partner, DeSano failed in March 2004 and on other occasions to ensure that Fidelity's broker selection disclosures were amended to reflect those factors and material conflicts of interest or that those conflicts were otherwise disclosed to Fidelity's clients.

72. The Forms ADV were materially misleading because they failed to disclose that, as set forth above, the traders' receipt of travel, entertainment and gifts and their family and romantic relationships were also factors in the traders' selection of brokers for Fidelity's clients' transactions, including transactions for the Fidelity Funds, and that Fidelity did not have a sufficient system of controls to detect, deter, and prevent such factors from entering into the selection of brokers. As a result, Fidelity willfully violated Sections 204 and 207 of the Advisers Act, and Rule 204-1 thereunder, and DeSano was a cause of Fidelity's violations of Sections 204 and 207 of the Advisers Act, and Rule 204-1 thereunder.

Bruderman and Driscoll Caused Fidelity's Failure to Disclose Certain Conflicts of Interest

73. As set forth above, Bruderman did not inform anyone at Fidelity that he received illegal drugs from brokers, and Driscoll did not inform anyone at Fidelity that his illegal gambling was facilitated by a broker.

74. Under Section 206 of the Advisers Act, an investment adviser has a fiduciary duty to disclose all material conflicts of interest to its advisory clients. During the Relevant Period, Fidelity failed to disclose to its clients, including the Fidelity Funds, the material conflicts of interest arising from Bruderman's receipt of illegal drugs from brokers or the facilitation of Driscoll's illegal gambling by a broker. As a result, Fidelity willfully violated Section 206(2) of the Advisers Act, and Bruderman and Driscoll were each a cause of Fidelity's violation of Section 206(2) of the Advisers Act.

D. VIOLATIONS

75. As described above, the respondents each willfully violated Section 17(e)(1) of the Investment Company Act, in that they received travel, entertainment and gifts (and illegal drugs for Bruderman and the facilitation of illegal gambling for Driscoll) from brokerage firms that sought and obtained brokerage business from Fidelity.

76. As described above, DeSano failed reasonably to supervise ten Fidelity traders (Beran, Bruderman, Burnieika, Burns, Donovan, Driscoll, Harris, Horan, Pascucci and Smith), within the meaning of Section 203(e)(6) of the Advisers Act, with a view to preventing their violations of Section 17(e)(1) of the Investment Company Act.

77. As described above, DeSano was a cause of Fidelity's violation of Section 206(2) of the Advisers Act through its failure to seek best execution for its clients' securities transactions by allowing the traders' receipt of travel, entertainment and gifts and the traders' family or romantic relationships to enter into its traders' selection of brokers.

78. As described above, DeSano willfully aided and abetted and was a cause of Fidelity's violation of Section 206(1) of the Advisers Act through his materially false and misleading statements and omissions to the trustees of the Fidelity Funds concerning the

factors considered in its selection of brokers and the bases upon which brokers competed for the Fidelity Funds' brokerage business.

79. As described above, DeSano was a cause of Fidelity's violations of Sections 204, 206(2) and 207 of the Advisers Act and Rule 204-1 thereunder through its materially false and misleading statements and omissions in its Forms ADV about its selection of brokers.

80. As described above, DeSano was a cause of Fidelity's violation of Section 206(2) of the Advisers Act through its failure to disclose to its clients, including the Fidelity Funds, material conflicts of interest arising from the receipt by certain Fidelity executives and traders, as described herein, of travel entertainment and gifts from, and certain traders' family or romantic relationships with, brokers seeking and obtaining securities transactions for Fidelity's clients.

81. As described above, Bruderman and Driscoll were each a cause of Fidelity's violation of Section 206(2) of the Advisers Act through its failure to disclose to its clients, including the Fidelity Funds, the material conflict of interest arising from the receipt of illegal drugs for Bruderman from brokers, and the facilitation of illegal gambling for Driscoll by a broker.

III.

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

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

B. What, if any, remedial action is necessary and appropriate in the public interest against the respondents pursuant to Sections 203(f), 203(i) and 203(k) of the Advisers Act and Sections 9(b), 9(d) and 9(f) of the Investment Company Act and whether orders to cease and desist are appropriate and in the public interest.

IV.

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

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

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

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

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

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

By the Commission.

Nancy M. Morris
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Chairman Cox
Not Participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 2716 / March 5, 2008

INVESTMENT COMPANY ACT OF 1940
Release No. 28188 / March 5, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12979

In The Matter of MARC C. BERAN, Respondent.	ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940 AND SECTIONS 9(b) AND 9(f) OF THE INVESTMENT COMPANY ACT OF 1940 AS TO MARC C. BERAN

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 203(f) 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 Marc C. Beran ("Beran" or "Respondent Beran").

II.

In anticipation of the institution of these proceedings, Respondent Beran has submitted an Offer of Settlement ("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 Beran 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 203(f) of the Investment Advisers Act of 1940 and Sections 9(b) and 9(f) of the Investment Company Act of 1940 as to Marc C. Beran ("Order"), as set forth below.

III.

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

Respondent

1. **Beran**, age 38, is a resident of Southborough, Massachusetts. At all relevant times, Beran was employed as a sector trader on the equity trading desk of FMR Co., Inc. ("FMR Co.") located in Boston, Massachusetts. Beran was associated with FMR Co. from in or about May 1998 until December 2004.

Relevant Parties

2. **Fidelity Management & Research Company** ("FMR") is registered with the Commission as an investment adviser (File No. 801-7884) pursuant to Section 203(c) of the Advisers Act, with its principal place of business in Boston, Massachusetts. FMR is a wholly owned subsidiary of FMR Corp., which utilizes the trade name "Fidelity Investments." FMR is an adviser to various institutional clients and has approximately $1.25 trillion in assets under management. FMR's institutional clients include the group of approximately 350 registered investment companies marketed under the "Fidelity Investments" trade name and managed by FMR and its affiliates (hereafter "the Fidelity Funds").

3. **FMR Co.** is registered with the Commission as an investment adviser (File No. 801-3447) pursuant to Section 203(c) of the Advisers Act, with its principal place of business in Boston, Massachusetts. FMR Co. is a wholly owned subsidiary of FMR, and provides portfolio management services as a sub-adviser to certain clients of FMR, including the Fidelity Funds.

Summary

4. This proceeding concerns Beran's acceptance of gifts and travel from securities brokerage firms ("brokerage firms") with which he, through FMR Co., conducted business on behalf of the Fidelity Funds. During the period from January 1, 2002 to October 2004 (the "Relevant Period"), Beran accepted approximately over $11,000 worth of travel and tickets to theater and sporting events, which were given to him by at least five representatives of brokerage

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

firms. By accepting those tickets, Beran willfully[2] violated Section 17(e)(1) of the Investment Company Act.

Background

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

Beran Accepted Gifts and Travel from Brokers

6. During the Relevant Period, Respondent Beran obtained over $11,000 in gifts and travel from representatives of five of the brokerage firms with whom he, through FMR Co., conducted business on behalf of the Fidelity Funds. These included tickets to out-of-town theater and local professional sporting events that the representatives of the brokerage firms did not attend. Beran also accepted two trips to Bermuda in which a representative of a brokerage firm, who accompanied Beran, paid for Beran and his family's luxury hotel accommodations, associated expenses, and for one trip, their commercial airfare.

7. Beran also engaged in email communications concerning certain gifts. In an email exchange with a broker who had invited him on a golf trip, Beran declined, stating "Thx [name of broker] but somehow I got roped into 2 trips in the next two months . . . one is fishing in Boca (I have never fished) 2nd is Caves Valley which [a certain individual] said is great only problem is that I have to trade w/ [the brokerage firm] after I go!" In an email exchange with another Fidelity trader, Beran says that "I figure I owe the broker 3 orders to pay for my annual . . . golf shirt."

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

8. As a result of the conduct described above, Beran willfully violated Section 17(e)(1) of the Investment Company Act, which makes it unlawful for an affiliated person of a registered investment company, or an affiliate of an affiliate, when acting as an agent, to accept compensation from any source (other than a salary or wages from the registered investment company) for the purchase or sale of any property to or for the registered investment company. Beran was an affiliated person of FMR Co., which is an affiliated person of investment

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[2] "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 he is violating one of the Rules or Acts.

companies (the Fidelity Funds), because FMR Co. advises those funds. Beran's receipt of gifts and travel from brokers constituted compensation in violation of Section 17(e)(1) of the Investment Company Act.

Undertakings

9. In connection with this proceeding and any related judicial or administrative proceeding or investigation commenced by the Commission or to which the Commission is a party, Respondent Beran (i) agrees to appear and be interviewed by Commission staff at such times and places as the staff requests upon reasonable notice; (ii) will accept service by mail or facsimile transmission of notices or subpoenas issued by or on behalf of the Commission for documents or testimony at depositions, hearings, or trials, or in connection with any related investigation by Commission staff; (iii) appoints Respondent Beran's attorney in this proceeding as agent to receive service of such notices and subpoenas; (iv) with respect to such notices and subpoenas, waives the territorial limits on service contained in Rule 45 of the Federal Rules of Civil Procedure and any applicable local rules, provided that the party requesting the testimony reimburses Respondent Beran's travel, lodging, and subsistence expenses at the then-prevailing U.S. Government per diem rates; and (v) consents to personal jurisdiction over Respondent Beran in any United States District Court for purposes of enforcing any such subpoena.

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

IV.

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

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

A. Respondent Beran be, and hereby is, censured;

B. Respondent Beran cease and desist from committing or causing any violations and any future violations of Section 17(e)(1) of the Investment Company Act;

C. IT IS FURTHER ORDERED that Respondent Beran shall, within ten (10) days of the entry of this Order, pay disgorgement of $11,508.44 and prejudgment interest of $1,584.48 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. 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 Respondent Beran as a Respondent in these proceedings, the file number of these

proceedings, a copy of which cover letter and money order or check shall be sent to David P. Bergers, Regional Director, U.S. Securities and Exchange Commission, Boston Regional Office, 33 Arch Street, 23rd Floor, Boston, MA 02110-1410;

D. IT IS FURTHER ORDERED THAT Respondent Beran shall, within ten (10) days of the entry of this Order, pay a civil money penalty in the amount of $10,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Respondent Beran as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to David P. Bergers, Regional Director, U.S. Securities and Exchange Commission, Boston Regional Office, 33 Arch Street, Boston, MA 02110-1410.

By the Commission.

Nancy M. Morris
Secretary

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

Chairman Cox
Not Participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT COMPANY ACT OF 1940
Release No. 28189 / March 5, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12980

In The Matter of PETER S. LYNCH, Respondent.	**ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 9(f) OF THE INVESTMENT COMPANY ACT of 1940, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER AS TO PETER S. LYNCH**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 9(f) of the Investment Company Act of 1940 ("Investment Company Act") against Peter S. Lynch ("Lynch" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent Lynch has submitted an Offer of Settlement ("Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 9(f) of the Investment Company Act of 1940, Making Findings, and Imposing a Cease-and-Desist Order as to Peter S. Lynch ("Order"), as set forth below.

III.

III.

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

Respondent

1. **Lynch**, age 64, lives in Marblehead, Massachusetts. He has been associated with Fidelity Management & Research Company (FMR) and FMR Co., Inc. (FMR Co.) (collectively, Fidelity) in various capacities since 1969, and was the portfolio manager of Fidelity's Magellan Fund from 1977 to 1990. Since retiring from Magellan, Lynch has been the vice chairman and a director of FMR and FMR Co. Lynch was a trustee of the complex of mutual funds marketed under the "Fidelity Investments" trade name (Fidelity Funds) from 1990 until February 2003, and has since served as a member of Advisory Board of the Fidelity Funds.

Relevant Parties

2. **FMR** is a privately held Massachusetts corporation registered with the Commission as an investment adviser pursuant to Section 203(c) of the Investment Advisers Act of 1940 ("Advisers Act"), with its principal place of business in Boston, Massachusetts. FMR is a wholly owned subsidiary of FMR LLC, a privately held Delaware limited liability company. FMR is an adviser to various institutional clients and has approximately $1.25 trillion in assets under management. FMR's institutional clients include a group of approximately 350 registered investment companies marketed under the "Fidelity Investments" trade name and managed by FMR and its affiliates (hereafter "the Fidelity Funds").

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

Summary

4. This proceeding concerns Peter Lynch's request and receipt of tickets to sporting and entertainment events from two traders on Fidelity's equity trading desk at a time when he was serving as vice chairman and director of Fidelity and trustee or member of the Advisory Board of the Fidelity Funds. With Lynch's knowledge, those traders obtained the requested tickets – often to sold-out events – from securities brokerage firms doing business or seeking to do business with Fidelity. In addition, the two traders – Robert Burns and Jeffrey Harris – directed transactions to the brokers who provided those tickets. During the period from 1999 to October 2004 (the "Relevant Period"), Lynch requested and received from Burns and Harris 61

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

tickets worth approximately $15,948 to 12 concerts and sporting and theater events, including fourteen, three-day passes to the 1999 Ryder Cup. By requesting that Burns and Harris obtain tickets for him, which they did by soliciting them from brokers, Lynch caused Burns' and Harris' violations of Section 17(e)(1) of the Investment Company Act.

Background

5. As portfolio manager of Fidelity Investments' Magellan Fund from 1977 to 1990, Lynch directed securities transactions for the fund to certain traders on Fidelity's equity trading desk. Since 1990, Lynch has not managed any investments for any Fidelity Investments fund.

6. During approximately the last five years that Lynch managed the Magellan Fund, Burns was one of Fidelity's equity traders assigned to handle securities orders for the Magellan Fund. During the Relevant Period, Lynch periodically requested that Burns obtain tickets for him for various sporting and entertainment events. In response to requests from Lynch, Burns solicited those tickets from brokers doing business or seeking to do business with Fidelity's equity trading desk. Burns directed transactions to the brokers who provided the tickets Lynch requested. Lynch was aware that tickets obtained for him by Burns were provided by brokers.

7. Annually during the Relevant Period, Lynch signed a form acknowledging his receipt of Fidelity's Code of Ethics for Personal Investing and certifying that he had read and understood the policies and conducted himself in accordance with them. Accompanying the acknowledgement forms that Lynch signed was Fidelity's Code of Ethics, which in several versions contained, among other things, a prohibition: "The Fidelity Companies generally prohibit employees from receiving gifts or other gratuities from any person or entity that does business with the Funds..."

8. From 1995 to 2003, as an interested trustee of the Fidelity Funds (and since 2003 as an advisory trustee), Lynch attended annual trustee meetings at which Fidelity's gifts and gratuities policies applicable to the independent trustees were discussed. Each year, the materials provided at those meetings included a statement concerning the general prohibition against receiving gifts worth more than $100.

Lynch Sought and Obtained Tickets through Fidelity's Equity Traders

9. During the Relevant Period, Lynch obtained, through his requests to Burns, and in one instance, Harris, approximately 61 tickets to 12 events. Lynch knew those tickets were provided by various brokers who handled and/or sought Fidelity's brokerage business. The total value of those tickets was approximately $15,948.

10. The tickets Lynch received included seats to various events, including eleven tickets to a U2 concert and fourteen, three-day passes to the 1999 Ryder Cup golf tournament held at The Country Club in Brookline, Massachusetts. After Lynch had been unsuccessful in obtaining tickets to the 1999 Ryder Cup on his own, he asked Burns to obtain the tickets for him.

To satisfy Lynch's request, Burns enlisted the assistance of other traders on Fidelity's equity trading desk. Lynch also obtained through Burns tickets to the Ryder Cup golf tournament in Michigan in 2004 (at least six tickets), and sporting events, concerts, and theater events. Lynch also obtained tickets to a Santana concert from Harris, who requested and received the tickets from a brokerage firm doing business with Fidelity.

11. Contrary to Fidelity policy, Lynch did not attend any of the events with representatives of the brokerage firms that provided the tickets. Furthermore, Lynch did not reimburse brokers for any of the tickets they obtained for him.

Certain Fidelity Traders and Brokers Doing Business with Fidelity
Were Aware That Lynch Obtained Tickets From Brokers

12. In addition to Burns and Harris, at least seven other traders on FMR Co.'s equity trading desk were aware during the Relevant Period that Lynch obtained tickets from brokers through requests to the equity trading desk. Lynch's conduct was the subject of comment between certain traders. Each of those Fidelity traders accepted tickets and/or other gifts for themselves from brokers.

13. The broker Burns solicited most often for tickets on behalf of Lynch also was aware that Lynch had requested the tickets.

Lynch Caused Violations of Section 17(e)(1) of the Investment Company Act

14. As a result of the conduct described above, Lynch caused Burns' and Harris' violations of Section 17(e)(1) of the Investment Company Act, which makes it unlawful for an affiliated person of a registered investment company, or an affiliate of an affiliate, when acting as an agent, to accept compensation from any source (other than a salary or wages from the registered investment company) for the purchase or sale of any property to or for the registered investment company. Burns and Harris were affiliated persons of FMR Co., which, at all relevant times, was an affiliated person of investment companies (Fidelity Investments' complex of mutual funds) because FMR Co. is an investment adviser to those funds. Burns and Harris accepted compensation in violation of Section 17(e)(1) of the Investment Company Act in the form of tickets they solicited and obtained from brokers at Lynch's request. By requesting the tickets from Burns and Harris, Lynch caused those violations.

Undertakings

15. In connection with this proceeding and any related judicial or administrative proceeding or investigation commenced by the Commission or to which the Commission is a party, Respondent Lynch (i) agrees to appear and be interviewed by Commission staff at such times and places as the staff requests upon reasonable notice; (ii) will accept service by mail or facsimile transmission of notices or subpoenas issued by or on behalf of the Commission for

documents or testimony at depositions, hearings, or trials, or in connection with any related investigation by Commission staff; (iii) appoints Respondent Lynch's attorney in this proceeding as agent to receive service of such notices and subpoenas; (iv) with respect to such notices and subpoenas, waives the territorial limits on service contained in Rule 45 of the Federal Rules of Civil Procedure and any applicable local rules, provided that the party requesting the testimony reimburses Respondent Lynch's travel, lodging, and subsistence expenses at the then-prevailing U.S. Government per diem rates; and (v) consents to personal jurisdiction over Respondent Lynch in any United States District Court for purposes of enforcing any such subpoena.

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

IV.

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

Accordingly, pursuant to Section 9(f) of the Investment Company Act, it is hereby ORDERED that:

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

B. IT IS FURTHER ORDERED that Respondent Lynch shall, within ten (10) days of the entry of this Order, pay disgorgement of $15,948.68 and prejudgment interest of $4,183.83 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. Payment shall be: (A) made by 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 Respondent Lynch as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to David P. Bergers, Regional Director, Division of Enforcement, U.S. Securities and Exchange Commission, Boston Regional Office, 33 Arch Street, 23rd Floor, Boston, MA 02110.

By the Commission.

Nancy M. Morris
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Chairman Cox
Not Participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 2714 / March 5, 2008

INVESTMENT COMPANY ACT OF 1940
Release No. 28186 / March 5, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12977

In The Matter of **BART A. GRENIER** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940 AND SECTIONS 9(b) and 9(f) OF THE INVESTMENT COMPANY ACT OF 1940 AS TO BART A. GRENIER**

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 203(f) 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 Bart A. Grenier ("Grenier" or "Respondent Grenier").

II.

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

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No.

INVESTMENT COMPANY ACT OF 1940
Release No.

ADMINISTRATIVE PROCEEDING
File No.

In The Matter of **BART A. GRENIER** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940 AND SECTIONS 9(b) and 9(f) OF THE INVESTMENT COMPANY ACT OF 1940 AS TO BART A. GRENIER**

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 203(f) 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 Bart A. Grenier ("Grenier" or "Respondent Grenier").

II.

In anticipation of the institution of these proceedings, Respondent Grenier has submitted an Offer of Settlement ("Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, which are admitted, Respondent Grenier 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 203(f) of the Investment Advisers Act of 1940 and Sections 9(b) and 9(f) of the Investment Company Act of 1940 as to Bart A. Grenier ("Order"), as set forth below.

III.

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

Respondent

1. **Grenier**, age 49, is a resident of Boston, Massachusetts. At all relevant times, Grenier was employed as a senior vice president of FMR Co., Inc. ("FMR Co.") located in Boston, Massachusetts. At all relevant times, Grenier had supervisory responsibility for FMR Co.'s equity trading desk and up to eight other FMR Co. business groups. With the exception of a four-month period in 1997, Grenier was associated with FMR Co. from in or about 1991 until June 2005.

Relevant Parties

2. **Fidelity Management & Research Company** ("FMR") is registered with the Commission as an investment adviser (File No. 801-7884) pursuant to Section 203(c) of the Advisers Act, with its principal place of business in Boston, Massachusetts. FMR is a wholly owned subsidiary of FMR LLC, which utilizes the trade name "Fidelity Investments." FMR is an adviser to various institutional clients and has approximately $1.25 trillion in assets under management. FMR's institutional clients include the group of approximately 350 registered investment companies marketed under the "Fidelity Investments" trade name and managed by FMR and its affiliates (hereafter "the Fidelity Funds").

3. **FMR Co.** is registered with the Commission as an investment adviser (File No. 801-3447) pursuant to Section 203(c) of the Advisers Act, with its principal place of business in Boston, Massachusetts. FMR Co. is a wholly owned subsidiary of FMR, and provides portfolio management services as a sub-adviser to certain clients of FMR, including the Fidelity Funds.

Summary

4. This proceeding concerns Grenier's acceptance of a substantial amount of tickets from securities brokerage firms ("broker-dealers") with which FMR Co. conducted business to events Grenier did not attend with representatives of the broker-dealers. During the period from January 1, 2002 to October 2004 (the "Relevant Period"), Grenier accepted approximately $38,500 worth of tickets to concerts and sporting events, which were given to him

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

directly or indirectly by representatives of at least five broker-dealers. Grenier secured tickets to several of the events by requesting that the then head of FMR Co.'s equity trading desk, Scott DeSano ("DeSano"), who reported directly to Grenier, obtain the tickets for him. Grenier obtained the balance of the tickets directly from broker-dealers that traded securities for and provided securities research to FMR Co. In September and October 2004, Grenier reimbursed representatives of broker-dealers a total of $14,348, which is what he understood to be the value of certain of the tickets Grenier received. By accepting those tickets, Grenier willfully[2] violated Section 17(e)(1) of the Investment Company Act. In the instances when Grenier requested that DeSano obtain tickets on Grenier's behalf and DeSano obliged Grenier, Grenier caused DeSano's violations of Section 17(e)(1) of the Investment Company Act.

Background

5. From at least January 1, 2002 to October 2004, Grenier supervised DeSano and up to eight other senior FMR Co. managers, and provided strategic direction to those business groups for which he had responsibility. Those nine business groups included equity trading, growth and income equity, value equity, equity real estate investment trusts, asset allocation, strategic advisers, high yield, money market, and fixed income. In addition, Grenier was a member of FMR Co.'s Soft Dollar Oversight Committee, which oversaw FMR Co.'s system to evaluate and compensate broker-dealers for their research.

6. Grenier and others at FMR Co., including investment managers and equity analysts, received research from broker-dealers to which FMR Co.'s equity trading desk directed client securities transactions for execution. FMR Co. paid for that research through trading commissions, and evaluated the quality of broker-dealers' research services through votes or "points" allocated by FMR Co. investment managers and equity analysts. The points were compiled for the Soft Dollar Oversight Committee. In connection with the research he received from broker-dealers, Grenier allocated his points each quarter during the Relevant Period to broker-dealers. In some cases, including for the broker-dealers from which Grenier obtained tickets, those points were used to evaluate the quality of the research the broker-dealers provided.

Grenier Accepted Tickets From Broker-Dealers

7. During the Relevant Period, Respondent Grenier obtained, directly or indirectly from at least five broker-dealers with which FMR Co. conducted business, approximately 70 tickets to 21 events that he attended without the representative of the broker-dealer present. Accordingly, those tickets, which cost broker-dealers approximately $38,500, constitute gifts from broker-dealers. Those gifts include a Super Bowl ticket package that cost the broker-dealer approximately $9,000, and premium seats to numerous Boston Red Sox and Boston Celtics

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[2] "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 he is violating one of the Rules or Acts.

games. Grenier obtained tickets to certain events by requesting that DeSano obtain the tickets for him. In those instances, DeSano obliged Grenier by procuring the tickets for Grenier from broker-dealers to which FMR Co. directed client securities transactions for execution. Grenier obtained the remaining tickets directly from broker-dealers that provided research to him and FMR Co.

Grenier's Reimbursement for Certain Tickets from Broker-Dealers

8. Commencing in July 2004, securities regulators conducted a routine examination of a broker-dealer ("Broker-Dealer A"). During that examination, securities regulators learned that Broker-Dealer A and its representatives appeared to have provided certain traders and other employees of FMR Co. with an excessive amount of travel, entertainment, gifts and gratuities.

9. In September 2004, Grenier reimbursed $3,248 to a representative of a broker-dealer who gave him tickets. The $3,248 represented the amount Grenier understood to be the value for 18 of the 70 tickets that Grenier accepted as gifts. Those tickets were for four events that took place in September 2004 and one event that took place in April 2004.

10. By at least the first week of October 2004, Grenier learned about issues concerning gifts being provided from Broker-Dealer A to at least one FMR Co. trader. Later that month, Grenier reimbursed a representative of a broker-dealer $11,100, representing what Grenier understood to be the value of 32 tickets given to Grenier. Those 32 tickets were for nine events Grenier did not attend with any representatives of the broker-dealer - six of which took place in 2003 and three of which took place between January and August 2004.

11. Of the $38,500 in tickets he received from broker-dealers with which FMR Co. conducted business, Grenier reimbursed a total of $14,348.

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

12. As a result of the conduct described above, Grenier willfully violated Section 17(e)(1) of the Investment Company Act, which makes it unlawful for an affiliated person of a registered investment company, or an affiliate of an affiliate, when acting as 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. Grenier was an affiliated person of FMR Co., which is an affiliated person of investment companies (Fidelity Investments' family of mutual funds), because FMR Co. advises those funds. Grenier's receipt of gifts from broker-dealers constituted compensation in violation of Section 17(e)(1) of the Investment Company Act.

13. As a result of the conduct described above, Grenier caused DeSano's violations of Section 17(e)(1) of the Investment Company Act. DeSano was an affiliated person of FMR Co., which is an affiliated person of investment companies (Fidelity Investments' family of mutual funds), because FMR Co. advises those funds. When Grenier requested that DeSano, who reported directly to Grenier, obtain tickets from broker-dealers on Grenier's behalf and DeSano

obliged Grenier by procuring tickets for Grenier from broker-dealers, DeSano accepted compensation, in violation of Section 17(e)(1) of the Investment Company Act. DeSano obtained items of value – tickets to concerts and sporting events – which he used to ingratiate himself by fulfilling his manager's request. By requesting that DeSano obtain those tickets from broker-dealers, Grenier caused DeSano's violations of Section 17(e)(1) of the Investment Company Act.

Undertakings

14. In connection with this proceeding and any related judicial or administrative proceeding or investigation commenced by the Commission or to which the Commission is a party, Respondent Grenier (i) agrees to appear and be interviewed by Commission staff at such times and places as the staff requests upon reasonable notice; (ii) will accept service by mail or facsimile transmission of notices or subpoenas issued by or on behalf of the Commission for documents or testimony at depositions, hearings, or trials, or in connection with any related investigation by Commission staff; (iii) appoints Respondent Grenier's attorney in this proceeding as agent to receive service of such notices and subpoenas; (iv) with respect to such notices and subpoenas, waives the territorial limits on service contained in Rule 45 of the Federal Rules of Civil Procedure and any applicable local rules, provided that the party requesting the testimony reimburses Respondent Grenier's travel, lodging, and subsistence expenses at the then-prevailing U.S. Government per diem rates; and (v) consents to personal jurisdiction over Respondent Grenier in any United States District Court for purposes of enforcing any such subpoena.

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

IV.

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

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

A. Respondent Grenier be, and hereby is, censured;

B. Respondent Grenier cease and desist from committing or causing any violations and any future violations of Section 17(e)(1) of the Investment Company Act;

C. IT IS FURTHER ORDERED that Respondent Grenier shall, within ten (10) days of the entry of this Order, pay disgorgement of $24,152 and prejudgment interest of $2,164.89 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. 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 Respondent Grenier as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to David P. Bergers, Regional Director, Division of Enforcement, U.S. Securities and Exchange Commission, Boston Regional Office, 33 Arch Street, 23rd Floor, Boston, MA 02110; and

D. IT IS FURTHER ORDERED THAT Respondent Grenier shall, within ten (10) days of the entry of this Order, pay a civil money penalty in the amount of $25,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Respondent Grenier as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to David P. Bergers, Regional Director, Division of Enforcement, U.S. Securities and Exchange Commission, Boston Regional Office, 33 Arch Street, 23rd Floor, Boston, MA 02110.

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. 57443 / March 6, 2008

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2795 / March 6, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12983

In the Matter of **WILLIAM J. RAUWERDINK, CPA,** **Respondent.**	**ORDER OF FORTHWITH SUSPENSION PURSUANT TO RULE 102(e)(2) OF THE COMMISSION'S RULES OF PRACTICE**

I.

The Securities and Exchange Commission deems it appropriate to issue an order of forthwith suspension of William J. Rauwerdink ("Rauwerdink") pursuant to Rule 102(e)(2) of the Commission's Rules of Practice [17 C.F.R. § 200.102(e)(2)].[1]

II.

The Commission finds that:

1. Rauwerdink is a certified public accountant in Michigan.

2. On June 20, 2007, a judgment of conviction was entered against Rauwerdink in *United States v. Rauwerdink*, No. 03 CR 80474-2, in the United States District Court for the Eastern District of Michigan, finding him guilty of one count of conspiracy to commit mail fraud, wire fraud, and bank fraud and to make false statements to a federal agency (the Commission),

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

Commission), and to one count of making false statements to a federal agency. The conduct occurred while Rauwerdink was Chief Financial Officer of Lason, Inc., a publicly traded company.

3. As a result of this conviction, Rauwerdink was sentenced to 45 months imprisonment in a federal penitentiary and 24 months supervised release, and ordered to pay restitution in the amount of $ 285,162,957.00.

III.

In view of the foregoing, the Commission finds that Rauwerdink has been convicted of a felony within the meaning of Rule 102(e)(2) of the Commission's Rules of Practice.

Accordingly, it is ORDERED, that William J. Rauwerdink is forthwith suspended from appearing or practicing before the Commission pursuant to Rule 102(e)(2) of the Commission's Rules of Practice.

By the Commission.

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. 57444 / March 6, 2008

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2796 / March 6, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12984

In the Matter of RICHARD D. NYE, 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 and in the public interest that public administrative proceedings be, and hereby are, instituted against Richard D. Nye ("Respondent" or "Nye") pursuant to Rule 102(e)(3)(i) of the Commission's Rules of Practice.[1]

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the

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

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

purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in Section III.3. below, which are admitted, Respondent consents to the entry of this Order Instituting 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 that:

1. Respondent Richard D. Nye, age 52, has held a Texas CPA license since 1979. He served as Cornerstone Propane Partners, L.P.'s ("Cornerstone's") vice president of finance and administration from January 1998 until November 2002, and as acting CFO from July 2001 until June 2002.

2. Cornerstone, a Delaware limited partnership, formerly with headquarters in Watsonville, California, was at one time one of the nation's largest propane marketers, and at the time of the alleged conduct discussed herein, its units were traded on the New York Stock Exchange and were registered under Section 12(b) of the Securities Exchange Act of 1934 ("Exchange Act").

3. On February 22, 2008, a final judgment was entered against Respondent permanently enjoining him from future violations of Sections 10(b) and 13(b)(5) of the Exchange Act and Rules 10b-5 and 13b2-1 thereunder, and aiding and abetting violations of Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 in civil S.E.C. v. Keith Baxter, et. al. (Civil Action 05-3843 RMW, N.D. Cal.). Respondent was ordered to pay a $25,000 civil money penalty and was barred as an officer or director of a public company for three years.

4. The Commission's complaint alleged, among other things, that Respondent signed public filings for Cornerstone during 2000 and 2001, including the Form 10-K for 2000 and three Forms 10-Q for 2001. The complaint alleged that he knew or was reckless in not knowing the public filings at issue failed to conform with Generally Accepted Accounting Principles ("GAAP"). The complaint further alleged that Cornerstone's subsidiary Coast Energy Group ("CEG") had suffered a comprehensive failure to accurately and timely record transactions on its books and records. The complaint further alleged that as a result Cornerstone's financial statements for the periods at issue were not presented in conformity with GAAP because, among other things, CEG's material transactions had not been properly recorded and the company's accounting records did not accurately reflect CEG's transactions. The complaint further alleged that Cornerstone issued a false press release and Form 10-K for 2001 that included materially false statements regarding the nature and origin of a $9.8 million write-off associated with Cornerstone's financial statement problems and that Nye knew or was reckless in not knowing that the statements were false.

IV.

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

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

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

B. After three years from the date of this Order, Nye 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 Nye'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. Nye, 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. Nye, 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 Nye's or the firm's quality control system that would indicate that Nye will not receive appropriate supervision;

c. Nye 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

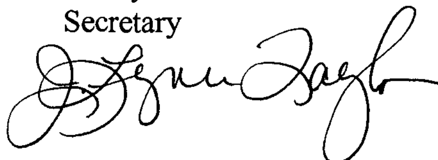
d. Nye acknowledges his responsibility, as long as Nye appears or practices before the Commission as an independent accountant, to comply with all requirements of the Commission and the Board, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews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

C. The Commission will consider an application by Nye 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 Nye'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. 57439 / March 6, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12981

In the Matter of CHARLES J. SPINELLI, ESQ. Respondent.	ORDER OF SUSPENSION PURSUANT TO RULE 102(e)(2) OF THE COMMISSION'S RULES OF PRACTICE

I.

The Securities and Exchange Commission deems it appropriate to issue an order of forthwith suspension of Charles J. Spinelli ("Spinelli") pursuant to Rule 102(e)(2) of the Commission's Rules of Practice [17 C.F.R. §200.102(e)(2)].[1]

II.

The Commission finds that:

1. Spinelli is a licensed attorney in New York.

2. On October 3, 2007, a judgment of conviction was entered against Spinelli in *United States v. Charles J. Spinelli*, No. 05-60212-CR-Jordan, in the United States District Court for the Southern District of Florida, finding him guilty of one count of conspiracy to commit wire fraud and one count of misprision of a felony.

3. As a result of this conviction, Spinelli was sentenced to 21 months imprisonment as to each count, to run concurrently with each other in a federal penitentiary and ordered to pay restitution in the amount of $43.4 million.

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

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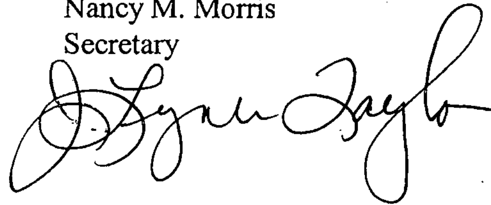
III.

In view of the foregoing, the Commission finds that Spinelli has been convicted of a felony within the meaning of Rule 102(e)(2) of the Commission's Rules of Practice.

Accordingly, it is ORDERED, that Charles J. Spinelli is forthwith suspended from appearing or practicing before the Commission pursuant to Rule 102(e)(2) of the Commission's Rules of Practice.

By the Commission.

Nancy M. Morris
Secretary



By: J. Lynn Taylor
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
March 6, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12982

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

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

1. Certified Services, Inc. ("Certified" or "Respondent") was incorporated in Nevada in 1999. Its headquarters were in Fort Lauderdale, Florida. The common stock of Certified has been registered under Section 12(g) of the Exchange Act since November 1996. The company's common stock (symbol "CSRV") is currently quoted on the "Pink Sheets" disseminated by Pink Sheets LLC. On May 12, 2005, Certified filed a voluntary Chapter 11 bankruptcy petition in the Southern District of Florida. Until May 23, 2006, Certified stock was listed and traded on the NASD Bulletin Board.

B. DELINQUENT PERIODIC FILINGS

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

13 ?6 35

3. Certified has failed to comply with Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder, while its common stock was registered with the Commission in that it has not filed an annual report on Form 10-K since April 22, 2004 or quarterly reports on Form 10-Q for any fiscal period subsequent to its fiscal quarter ending September 30, 2004.

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

III.

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

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

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

IV.

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

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

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

This Order shall be served forthwith upon Respondent personally, or by certified, registered, or express mail, or any 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

By: J. Lynn Taylor
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 239, 270, and 274

[Release Nos. 33-8901; IC-28193; File No. S7-07-08]

RIN 3235-AJ60

Exchange-Traded Funds

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission ("Commission" or "SEC") is proposing a new rule under the Investment Company Act of 1940 that would exempt exchange-traded funds ("ETFs") from certain provisions of that Act and our rules. The rule would permit certain ETFs to begin operating without the expense and delay of obtaining an exemptive order from the Commission. The rule is designed to eliminate unnecessary regulatory burdens, and to facilitate greater competition and innovation among ETFs. The Commission also is proposing amendments to our disclosure form for open-end investment companies, Form N-1A, to provide more useful information to investors who purchase and sell ETF shares on national securities exchanges. In addition, the Commission is proposing a new rule to allow mutual funds (and other types of investment companies) to invest in ETFs to a greater extent than currently permitted under the Investment Company Act.

DATES: Comments should be received on or before [insert date 60 days after publication in the Federal Register].

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

Electronic Comments:

- Use the Commission's Internet comment form

(http://www.sec.gov/rules/proposed.shtml); or

- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-07-08 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 S7-07-08. 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, on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: With respect to proposed rule 6c-11 and amendments to Form N-1A, Dalia Osman Blass, Senior Counsel, or Penelope Saltzman, Acting Assistant Director, (202) 551-6792, with respect to proposed rule 12d1-4 and proposed amendments to rule 12d1-2, Adam Glazer, Senior Counsel, or Penelope Saltzman, Acting Assistant Director, (202) 551-6792, Office of Regulatory Policy, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE, Washington, DC

20549-5041.

SUPPLEMENTARY INFORMATION: The Commission is proposing for public comment new rules 6c-11 [17 CFR 270.6c-11] and 12d1-4 [17 CFR 270.12d1-4] and amendments to rule 12d1-2 [17 CFR 270.12d1-2] under the Investment Company Act of 1940 ("Investment Company Act" or "Act"),[1] and amendments to Form N-1A[2] under the Investment Company Act and the Securities Act of 1933 (the "Securities Act").[3]

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1 15 U.S.C. 80a. Unless otherwise noted, all references to rules under the Investment Company Act will be to Title 17, Part 270 of the Code of Federal Regulations [17 CFR 270], and all references to statutory sections are to the Investment Company Act.

2 17 CFR 239.15A, 17 CFR 274.11A.

3 15 U.S.C. 77a.

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I. Introduction

Exchange-traded funds are an increasingly popular investment vehicle.[4] Last year, the number of ETFs traded in U.S. markets increased by 67 percent, from 357 to 601, and the assets held by ETFs increased by about 42 percent, to approximately $580 billion.[5] Although aggregate ETF assets are less than seven percent of assets held by traditional mutual funds (i.e., open-end investment companies),[6] they are growing more rapidly.[7]

ETFs offer public investors an undivided interest in a pool of securities and other assets

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4 When we refer to an ETF in this release, we refer to an ETF that meets the definition of "investment company" and is registered under the Investment Company Act generally because it issues securities and is primarily engaged or proposes to primarily engage in the business of investing in securities. Some other types of exchange-traded funds, which we will not discuss in this release, invest primarily in commodities or commodity-based instruments, such as crude oil and precious metal ("commodity ETFs"). Commodity ETFs are typically organized as trusts, and issue shares that trade on a securities exchange like other ETFs, but they are not "investment companies" under the Investment Company Act. See section 3(a)(1) (defining the term "investment company" as a company that "(A) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities; (B) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or (C) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis."). 15 U.S.C. 80a-3(a)(1).

5 Investment Company Institute ("ICI"), Outline of Supplemental Tables for Exchange-Traded Fund Report (http://members.ici.org/stats/etfdata.xls ("ICI ETF Statistics 2007")), Exchange-Traded Fund Assets December 2007, Jan. 30, 2008 ("ICI ETF Assets 2007"). ICI statistics cited in this release may be found at: http://www.ici.org/stats/etf/index.html and exclude commodity ETFs. By comparison, 153 ETFs were introduced in 2006, 50 were introduced in 2005, and 32 ETFs were introduced in 2004. ICI, 2007 Investment Company Fact Book, May 2007.

6 In 2007, net new investment in ETFs was approximately $142 billion compared to $212 billion in traditional mutual funds, or 67 percent of net new investment in traditional mutual funds. ICI ETF Statistics 2007, supra note 5; ICI, Trends in Mutual Fund Investing December 2007, Jan. 30, 2008 ("ICI Trends December 2007").

7 ICI ETF Assets 2007, supra note 5. As of December 2007, assets held by traditional equity and bond mutual funds were $8.9 trillion. ICI Trends December 2007, supra note 6. In 2007, ETF assets grew 42 percent (from $407.9 billion to $579.5 billion) while traditional equity and bond mutual fund assets grew 9.7 percent (from $8.06 trillion to $8.9 trillion). See ICI ETF Statistics 2007, supra note 5; ICI Trends December 2007, supra note 6.

and thus are similar in many ways to traditional mutual funds, except that shares in an ETF can be bought and sold throughout the day like stocks on an exchange through a broker-dealer.[8] ETFs therefore possess characteristics of traditional mutual funds, which issue redeemable shares, and of closed-end investment companies, which generally issue shares that trade at negotiated market prices on a national securities exchange and are not redeemable.[9]

Since they were first developed in the early 1990s, ETFs have evolved. The first ETFs held a basket of securities that replicated the component securities of broad-based stock market indexes, such as the S&P 500.[10] Many of the newer ETFs are based on more specialized indexes,[11] including indexes that are designed specifically for a particular ETF,[12] bond indexes,[13]

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[8] ETF shares represent an undivided interest in the portfolio of assets held by the fund. ETFs are registered with the Commission and are organized either as open-end investment companies or unit investment trusts ("UITs"). See section 5(a)(1) of the Investment Company Act (defining "open-end company" as a management company that is offering for sale or has outstanding any redeemable security of which it is the issuer); section 4(2) of the Act (defining "unit investment trust" as an investment company that (A) is organized under a trust indenture, contract of custodianship or agency, or similar instrument, (B) does not have a board of directors, and (C) issues only redeemable securities, each of which represents an undivided interest in a unit of specified securities, but does not include a voting trust). 15 U.S.C. 80a-5(a)(1).

[9] ETFs today have certain characteristics that have made them attractive to investors. Many have lower expense ratios and certain tax efficiencies compared to traditional mutual funds, and they allow investors to buy and sell shares at intra-day market prices. Moreover, investors can sell ETF shares short, write options on them, and set market, limit, and stop-loss orders on them. The shares of many ETFs often trade on the secondary market at prices close to the net asset value ("NAV") of the shares, rather than at discounts or premiums.

[10] See, e.g., SPDR Trust, Series 1, Investment Company Act Release Nos. 18959 (Sept. 17, 1992) [57 FR 43996 (Sept. 23, 1992)] (notice) and 19055 (Oct. 26, 1992) (order) ("SPDR Order"); Diamonds Trust, Investment Company Act Release Nos. 22927 (Dec. 5, 1997) [62 FR 65453 (Dec. 12, 1997)] (notice) and 22979 (Dec. 30, 1997) (order). The S&P 500 stands for the Standard & Poor's 500 Composite Stock Price Index.

[11] ETF providers offer ETFs that track the performance of indexes related to particular industries or market sectors. In 2007, domestic sector/industry ETFs increased by 62% from 135 to 219. ICI ETF Assets 2007, supra note 5.

[12] Many of these indexes are essentially portfolios of assets that are compiled (and change) on the basis of criteria that the index provider has designed for the particular ETF. Some indexes, for example, are "fundamental" indexes or rules-based indexes, in which the securities are chosen on criteria such as dividends and core earnings. See, e.g., PowerShares Exchange-Traded Fund

(footnote continued)

and international indexes.[14] Originally marketed as opportunities for investors to participate in tradable portfolio or basket products, ETFs are held today in increasing amounts by institutional investors (including mutual funds) and other investors as part of sophisticated trading and hedging strategies.[15] Shares of ETFs can be bought and held (sometimes as a core component of a portfolio),[16] or they can be traded frequently as part of an active trading strategy.[17]

Like money market funds first offered in the 1970s, ETFs represent a new type of

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Trust, Investment Company Act Release Nos. 25961 (Mar. 4, 2003) [68 FR 11598 (Mar. 11, 2003)] (notice) ("PowerShares 2003 Notice") and 25985 (Mar. 28, 2003) (order) ("PowerShares 2003 Order") (PowerShares offers ETFs that mirror custom-built indexes based on "Intellidexes," which were created by a quantitative unit of the American Stock Exchange). A few of the index providers that compile and revise the indexes are affiliated with the sponsor of the ETF. See, e.g., WisdomTree Investments, Investment Company Act Release Nos. 27324 (May 18, 2006) [71 FR 29995 (May 24, 2006)] (notice) ("WisdomTree Notice") and 27391 (June 12, 2006) (order) ("WisdomTree Order") (WisdomTree's ETFs seek to track the price and yield performance of domestic and international equity securities indexes provided by an affiliate).

[13] As of December 2007, 49 ETFs track bond indexes. ICI, Exchange-Traded Fund Assets December 2007, Jan. 30, 2008. See, e.g., Ameristock ETF Trust, Investment Company Act Release Nos. 27847 (May 30, 2007) [72 FR 31113 (June 5, 2007)] (notice) ("Ameristock Notice") and 27874 (June 26, 2007) (order); Vanguard Bond Index Funds, Investment Company Act Release Nos. 27750 (Mar. 9, 2007) [72 FR 12227 (Mar. 15, 2007)] (notice) and 27773 (Apr. 2, 2007) (order); Barclays Global Fund Advisors, Investment Company Act Release Nos. 27608 (Dec. 21, 2006) [71 FR 78235 (Dec. 28, 2006)] (notice) ("Barclays High Yield Notice") and 27661 (Jan. 17, 2007) (order).

[14] The first international equity ETFs were introduced in 1996. As of December 2007, there were 159 ETFs that provide exposure to international equity markets. ICI, Exchange-Traded Fund Assets December 2007, Jan. 30, 2008. International index-based ETFs increased by 87% from 85 in 2006 to 159 in 2007. Id.

[15] David Hoffman, Funds' grip loosens as ETFs gain, InvestmentNews, Apr. 28, 2006 (reporting that in 2004, 44% of 821 advisory firms polled by Financial Research Corp. of Boston said they collectively allocated an average of 12% of total assets under management to ETFs as compared with 2003, in which only 34% used ETFs and collectively allocated an average of 8% of assets under management).

[16] See, e.g., iShares Trust, Investment Company Act Release No. 25969 (Mar. 21, 2003) [68 FR 15010 (Mar. 27, 2003)].

[17] See GARY L. GASTINEAU, EXCHANGE-TRADED FUNDS MANUAL, 2 (2002) ("GASTINEAU") (ascribing the popularity of ETFs among active traders to high trading volume, competitive market makers, and active arbitrage pricing.). Morgan Stanley, Exchange-Traded Funds Quarterly Report, Nov. 16, 2006, at 13 ("They can be used by market timers wishing to gain or reduce exposure to entire markets or sectors throughout the trading day.").

registered investment company ("fund"). And like money market funds, they have required exemptions from certain provisions of the Act before they can commence operations.[18] Since 1992, the Commission has issued 61 orders to ETFs and their sponsors.[19]

In this release, we propose a new rule that would codify the exemptive orders we have issued to ETFs. Proposed rule 6c-11 would allow new competitors (i.e., those sponsors who do not already have exemptive orders) to enter the market more easily. We also are proposing amendments to our registration form for open-end funds, Form N-1A, to provide more useful information to individual investors who purchase and sell ETF shares on national securities exchanges. Finally, we are proposing a new rule to allow funds to invest in ETFs to a greater extent than currently permitted under the Act and our rules.

II. OPERATION OF EXCHANGE-TRADED FUNDS

All ETFs trading today operate in a similar way.[20] Unlike traditional mutual funds, ETFs

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[18] See rule 2a-7 under the Act, which codified the standards for granting the applications filed by money market funds for exemptions from the pricing and valuation provisions of the Act. For a discussion of the administrative history of rule 2a-7, see Valuation of Debt Instruments and Computation of Current Price per Share by Certain Open-End Investment Companies (Money Market Funds), Investment Company Act Release No. 12206 (Feb. 1, 1982) [47 FR 5428 (Feb. 5, 1982)].

[19] Since 2000, the Commission has provided ETF sponsors relief for any ETFs created in the future in connection with their exemptive orders so that the sponsors can introduce new ETFs if the ETFs meet the terms and conditions contained in the exemptive orders. See, e.g., Barclays Global Fund Advisors, Investment Company Act Release Nos. 24394 (Apr. 17, 2000) [65 FR 21219 (Apr. 20, 2000)] (notice) and 24451 (May 12, 2000) (order).

[20] Until recently, all ETFs had an investment objective of seeking returns that are correlated to the returns of a securities index, and in this respect operated much like traditional index funds. Recently, we issued orders approving actively managed ETFs. See WisdomTree Trust, et al., Investment Company Act Release Nos. 28147 (Feb. 6, 2008) [73 FR 7776 (Feb. 11, 2008)] (notice) ("WisdomTree Actively Managed ETF Notice") and 28174 (Feb. 27, 2008) (order) ("WisdomTree Actively Managed ETF"); Barclays Global Fund Advisors, et al., Investment Company Act Release Nos. 28146 (Feb. 6, 2008) [73 FR 7771 (Feb. 11, 2008)] (notice) and 28173 (Feb. 27, 2008) (order) ("Barclays Actively Managed ETF"); Bear Sterns Asset Management, Inc., et al., Investment Company Act Release Nos. 28143 (Feb. 5, 2008) [73 FR 7768 (Feb. 11, 2008)] (notice) and 28172 (Feb. 27, 2008) (order) ("Bear Sterns Actively Managed ETF"); PowerShares Capital Management LLC, et al., Investment Company Act

(footnote continued)

do not sell or redeem their individual shares ("ETF shares") at net asset value ("NAV"). Instead, financial institutions purchase and redeem ETF shares directly from the ETF, but only in large blocks called "creation units."[21] A financial institution that purchases a creation unit of ETF shares first deposits with the ETF a "purchase basket" of certain securities and other assets identified by the ETF that day, and then receives the creation unit in return for those assets. The basket generally reflects the contents of the ETF's portfolio and is equal in value to the aggregate NAV of the ETF shares in the creation unit. After purchasing a creation unit, the financial institution may hold the ETF shares, or sell some or all in secondary market transactions.[22]

Like operating companies and closed-end funds, ETFs register offerings and sales of ETF shares under the Securities Act and list their shares for trading under the Securities Exchange Act of 1934 ("Exchange Act").[23] As with any listed security, investors may trade ETF shares at market prices. ETF shares purchased in secondary market transactions are not redeemable from the ETF except in creation units.

The redemption process is the reverse of the purchase process. The financial institution acquires (through purchases on national securities exchanges, principal transactions, or private transactions) the number of ETF shares that comprise a creation unit, and redeems the creation

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Release Nos. 28140 (Feb. 1, 2008) [73 FR 7328 (Feb. 7, 2008)] (notice) ("PowerShares Actively Managed ETF Notice") and 28171 (Feb. 27, 2008) (order) ("PowerShares Actively Managed ETF" and collectively, "Actively Managed ETF Orders").

21 As discussed further below, creation units typically consist of at least 25,000 ETF shares. <u>See infra</u> note 113.

22 We note that depending on the facts and circumstances, broker-dealers that purchase a creation unit and sell the shares may be deemed to be participants in a distribution, which could render them statutory underwriters and subject them to the prospectus delivery and liability provisions of the Securities Act. <u>See</u> 15 U.S.C. 77b(a)(11).

23 15 U.S.C. 78a.

unit from the ETF in exchange for a "redemption basket" of securities and other assets.[24] An investor holding fewer ETF shares than the amount needed to constitute a creation unit (most retail investors) may dispose of those ETF shares by selling them on the secondary market. The investor receives market price for the ETF shares, which may be higher or lower than the NAV of the shares, and pays customary brokerage commissions on the sale.

The ability of financial institutions to purchase and redeem creation units at each day's NAV creates arbitrage opportunities that may help keep the market price of ETF shares near the NAV per share of the ETF. For example, if ETF shares begin trading on national securities exchanges at a price below the fund's NAV per share, financial institutions can purchase ETF shares in secondary market transactions and, after accumulating enough shares to comprise a creation unit, redeem them from the ETF in exchange for the more valuable securities in the ETF's redemption basket. Those purchases create greater market demand for the ETF shares, and thus tend to drive up the market price of the shares to a level closer to NAV.[25] Conversely, if the market price for ETF shares exceeds the NAV per share of the ETF itself, a financial institution can deposit a basket of securities in exchange for the more valuable creation unit of ETF shares, and then sell the individual shares in the market to realize its profit. These sales would increase the supply of ETF shares in the secondary market, and thus tend to drive down the price of the ETF shares to a level closer to the NAV of the ETF share.[26]

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[24] ETFs sometimes provide cash-in-lieu payments on some (or all) purchases or redemptions. See infra notes 120-121 and accompanying text.

[25] The purchase of the ETF shares on the secondary market combined with the sale of the redemption basket securities also may create upward pressure on the price of ETF shares and/or downward pressure on the price of redemption basket securities, driving the market price and ETF NAV closer together.

[26] The institution's purchase of the purchase basket securities combined with the sale of ETF shares also may create downward pressure on the price of ETF shares and/or upward pressure on the

(footnote continued)

Arbitrage activity in ETF shares is facilitated by the transparency of the ETF's portfolio. Each day, the ETF publishes the identities of the securities in the purchase and redemption baskets, which are representative of the ETF's portfolio.[27] Each exchange on which the ETF shares are listed typically discloses an approximation of the current value of the basket on a per share basis ("Intraday Value")[28] at 15 second intervals throughout the day and, for index-based ETFs, disseminates the current value of the relevant index.[29] This transparency can contribute to the efficiency of the arbitrage mechanism because it helps arbitrageurs determine whether to purchase or redeem creation units based on the relative values of ETF shares in the secondary market and the securities contained in the ETF's portfolio.

Arbitrage activity in ETF shares also appears to be affected by the liquidity of the securities in an ETF's portfolio. Most ETFs represent in their applications for exemptive relief

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price of purchase basket securities, driving the market price and the ETF's NAV closer together.

ETF sponsors and market participants report that the average deviation between the daily closing price and the daily NAV of ETFs that track domestic indexes is generally less than 2%. See, e.g., Vanguard U.S. Stock ETFs, Prospectus 56-59 (Apr. 27, 2007). ETFs that track foreign indexes may have a more significant deviation. See, e.g., iShares FTSE/Xinhua China 25 Index Fund, Prospectus 19 (Dec. 1, 2006).

27 With respect to index-based ETFs, portfolio transparency is enhanced by the transparency of the underlying index. Index providers publicly announce the components of their indexes. Because an index-based ETF seeks to track the performance of an index, often by replicating the component securities of the index, the transparency of the underlying index results in a high degree of transparency in the ETF's investment operations. Similarly, each of the actively managed ETFs operating under the recent exemptive orders approved by the Commission is required to make public each day the securities and other assets in its portfolio. See Actively Managed ETF Orders, supra note 20.

28 The Intraday Value also is referred to as the Intraday Indicative Value, Indicative Optimized Portfolio Value, Indicative Fund Value, Indicative Trust Value, or Indicative Partnership Value.

29 National securities exchanges are permitted to disseminate this information at 60 second intervals for ETFs that track non-U.S. indexes. See, e.g., Commentary .01(b)(2) to NYSE Acra Equities Rule 5.2(j)(3); Commentary 0.2(a)(C)(c) to American Stock Exchange Constitution and Rules & Arbitration Awards Rule 1000A.

that they invest in highly liquid securities.[30] Effective arbitrage depends in part on the ability of financial institutions to readily assemble the basket for purchases of creation units and to sell securities received upon redemption of creation units, and liquidity appears to be a factor in this process. An ETF's investment in less liquid securities may reduce arbitrage efficiency and thereby increase both the likelihood that a deviation between ETF share market price and NAV per share may occur and the amount of any deviation that does occur.

III. EXEMPTIONS PERMITTING FUNDS TO FORM AND OPERATE AS ETFS

Today we are proposing for public comment a new rule that would codify much of the relief and many of the conditions of orders that we have issued to index-based ETFs in the past, and more recently to certain actively managed ETFs. The proposed rule is designed to enable most ETFs to begin operations without the need to obtain individual exemptive relief from the Commission.

A. Scope of Proposed Rule 6c-11

1. Index-Based ETFs

Proposed rule 6c-11, like our orders, would provide exemptions for ETFs that have a stated investment objective of maintaining returns that correspond to the returns of a securities

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[30] Index-based ETFs track indexes that have specified methodologies for selecting their component securities. The methodologies generally ensure that an index consists of securities that will be highly liquid. See, e.g., Barclays High Yield Notice, supra note 13 ("The Underlying Index is a rules-based index designed to reflect the 50 most liquid U.S. dollar-denominated high-yield corporate bonds registered for sale in the U.S. or exempt from registration."). Because index-based ETFs either replicate or sample the indexes, their portfolio securities also should possess these characteristics. The actively managed ETFs also appear to invest in highly liquid securities. See WisdomTree Actively Managed ETF, supra note 20 (investing in U.S. and foreign money market securities); Barclays Actively Managed ETF, supra note 20 (investing in foreign money market securities); Bear Sterns Actively Managed ETF, supra note 20 (investing primarily in investment-grade fixed income securities); PowerShares Actively Managed ETF, supra note 20 (investing in large cap companies or U.S. government and corporate debt securities).

index whose provider discloses on its Internet Web site the identities and weightings[31] of the component securities and other assets of the index.[32] In this respect, the rule would codify our previous exemptive orders. Our experience is that the conditions included in the index-based ETF orders have effectively preserved the statutory purposes of the Act.

The proposed rule would not limit the types of indexes that an ETF may track or the types of securities that comprise any index. Thus, the rule would not limit the exemption to ETFs investing in liquid securities or assets, although existing ETFs generally have represented to us that their portfolios are comprised of highly liquid securities,[33] and, as open-end funds, are required to comply with the liquidity guidelines applicable to all open-end funds.[34]

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31 Proposed rule 6c-11(e)(9) defines "weighting of the component security" as "the percentage of the index's value represented, or accounted for, by such component security."

32 Proposed rule 6c-11(e)(4)(v)(B) (defining "exchange-traded fund"); see infra Section III.B.1 for a discussion of this index transparency requirement. Index-based ETFs obtain returns that correspond to those of an underlying index by replicating or sampling the component securities of the index. An ETF that uses a replicating strategy generally invests in the component securities of the underlying index in the same approximate proportions as in the underlying index. See, e.g., First Trust Exchange-Traded Fund, Investment Company Act Release No. 27051 (Aug. 26, 2005) [70 FR 52450 (Sept. 2, 2005)] ("First Trust Notice") at n.1. If, however, there are practical difficulties or substantial costs involved in holding every security in the underlying index, the ETF may use a representative sampling strategy pursuant to which it will invest in some but not all of the relevant component securities. An ETF that uses a sampling strategy includes in its portfolio securities that are designed, in the aggregate, to reflect the underlying index's capitalization, industry, and fundamental investment characteristics, and to perform like the index. The ETF implements the sampling strategy by acquiring a subset of the component securities of the underlying index, and possibly some securities that are not included in the corresponding index that are designed to help the ETF track the performance of the index. See, e.g., id.

33 See supra note 30 and accompanying and following text. See also WisdomTree Notice, supra note 12 at n.8 and accompanying text.

34 Long-standing Commission guidelines have required open-end funds to hold no more than 15% of their net assets in illiquid securities and other illiquid assets. See Statement Regarding "Restricted Securities," Investment Company Act Release No. 5847 (Oct. 21, 1969) [35 FR 19989 (Dec. 31, 1970)]; Revisions of Guidelines to Form N-1A, Investment Company Act Release No. 18612 (Mar. 12, 1992) [57 FR 9828 (Mar. 20, 1992)]. A fund's portfolio security is illiquid if it cannot be disposed of in the ordinary course of business within seven days at approximately the value ascribed to it by the ETF. See Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies, Investment Company Act Release (footnote continued)

We request comment regarding the effect of portfolio liquidity on the potential for deviation between ETF share market price and NAV and the amount of any deviation. In addition to the liquidity guidelines applicable to all open-end funds, should the Commission include additional liquidity requirements as a condition of the exemptions? If so, what additional requirements and why? Should the chance (or likelihood) that substantial discounts or premiums may occur if an ETF portfolio contains less liquid securities or assets be a regulatory concern for the Commission, or should it be treated as a material risk to be disclosed to prospective investors, permitting them to evaluate whether the risk makes the ETF an appropriate investment in light of the investor's investment objectives?[35] We note that currently there is substantially more market interest in ETFs that track broad-based indexes that are comprised of highly liquid securities than ETFs that track more specialized indexes.[36] How would liquidity or illiquidity of securities or other assets in an ETF's portfolio affect the ability of financial institutions to assemble securities for a purchase basket and thus the arbitrage mechanism and operation of the ETF? Would liquidity requirements preclude the development of specialty ETFs that serve narrow investment purposes but which may satisfy particular investment needs of certain investors?

2. Actively Managed ETFs

We recently issued exemptive orders to several actively managed ETFs and their

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No. 14983 (Mar. 12, 1986) [51 FR 9773 (Mar. 21, 1986)] (adopting amendments to rule 2a-7 under the Act); Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities under Rules 144 and 145, Investment Company Act Release No. 17452 (Apr. 23, 1990) [55 FR 17933 (Apr. 30, 1990)] (adopting Rule 144A under the Securities Act).

[35] The Commission is proposing an amendment to Form N-1A that would codify the condition in our orders that ETFs disclose the extent and frequency with which market prices have tracked their NAV. See infra notes 169-170 and accompanying text.

[36] See ICI ETF Statistics 2007, supra note 5.

sponsors.[37] Like our orders, proposed rule 6c-11 would provide an exemption for an actively managed ETF that discloses on its Internet Web site each business day the identities and weightings of the component securities and other assets held by the ETF.[38] Unlike index-based ETFs, an actively managed ETF does not seek to track the return of a particular index. Instead, an actively managed ETF's investment adviser, like an adviser to any traditional actively managed mutual fund, generally selects securities consistent with the ETF's investment objectives and policies without regard to a corresponding index.

In 2001, we sought comment on the concept of an actively managed ETF ("2001 Concept Release").[39] We requested comment on a broad number of questions that we felt were important to consider before expanding the scope of the exemptive orders we had issued. We wanted to know how investors would use an actively managed ETF because it seemed that, unlike an investment in an index-based ETF, an investment in an actively managed ETF could not be used, for example, to implement a hedging strategy. We questioned whether an actively managed ETF would provide investors with the same or similar benefits as index-based ETFs, including potential tax efficiencies and low expense ratios.

Our 2001 Concept Release also asked more focused questions about the structural and operational differences between the two types of ETFs and how those differences might affect the market value of ETF shares. We inquired whether as a matter of public policy an ETF must be designed to enable efficient arbitrage and thereby minimize the probability that ETF shares

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[37] See Actively Managed ETF Orders, supra note 20.

[38] Proposed rule 6c-11(e)(4)(v)(A); see infra Section III.B.1 for a discussion of this requirement.

[39] See Actively Managed Exchange-Traded Funds, Investment Company Act Release No. 25258 (Nov. 8, 2001) [66 FR 57614 (Nov. 15, 2001)] ("2001 Concept Release").

would trade at a material premium or discount.[40] We asked, for example, whether actively managed ETFs must have the same degree of portfolio transparency as index-based ETFs, a factor that appeared to contribute significantly to arbitrage efficiency.[41] It was unclear to us at that time whether an adviser to actively managed ETFs would be willing to provide the same degree of transparency as an adviser to index-based ETFs because, for example, disclosure could allow market participants to access the fund's investment strategy.[42] We were concerned that reduced transparency could expose arbitrageurs to greater investment risk and result in a less efficient arbitrage mechanism, which in turn could lead to more significant premiums and discounts than experienced by index-based ETFs.

We received 20 comments from market participants, many of which supported the introduction of actively managed ETFs.[43] Many commenters stated that actively managed ETFs would have the potential to provide investors with uses and benefits similar to index-based ETFs. For example, commenters maintained that, like index-based ETFs, actively managed ETFs could potentially serve as short-term or long-term investment vehicles, allow investors to gain

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40 Id. at text following n.35.

41 See supra note 27 and accompanying text.

42 We also noted concerns that full disclosure could permit market participants to "front-run" portfolio trades. See infra text accompanying and preceding note 84. In addition, because actively managed portfolios likely would change more frequently and in less foreseeable ways than a portfolio of index-based ETFs, we were unclear how or whether an actively managed ETF would communicate intra-day portfolio changes to investors. See generally, Russ Wermers, The Potential Effects of More Frequent Portfolio Disclosure on Mutual Fund Performance, Investment Company Institute Perspective, June 2001, Vol. 7, No. 3, at http://www.ici.org/perspective/per07-03.pdf. (examining the potential effects of more frequent portfolio disclosure on the performance of mutual funds and concluding that, with more frequent disclosure, shareholders would likely receive lower total returns on their investments due to, among other things, front-running and free-riding).

43 The comment letters to the 2001 Concept Release are available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549 (File No. S7-20-01), and are available on the Commission's Internet Web site (http://www.sec.gov/rules/concept/s72001.shtml).

exposure to an asset category such as value, growth or income, and play a significant role in an investor's hedging strategies.[44] Commenters also asserted that actively managed ETFs have the potential for providing investors benefits similar to index-based ETFs, including low expense ratios and intra-day exchange trading.[45] Other commenters, however, questioned whether some of the investor benefits traditionally associated with index-based ETFs would be present with actively managed ETFs.[46]

Commenters agreed that actively managed ETFs should be designed, like index-based ETFs, with an arbitrage mechanism intended to minimize the potential deviation between market price and NAV of ETF shares.[47] Not all commenters agreed, however, on whether we should be concerned with the extent of premiums or discounts and, therefore, whether we should require full portfolio transparency. Some asserted that the amount of any discount or premium that might develop ought not to be a consideration for us in determining whether to grant exemptive

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44 See, e.g., Comment Letter of the American Stock Exchange LLC, File No. S7-20-01 (Mar. 5, 2002) ("For example, an investor may find that a particular actively managed ETF more closely tracks his securities holdings, and therefore may be a more effective hedge."); Comment Letter of State Street Bank and Trust Company, File No. S7-20-01 (Jan. 14, 2002). One commenter asserted, however, that actively managed ETFs would be of greater interest to retail investors; institutional investors would not use active fund products for hedging, cash equitization or other strategies. Comment Letter of Barclays Global Investors, File No. S7-20-01 (Jan. 11, 2002).

45 See, e.g., Comment Letter of the American Stock Exchange LLC, File No. S7-20-01 (Mar. 5, 2002); Comment Letter of State Street Bank and Trust Company, File No. S7-20-01 (Jan. 14, 2002).

46 One commenter, for example, asserted that an actively managed ETF would likely not experience similar tax efficiency because that is predominantly a function of the low portfolio turnover of index-based ETFs. The commenter also noted that actively managed ETFs are unlikely to have the low expenses associated with index-based ETFs, which result primarily from lower advisory fees associated with the passive management of those funds. Comment Letter of the Vanguard Group, File No. S7-20-01 (Feb. 14, 2002).

47 See, e.g., Comment Letter of the Vanguard Group, File No. S7-20-01 (Feb. 14, 2002); Comment Letter of Barclays Global Investors, File No. S7-20-01 (Jan. 11, 2002).

relief.[48] One commenter argued that ETFs with share prices that significantly deviate from NAV would likely not attract the interest of investors and would ultimately fail if they did not provide information necessary for market participants to make knowledgeable investment decisions.[49] Other commenters asserted that it is important to require that ETFs provide all investors with the same information about portfolio holdings[50] and to require clear fund disclosures regarding the risks associated with the level of transparency provided.[51] These commenters stressed the need,

48 See, e.g., Comment Letter of the American Bar Association, Committee on Federal Regulation of Securities, File No. S7-20-01 (Feb. 1, 2002) ("We believe that the Commission should not mandate the level of transparency in ETFs' portfolios, but rather should allow fully informed demand in the financial markets to determine the proper levels. Different segments of the market with different needs might demand investment vehicles with different variation. To prevent market demand from determining the structure of investment vehicles would retard efficiency, competition, and capital formation."); Comment Letter of State Street Bank and Trust Company, File No. S7-20-01 (Jan. 14, 2002) ("...[A] non-transparent actively managed ETF will be no worse off than closed-end funds trading today. In fact, the premium/discount of a non-transparent ETF should be narrower due to the ETF's open-ended qualities."); Comment Letter of the Vanguard Group, File No. S7-20-01 (Feb. 14, 2002) ("While [spreads] may be higher for actively managed ETFs than for index ETFs, we do not believe that the discounts between market price and NAV will approach those seen in closed-end funds.").

49 See Comment Letter of State Street Bank and Trust Company, File No. S7-20-01 (Jan. 14, 2002); see also Comment Letter of the American Bar Association, Committee on Federal Regulation of Securities, File No. S7-20-01 (Feb. 1, 2002) ("Ultimately it is in the interest of the sponsor and investment adviser to provide for effective arbitrage opportunities. It is unlikely that an actively managed ETF sponsor would be able to convince the critical market participants such as specialists, market makers, arbitragers and other Authorized Participants to support a product that contained illiquid securities to a degree that would affect the liquidity of the ETF, making it difficult to price, trade and hedge, ultimately leading to its failure in the marketplace.").

50 See, e.g., Comment Letter of the Vanguard Group, File No. S7-20-01 (Feb. 14, 2002) ("Sponsors of actively managed ETFs should not be permitted to provide more information about portfolio holdings to the exchange specialist and market makers than they provide to other investors. Vanguard believes, as a matter of fundamental fairness, that all investors in a fund must be treated equally. Providing information only to a favored few is inconsistent with the foundation of our capital markets—full and fair disclosure to all investors.").

51 See, e.g., Comment Letter of Morgan Stanley & Co., File No. S7-20-01 (May 3, 2002) ("Even if the Commission were to determine that new forms of ETFs do pose a significant risk of trading at a discount or premium to NAV, we do not believe that the Commission should delay approval of the product for this reason. Instead, we would urge the Commission to address any perceived investor risks by requiring additional risk disclosure."); Comment Letter of the Vanguard Group, File No. S7-20-01 (Feb. 14, 2002) ("Investors in an actively managed ETF must receive adequate disclosure about the risks associated with the level of the ETF's transparency (and other risks

(footnote continued)

however, for sufficient market information to value the fund's portfolio.[52] Others argued that portfolio transparency is essential to support effective arbitrage.[53] One commenter asserted that any lack of transparency would negatively impact an ETF's arbitrage mechanism and would likely result in ETF shares trading at secondary market prices that do not reflect the value of the ETF's underlying portfolio.[54] The commenter noted that to the extent an ETF operates with less than full transparency during periods of market volatility, this would likely result in some individual investors buying or selling ETF shares at secondary market prices moving in the opposite direction of the ETF's NAV. The commenter urged us to consider carefully the consequence of granting an exemption that might yield such a result.[55] The Investment Company Institute asserted that to the extent that all or part of an ETF's portfolio is not transparent, it could raise significant investor protection concerns including the potential for disparate treatment

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unique to actively managed ETFs) ..... if the ETF has limited transparency, the fund's disclosure documents should discuss the possibility that the spreads between bid and asked prices and between the market price and NAV of the fund's exchange-traded shares may be higher than is typically the case of index ETFs.").

[52] See, e.g., Comment Letter of the American Stock Exchange LLC, File No. S7-20-01 (Mar. 5, 2002) (asserting that non-transparent actively managed ETFs need not disclose the full contents of their portfolios "so long as there is sufficient market information available to value the portfolio or a creation unit (or if different, the Redemption Basket) on an intra-day basis so as to facilitate secondary market trading and hedging."); Comment Letter of State Street Bank and Trust Co., File No. S7-20-01 ("While the importance of an effective arbitrage mechanism is clear, there are potential ways to achieve an effective arbitrage mechanism with less than full transparency, and, potentially, with no portfolio transparency. This may be accomplished with proper disclosure of an actively managed ETF's investment strategy and portfolio characteristics.").

[53] See, e.g., Comment Letter of Barclays Global Investors, File No. S7-20-01 (Jan. 11, 2002) ("It is generally accepted that portfolio transparency is the key to effective arbitrage. Therefore, the most significant issue for the Commission ... is whether [actively managed ETFs] would provide the necessary level and frequency of portfolio disclosure to support efficient arbitrage.").

[54] Id.

[55] Id.

of investors and the potential for the ETF to trade at significant premiums and discounts.[56]

Today we propose exemptions applicable to both index-based and actively managed ETFs that provide portfolio transparency to market participants. The comments we received, together with subsequent developments, address the principal concerns we raised in the 2001 Concept Release with respect to actively managed ETFs. We have received a number of applications from actively managed ETFs whose sponsors are interested in offering fully transparent, actively managed ETFs, and recently we have issued orders approving several of these ETFs.[57] As described in these applications, an actively managed ETF would operate in the same manner as an index-based ETF.[58] Each would be registered under the Act as an open-end fund and would redeem shares in creation units in exchange for basket assets. Each would be listed on a national securities exchange, and investors would trade the ETF shares throughout the day at market prices in the secondary market.[59] The national securities exchange typically would disseminate the Intraday Value of ETF shares at 15-second intervals throughout the trading day,[60] thereby providing institutional investors and other arbitrageurs the information necessary to engage in ETF share purchases and sales on the secondary market, and purchases and redemptions with the fund, which should help keep ETF share prices from trading at a significant discount or premium.[61] Finally, the actively managed ETFs represent that they would provide

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56 Comment Letter of the Investment Company Institute, File No. S7-20-01 (Jan. 14, 2002).

57 See Actively Managed ETF Orders, supra note 20.

58 See id.

59 See infra notes 88-94 and accompanying text for a discussion of the proposed rule's condition that ETF shares be approved for listing and trading on a national securities exchange.

60 See infra notes 92-94 and accompanying text for a discussion of the proposed rule's condition that ETFs be listed on an exchange that disseminates the Intraday Value of ETF shares on a regular basis.

61 See supra notes 27-29 and accompanying and following text. See also Actively Managed ETF (footnote continued)

ETF investors with uses and benefits similar to index-based ETFs.[62]

We believe that permitting fully transparent, actively managed ETFs would provide additional investment choices for investors and that exemptions necessary to permit the operation of these ETFs would be in the public interest and consistent with the policies and purposes of the Act. By proposing this rule we are not, however, suggesting that we will not consider applications for exemptive orders for actively managed ETFs that do not satisfy the proposed rule's transparency requirements. Rather, we are at this time proposing to permit fully transparent, actively managed ETFs to be offered without first seeking individual exemptive orders from the Commission.

We request comment on allowing actively managed ETFs with fully transparent portfolios to rely on the exemptions provided by the proposed rule. We only recently approved orders to allow certain actively managed ETFs and have not had the opportunity to observe how they operate in the markets over a significant period of time. Should we wait until we have gained greater experience with the operation of actively managed ETFs before adopting a final rule applicable to them? Is there any concern that a fully transparent actively managed ETF would not facilitate an efficient arbitrage mechanism? Would actively managed ETFs provide investors with uses and benefits similar to or different than their index-based counterparts? Do these or any other concerns regarding the operation of a fully transparent actively managed ETF warrant limiting the rule to index-based ETFs and considering exemptions for actively managed ETFs on a case by case basis through the exemptive applications process? Should we consider

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Orders supra note 20.

62 See, e.g., In re PowerShares Capital Management LLC, et al., Fifth Amendment, File No. 812-13386, filed Jan. 7, 2008 ("PowerShares Actively Managed ETF Application"), at 12-13 (available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549).

exemptions for other types of actively managed ETFs? If so, how would the arbitrage mechanism work in these ETFs? What kinds of conditions should we consider in order to facilitate an arbitrage mechanism?

3. Organization as an Open-end Investment Company

Our proposed rule would be available only to ETFs that are organized as open-end funds.[63] We have provided similar exemptions to unit investment trusts ("UITs") in the past.[64] However, because we have not received an exemptive application for a new ETF to be organized as a UIT since 2002, there does not appear to be a need to include UIT relief in the proposed rule.[65] We understand that ETF sponsors prefer the open-end fund structure because it allows more investment flexibility.[66] In addition, unlike an ETF that is a UIT, an open-end fund ETF may participate in securities lending programs and has greater flexibility in reinvesting dividends received from portfolio securities. Of the 601 ETFs in existence as of December 2007, 593 were organized as open-end funds.[67]

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63 Proposed rule 6c-11(e)(4).

64 See, e.g., SPDR Order, supra note 10. See supra note 8 for a definition of UITs.

65 Although two exemptive applications for ETFs organized as UITs were filed in 2007, the applications were occasioned by the transfer of the sponsorship from Nasdaq Financial Products Services, Inc. to PowerShares Capital Management, LLC and did not result in new ETFs. See BLDRs Index Funds Trust, Investment Company Act Release No. 27745 (Feb. 28, 2007) [72 FR 9787 (Mar. 5, 2007)] ("BLDRs Notice"); Nasdaq-100 Trust, Series 1, Investment Company Act Release No. 27740 (Feb. 27, 2007) [72 FR 9594 (Mar. 2, 2007)].

66 A UIT portfolio is fixed, and substitution of securities may take place only under certain circumstances. As a result, an ETF organized as a UIT typically replicates the holdings of the index it tracks. By contrast, existing ETFs organized as open-end funds may employ investment advisers and use a "sampling" strategy to track the index. Using a sampling strategy, an investment adviser can construct a portfolio that is a subset of the component securities in the corresponding index, rather than a replication of the index. The investment adviser also may invest a specific portion of the ETF's portfolio in securities and other financial instruments that are not included in the corresponding index if the adviser believes the investment will help the ETF track its underlying index. See, e.g., First Trust Notice, supra note 32, at. n.1.

67 The number of ETFs organized as UITs is based on information in the Commission's database of Form N-SAR filings.

We request comment on whether we should include ETFs organized as UITs in the definition of ETF under the proposed rule. If so, should they be subject to the same conditions set forth in the proposed rule?

B. Conditions

ETF sponsors have sought exemptions from certain provisions of the Act and our rules so that they may register ETFs as open-end funds. The principal distinguishing feature of open-end funds is that they offer for sale redeemable securities.[68] The Act defines "redeemable security" as any security that allows the holder to receive his or her proportionate share of the issuer's current net assets upon presentation to the issuer.[69]

Section 22(d) of the Act prohibits any dealer in redeemable securities from selling open-end fund shares at a price other than a current offering price described in the fund's prospectus.[70] Rule 22c-1 under the Act requires funds, their principal underwriters, and dealers 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.[71] Together, these provisions are designed to require that fund shareholders are treated equitably when buying and selling their fund shares.[72]

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68 15 U.S.C. 80a-5(a)(1); see infra notes 109-121 and accompanying text.

69 15 U.S.C. 80a-2(a)(32).

70 15 U.S.C. 80a-22(d).

71 17 CFR 270.22c-1(a). The rule requires that funds calculate their NAV at least once daily Monday through Friday (with certain exceptions, including days on which no securities are tendered for redemption and the fund receives no orders to purchase or sell securities). See 17 CFR 270.22c-1(b)(1). Today, most funds calculate NAV as of the time the major U.S. stock exchanges close (typically at 4:00 p.m. Eastern Time). Thus, a fund's NAV generally reflects the closing prices of the securities it holds. Under rule 22c-1, an investor who submits an order before the 4:00 p.m. pricing time receives that day's price, and an investor who submits an order after the pricing time receives the next day's price.

72 See generally, H.R. REP. NO. 2639, 76th Cong., 3d Sess., 8 (1940). See also INVESTMENT TRUSTS AND INVESTMENT COMPANIES, REPORT OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. NO. 279, 76th Cong., 1st Sess., pt. 3, at 860-874 (1939).

ETFs seeking to register as open-end funds under the Act require exemptions from these provisions because certain investors may purchase and sell individual ETF shares on the secondary market at current market prices, i.e., at prices other than those described in the ETF's prospectus or based on NAV. As discussed above, investors (typically financial institutions) can purchase and redeem shares from the ETF at NAV only in creation units.[73] Because these financial institutions can take advantage of disparities between the market price of ETF shares and NAV, they may be in a different position than investors who buy and sell individual ETF shares only on the secondary market.[74] The disparities in market price and NAV, however, provide those institutional investors with opportunities for arbitrage that would tend to drive the market price in the direction of the ETF's NAV to the benefit of retail investors.[75]

Today, we propose a rule with certain conditions that may permit the ETF structure to operate within the scope of the Act without sacrificing appropriate investor protection, and is designed to be consistent with the purposes fairly intended by the policy and provisions of the Act.[76] Our orders have provided exemptions from the definition of "redeemable security" and section 22(d) and rule 22c-1 for ETFs with an arbitrage mechanism that helps maintain the equilibrium between market price and NAV. Our proposed rule would codify these exemptions subject to three conditions that appear to have facilitated the arbitrage mechanism: transparency

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[73] See supra Section II for a discussion on the operation of ETFs.

[74] See, e.g., Comment Letter of Barclays Global Investors, File No. S7-20-01 (Jan. 11, 2002) ("[D]uring periods of market volatility… it is not unreasonable to assume that some retail investors would buy or sell ETF shares at secondary market prices moving in the opposite direction of a fund's NAV.").

[75] See supra notes 25-26 and accompanying text.

[76] Section 6(c) of the Act permits the Commission, conditionally or unconditionally, to exempt by rule any person, security, or transaction (or classes of persons, securities, or transactions) from any provision of the Act "if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions" of the Act. 15 U.S.C. 80a-6(c).

of the ETF's portfolio, disclosure of the ETF's Intraday Value, and listing on a national securities exchange.

1. Transparency of Index and Portfolio Holdings

To take advantage of the proposed exemption, an ETF must either (i) disclose on its Internet Web site each business day the identities and weightings of the component securities and other assets held by the fund, or (ii) have a stated investment objective of obtaining returns that correspond to the returns of a securities index, whose provider discloses on its Internet Web site the identities and weightings of the component securities and other assets of the index.[77] The Web page of the ETF or the index provider, as the case may be, must be publicly accessible at no charge.[78] Thus, the proposed rule would allow for an actively managed ETF provided that the actively managed ETF discloses its portfolio assets each business day.[79]

We seek comment on these transparency conditions. In particular, we request comment on the proposed provision requiring that an ETF that tracks an index and does not disclose its portfolio each business day must track an index whose provider discloses on an Internet Web site the component securities and other assets of the index it tracks.[80] Is it necessary for the rule to include this option instead of simply requiring daily portfolio disclosure by the ETF? What circumstances, if any, would prevent an index-based ETF from disclosing its portfolio

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77 Proposed rule 6c-11(e)(4)(v).

78 Id.

79 See supra discussion at Section III.A.2. An index-based ETF that has the investment objective of obtaining returns that correspond to the returns of multiple securities indexes may rely on the proposed rule provided that it discloses its portfolio in the same manner as a fully transparent actively managed ETF.

80 The proposed rule defines an "index provider" to mean the person that determines the securities and other assets that comprise a securities index. See proposed rule 6c-11(e)(7).

holdings?[81] Would Internet Web site disclosure of portfolio holdings be sufficient? If not, what other means of disclosure should the ETF or the index provider use?

We also seek comment on whether we should require ETFs to disclose daily on their Internet Web sites liabilities (as well as portfolio holdings) to permit investors, particularly arbitrageurs, to evaluate the impact of leverage from borrowings on the fund's portfolio.[82] Should we limit such a requirement to certain kinds of ETFs that may have significant liabilities? If so, how should we identify the ETFs that would be subject to the condition?

One of the issues we discussed in the 2001 Concept Release was that full portfolio transparency could give market participants an ability to access the fund's market strategies (i.e., "free-riding") and, in some cases, the ability to trade ahead of the ETF (i.e., "front-running").[83] Those commenters who addressed the issue generally agreed that intra-day or advance portfolio disclosure may be detrimental to an actively managed ETF because it could enable third parties to front-run the fund.[84] Therefore, the proposed rule does not require disclosure of intra-day changes in the portfolio of the ETF, because currently, intra-day changes do not affect the composition of the ETF's basket assets until the next trading day.[85] The proposed rule also does not require advance disclosure of portfolio trades.[86]

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81 See supra note 27.

82 For example, if an ETF enters into a written call to hedge the fair value exposure of an equity security in its portfolio, it would sacrifice any unrealized gains caused by the price of the equity security increasing above the price at which the call may be exercised (i.e. the strike price). Unless the ETF discloses the presence of these and similar liabilities, investors may not be able to evaluate the impact of leverage on the NAV of the ETF.

83 Market participants could trade ahead of an ETF if it disclosed portfolio assets in advance of the trades, rather than after the assets were acquired.

84 See, e.g., Comment Letter of the Vanguard Group, File No. S7-20-01 (Feb. 14, 2002); Comment Letter of the Investment Company Institute, File No. S7-20-01 (Jan. 14, 2002).

85 Applicants seeking exemptions for actively managed ETFs noted that under accounting procedures followed by the funds, portfolio trades made on the prior business day ("T") would be

(footnote continued)

We request comment on these aspects of the proposal. Should the rule require disclosure of portfolio changes more often than once a day? How would more frequent disclosure affect the arbitrage mechanism? Would more frequent disclosure increase the likelihood of free-riding or front-running? The rule does not limit ETFs to tracking specialized indexes that change their assets at or below a specified frequency. How might this affect the transparency of the portfolios of ETFs that would rely on index rather than portfolio disclosure?[87]

Should the proposed rule prohibit advance portfolio disclosure? Would advance portfolio disclosure increase the likelihood of free-riding or front-running? If so, should the risk that participants may engage in these activities be treated as a material risk to be disclosed to prospective investors permitting them to evaluate whether the risk makes the ETF an appropriate investment in light of the particular investor's investment objectives? How would advance disclosure affect the arbitrage mechanism? If the portfolio disclosed in advance differed from the actual portfolio acquired, would that affect the market's ability to price the ETF's shares?

2. Listing on a National Securities Exchange and Dissemination of Intraday Value

An ETF that relies on rule 6c-11 would need to satisfy two additional conditions set forth in the paragraph defining "exchange-traded fund."[88] First, shares issued by the ETF would have

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booked and reflected in the fund's NAV on the current business day ("T+1"). See, e.g., WisdomTree Actively Managed ETF Notice, supra note 20, at n.5. As a result, these funds will not have to announce trades before they are made. In addition, the funds will be able to disclose at the beginning of each trading day the portfolio that will form the basis of the NAV calculation at the end of the day. Id.

86 See proposed rule 6c-11(e)(4)(v)(A). Under the proposed rule, an ETF could disclose its portfolio at the end of the day on which relevant portfolio trades occurred (i.e., after the portfolio assets are acquired) or the beginning of the following day, which would eliminate the potential for front-running.

87 See supra note 77 and accompanying text.

88 Proposed rule 6c-11(e)(4) (defining "exchange-traded fund").

to be approved for listing and trading on a national securities exchange.[89] We have premised our previous exemptive orders on the ETF listing its shares for trading on a national securities exchange.[90] Listing on an exchange would provide an organized and continuous trading market for the ETF shares at negotiated prices. Applicants for exemptive relief have noted that this intra-day trading, combined with the arbitrage mechanism inherent in the ETF structure, should prevent significant premiums and discounts between the market price of ETF shares and the Intraday Value.[91]

Second, an ETF could rely on the rule only if a national securities exchange disseminates the Intraday Value at regular intervals during the trading day.[92] Applications for exemptive relief have noted that exchanges typically disseminate the Intraday Value every 15 seconds during trading hours.[93] They have also asserted that this regular dissemination of the Intraday Value enables market makers to engage in the arbitrage activities that determine the market price for ETF shares.[94]

We request comment on these two conditions. Should the rule require that ETF shares be listed on a national securities exchange? Should the rule make allowance for shares that are delisted for a short time, or for suspensions in listing? If an ETF's shares were not listed for

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89 Proposed rule 6c-11(e)(4)(iii).

90 See, e.g., HealthShares, Inc., Investment Company Act Release No. 27553 (Nov. 16, 2006) [71 FR 67404, 67408 (Nov. 21, 2006)] ("HealthShares Notice").

91 See, e.g., Amended and Restated Application of Ziegler Exchange Traded Trust, File No. 812-13224, filed Dec. 19, 2006 ("Ziegler Application"), at 10; PowerShares Actively Managed ETF Notice, supra note 20.

92 Proposed rule 6c-11(e)(4)(i).

93 See, e.g., Van Eck, Van Eck Associates Corp., Investment Company Act Release No. 27283 (Apr. 7, 2006) [71 FR 19214 (Apr. 13, 2006)], at n.3; PowerShares Actively Managed ETF Notice, supra note 20, at n.2.

94 See, e.g., Ziegler Application, supra note 91, at 26-27.

trading on a national securities exchange (even on a temporary basis), would the ETF structure permit the arbitrage mechanism to function appropriately? Should the rule require an ETF to liquidate or take other steps in the event of delisting? Should the proposed rule condition relief on listing exchanges disseminating the Intraday Value? If not, are there other means for market makers to receive the Intraday Value? Are there alternatives to using the basket as the basis for the Intraday Value calculation? For example, should the rule require the entity calculating the Intraday Value to use the ETF's portfolio (as opposed to the basket)? Should the calculation method be prescribed?

The proposed rule does not require the dissemination of an ETF's Intraday Value at specific intervals because the rules of national securities exchanges, as approved by the Commission, establish the frequency of disclosure.[95] Should the rule specify a minimal frequency? For example, should the rule prohibit an ETF from relying on the exemption if it is listed on an exchange that permits dissemination at intervals longer than the current 15 or 60-second intervals?

3. Marketing

Our exemptive orders included a condition requiring each ETF to agree not to market or advertise the ETF as an open-end fund or mutual fund and to explain that ETF shares are not individually redeemable.[96] This condition was designed to help prevent retail investors from confusing ETFs with traditional mutual funds. Similarly, the proposed rule would require each ETF relying on the rule to identify itself in any sales literature as an ETF that does not sell or redeem individual shares, and explain that investors may purchase or sell individual ETF shares

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[95] An ETF's Intraday Value is disseminated every 15 seconds (or 60 seconds in the case of ETFs that track foreign indexes). See supra note 29 and accompanying text.

[96] See, e.g., WisdomTree Order, supra note 12.

in secondary market transactions that do not involve the ETF.[97] This condition, like the prior condition in our orders, is designed to help prevent retail investors from confusing ETFs with traditional mutual funds.

We request comment on whether the proposed condition is likely to provide a benefit for investors with respect to ETF marketing and advertising materials. Are investors confused about the distinction between ETFs and traditional mutual funds? Should any confusion be addressed through rule requirements? Should the rule require ETFs to identify themselves as either index-based or actively managed ETFs?

4. Conflicts of Interest

Section 1(b)(2) of the Investment Company Act states that the public interest and the interest of investors are adversely affected when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, or other affiliated persons, and underwriters, brokers, or dealers rather than in the interest of shareholders.[98] The operation of an ETF—specifically, the process in which a creation unit is purchased by delivering basket assets to the ETF, and redeemed in exchange for basket assets—may lend itself to certain conflicts for the ETF's investment adviser, which has discretion to specify the securities included in the baskets. For example, the adviser could direct creation unit purchasers to purchase securities from affiliates of the adviser for subsequent presentation to the ETF. As we noted in the 2001 Concept Release, these conflicts would appear

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[97] Proposed rule 6c-11(e)(4)(ii). The term sales literature is defined in the proposed rule to mean any advertisement, pamphlet, circular, form letter, or other sales material addressed to or intended for distribution to prospective investors other than a registration statement filed with the Commission under section 8 of the Act. Proposed rule 6c-11(e)(8). An ETF would have to make similar disclosures in its prospectus under the proposed amendments to Form N-1A. See proposed Item 6(h)(3) of Form N-1A, and infra text accompanying note 159.

[98] 15 U.S.C. 80a-1(b)(2).

to be minimized in the case of an index-based ETF because the universe of securities that may be included in the ETF's portfolio generally is restricted by the composition of its corresponding index.[99] We also noted that the same would not appear to be the case for an actively managed ETF. Because the adviser to an actively managed ETF would have greater discretion to designate securities to be included in the basket assets, a greater potential for conflicts appears to exist.

Commenters generally stated that actively managed ETFs would not be faced with conflicts that are different from those that currently exist for actively managed mutual funds.[100] One commenter, however, recommended that the Commission impose any prohibitions or conditions under the Act that would apply to transactions directly effected by the adviser on any transactions effected at the adviser's discretion.[101] The commenter noted that, for example, an ETF that is prohibited from acquiring a security in certain underwritings (under section 10(f) of the Act)[102] should be prohibited from circumventing this prohibition by including the security in the ETF's basket assets. Similarly, an adviser could attempt to circumvent section 17(a) restrictions on principal transactions between a registered fund and its affiliates by designating a security for the basket assets that a creation unit purchaser would have to purchase from an

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99 See 2001 Concept Release, supra note 39, at Section IV.E.2.

100 See, e.g., Comment Letter of the American Stock Exchange LLC, File No. S7-20-01 (Mar. 5, 2002); Comment Letter of State Street Bank and Trust Company, File No. S7-20-01 (Jan. 14, 2002); Comment Letter of Nuveen Investments, File No. S7-20-01 (Jan. 14, 2002).

101 Comment Letter of the Investment Company Institute, File No. S7-20-01 (Jan. 14, 2002).

102 Section 10(f) of the Act prohibits a fund from purchasing any security during an underwriting or selling syndicate if a principal underwriter of the security is an officer, director, member of an advisory board, investment adviser, or employee of the fund or if any of these persons is an affiliate of the principal underwriter. 15 U.S.C. 80a-10(f). This section protects fund shareholders by preventing an affiliated underwriter from placing or "dumping" unmarketable securities in the fund.

affiliate of the adviser.[103]

We have not included a condition in the proposed rule prohibiting an actively managed ETF's adviser, directly or indirectly, from causing a creation unit purchaser to acquire a security for the ETF through a transaction in which the ETF could not engage directly. An adviser to an actively managed ETF already is subject to section 48(a) of the Act, which prohibits a person from doing indirectly, through another person, what that person is prohibited by the Act from doing directly. An adviser, therefore, would be prohibited from causing an institution that transacts directly with the ETF (or any investor on whose behalf the institution may transact with the ETF) to acquire any security for the ETF through a transaction in which the ETF could not engage directly.[104]

We request comment on whether it would be useful to include a condition in the proposed rule reminding ETFs relying on the rule of the prohibitions contained in section 48(a) of the Act. We also request comment on potential conflicts of interest for an ETF's investment adviser. Does an adviser to a fully transparent, actively managed ETF face different conflicts of interest from the conflicts of an adviser to a traditional mutual fund? If so, what are those conflicts and how could the rule address them?

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103 Section 17(a) generally prohibits affiliated persons of a registered fund ("first-tier affiliates") or affiliated persons of the fund's affiliated persons ("second-tier affiliates") from selling securities or other property to the fund (or any company the fund controls). 15 U.S.C. 80a-17(a).

104 See Lessler v. Little, 857 F.2d 866, 873-874 (1st Cir. 1988) (reversing dismissal of a claim that principals of a registered investment company and its adviser had violated sections 17(a)(2) and 48(a) of the Act by purchasing the fund's assets indirectly by arranging for sale of the fund to a third party in conjunction with an arrangement whereby the adviser obtained excessive interest in the transferred assets); SEC v. Commonwealth Chemical Securities, 410 F. Supp 1002, 1018 (S.D.N.Y. 1976) (finding violations of sections 17(a) and 48(a) of the Act by directors of a registered investment company who caused a third party to purchase shares in an offering underwritten by an affiliated broker-dealer and sold the shares to the registered investment company).

5. Affiliated Index Providers

Federal securities laws and the rules of national securities exchanges require funds and their advisers to adopt measures reasonably designed to prevent misuse of non-public information.[105] Funds are likely to be in a position to well understand the potential circumstances and relationships that could give rise to the misuse of non-public information, and can develop appropriate measures to address them. We believe these requirements should be sufficient to protect against the abuses addressed by the terms in the exemptive applications of ETF sponsors that represented they would use an affiliated index provider. The proposed rule, therefore, does not include terms from previous applications that are designed to prevent the communication of material non-public information between the ETF and the affiliated index provider.[106]

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105 See rule 38a-1 (requiring funds to adopt policies and procedures reasonably designed to prevent violation of federal securities laws); rule 17j-1 (requiring funds to adopt a code of ethics containing provisions designed to prevent certain fund personnel ("access persons") from misusing information regarding fund transactions); Section 204A of the Investment Advisers Act of 1940 ("Advisers Act") (15 U.S.C. 80b-204A) (requiring an adviser to adopt policies and procedures that are reasonably designed, taking into account the nature of its business, to prevent the misuse of material, non-public information by the adviser or any associated person, in violation of the Advisers Act or the Exchange Act, or the rules or regulations thereunder); Section 15(f) of the Exchange Act (15 U.S.C. 78o(f)) (requiring a registered broker or dealer to adopt policies and procedures reasonably designed, taking into account the nature of the broker's or dealer's business, to prevent the misuse of material, nonpublic information by the broker or dealer or any person associated with the broker or dealer, in violation of the Exchange Act or the rules or regulations thereunder).

See, e.g. Rule Commentary .02(b)(i) of American Stock Exchange Rule 1000A (requiring "firewalls" between an ETF and an affiliated index provider).

106 The terms are intended to address the potential conflicts of interest between the ETF adviser and its affiliated index provider, and include: (i) all of the rules that govern inclusion and weighting of securities in each index are made publicly available; (ii) the ability to change the rules for index compilation is limited and public notice is given before any changes are made; (iii) "firewalls" exist between (A) the staff responsible for the creation, development and modification of the index compilation rules and (B) the portfolio management staff; (iv) the calculation agent, who is responsible for all index maintenance, calculation, dissemination, and reconstitution activities, is not affiliated with the index provider, the ETF or any of their affiliates; and (v) the component securities of the index may not be changed more frequently than on a specified periodic basis. See HealthShares Notice, supra note 90; WisdomTree Notice, supra note 12.

We request comment on our proposal to eliminate these terms. Should the rule include any of the terms included in previous exemptive applications for affiliated index providers? If so, which terms and why?

C. Exemptive Relief

The unique structure of ETFs has required ETF sponsors to seek relief from certain provisions of the Act and our rules in order to form and operate. Proposed rule 6c-11 would permit an ETF that meets the conditions of the rule to redeem shares in creation unit aggregations, to trade at current market prices, to engage in in-kind transactions with certain affiliates and, in certain circumstances, to pay the proceeds from the redemption of shares in more than seven days. The proposed exemptions would be subject to certain conditions that are designed to address the concerns underlying the statute and thereby satisfy the requirement that exemptions from statutory provisions are in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy of the Act.[107]

1. Issuance of "Redeemable Securities"

Our exemptive orders have provided ETFs with relief from sections 2(a)(32) and 5(a)(1)[108] of the Act so that they may register under the Act as open-end funds while issuing shares that are redeemable in creation units only.[109] In support of the relief, ETF sponsors have noted that because the market price of ETF shares is disciplined by arbitrage opportunities, investors in ETF shares generally should be able to sell the shares in secondary market

[107] See 15 U.S.C. 80a-6(c).

[108] 15 U.S.C. 80a-2(a)(32) (defining "redeemable security" as any security the terms of which permit the holder upon presentation to receive the holder's proportionate share of the issuer's current net assets, or the cash equivalent); 15 U.S.C. 80a-5(a)(1).

[109] These exemptions are granted under section 6(c) of the Act. See supra note 76.

transactions at approximately their NAV.[110]

Proposed rule 6c-11 would deem an equity security issued by an ETF to be a "redeemable security" for purposes of section 2(a)(32) of the Act.[111] This provision would permit an ETF to register with the Commission as an open-end fund, which the Act defines as an investment company that issues redeemable securities,[112] even though ETF shares are issued and redeemed in creation unit aggregations.[113] This approach would provide ETFs with the same relief contained in our exemptive orders without exempting ETFs from other requirements imposed under the Act and our rules that apply to funds that issue redeemable securities.[114]

We request comment on this aspect of the proposed rule. Are there differences in ETFs and other funds that would justify not applying any provision of the Act or our rules that applies to funds that issue redeemable securities?

As discussed above, ETFs today operate with an arbitrage mechanism designed to minimize the potential deviation between the market price and NAV of ETF shares. The proposed rule would require that an ETF establish creation unit sizes the number of shares of which are reasonably designed to facilitate arbitrage, which is described in the proposed

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110 See, e.g., Ziegler Exchange Traded Trust, Investment Company Act Release No. 27610 (Dec. 22, 2006) [72 FR 163 (Jan. 3, 2007)] ("Ziegler Notice"); PowerShares Actively Managed ETF Notice, supra note 20, at text following n.5.

111 Proposed rule 6c-11(a). Our orders provided an exemption from sections 2(a)(32) and 5(a)(1) to allow ETFs to redeem securities in creation unit aggregations rather than individually.

112 See 15 U.S.C. 80a-5(a)(1).

113 ETF creation units have ranged from 25,000 to 200,000 ETF shares. See, e.g., PowerShares Actively Managed ETF Notice, supra note 20 (creation units are blocks of 50,000 to 100,000 ETF shares); ProShares Trust, Investment Company Act Release No. 27323 (May 18, 2006) [71 FR 29991 (May 24, 2006)] (notice) ("ProShares Notice") (creation units are blocks of 25,000 to 50,000 ETF shares); WisdomTree Notice, supra note 12 (creation units are blocks of 25,000 to 200,000 ETF shares).

114 See, e.g., 15 U.S.C. 80a-22; 17 CFR 270.22c-1. In addition, the rules under the Exchange Act that apply to redeemable securities issued by a mutual fund would apply to ETFs. See, e.g., 17 CFR 240.15c3-1.

definition of creation unit as the purchase (or redemption) of shares from the ETF with an offsetting sale (or purchase) of shares on a national securities exchange at as nearly the same time as practicable for the purpose of taking advantage of a difference in the Intraday Value and the current market price of the shares.[115] The proposed rule also would require an ETF to disclose in its prospectus and any sales literature the number of ETF shares for which it will issue or redeem a creation unit to alert investors that they cannot purchase or redeem individual ETF shares directly from or with the ETF.[116]

The proposed condition regarding creation unit size is intended to require ETFs that rely on the proposed rule to choose creation unit sizes that promote an arbitrage mechanism and to preclude ETFs from setting very low or high thresholds, such as one ETF share per creation unit or one million ETF shares per creation unit. A low creation unit size could, as a practical matter, make the use of creation unit redemption irrelevant. The ETF would, in effect, be issuing and redeeming ETF shares like a traditional mutual fund, but the shares would trade on an exchange. Conversely, a high creation unit size could reduce the willingness or ability of institutional arbitrageurs to engage in creation unit purchases or redemptions. Impeding the ability of arbitrageurs to purchase and redeem ETF shares could disrupt the arbitrage pricing discipline, which could lead to more frequent occurrences of pricing premiums or discounts.

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115 Proposed rule 6c-11(e)(3). We note that the Board of Governors of the Federal Reserve defines "arbitrage" in a similar manner in section 220.6(b) of Regulation T ("Arbitrage. A creditor may effect and finance for any customer bona fide arbitrage transactions. For the purpose of this section, the term "bona fide arbitrage" means: (1) A purchase or sale of a security in one market together with an offsetting sale or purchase of the same security in a different market at as nearly the same time as practicable for the purpose of taking advantage of a difference in prices in the two markets; or (2) A purchase of a security which is, without restriction other than the payment of money, exchangeable or convertible within 90 calendar days of the purchase into a second security together with an offsetting sale of the second security at or about the same time, for the purpose of taking advantage of a concurrent disparity in the prices of the two securities."). 12 CFR 220.6.

116 Proposed rule 6c-11(e)(4)(ii); Proposed Item 6(h)(3) to Form N-1A.

We request comment on the proposed requirement for creation unit size, which is included in the proposed rule's definition of "creation unit." Does the requirement that an ETF establish creation unit sizes the number of which is reasonably designed to facilitate arbitrage provide the sponsor or adviser of the ETF with sufficient guidance in setting appropriate thresholds? Should we include other elements in our description of arbitrage, which is included in the definition of creation unit? If so, what elements? Should the proposed rule instead require the board of directors of the ETF to make a finding that the ETF is structured in a manner reasonably intended to facilitate arbitrage? This finding could require the board, for example, to look at the number of shares in each creation unit and the liquidity of the portfolio securities and other assets. What other elements, if any, should the board be required to review in making this finding?

The proposed rule does not include numerical thresholds for the number of ETF shares in each creation unit. Should the proposed rule include minimum or maximum numerical thresholds? If so, what would be appropriate thresholds and why? For example, should the rule set a minimum of 100 ETF shares, and/or a maximum of 500,000 ETF shares, per creation unit? Are our concerns with respect to smaller- or larger-sized creation units addressed by requiring ETFs to establish creation unit sizes that facilitate arbitrage? If the rule does not include any thresholds, would any of the exemptions provided by the proposed rule be inappropriate for an ETF with smaller- or larger-sized creation units? If so, which exemptions?

ETF applicants represent that ETF share prices are disciplined by arbitrage opportunities created by the ability to purchase and redeem creation units at NAV on a daily basis.[117] Would

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[117] See, e.g., Zeigler Application, supra note 91, at 52-53; see also supra notes 25-26 and accompanying and preceding text.

this pricing mechanism function differently for smaller-or larger-sized creation units? Because ETFs charge transaction fees for direct purchases and redemptions from the fund, ETF applicants have asserted that the interests of long-term shareholders should not be diluted by frequent traders, if those transaction fees accurately reflect the costs to the fund.[118] Are smaller-sized creation units likely to cause the transaction fees charged by ETFs to be insufficient to protect the long-term shareholders in the event of more frequent purchases and redemptions? If so, should an ETF relying on the proposed exemption be required to take additional measures designed to protect long-term shareholder interests from being diluted by frequent traders? If so, what measures?

As discussed above, ETFs issue and redeem shares in creation unit aggregations in exchange for the deposit or delivery of a basket of securities and other assets. The proposed rule defines "basket assets" to mean the securities or other assets specified each business day in name and number by the ETF as the securities or assets in exchange for which it will issue, or in return for which it will redeem, ETF shares.[119] The rule does not require that the basket mirror the portfolio of the ETF because in some circumstances it may not be practicable, convenient or operationally possible for the ETF to operate on an in-kind basis.[120] The rule, like our orders,

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118 See Zeigler Application, supra note 91, at 23; PowerShares Actively Managed ETF Application, supra note 62, at 17-18.

119 Proposed rule 6c-11(e)(1). Under the proposed rule, the term "business day" with respect to an ETF would mean any day that the fund is open for business, including any day on which it is required to make payment under section 22(e) of the Act. Section 22(e) of the Act prohibits registered funds from suspending the right of redemption or postponing the date of payment upon redemption of any redeemable security for more than seven days except for certain periods specified in the provision. See 15 U.S.C. 80a-22(e). Proposed rule 6c-11(e)(2).

120 The ETF and its adviser may decide to permit cash-only purchases of creation units to minimize transaction costs or enhance the ETF's operational efficiency. For example, on a day when a substantial rebalancing of an index-based ETF's portfolio is required, the adviser might prefer to receive cash rather than in-kind securities so that it has the liquid resources at hand to make the necessary purchases. If the ETF received in-kind securities on that day, it might have to sell

(footnote continued)

allows an ETF to require or permit a purchasing or redeeming shareholder to substitute cash for some or all of the securities in the basket assets.[121]

We request comment on the proposed definition of basket assets. Are there any reasons why an ETF should not be permitted to substitute cash for some or all of the assets in the basket? Should the proposed rule include any conditions for when an ETF may require or permit cash substitutions? If so, what conditions should be included? Should the rule specify how the ETF would announce the composition of the basket? For example, should the rule mandate that the ETF post the information on its Internet Web site? Should the rule specify the frequency with which the ETF must announce the composition of the basket? If so, how often?

2. Trading of ETF Shares at Negotiated Prices

As noted above, section 22(d), among other things, prohibits a dealer from selling a redeemable security that is being offered currently to the public by or through an underwriter, except at a current public offering price described in the prospectus.[122] Rule 22c-1 generally requires that a dealer selling, redeeming, or repurchasing a redeemable security do so only at a

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some securities and acquire new ones to properly track its underlying index, incurring transaction costs that could have been avoided if the ETF had received cash instead. See, e.g., Ziegler Application, supra note 91, at 21-22. For some ETFs that track country-specific equity securities indexes, it is operationally necessary to engage in cash-only transactions because of local law restrictions on transferability of securities. See iShares, Inc., Investment Company Act Release Nos. 25595 (May 29, 2002) [67 FR 38684 (June 5, 2002)] (notice) and 25623 (June 25, 2002) (order) (certain iShares ETFs that invest in certain foreign markets currently effect purchases and redemptions through cash transactions).

121 Proposed rule 6c-11(e)(1). Though the standard operations of most existing ETFs involve in-kind purchases and redemptions, the Commission has consistently permitted the substitution of cash for certain securities in the basket assets. See, e.g., WisdomTree Notice, supra note 12 at text preceding n.9. In addition, the Commission has permitted ETFs that primarily hold financial instruments, cash and cash equivalents in their portfolios to operate on a cash-only basis because of the limited transferability of financial instruments. See, e.g., ProShares Notice, supra note 113, at n.2 and accompanying text. See also SPDR Lehman Municipal Bond ETF, Prospectus 19-22 (Sept. 10, 2007) (ETF generally sells creation units for cash only and redeems creation units in-kind only).

122 15 U.S.C. 80a-22(d).

price based on its NAV.[123] Because secondary market trading in ETF shares takes place at current market prices, and not at the current offering price described in the prospectus or based on NAV, ETFs have obtained exemptions from section 22(d) and rule 22c-1.

The provisions of section 22(d), as well as rule 22c-1, are designed to prevent dilution caused by certain riskless trading schemes by principal underwriters and dealers, and to prevent unjust discrimination or preferential treatment among investors purchasing and redeeming fund shares.[124] The proposed rule would exempt a dealer in ETF shares from section 22(d) of the Act and rule 22c-1(a) with regard to purchases, sales and repurchases of ETF shares in secondary market transactions at current market prices.[125] As discussed above, we have provided exemptions from section 22(d) and rule 22c-1 in our orders because the arbitrage function appears to address the potential concerns regarding shareholder dilution and unjust discrimination that these provisions were designed to address.[126] In addition, secondary market trading should not cause dilution for ETF shareholders because those transactions do not directly involve ETF portfolio assets (the transactions are with other investors, not the ETF), and thus have no direct impact on the NAV of ETF shares held by other investors. Moreover, to the extent that different prices for ETF shares exist during a given trading day, or from day to day, these variations occur as a result of third-party market forces, such as supply and demand, and

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123 17 CFR 270.22c-1.

124 For a complete legislative history of section 22(d), see Exemption from Section 22(d) to Permit the Sale of Redeemable Securities at Prices that Reflect Different Sales Loads, Investment Company Act Release No. 13183 (Apr. 22, 1983) [44 FR 19887 (May 10, 1983)]. See also Adoption of Rule 22c-1 under the Investment Company Act of 1940 Prescribing the Time of Pricing Redeemable Securities for Distribution, Redemption, and Repurchase and Amendment of Rule 17a-3(a)(7) under the Securities Exchange Act of 1934 Requiring Dealers to Time Stamp Orders, Investment Company Act Release No. 5519 (Oct. 16, 1968) [33 FR 16331 (Nov. 7, 1968)].

125 Proposed rule 6c-11(b).

126 See supra notes 71-7573 and accompanying text.

not as a result of discrimination or preferential treatment among purchasers.

We request comment on this proposed relief. Should the relief also apply to parties other than dealers in ETF shares? If so, which other parties require similar relief, and why? Do dealers (or others) need relief from other provisions to facilitate transactions in ETF shares on the secondary market?

3. In-Kind Transactions between ETFs and Certain Affiliates

Section 17(a) of the Act generally prohibits an affiliated person of a registered investment company, or an affiliated person of such person, from selling any security to or purchasing any security from the company.[127] Purchases and redemptions of ETF creation units are typically in-kind rather than cash transactions,[128] and section 17(a) prohibits these in-kind purchases and redemptions by persons who are affiliated with the ETF, including those affiliated because they own 5 percent or more, and in some cases more than 25 percent, of the ETF's outstanding securities ("first-tier affiliates"), and by persons who are affiliated with the first-tier affiliates or who own 5 percent or more, and in some cases more than 25 percent, of the outstanding securities of one or more funds advised by the ETF's investment adviser ("second-tier affiliates").[129]

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[127] 15 U.S.C. 80a-17(a).

[128] ETFs must comply with the federal securities laws in accepting and satisfying redemptions with basket assets, including the registration provisions of the Securities Act. See, e.g., Ameristock Notice, supra note 13, at n.3.

[129] An affiliated person of a fund includes, among others: (i) any person directly or indirectly owning, controlling, or holding with power to vote, five percent or more of the outstanding voting securities of the fund; (ii) any person five percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote by the fund; and (iii) any person directly or indirectly controlling, controlled by, or under common control with such other person. 15 U.S.C. 80a-2(a)(3)(A), (B) and (C). A control relationship will be presumed where one person owns more than 25 percent of another person's outstanding voting securities. 15 U.S.C. 80a-2(a)(9).

We have granted exemptions from sections 17(a)(1) and (a)(2)[130] of the Act to allow these first- and second-tier affiliates of the ETF to purchase and redeem creation units through in-kind transactions.[131] In seeking this relief, applicants have submitted that because the first- and second-tier affiliates are not treated differently from non-affiliates when engaging in purchases and redemptions of creation units, there is no opportunity for these affiliated persons to effect a transaction detrimental to the other ETF shareholders. The securities to be deposited for purchases of creation units and to be delivered for redemptions of creation units are announced at the beginning of each day. All purchases and redemptions of creation units are at an ETF's next-calculated NAV (pursuant to rule 22c-1), and the securities deposited or delivered upon redemption are valued in the same manner, using the same standards, as those securities are valued for purposes of calculating the ETF's NAV.

The proposed rule would permit first- and second-tier affiliates of the ETF to purchase and redeem creation units through in-kind transactions.[132] The proposed exemption would not, however, apply to a specific category of redemptions that would be addressed in new rule 12d1-4, which we also are proposing today. Section 12(d)(1) of the Act imposes substantial limitations on the ability of investment companies to invest in other investment companies.[133] As discussed in Section IV of this release, proposed rule 12d1-4 would permit investment companies to acquire shares of ETFs in excess of the limitations on those investments under section 12(d)(1) of the Act subject to certain conditions intended to address the concerns underlying those limitations. One of the proposed conditions would prohibit investment

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130 15 U.S.C. 80a-17(a)(1), 80a-17(a)(2).

131 See, e.g., HealthShares Notice, supra note 90, at text following n.10.

132 Proposed rule 6c-11(d).

133 See infra note 194 and accompanying text.

companies from redeeming certain ETF shares acquired in reliance on proposed rule 12d1-4.[134] In order to make proposed rule 6c-11 consistent with the conditions in proposed rule 12d1-4, we propose to exclude investment companies that acquire ETF shares in reliance on proposed rule 12d1-4 from relying on proposed rule 6c-11(d) to redeem those ETF shares in kind.[135]

We request comment on this proposed exemption. Does the proposed exemption raise any risks with regard to affiliated transactions with the ETF? If so, should the exemption include any conditions to minimize those risks? Should the relief extend to parties that are affiliated persons of an ETF for other reasons? For example, should a broker-dealer that is affiliated with the ETF's adviser be allowed to transact in-kind with the ETF?

4. Additional Time for Delivering Redemption Proceeds

Section 22(e) of the Act generally prohibits a registered open-end investment company from suspending the right of redemption, or postponing the date of satisfaction of redemption requests more than seven days after the tender of a security for redemption.[136] Some ETFs that track foreign indexes have stated that local market delivery cycles for transferring foreign securities to redeeming investors, together with local market holiday schedules, require a delivery process in excess of seven days. These ETFs have requested, and we have granted, relief from section 22(e) so that they may satisfy redemptions up to a specified maximum number of calendar days depending upon specific circumstances in the local markets, as

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[134] As discussed in Section IV.B.2, infra, this condition is designed to prevent a fund that relies on the proposed rule to acquire ETF shares in excess of the limits of section 12(d)(1)(A)(i) from unduly influencing the ETF by the threat of a large-scale redemption.

[135] The proposed rule would not permit an investment company that has acquired ETF shares in excess of the limits in section 12(d)(1)(A)(i) of the Act in reliance on proposed rule 12d1-4(a) to rely on proposed rule 6c-11(d) with regard to the purchase of basket assets (i.e., the purchase of securities identified in the basket when redeeming ETF shares). Proposed rule 6c-11(d).

[136] 15 U.S.C. 80a-22(e).

disclosed in the ETF's prospectus or statement of additional information ("SAI"). Other than in the disclosed situations, these ETFs satisfy redemptions within seven days.[137]

Section 22(e) of the Act is designed to prevent unreasonable delays in the satisfaction of redemptions, and ETF sponsors have asserted that the requested relief will not lead to the problems that section 22(e) was designed to prevent.[138] They have represented that the ETF's SAI would disclose those local holidays (over the period of at least one year following the date of the SAI) that are expected to prevent the satisfaction of redemptions in seven days and the maximum number of days needed to satisfy redemption requests with respect to the foreign securities at issue.[139]

The delay in satisfying redemption requests seems reasonable under the circumstances described by the ETF sponsors because it is for a limited period of time and disclosed to investors. The proposed rule, therefore, would codify the relief from section 22(e) of the Act previously provided to ETFs. If an ETF has a foreign security in its basket assets and a foreign holiday prevents timely delivery of the foreign security, the ETF would be exempt from the prohibition in section 22(e) against postponing the date of satisfaction upon redemption for more than seven days. To rely on this exemption, the ETF would be required to disclose in its SAI the foreign holidays it expects to prevent timely delivery of the foreign securities and the maximum

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137 In their applications, ETFs acknowledge that no relief obtained from the requirements of section 22(e) will affect any obligations that they may otherwise have under rule 15c6-1 under the Exchange Act. See, e.g., In re Barclays Global Fund Advisors, Second Amended and Restated Application, File No. 812-11598, filed May 11, 2000 ("Barclays Foreign Application"), at 76. (available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549). Rule 15c6-1 requires that most securities transactions be settled within three business days of the trade date. 17 CFR 240.15c6-1.

138 See Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess. 291-293 (statements of David Schenker).

139 See, e.g., Barclays Foreign Application, supra note 137, at 76-84.

number of days it anticipates it would need to deliver the foreign securities. Finally, the delivery would have to take place no more than 12 calendar days after the tender of ETF shares (in a creation unit).[140]

We request comment on this relief in the proposed exemption. Is the relief necessary? We specifically request comment from ETFs regarding the frequency with which they have relied on this exemption. Could an ETF pay cash (as part of the basket assets) in lieu of foreign securities in the case of delays in settlement? Should the relief be limited to ETFs that satisfy redemptions entirely through in-kind transactions? Is the number of days in the proposed rule sufficient or is it too long? Should the rule refer to the applicable local market's settlement cycle without specifying a number of days? Should the disclosure be included in the prospectus of the ETF instead of the SAI, which is only delivered upon request? Should the disclosure be included in any sales literature of the ETF?

The rule would provide relief if the ETF's basket assets include a foreign security. Should the rule also provide relief if an ETF has foreign securities included in its portfolio and, if so, why? Would actively managed ETFs present any issues with respect to this exemption that do not exist with respect to index-based ETFs? Could the investment adviser to an actively managed ETF manage the ETF so as to comply with section 22(e)?

The proposed rule defines "foreign security" to mean any security issued by a government or any political subdivision of a foreign country, a national of any foreign country, or a corporation or other organization incorporated or organized under the laws of any foreign

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140 Proposed rule 6c-11(c). Applicants requesting this exemptive relief generally have represented that they would be able to deliver redemption proceeds within 12 calendar days. See, e.g., WisdomTree Notice, supra note 12. An ETF relying on this exemption would disclose the information in the SAI. See Item 18 of Form N-1A (requiring disclosures regarding purchase, redemption, and pricing of shares).

country, and for which there is no established United States public trading market as that term is used in Item 201 of Regulation S-K under the Exchange Act. Use of the phrase "established United States public trading market" is designed to limit this relief to ETFs that invest in securities that do not have an active trading market in the United States. The rule does not rely on registration status because an unregistered large foreign private issuer may have an active U.S. market for its securities, in which case the ETF should be able to meet redemption requests in a timely manner.[141]

We request comment on the definition of "foreign security." Should the definition provide any additional exceptions?

D. Disclosure Amendments

Congress enacted the federal securities laws to promote fair and honest securities markets, and an important purpose of these laws is to promote full and fair disclosure of important information by issuers of securities to the investing public. The Securities Act and the Exchange Act, as implemented by Commission rules and regulations, provide for systems of mandatory disclosure of certain material information in securities offerings and in periodic reports. Accordingly, the Securities Act requires delivery of a prospectus meeting the requirements of section 10(a) to each investor in a registered offering.[142] The Securities Act also

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[141] See 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, Securities Exchange Act Release No. 55540 (Mar. 27, 2007) [72 FR 16934 (Apr. 5, 2007)] (adopting rule 12h-6 under the Exchange Act, which permits a foreign issuer to terminate its Exchange Act registration and reporting obligations regarding a class of equity securities if the average daily trading volume ("ADTV") of the securities in the United States has been 5 percent or less of the ADTV of that class of securities in the issuer's principal trading market during a recent 12-month period, regardless of the size of its U.S. public float).

[142] 15 U.S.C. 77j(a). This is known as a "final prospectus." In 2005, the Commission adopted rule 172 under the Securities Act which generally deems final prospectus delivery satisfied when the prospectus is filed with the Commission ("access equals delivery"). 17 CFR 230.172. The

(footnote continued)

requires dealers in a security, for a specified period of time after the registration statement for the security becomes effective, to deliver a final prospectus to purchasers, including to most persons purchasing shares in secondary market transactions.[143] The Investment Company Act, however, requires dealers to continue prospectus delivery to investors in open-end funds, including ETFs, which continuously offer their securities to the public.[144]

1. Delivery of Prospectuses to Investors

Our orders generally have exempted broker-dealers selling ETF shares from the obligation to deliver prospectuses in most secondary market transactions.[145] Applicants have represented that broker-dealers would instead deliver a "product description" containing basic

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Commission, however, specifically excluded registered investment companies from rule 172. See Securities Offering Reform, Securities Act Release No. 8591 (July 19, 2005) [70 FR 44722 (Aug. 3, 2005)]. For a detailed discussion on the prospectus delivery requirements and related liabilities with respect to open-end investment companies, see Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, Investment Company Act Release No. 28064 (Nov. 21, 2007) [72 FR 67790 (Nov. 30, 2007)] ("Enhanced Disclosure Proposing Release") at sections II.B.1 and II.B.4.

[143] Under section 4(3) of the Securities Act, dealers must deliver a prospectus in connection with original sales by the dealer of securities obtained from or through an underwriter, and resales by the dealer occurring during the 40 days (90 days for first-time issuers) after the effective date of the registration statement (or, under certain circumstances, a different date). This aftermarket delivery obligation applies to all dealers, whether or not they participated in the offering itself. 15 U.S.C. 77d(3). See also rule 174 under the Securities Act, which provides an exception from the requirement in section 4(3) that a prospectus be delivered prior to the expiration of the applicable 40-day or 90-day period. 17 CFR 230.174.

[144] Section 24(d) of the Act eliminates the dealer's exception with respect to securities issued by funds and UITs on the theory that, because those issuers continuously offer their securities to the public, all dealers should be compelled to use the statutory prospectus. See H.R. REP. NO. 1542, 83d Cong., 2d Sess. 29-30 (1954).

[145] Most of the orders have granted exemptions from section 24(d) of the Act, which makes inapplicable the dealer exception in section 4(3) of the Securities Act to transactions in redeemable securities issued by an open-end fund. 15 U.S.C. 80a-24(d); 15 U.S.C. 77(d)(3); see, e.g., WisdomTree Notice, supra note 12, at n.14. ETFs that have this relief continue to be subject to prospectus delivery requirements in connection with sales of creation units and other non-secondary market transactions. Our most recent orders permitting certain actively managed ETFs do not, however, provide this exemption. See Actively Managed ETF Orders, supra note 20.

information about the ETF and its shares.[146] Proposed rule 6c-11 would not include a similar exemption, and thus broker-dealers would be required to deliver a prospectus meeting the requirements of section 10(a) of the Securities Act to investors purchasing ETF shares.[147]

We understand that many, if not most, broker-dealers selling ETF shares in secondary market transactions do, in fact, transmit a prospectus to purchasers, and thus they have not relied on the exemptions we have provided in our orders. More important, we believe an exemption allowing dealers to deliver product descriptions would be unnecessary given our proposal regarding summary prospectus disclosure. As discussed below,[148] we recently proposed amendments to Form N-1A and to rule 498 under the Securities Act,[149] in order to enhance the disclosures that are provided to mutual fund investors ("Enhanced Disclosure Proposing Release").[150] The proposed amendments, if adopted, would require key information to appear in plain English in a standardized order at the front of the mutual fund prospectus ("summary section").[151] A person could satisfy its mutual fund prospectus delivery obligations under section 5(b)(2) of the Securities Act by sending or giving this key information directly to investors in the form of a summary prospectus and providing a prospectus that meets the requirements of section

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[146] See, e.g., Ziegler Notice, supra note 110. The product description provides a summary of the salient features of the ETF and its shares, including the investment objectives of the fund, the manner in which ETF shares trade on the secondary market, and the manner in which creation units are purchased and redeemed. National securities exchanges on which ETFs are listed have adopted rules requiring the delivery of product descriptions. See, e.g., American Stock Exchange Rules 1000 and 1000A.

[147] 15 U.S.C. 77j(a). This prospectus delivery requirement would apply to all ETFs, including ETFs operating under current exemptive orders. Therefore, we propose to amend orders we issued to open-end ETFs to exclude the section 24(d) exemption we have issued to existing ETFs. See infra Section III.E for a discussion of this proposed amendment to existing orders.

[148] See infra notes 176-185 and accompanying text.

[149] 17 CFR 230.498.

[150] See Enhanced Disclosure Proposing Release, supra note 142.

[151] See id., at Section II.A.

10(a) of the Securities Act ("statutory prospectus") on an Internet Web site.[152] If adopted, broker-dealers selling ETF shares could deliver a summary prospectus in secondary market transactions. We believe the summary prospectus would contain material information that may not be included in a product description, but, like the product description, would be in a form that would be easy to use and readily accessible.

We request comment on this approach. Are we correct in our understanding that many, if not most, broker-dealers deliver a prospectus instead of a product description in connection with sales of ETF shares in secondary market transactions? If so, why?

If we were to adopt rule 6c-11 before the amendments proposed in the Enhanced Disclosure Proposing Release, we would expect to permit delivery of a product description in lieu of a prospectus, pending final determination of that proposal by the Commission. We request comment on this approach. Should we permit all ETFs, including actively managed ETFs and index-based ETFs that rely on the rule instead of an exemptive order to deliver product descriptions? Should we prescribe the form of the product description? For example, should we propose specific requirements for product descriptions that would provide ETF investors with information similar to that received by traditional mutual fund investors, such as the fee table, name and length of service of the portfolio manager, and return information, as noted above? Alternatively, should the product description conform to the disclosures in the summary section as proposed in Section III.D.2 below?[153] If so, are there any additional disclosures to those in the proposed summary section that ETFs should be required to include in a product description? Are there any disclosures in the proposed summary section that ETFs should not be required to

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[152] 15 U.S.C. 77j(a). The fund also would be required to provide additional information on its Web site. See Proposed rule 498(c).

[153] See infra notes 175-189 and accompanying text.

include in the product description?

If we do not adopt the amendments proposed in the Enhanced Disclosure Proposing Release, we would anticipate that dealers in ETF shares will nevertheless continue their current practice of delivering prospectuses to investors. We request comment on whether the rule should require dealers to deliver prospectuses instead of product descriptions.[154] ETFs are becoming more like traditional mutual funds in several respects. As discussed above, when we began issuing exemptive orders to ETFs, they had basic investment objectives (to track a widely-followed index) and simple investment techniques (investment in all, or a representative sample of, the securities of a widely followed index).[155] Soon, however, some ETFs will be actively managed and have portfolio managers whose role is important to the success of the fund.[156] ETF operations, investment objectives, expenses, and other characteristics may become more varied as well. Because prospectuses contain information in a standardized form prescribed by the Commission, the use of these disclosure forms could promote greater uniformity in the content and level of disclosure among ETFs.[157] In addition, as discussed below, we are proposing to amend Form N-1A to include additional information relevant to a retail investor in an ETF, who does not typically buy or redeem individual shares directly from the fund.

If we were to retain the prospectus delivery exemption for broker-dealers, should the

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[154] For a discussion of the additional burdens associated with the requirement that broker-dealers deliver prospectuses in secondary market transactions involving ETF shares, see infra discussion at Section VIII.

[155] See supra note 10 and accompanying text.

[156] The investment objectives and techniques of index-based ETFs also have become more complex. Some ETFs today follow specialized or custom-designed indexes; others are leveraged through use of futures contracts and other types of derivative instruments.

[157] Certain disclosures required by Form N-1A that generally are not included in product descriptions may be important to some investors given the evolution of ETFs. Product descriptions do not, for example, include a fee table itemizing the ETF's expenses, or the name and length of service of the portfolio manager.

exemption be limited to index-based ETFs or only to certain index-based ETFs, such as those that replicate the components of a broad-based stock market index? If we were to retain the exemption, should we require broker-dealers to deliver prospectuses instead of product descriptions to purchasers of actively managed ETF shares?

2. Amendments to Form N-1A

We are proposing several amendments to Form N-1A, the registration form used by open-end management investment companies to register under the Act and to offer their securities under the Securities Act, to accommodate the use of this form by ETFs. The proposed amendments for ETF prospectuses are designed to meet the needs of investors (including retail investors) who purchase shares in secondary market transactions rather than financial institutions purchasing creation units directly from the ETF.

We request comment on our proposal to amend Form N-1A to meet the needs of secondary market investors. Is this distinction we propose to draw between purchasers of shares in secondary market transactions and purchasers of creation units from the fund appropriate? Should we instead revise Form N-1A to include the additional disclosure (as discussed below) we are proposing today for secondary market investors without eliminating (as discussed below) certain disclosures relevant to creation unit purchasers? Would secondary market investors be confused if Form N-1A included disclosure relevant to both types of investors?

Purchasing and Redeeming Shares. We propose to amend Item 6 of Form N-1A to eliminate the requirement that ETF prospectuses disclose information on how to buy and redeem shares of the ETF because it is not relevant to secondary market purchasers of ETF shares.[158] Instead ETF prospectuses would simply state the number of shares contained in a creation unit

[158] Proposed Item 6(h)(1) of Form N-1A.

(i.e. the amount of shares necessary to redeem with the ETF) and that individual shares can only be bought and sold on the secondary market through a broker-dealer.[159] Similarly, we also would amend Item 3 to exclude from the fee table fees and expenses for purchases or sales of creation units.[160] Instead, the proposed amendment would require an ETF to modify the narrative explanation preceding the example in the fee table to state that individual ETF shares are sold on the secondary market rather than redeemed at the end of the periods indicated, and that investors in ETF shares may be required to pay brokerage commissions that are not reflected in the fee table.[161]

We request comment on our assumption that investors (including most individual investors) purchasing their shares in secondary market transactions do not need to know information on how creation units are purchased and redeemed, or the payment of transaction fees by investors purchasing or redeeming creation units. If they do need this information, why?

ETFs would still be required to include disclosure on how creation units are offered to the public in the SAI.[162] We are not proposing to amend this disclosure to include information on creation unit redemption, which Item 6 currently requires and which we propose to eliminate. Should we amend the SAI to include the disclosure requirements we are proposing to eliminate from Item 6? Should we require that the information in the SAI regarding the purchase of creation units also specify associated fees and expenses? As an alternative, should we require purchase and redemption information and associated fees and expenses to remain in Item 3 and

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159 Proposed Item 6(h)(3) of Form N-1A.

160 Proposed Instruction 1(e)(i) to Item 3 of Form N-1A.

161 Proposed Instruction 1(e)(ii) to Item 3 of Form N-1A. We also are proposing a conforming amendment to the fee table in ETF annual and semi-annual reports. Proposed Instruction 1(e) to Item 22(d) of Form N-1A.

162 Item 18(a) of Form N-1A.

Item 6 only for prospectuses provided to investors purchasing creation units, such as in the form of a supplementary prospectus?

The proposed alternative disclosures in Items 3 and 6 would not be available, however, to ETFs with creation units of less than 25,000 shares because more retail investors would be able to transact directly with an ETF that has smaller-sized creation units.

We request comment on whether the exemptions we are providing from Items 3 and 6 of Form N-1A should be based on the size of the creation unit, and whether 25,000 shares per creation unit is an appropriate threshold. Should it be higher or lower? Should we instead adopt a threshold based on the value of shares rather than the number of shares?

Total Return. We propose to modify instructions to several items that require the use of the ETF's NAV to determine its return. In addition to returns based on NAV, ETFs also would be required to include returns based on the market price of fund shares.[163] As discussed above, returns based on market price may be different than returns based on the fund's NAV and better relate to an ETF investor's experience in the fund.

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[163] We propose to amend the average annual return table to include a separate line item for returns based on the market price of ETF shares. Proposed Instruction 5(a) to Item 2(c)(2) of Form N-1A. This would codify, with modifications, a condition in ETF exemptive orders. See, e.g., Ziegler Notice, supra note 110. The condition in our exemptive orders did not specify the location of the disclosure in the prospectus. As a result, ETFs include an additional table in the prospectus, rather than including market price returns in the average annual returns table required by Item 2. In addition, ETFs use different time periods for the disclosure, with some using calendar years and others fiscal years. The proposed amendment would eliminate use of a second table, which may confuse investors. It also would standardize the reporting period by requiring all ETFs to present the information using calendar years.

We also propose to amend the financial highlights table to require ETFs to calculate total return at market prices in addition to returns at NAV. This proposed amendment would provide secondary market investors with more pertinent information as to the effect of market price movements on their investments. Proposed Instruction 3(f) to Item 8(a) of Form N-1A. Under the proposed amendment, ETFs would be required to include two bar charts under Item 2 of the form; one using market price returns and one using NAV returns. See Instruction 1(a) to Item 2(c)(2) of Form N-1A.

We request comment on whether use of market prices, in addition to NAV, would provide secondary market purchasers of ETF shares with meaningful information on their investments. Alternatively, should we require returns to be computed solely using market prices? Would investors find it confusing to have fund returns presented using both market price and NAV? Should we limit this amendment to ETFs with creation units of 25,000 shares or more because more retail investors may be able to transact directly with the ETF in the event of smaller creation units?

For purposes of determining ETF returns, we would define "market price" as the last price at which ETF shares trade on their principal U.S. trading market during a regular trading session (i.e. closing price).[164] Is this an appropriate definition for market price, or should we instead (or in addition) define the market price as the mid-point price between the highest bid and the lowest offer on the principal U.S. market on which the ETF shares are traded, at the time the fund's NAV is calculated?[165]

Premium/Discount Information. We propose to require that each ETF disclose to investors information about the extent and frequency with which market prices of fund shares have tracked the fund's NAV.[166] This disclosure, which would be required on the fund's Internet

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[164] Proposed definition of "Market Price" in General Instruction A of Form N-1A. We consider the closing price to be the strongest indicator of market value. See Codification of Financial Reporting Policies, Section 404.03.b.ii, "Valuation of Securities—Securities Listed for Trading on a National Securities Exchange," reprinted in SEC Accounting Rules (CCH) ¶ 38,221 ("ASR 118"), at 38, 424-38, 425. See also Fair Value Measurements, Statement of Financial Accounting Standards No. 157, § 24 (Fin. Accounting Standards Bd. 2006) ("FASB 157") ("[A] quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available.").

[165] In circumstances where closing price may be less accurate because the last trade occurred at a much earlier point in the day than NAV calculation, some ETFs have used the mid-point price, rather than the closing price. See, e.g., Claymore Exchange-Traded Fund Trust, Investment Company Act Release No. 27469 (Aug. 28, 2006) [71 FR 51869 (Aug. 31, 2006)].

[166] Proposed Item 6(h)(4) to Form N-1A.

Web site and included in its prospectus, is a condition to relief in ETF exemptive orders.[167] Proposed rule 6c-11 also would require each ETF to disclose on its Internet Web site the prior business day's last determined NAV, the market closing price of its shares and the premium/discount of the closing price to NAV.[168] This disclosure is designed to alert investors to the current relationship between NAV and the market price of the ETF's shares, and that they may sell or purchase ETF shares at prices that do not correspond to the NAV of the fund.

Proposed Item 6(h)(4) of Form N-1A would require disclosure in the ETF prospectus of the number of trading days, during the most recently completed calendar year and quarters since that year, on which the market price of the ETF shares was greater than the fund's NAV and the number of days it was less than the fund's NAV (premium/discount information).[169] In addition to alerting investors that the ETF's NAV and share price may differ, this disclosure also would provide historical information regarding the frequency of these deviations. In light of the historical premium/discount disclosure in the ETF prospectus and in order to avoid duplicative disclosures that may result in additional regulatory burdens, proposed rule 6c-11, unlike the exemptive orders, would not require ETFs to include historical premium/discount information on their Internet Web sites.

We request comment on whether daily and historical premium/discount information, which ETFs currently provide, is useful to investors. One commenter to the 2001 Concept

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167 See, e.g., WisdomTree Notice supra note 12; Zeigler Notice supra note 110.

168 Proposed rule 6c-11(e)(4)(iv).

169 Consistent with current orders, ETFs would be required to present premiums or discounts as a percentage of NAV. They also would be required to explain that shareholders may pay more than NAV when purchasing shares and receive less than NAV when selling, because shares are bought and sold at market prices. Proposed Instructions 2, 3 to Item 6(h)(4) of Form N-1A. In addition, the amendments also would require each ETF to identify the trading symbol(s) and principal U.S. market(s) on which the shares are traded. Proposed Item 6(h)(2) of Form N-1A.

Release suggested that investors need not receive premiums/discounts against NAV disclosure because the more useful information is the Intraday Value of the fund's basket as disseminated by national securities exchanges at regular intervals.[170] This information, according to the commenter, provides investors with contemporaneous pricing of the fund's portfolio and enables the investor to see, at the time his order is entered, whether the Intraday Value is close to (or between) the bid-asked price.

We request comment on whether investors need premium/discount disclosure in light of the dissemination of the ETF's Intraday Value at regular intervals during trading hours. We request ETF sponsors commenting on this condition of the rule to provide us with data regarding the frequency with which visitors to their Internet Web sites access this information. In addition to current premium/discount information, should we also require ETF Web sites to provide historical premium/discount information as is currently required by exemptive orders? If the Web site includes historical premium/discount information, should the rule also require historical information in Form N-1A? If so, over what periods?

Periodic Report Information. We are proposing conforming amendments to ETF return information in ETF annual reports. The proposed amendments would require each ETF to use the market price of fund shares in addition to NAV to determine its return,[171] and include a table

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[170] See Comment Letter of Nuveen Investments, File No. S7-20-01 (Jan. 14, 2002). See also GASTINEAU, supra note 17, at 230-241.

[171] Proposed Instruction 12(b) to Item 22(b)(7) of Form N-1A. This proposed disclosure would be identical to proposed Instruction 5(a) to Item 2(c)(2) of Form N-1A. See supra note 163. We also are proposing to require ETFs to include a new line graph comparing the initial and subsequent account values using market price, following the line graph using NAV required by Item 22(b)(7)(ii)(A) of Form N-1A. Proposed Instruction 12(a) to Item 22(b)(7) of Form N-1A. Consistent with the amendments proposed above, this proposed amendment also is designed to provide individual investors with the effect of market price fluctuations on their investment.

with premium/discount information for the five recently completed fiscal years.[172]

We request comment on whether it is necessary to include similar disclosure in both the prospectus and annual report of an ETF. Should ETFs that provide this information on their Internet Web sites be exempt from this annual report requirement? Is it necessary for the ETF to provide premium/discount data for the most recently completed five fiscal years? Should the reporting period conform to that proposed under Item 6 of the form (i.e., one calendar year and most recent quarters since that year)?

We also are proposing to amend the prospectus and annual report requirements of Form N-1A to require an index-based ETF to compare its performance to its underlying index rather than a benchmark index.[173] This amendment would permit use of a narrow-based or affiliated index and eliminate the opportunity for an index-based ETF to select an index different from its underlying index which should better reflect whether the ETF's performance corresponds to the index the performance of which it seeks to track.[174]

We request comment on whether it is appropriate to require an index-based ETF to compare its performance to its underlying index. Should an index-based ETF that tracks an

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172 Proposed Item 22(b)(7)(iv) of Form N-1A. Although similar to the proposed disclosure amendment to the shareholder information in Item 6 of the form, this proposed disclosure would span a longer, and different, reporting period: five fiscal years instead of the most recent calendar year and quarter(s). See Proposed Item 6(h)(4) of Form N-1A. The proposed amendment would require fiscal year disclosure to conform to currently required disclosure in Item 22(b)(7). We are also proposing to include instructions similar to those proposed in Item 6 to assist funds in meeting this proposed disclosure obligation. Proposed Instructions to Item 22(b)(7)(iv) of Form N-1A.

173 Proposed Instruction 5(b) to Item 2(c)(2) of Form N-1A; Proposed Instruction 12(c) to Item 22(b)(7) of Form N-1A.

174 Item 2(c)(2)(iii) of Form N-1A; Instruction 12(c) to Item 22(b)(7) of Form N-1A. The form requires use of a broad-based index and prohibits use of affiliated indexes unless widely used and recognized. Our amendment would require ETFs that track narrow, custom indexes or affiliated indexes, to use the underlying index when presenting this return information.

index compiled by an affiliated index provider use a benchmark index instead of, or in addition to, its underlying index? Should an index-based ETF that tracks a fundamental or other custom-designed index use a benchmark index instead of, or in addition to, its underlying index?

Summary Prospectus. As noted above, we recently issued the Enhanced Disclosure Proposing Release, which would require key information to appear in plain English in a summary section of the prospectus.[175] In addition, a person could satisfy its mutual fund delivery obligations under section 5(b)(2) of the Securities Act by delivering the summary prospectus to investors and providing a statutory prospectus on an Internet Web site. Upon request, a fund also would be required to send the statutory prospectus to the investor.[176]

As proposed, the summary section would include certain key information, which also would comprise the information in the summary prospectus. This key information would include: (i) investment objectives;[177] (ii) costs;[178] (iii) principal investment strategies, risks, and

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175 See supra notes 148-152 and accompanying text. References to Form N-1A amendments in the Enhanced Disclosure Proposing Release, supra note 142, are to the "proposed summary prospectus."

176 See Enhanced Disclosure Proposing Release, supra note 142, at Section II.B (proposed rule 498 under the Securities Act).

177 See id., at n.43 and accompanying text (proposed summary prospectus Item 2 of Form N-1A). This is the same information required by current Item 2(a) of Form N-1A.

178 See id., at nn.44-55 and accompanying text (proposed summary prospectus Item 3 of Form N-1A). This information would be substantially the same as that required by current Item 3 of Form N-1A (the risk/return summary fee table and example), except for proposed amendments that would: (i) require funds that offer discounts on front-end sales charges for volume purchases (i.e. breakpoints) to include a brief narrative disclosure alerting investors to the availability of those discounts; (ii) revise the parenthetical following the heading "Annual Fund Operating Expenses" to read "ongoing expenses that you pay each year as a percentage of the value of your investment" in place of "expenses that are deducted from Fund assets"; (iii) require funds to add brief disclosure regarding portfolio turnover immediately following the fee table example; and (iv) permit funds to include additional captions directly below the "Total Annual Fund Operating Expenses" caption in cases where there were expense reimbursement or fee waiver arrangements that reduced fund operating expenses and that will continue to reduce them for no less than one year from the effective date of the fund's registration statement.

performance;[179] (iv) the fund's top ten portfolio holdings as of the end of its most recent calendar quarter;[180] (v) identity of investment advisers and portfolio managers;[181] (vi) brief purchase and sale and tax information;[182] and (vii) financial intermediary compensation.[183] This information is drawn largely from the current risk/return summary and rule 498 fund profile.[184] In addition, the summary prospectus would be required to include on the cover page or at the beginning: (i) the

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[179] See id., at nn.56-57 and accompanying text (proposed summary prospectus Item 4 of Form N-1A). This would include the same information required by current Items 2(b) and (c) of Form N-1A.

[180] See id., at nn.58-66 and accompanying text (proposed summary prospectus Item 5 of Form N-1A). This information currently is not required in a fund's prospectus. The proposal would allow funds to list an amount not exceeding five percent of the total value of the portfolio holdings in one amount as "Miscellaneous securities" provided certain specified conditions are met. Id. at n.66 and accompanying text (proposed Instruction 3 to proposed summary prospectus Item 5 of Form N-1A).

[181] See id., at nn.67-72 and accompanying text (proposed summary prospectus Item 6 of Form N-1A) (proposing that a fund disclose the name of each investment adviser and sub-adviser of the fund, followed by the name, title, and length of service of the fund's portfolio managers). This information is similar to disclosures required by current Item 5 of Form N-1A. Certain additional disclosures regarding investment advisers and portfolio managers that are currently required in the statutory prospectus would continue to be required in the statutory prospectus, but not in the summary section. See id., at n.68.

[182] See id., at nn.73-74 and accompanying text (proposed summary prospectus Item 7 of Form N-1A) (proposing that a fund disclose minimum initial or subsequent investment requirements, the fact that the shares are redeemable, and identify the procedures for redeeming shares (e.g., on any business day by written request, telephone, or wire transfer)), and nn.75-76 and accompanying text (proposed summary prospectus Item 8 of Form N-1A) (proposing that a fund state, as applicable, that it intends to make distributions that may be taxed as ordinary income or capital gains or that the fund intends to distribute tax-exempt income, and proposing that a fund that holds itself out as investing in securities generating tax-exempt income provide, as applicable, a general statement to the effect that a portion of the fund's distributions may be subject to federal income tax).

[183] See id., at nn.77-78 and accompanying text (proposed summary prospectus Item 9 of Form N-1A) (proposing that a fund provide disclosure that, if an investor purchases the fund through a broker-dealer or other financial intermediary (such as a bank), the fund and its related companies may pay the intermediary for the sale of fund shares and related services, and state that these payments may influence the broker-dealer or other intermediary and the salesperson to recommend the fund over another investment).

[184] Registrants would not be permitted to include any additional information in the summary section. See id., at n.37 and accompanying text (proposed summary prospectus General Instruction C.3.(b) of Form N-1A).

fund's name and the share classes to which the summary prospectus relates; (ii) a statement identifying the document as a "summary prospectus"; (iii) the approximate date of the summary prospectus's first use; and (iv) the following legend:

> Before you invest, you may want to review the Fund's prospectus, which contains more information about the Fund and its risks. You can find the Fund's prospectus and other information about the Fund online at [_______]. You can also get this information at no cost by calling [______] or by sending an e-mail request to [________].[185]

If adopted, the amendments to Form N-1A and rule 498 proposed in the Enhanced Disclosure Proposing Release would require open-end ETFs to include the summary section in their prospectuses and permit persons to satisfy their prospectus delivery obligations by sending or giving the summary prospectus and providing the statutory prospectus on an Internet Web site in the manner set forth in the proposed rules. Today, we also propose that, if the Enhanced Disclosure Proposing Release is adopted, ETFs include in the summary section of their prospectuses, and in their summary prospectuses, the additional proposed disclosures discussed above. Specifically, we would modify the amendments proposed in the Enhanced Disclosure Proposing Release to include our proposed amendments to ETF disclosures as follows: (i) our proposed amendments regarding disclosures about creation units and the purchase and sale of individual ETF shares would be included in proposed summary prospectus Item 7, which would require brief purchase and sale information;[186] (ii) the additional information on market price returns would be included in proposed summary prospectus Item 4, which includes the

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[185] See id., at n.98 and accompanying text (proposed rule 498(b)(1) under the Securities Act).

[186] The disclosures in our proposed Items 6(a)(1), 6(h)(2) and 6(h)(3) to Form N-1A would be included in proposed summary prospectus Item 7 of Form N-1A. As noted, our proposed amendments also would require the ETF to modify the narrative explanation preceding the example in the fee table, see supra note 160, which would remain in current Item 3 of Form N-1A.

risk/return summary, bar chart and table;[187] and (iii) premium/discount information would be included in proposed summary prospectus Item 7 (purchase and sale information).[188] We also would permit ETFs to exclude proposed information regarding the purchase and sale of creation units consistent with our proposal today.[189]

We request comment on whether ETFs should send or give the proposed additional items in the summary prospectus. If so, should any information from the statutory prospectus, in addition to the items that we are proposing today, be included in the summary section of an ETF's prospectus and, therefore, in its summary prospectus? Should ETFs not be required to include certain items in the summary section? For example, in light of the transparency of portfolio holdings of an ETF, should ETFs not have to include the top ten portfolio holdings? Should ETFs be permitted or required to locate any of the specific disclosures proposed in this release or in the Enhanced Disclosure Proposing Release elsewhere in the prospectus outside the summary section?

E. Amendment of Previously Issued Exemptive Orders

As discussed above, our orders have exempted ETFs from compliance with section 24(d) of the Act to relieve dealers from delivering prospectuses to investors in secondary market

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187 Our proposed instructions 5(a) and (b) to the risk return bar chart and table (current Item 2(c)(2) of Form N-1A), see note 163 and accompanying and following text, would be added to the end of the proposed instructions to proposed summary prospectus Item 4.

188 The disclosure in our proposed Item 6(h)(4) to Form N-1A, see notes 167-169 and accompanying and following text, would be included at the end of proposed summary prospectus Item 7 of Form N-1A. Our proposed amendments to the financial highlights (current Item 8 of Form N-1A) and the financial statements (current Item 22 of Form N-1A) would be included in the proposed summary prospectus Items 14 and 28 of Form N-1A, respectively.

189 ETFs would be permitted to exclude from the fee table (current Item 3 and proposed summary prospectus Item 3 of Form N-1A) the fees and expenses associated with creation unit purchases and redemptions and would be permitted to exclude the disclosure required by proposed summary prospectus Items 7(a) and 7(b) of Form N-1A. See supra notes 158-160 and accompanying text.

transactions. We are proposing today not to include such an exemption in rule 6c-11 to ensure that broker-dealers are subject to the same delivery requirements with respect to all ETFs.[190] In addition, we are proposing amendments to Form N-1A that would revise the prospectus requirements in that form in order to provide more useful information to investors in ETF shares. Therefore, pursuant to our authority under section 38(a) of the Act, we propose to amend the exemptive orders we have issued to ETFs that are open-end funds to eliminate the section 24(d) exemptions and require ETFs to satisfy their statutory prospectus delivery requirements.[191]

The consequence of the amendment to these orders, if adopted, would be to put ETFs that have received exemptive orders on the same footing as ETFs that may in the future rely solely on rule 6c-11, and thus eliminate any competitive advantage they might otherwise obtain by having obtained orders before adoption of the rule.[192] The amendment would be limited to orders issued to ETFs seeking to operate as open-end management companies.

We are not proposing to rescind the orders we have issued because we do not believe rescission would be necessary to eliminate competitive advantages for ETFs that have already received exemptive orders. With the exception of the section 24(d) exemption (and the related prospectus disclosure requirements), the proposed rule contains broader exemptive relief than that provided in our orders and therefore we expect most, if not all, ETFs would rely on the rule

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190 See supra Section III.D.1.

191 Section 38(a) of the Act provides the Commission with the authority to amend orders when necessary or appropriate to the exercise of its powers conferred elsewhere in the Act. We are not proposing to amend the orders of UITs that have sought and obtained an exemption from section 24(d) of the Act because those ETFs do not prepare their prospectuses in accordance with Form N-1A.

192 For the same purpose, we expect all funds seeking exemptive orders to operate an ETF after today to agree as a condition of the order that the requested order would expire on the effective date of any Commission rule under the Act that provides relief permitting the operation of index-based or actively managed ETFs.

if and when it is adopted.

We request comment on whether we should rescind our previous orders. Is our assumption correct that most ETFs that have orders would rely on the rule?

IV. EXEMPTION FOR INVESTMENT COMPANIES INVESTING IN ETFS

A. Background

As we discussed above, institutional investors, including funds, have invested in ETFs to achieve asset allocation, diversification, or other investment objectives.[193] Some funds invest primarily in ETFs. A fund's ability to invest in ETFs, however, is limited because section 12(d)(1) of the Act prohibits a fund (and companies or funds it controls) ("acquiring fund") from:

(i) acquiring more than three percent of any other investment company's outstanding voting securities ("acquired fund");

(ii) investing more than five percent of its total assets in any one acquired fund; or

(iii) investing more than ten percent of its total assets in all acquired funds.[194]

Section 12(d)(1) was enacted to limit so-called "fund of funds" arrangements. Congress was concerned about "pyramiding," a practice under which investors could use a limited

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[193] See supra note 15 and accompanying text (funds also use ETFs for hedging purposes). See also, e.g., iShares Trust, Investment Company Act Release No. 25969 (Mar. 21, 2003) [68 FR 15010 (Mar. 27, 2003)].

[194] See 15 U.S.C. 80a-12(d)(1)(A). Both registered and unregistered funds are subject to these limits with respect to their investments in a registered fund. Registered funds are also subject to these same limits with respect to their investments in an unregistered fund. Unregistered funds are not subject to limits on their investments in another unregistered fund. Id. ETFs are registered funds and therefore both registered and unregistered funds are subject to section 12(d)(1)(A)'s limits with respect to investments in ETFs. Section 12(d)(1)(B) prohibits a registered open-end fund from selling any security issued by the fund to any other fund (including unregistered funds) if, after the sale, the acquiring fund would: (i) together with companies and funds it controls, own more than three percent of the acquired fund's voting securities; or (ii) together with other funds (and companies they control) own more than ten percent of the acquired fund's voting securities. 15 U.S.C. 80a-12(d)(1)(B).

investment in an acquiring fund to gain control of another (and potentially much larger) fund and use the assets of the acquired fund to enrich themselves at the expense of acquired fund shareholders.[195] Control could be exercised either directly (such as through holding a controlling interest) or indirectly (such as by coercion through the threat of large-scale redemptions).[196] Congress also was concerned about the potential for excessive fees when one fund invested in another,[197] and the formation of overly complex structures that could be confusing to investors.[198]

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[195] The legislative history of these provisions cites examples of controlling investors in an acquiring fund using "pyramiding schemes" to force acquired funds to purchase securities of companies in which the investors had an interest and to direct underwriting and brokerage business to broker-dealers they controlled. In an open-end fund, controlling investors were able to exert control and influence over acquired funds through the threat of large-scale redemptions. In the 1960s, Fund of Funds, Ltd., an unregistered foreign investment company, acquired controlling interests in several registered U.S. funds and was able to exert undue influence over the management of those acquired funds by threatening advisers to those funds with large redemptions. See SEC, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 2337, 89th Cong., 2d Sess. at 315-16 (1966) ("1966 Study"). Congress enacted section 12(d)(1) to prevent these abuses and amended the section in 1970 to prevent similar abuses by investors in unregistered acquiring funds. Congress later amended section 12(d)(1) to give the Commission specific authority to provide exemptions from these limitations. See infra notes 200 and 214 and accompanying text.

[196] Large-scale redemptions may disrupt portfolio management or increase transaction fees if fund managers must hold cash or sell portfolio securities at an inopportune time to meet redemptions. Large-scale redemptions also may be threatening to a fund manager because they decrease the fund's assets under management, on which the manager's fee is based.

[197] Pyramiding schemes resulted in fund shareholders paying excessive charges due to duplicative fees at the acquiring and acquired fund levels. See SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. DOC. NO. 279, 76th Cong., 1st Sess., pt.3, at 2721-95 (1939) ("INVESTMENT TRUST STUDY"). See also Fund of Funds Investments, Investment Company Act Release No. 26198 (Oct. 1, 2003) [68 FR 58226 (Oct. 8, 2003)] ("Fund of Funds Proposing Release") at nn.2-6 and accompanying text. For example, from 1927 to 1936, it was estimated that the duplication of expenses incurred by funds investing in other funds exceeded five percent of the total operating expenses for all management funds. See INVESTMENT TRUST STUDY, at 2727-2728. Fund of Funds, Ltd. also charged duplicative advisory fees at the acquiring and acquired fund levels, provided sales loads to an affiliated broker for each investment the acquiring fund made in an acquired fund, and directed brokerage to an affiliate of the fund of funds. See 1966 Study, supra note 195, at 318-320; Arthur Lipper Corp., et al. v. SEC, Securities Exchange Act Release No. 11773, 46 S.E.C. 78 (Oct. 24, 1975), sanction modified, 547 F.2d 171 (2d Cir. 1976) (a Fund of Funds, Ltd. affiliated broker-dealer received commissions under step-out arrangements with Arthur Lipper Corp, a registered broker-dealer, and other broker-dealers).

[198] Pyramiding of funds resulted in complicated corporate structures that were confusing to

(footnote continued)

Congress imposed these limits, in part, based on our conclusion in 1966 that fund of funds structures served little or no economic purpose.[199]

Our views and those of Congress regarding the economic value of fund of funds arrangements have changed over the years as fund of funds arrangements have been created that serve new, legitimate purposes. Recognizing this, in 1996, Congress granted us specific authority to provide exemptions allowing fund of funds arrangements, and directed that we use it "in a progressive way."[200] Pursuant to this authority, we have provided exemptions to permit certain fund of funds arrangements that would otherwise be prohibited under section 12(d)(1). For example, in 2006 we adopted rule 12d1-1, which allows funds to invest in money market funds in excess of section 12(d)(1) limits.[201] We also have issued exemptive orders that allow many funds to invest in unaffiliated traditional funds ("multigroup fund orders") and that allow the sale of shares issued by several ETFs to unaffiliated funds in excess of the statutory limits.[202]

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shareholders and made it difficult for shareholders to determine the nature and value of the holdings ultimately underlying each shareholder's investment. See INVESTMENT TRUST STUDY, supra note 197, at 2778-93.

199 See id., at 2725-41.

200 See National Securities Markets Improvement Act of 1996, P.L. 104-290, § 202(4), 110 Stat. 3416, 3427 (1996) ("NSMIA"); H.R. REP. NO. 622, 104TH CONG., 2D SESS., at 43-44 (1996) ("H.R. REP. NO. 622") (discussing new section 12(d)(1)(J) of the Act that gives the Commission authority, by rule or order, to provide exemptions from the limits of section 12(d)(1) when it is consistent with the public interest and the protection of investors). In 1996, Congress also amended the Act to include a statutory exemption from section 12(d)(1) limits for funds that invest in funds in the same fund group. NSMIA, § 202(5). See also infra note 214 and accompanying text.

201 See Fund of Funds Investments, Investment Company Act Release No. 27399 (June 20, 2006) [71 FR 36640 (June 27, 2006)] ("Fund of Funds Adopting Release"); 17 CFR 270.12d1-1.

202 See, e.g., Schwab Capital Trust, et al., Investment Company Act Release Nos. 24067 (Oct. 1, 1999) [64 FR 54939 (Oct. 8, 1999)] (notice) ("Schwab Notice") and 24113 (Oct. 27, 1999) (order) ("Schwab Order"); First Trust Exchange-Traded Fund, et al., Investment Company Act Release Nos. 27812 (Apr. 30, 2007) [72 FR 25795 (May 7, 2007)] (notice) and 27845 (May 30, 2007) (order); iShares Trust, et al., Investment Company Act Release Nos. 25969 (Mar. 21, 2003) [68 FR 15010 (Mar. 27, 2003)] (notice) and 26006 (Apr. 15, 2003) (order).

The exemptions provided under the rule and these orders facilitate the acquiring funds' ability to achieve their investment objectives by expanding their investment options to include investments in unaffiliated funds in a manner consistent with the protection of investors. These exemptions also increase the potential pool of investors and assets available for investment in ETFs and traditional funds.

ETF applicants have sought exemptive orders similar to those we have issued to funds investing in unaffiliated traditional funds.[203] The conditions included in those orders were designed to prevent the abuses that historically were associated with fund of funds arrangements and that led Congress to enact section 12(d)(1).[204] The conditions include: (i) limits on the control and influence an acquiring fund can exert on the acquired fund;[205] (ii) limits on certain

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[203] Fifteen orders have been issued to ETFs allowing other funds to invest in ETFs beyond the limits of section 12(d)(1). See, e.g., iShares Trust, et al., Investment Company Act Release No. 25969 (Mar. 21, 2003) [68 FR 15010 (Mar. 27, 2003)].

[204] See, e.g., Schwab Notice and Order, supra note 202.

[205] The exemptive orders permitting investments in ETFs contain the following conditions relating to influence and control: (i) the acquiring fund's investment adviser or sponsor, any person in a control relationship with that investment adviser or sponsor, any investment company (including a company that would be an investment company but for the exceptions provided in sections 3(c)(1) and 3(c)(7) of the Act) that is advised or sponsored by the acquiring fund's investment adviser or sponsor, or any person in a control relationship with that investment adviser or sponsor cannot control the ETF within the meaning of section 2(a)(9) of the Act; (ii) neither the acquiring fund nor certain of its affiliates cause any existing or potential investment by the acquiring fund in ETF shares to influence the terms of any services or transactions between the acquiring fund or its affiliate and the ETF or an ETF affiliate; (iii) the board of directors (or trustees) of the acquiring fund, including a majority of the independent directors, adopts procedures reasonably designed to assure that the acquiring fund's investment adviser(s) is conducting the acquiring fund's investment program without taking into account any consideration received by the acquiring fund or an acquiring fund affiliate from the ETF or an ETF affiliate in connection with any services or transactions; (iv) the board of directors of an open-end ETF, including a majority of its independent directors, determines that any consideration paid by the ETF to the acquiring fund or an acquiring fund affiliate in connection with any services or transactions: (a) is fair and reasonable in relation to the nature and quality of the services and benefits received by the ETF; (b) is within the range of consideration that the ETF would be required to pay to another unaffiliated entity in connection with the same services or transactions; and (c) does not involve overreaching on the part of any person concerned; (v) neither the acquiring fund nor certain of its affiliates (except to the extent it is acting in its capacity as an investment adviser or sponsor to the

(footnote continued)

fees charged to the acquiring fund and its shareholders;[206] (iii) limits on the acquired fund's ability to invest in other funds;[207] (iv) the acquired fund and each acquiring fund must enter into an agreement stating that both funds understand the terms and conditions of the order and agree

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ETF) causes the ETF to purchase a security in any affiliated underwriting (an underwriting in which an affiliate of the acquiring fund is a principal underwriter); (vi) the board of directors of an open-end ETF, including a majority of the independent directors, adopts procedures reasonably designed to monitor any purchases of securities by the ETF in an affiliated underwriting, including any purchases made directly from the affiliate, and the board reviews these purchases at least annually to determine whether the purchases were influenced by the acquiring fund's investment in the ETF, in its review the board must consider: (a) whether the purchases were consistent with the ETF's investment objectives and policies; (b) how the performance of the purchased securities compares to the performance of comparable securities purchased during a comparable period of time in an unaffiliated underwriting or to a benchmark such as a comparable market index; and (c) whether the amount of securities purchased has changed significantly from prior years; and (vii) the ETF maintains and preserves permanently in an easily accessible place a written copy of the procedures designed to monitor purchases made in an affiliated underwriting and maintains and preserves for at least six years, the first two in an easily accessible place, a written record of each purchase (and the terms thereof) of securities in an affiliated underwriting and the information or materials upon which the board's determinations were made. See, e.g., Healthshares™, Inc. and XShares Advisors LLC, Investment Company Act Release No. 27844 (May 29, 2007) [72 FR 30885 (June 4, 2007)] ("Healthshares™, Inc. and XShares Order").

206 The exemptive orders permitting investments in ETFs contain the following conditions relating to fee limits: (i) before approving any advisory contract under section 15 of the Act, the board, including a majority of independent directors, finds that the advisory fees charged under the contract are based on services provided that are in addition to, rather than duplicative of, the services provided under the ETF advisory contract(s) and these findings and their basis are recorded in the minute books of the acquiring fund; (ii) the acquiring fund's adviser(s) (or if the acquiring fund is a UIT, its trustee or sponsor) waives fees payable to it by the acquiring fund in an amount at least equal to any compensation (including fees received pursuant to any 12b-1 plan) received from the ETF by the acquiring fund's adviser, trustee, or sponsor or an affiliated person of the acquiring fund's adviser, trustee, or sponsor (other than any advisory fees paid by the ETF to the adviser, trustee, or sponsor or its affiliated person) in connection with the acquiring fund's investment in the ETF; and (iii) any sales charge and/or service fees charged with respect to shares of the acquiring fund do not exceed the limits applicable to a fund of funds as set forth in Rule 2830 of the NASD Conduct Rules (or with respect to registered separate accounts that invest in a fund of funds, no sales load is charged at the acquiring fund level or ETF level and other sales charges and services fees, if any, are only charged at either the acquiring fund level or ETF level, not both). See, e.g., Healthshares™, Inc. and XShares Order, supra note 205.

207 Under the exemptive orders permitting investments in ETFs, the ETF may not invest in shares of other funds (including companies relying on sections 3(c)(1) and 3(c)(7) of the Act) in excess of the limits in section 12(d)(1)(A) of the Act (some orders allow a few exceptions to this condition, see infra note 225). See, e.g., Healthshares™, Inc. and XShares Order, supra note 205.

to fulfill their responsibilities under the order ("participation agreement");[208] and (v) the acquiring fund provides a list of certain of its affiliates to the acquired fund.[209]

More recently, sponsors of some ETFs as well as managers of funds investing in ETFs have expressed concern to our staff that some of the conditions in the exemptive orders are burdensome and unnecessary in the context of a fund investment in an ETF, which is less likely to be subject to at least some of the abuses these conditions were designed to prevent.[210] For example, ETF sponsors have communicated to our staff that the participation agreement condition is cumbersome and costly because the ETFs must enter into an agreement with each acquiring fund and each acquiring fund seeks to negotiate different terms in its agreement.[211] They have suggested that we develop conditions that address the concerns underlying section 12(d)(1) in a manner that is more suited to fund investments in ETFs.[212]

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[208] The exemptive orders require an agreement between the acquiring fund and the ETF stating that their boards and investment advisers, or their sponsors and trustees, as applicable, understand the terms and conditions of the order and agree to fulfill their responsibilities under the order (and the acquiring fund transmits to the ETF a list of certain of its affiliates and underwriting affiliates) and the acquiring fund and ETF maintain and preserve a copy of the exemptive order, participation agreement, and the list of affiliates with any updated information for the duration of the investment and for at least six years thereafter, the first two years in an easily accessible place. See, e.g., Healthshares™, Inc. and XShares Order, supra note 205.

[209] See supra note 208.

[210] See infra Section IV.B.

[211] Acquiring funds also have indicated to the staff that it is burdensome for them to enter into participation agreements with each ETF in which the funds want to invest.

[212] Many funds also appear to consider investments in ETFs to be different than investments in other investment companies. In 2004, our staff conducted examinations of a number of mutual fund complexes, which focused on the funds' investments in ETFs and whether those investments were made in accordance with section 12(d)(1) of the Act. Most of the examined mutual fund complexes treated ETF investments like investments in traditional equity securities and did not identify ETFs as registered funds subject to the requirements of section 12(d)(1) of the Act. Thus, those that acquired more than three percent of the voting securities of an ETF or invested more than five percent of the acquiring fund's assets in the voting securities of an ETF were inconsistent with section 12(d)(1). Most of the mutual funds examined invested in ETFs in order to: (i) hedge the portfolio; (ii) "equitize" cash balances in order to earn returns in excess of money market rates; and (iii) gain exposure to a specific market and/or industry sector in an

(footnote continued)

B. Proposed Rule 12d1-4 Conditions

Today, we are proposing a new rule 12d1-4, which would provide an exemption to permit acquiring funds to invest in ETFs in excess of the limits of section 12(d)(1), subject to four conditions that are designed to address the historical abuses that result from pyramiding and the threat of large-scale redemptions and may arise in connection with investments in ETFs.[213] The relief we propose is subject to fewer conditions than our exemptive orders but, unlike our orders, would limit an acquiring fund's ability to redeem ETF shares.[214]

1. Control

In order to address the concern that a fund could exert control over another fund, the proposed rule would limit the exemption to an acquiring fund (and any entity in a control relationship with the acquiring fund) that does not "control" an ETF.[215] The Act defines

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efficient manner.

[213] We are also proposing related amendments to rule 12d1-2 under the Act to include within its exemptive relief investments in ETFs made in reliance on proposed rule 12d1-4 and investments in non-security assets. See infra Section V.

[214] In 1996, Congress added section 12(d)(1)(J) to the Act, which gave us specific authority to exempt any person, security or transaction, or any class or classes of transactions, from section 12(d)(1) of the Act if the exemption is consistent with the public interest and the protection of investors. NSMIA, § 202(4) (codified at 15 U.S.C. 80a-12(d)(1)(J)). The House Report accompanying the legislation urged the Commission to use the additional exemptive authority under section 12(d)(1)(J) "in a progressive way as the fund of funds concept continues to evolve over time." H.R. REP. NO. 622, supra note 200, at 43-44 (1996). The House Report explained that, in exercising its exemptive authority, the Commission should consider factors that relate to the protection of investors, including the extent to which a proposed arrangement is subject to conditions that are designed to address conflicts of interest and overreaching by a participant in the arrangement, so as to avoid the abuses that gave rise to the initial adoption of the Act's restrictions against funds investing in other funds. Id. at 44.

[215] Proposed rule 12d1-4(a)(1). The condition would provide that: (i) an acquiring fund and any of its investment advisers or depositors, and any company in a control relationship with the acquiring fund or any of its investment advisers or depositors, each individually or in the aggregate, do not control an ETF; and (ii) if, as a result of a decrease in the outstanding voting securities of an ETF, the acquiring fund, any of its investment advisers, and any company in a control relationship with the acquiring fund or its investment adviser, either individually or together in the aggregate, become holders of more than 25 percent of the outstanding voting securities of an ETF (i.e., are presumed to control the ETF, see infra notes 217-218 and

(footnote continued)

"control" to mean "the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company."[216] The Act also creates rebuttable presumptions that any person who directly or indirectly beneficially owns more than 25 percent of the voting securities of a company controls the company and that one who does not own that amount does not control it.[217] The effect of the proposed rule, if adopted, would be that an acquiring fund's beneficial ownership of up to 25 percent of the voting securities of an ETF, by itself, would not constitute control over the ETF. As a result, a fund relying on the rule could make a substantial investment in an ETF (i.e., up to 25 percent of the ETF's shares) without seeking further exemption from us.

If, however, an acquiring fund uses its ownership interest in the ETF (even if that interest is 25 percent or less) to exercise a controlling influence over the ETF's management or policies, the fund would not be able to rely on the proposed rule.[218] For example, an acquiring fund that used its share position to persuade an ETF manager to enter into a transaction with an affiliate of the acquiring fund or its adviser would almost certainly exercise a controlling influence on the ETF's management and thus lose its exemption under the proposed rule.[219]

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accompanying text), each of those shareholders must vote its shares of the ETF in the same proportion as the vote of all the other ETF shareholders. The same condition is in our exemptive orders.

[216] 15 U.S.C. 80a-2(a)(9).

[217] Id. These presumptions continue until the Commission makes a final determination to the contrary by order either on its own motion or on application by an interested person. Id.

[218] A determination of control depends on the facts and circumstances of the particular situation. "[N]o person may rely on the presumption that less than 25 percent ownership is not control when, in fact, a control relationship exists under all the facts and circumstances." Exemption of Transactions by Investment Companies with Certain Affiliated Persons, Investment Company Act Release No. 10698 (May 16, 1979) [44 FR 29908 (May 23, 1979)] at n.2. (citing Fundamental Investors, Inc., 41 SEC 285 (1962)) ("Fundamental Investors") (Commission order noting that rebutting presumption of control can have retrospective as well as prospective effect).

[219] We have long held that "controlling influence" includes, in addition to voting power, a

(footnote continued)

We request comment on the proposed condition. Do ETF sponsors believe that it would sufficiently protect the ETF from the type of coercive behavior on the part of acquiring funds that section 12(d)(1) was intended to prevent?

2. Redemptions

The proposed rule includes two provisions that would prevent an acquiring fund from redeeming shares it acquired in reliance on the proposed rule. First, the rule would prohibit an acquiring fund that relies on the proposed rule to acquire shares in excess of section 12(d)(1)(A)(i) limits (i.e., to acquire more than three percent of an ETF's shares) from redeeming those shares.[220] As a result, acquiring funds would not be able to threaten large-scale redemptions as a means of coercing an ETF. It is our understanding that most acquiring funds purchase and sell ETF shares in secondary market transactions. Accordingly, this condition, while precluding one of the historical abuses associated with fund of funds arrangements, would not prevent acquiring funds from taking passive shareholder positions in ETF shares (in excess of section 12(d)(1) limits) in order to, for example, gain exposure to a particular market segment.

We request comment on whether the condition achieves this purpose. If not, are there

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dominating persuasiveness of one or more persons, the act or process that is effective in checking or directing action or exercising restraint or preventing free action, and the latent existence of power to exert a controlling influence. See, e.g., Investors Mutual, Inc., Investment Company Act Release No. 4595 (May 11, 1966) at text accompanying nn.11-14 (citing The Chicago Corporation, Investment Company Act Release No. 1203 (Aug. 24, 1948); Transit Investment Corporation, Investment Company Act Release No. 927 (July 31, 1946); In the Matter of the M.A. Hanna Company, Investment Company Act Release No. 265 (Nov. 26, 1941)).

220 Proposed rule 12d1-4(a)(2). Under the proposed rule, an acquiring fund would be deemed to have redeemed or sold the most recently acquired ETF shares first. Id. As a result, an acquiring fund could redeem shares from an ETF only when the fund (and companies or funds it controls) holds ETF shares in an amount consistent with section 12(d)(1)(A)(i) limits. An acquiring fund that relies on the proposed rule to invest more than five percent of its assets in the acquired ETF (prohibited by section 12(d)(1)(A)(ii)) and/or to invest more than 10 percent of its assets in all funds (including the acquired ETF) (prohibited by section 12(d)(1)(A)(iii)) but that does not acquire more than three percent of the acquired ETF's outstanding securities would not be prohibited from redeeming shares of the ETF under the proposed rule.

other conditions that would better address the concern?

Second, the proposed rule would prohibit an ETF, its principal underwriter, and a broker or a dealer that relies on the rule to sell ETF shares in excess of section 12(d)(1)(B) limits from redeeming (or submitting an order to redeem) those shares acquired by another fund that exceed the three percent limit in section 12(d)(1)(A)(i).[221] We recognize that it may be difficult in all circumstances for an ETF, its principal underwriter, a broker or a dealer to know whether a redemption order is submitted by an acquiring fund that acquired more than three percent of the ETF's shares in reliance on the proposed rule. Accordingly, we are proposing to include a safe harbor for each of those entities if it has: (i) received a representation from the acquiring fund that none of the ETF's shares the acquiring fund is redeeming includes any shares that it acquired in excess of three percent of the ETF's shares in reliance on proposed rule 12d1-4(a); and (ii) no reason to believe that the acquiring fund is redeeming ETF shares that the acquiring fund acquired in excess of three percent of the ETF's shares in reliance on the proposed rule.[222] If an acquiring fund attempts to redeem ETF shares in connection with a threat to coerce the ETF, the ETF would know of the attempt. In those circumstances, or if the principal underwriter, broker or dealer knows or has reason to know of the threat, the entity could not redeem (or submit for

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[221] Proposed rule 12d1-4(b)(1). Under the proposed rule, an exchange-traded fund, any principal underwriter thereof, and a broker or a dealer may sell or otherwise dispose of exchange-traded fund shares if the exchange-traded fund does not redeem, or the principal underwriter, broker or dealer does not submit for redemption any of the exchange-traded fund's shares that were acquired by an acquiring fund in excess of the limits of section 12(d)(1)(A)(i) in reliance on proposed rule 12d1-4(a). Id. An acquiring fund would be deemed to have redeemed or sold the most recently acquired exchange-traded fund shares first. Id. See also supra note 220.

We note that our adoption of proposed rule 12d1-4 would not preclude an acquiring fund from continuing to rely on exemptive orders we have previously issued that permit funds to invest in ETFs in excess of the limits of section 12(d)(1) but which do not restrict their ability to redeem ETF shares, subject to the conditions set forth in the orders and described above. Moreover, we intend to continue to issue such orders and may consider their codification in a rule in the future.

[222] Proposed rule 12d1-4(b)(2).

redemption) the ETF shares held by the acquiring fund. We believe that the proposed condition prohibiting acquiring funds from redeeming ETF shares acquired in reliance on the proposed rule should sufficiently prevent an acquiring fund from threatening redemptions as a means of coercing an ETF adviser.

We request comment on these conditions. Do most funds that invest in ETFs redeem their shares or sell them in secondary market transactions? Would the prohibition on redemption impede the ability of acquiring funds to dispose of ETF shares? Do acquiring funds realize significant benefits from the ability to redeem ETF shares?

The proposed conditions limiting redemptions of ETF shares are designed to eliminate the threat of redemption that an acquiring fund could otherwise use to coerce an ETF. Accordingly, the proposed rule does not include the conditions in our exemptive orders that require the ETF[223] and the acquiring fund to take measures to prevent the acquiring fund from

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[223] The orders require that: (i) the board of directors of an ETF, including a majority of its independent directors, determines that any consideration paid by the ETF to the acquiring fund or any investment adviser, depositor, or principal underwriter of the acquiring fund and any person controlling, controlled by, or under common control with an investment adviser, depositor, or principal underwriter of the acquiring fund, (but not including any investment adviser of the ETF or any person controlling, controlled by, or under common control with the investment adviser of the ETF) ("acquiring fund affiliate") in connection with any services or transactions: (a) is fair and reasonable in relation to the nature and quality of the services and benefits received by the ETF; (b) is within the range of consideration that the ETF would be required to pay to another unaffiliated entity in connection with the same services or transactions; and (c) does not involve overreaching on the part of any person concerned; (ii) the ETF board of directors, including a majority of the independent directors, adopts procedures reasonably designed to monitor any purchases of securities by the ETF in an underwriting in which a principal underwriter is an officer, director, member of an advisory board, acquiring fund investment adviser, acquiring fund depositor, or an acquiring fund employee or an affiliated person of any such person ("affiliated underwriting"), and the board reviews these purchases at least annually to determine whether the purchases were influenced by the acquiring fund's investment in the ETF; and (iii) the ETF maintains and preserves a copy of the procedures designed to monitor purchases made in an affiliated underwriting and maintains a written record of each purchase of securities in an affiliated underwriting and the information or materials upon which the board's determinations were made. See supra note 205.

unduly influencing the ETF.[224]

We request comment on the exclusion of these conditions from the proposed rule. Is there a concern that if the acquiring fund and ETF do not take particular measures to prevent the acquiring fund from unduly influencing the ETF, acquiring funds may be able more easily to coerce the ETF? Notwithstanding the prohibition on control and redemption, should we be concerned about particular transactions between an acquiring fund (or an acquiring fund affiliate) and an ETF, or an ETF's purchase of securities during an underwriting in which a principal underwriter is an affiliate of the acquiring fund or its adviser? If there is reason for concern about ETF purchases of securities in an affiliated underwriting, is that concern limited to purchases from an affiliate of the acquiring fund or its adviser? Should any specific conditions in the exemptive orders be included in the proposed rule in addition to or in place of the proposed conditions to prevent an acquiring fund or an acquiring fund affiliate from unduly influencing an ETF?

3. Complex Structures

To prevent the formation of overly complex multi-tiered fund structures, the proposed rule would prohibit an acquired ETF from itself being a fund of funds (i.e., the rule would

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[224] The orders require that: (i) neither the acquiring fund nor any acquiring fund affiliate cause any existing or potential investment by the acquiring fund in an ETF to influence the terms of any services or transactions between the acquiring fund or an acquiring fund affiliate and the ETF (or certain affiliates of the ETF); (ii) neither the acquiring fund nor an acquiring fund affiliate causes the ETF to purchase a security in any affiliated underwriting; and (iii) the acquiring fund board of directors, including a majority of its independent directors, adopts procedures reasonably designed to assure that the acquiring fund's investment adviser(s) is conducting the acquiring fund's investment program without taking into account any consideration received by the acquiring fund or an acquiring fund affiliate from the ETF (or certain affiliates of the ETF). See supra note 205.

As discussed above, the proposed rule would however include the condition from our exemptive orders that an acquiring fund (and any entity in a control relationship with the acquiring fund) could not "control" the ETF. See supra note 215 and accompanying text.

prohibit a fund of funds of funds, or three-tier fund, structure).[225] A fund of ETFs has the potential to become a complicated corporate structure of the kind that concerned Congress when section 12(d)(1) was enacted.[226] If an acquiring fund invests in an ETF that in turn invests in other funds (including other ETFs), an acquiring fund shareholder could find it difficult to determine the nature and value of the holdings ultimately underlying his or her investment. The proposed rule is designed to allow an ETF the flexibility to invest in other funds in order to meet its investment objectives while preventing shareholder confusion as to the nature of their investment in an acquiring fund by limiting the extent of those ETF investments.[227]

We request comment on the proposed limits on an ETF itself being a fund of funds. Are

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225 Proposed rule 12d1-4(a)(4) ("The exchange-traded fund has a disclosed policy that prohibits it from investing more than 10 percent of its assets in: (i) Other investment companies in reliance on section 12(d)(1)(F) or section 12(d)(1)(G) of the Act or [rule 12d1-4]; and (ii) Any other company that would be an investment company under section 3(a) of the Act but for the exceptions to that definition provided in sections 3(c)(1) and 3(c)(7) of the Act (15 U.S.C. 80a-3(c)(1) and 80a-3(c)(7))."). Section 12(d)(1)(A)(iii) of the Act limits an acquiring fund's total investment in other funds to no more than 10 percent of the acquiring fund's assets. An ETF would still be able to make limited investments in other funds, including other ETFs. This is similar to a condition in section 12(d)(1)(G) of the Act that provides an exemption from section 12(d)(1) limits for funds to invest in other funds in the same group provided, among other things, the acquired fund has a policy that it will not rely on exemptions allowing it to be a fund of funds. See 15 U.S.C. 80a-12(d)(1)(G)(i)(IV). The exemptive orders generally prohibit an acquired ETF from investing in other funds beyond section 12(d)(1)(A) limits. Many of the orders have provided exceptions to this general prohibition, which permit the ETF to invest in money market funds beyond the limits of section 12(d)(1)(A) either in reliance on another exemptive order allowing the ETF to do so or in reliance on rule 12d1-1. In addition, some of the orders permit the ETF to invest in another fund beyond the limits of section 12(d)(1)(A) to the extent permitted by section 12(d)(1)(E) of the Act. An acquiring fund relying on any of these exceptions may have difficulty determining whether an acquired ETF would itself be considered a fund of funds because the acquiring fund might not be able to ascertain easily if the ETF is relying on an order, section 12(d)(1)(E) of the Act, or rule 12d1-1 to invest in other funds beyond the limits of section 12(d)(1)(A) of the Act. The orders also do not anticipate any future exemptive relief the Commission might provide to allow acquired ETFs to invest in other non-money market funds in excess of section 12(d)(1)(A) limits. Limiting exemptive relief to investments in ETFs with disclosed policies would allow an acquiring fund to determine easily if it could invest in a particular ETF.

226 See supra note 198 and accompanying text.

227 Under the proposed rule, an acquiring fund could invest in an ETF that invests up to 10 percent of its assets in other ETFs.

the proposed limits on an underlying ETF's investments in other funds sufficient to prevent investor confusion? If not, what limits should the proposed rule include to prevent shareholder confusion? Should the proposed rule include the same limit (and exceptions to the limit) as in our exemptive orders?[228] Are there reasons not to restrict the ability of an acquired ETF itself to invest in other funds, including ETFs, beyond the limits of section 12(d)(1)(A)?[229] Does the fact that ETF shares trade more like a typical equity security make it less likely that investors would be confused if we were to allow an acquiring fund to invest in an ETF that itself invests more than ten percent of its assets in other ETFs in reliance on proposed rule 12d1-4?

4. Layering of Fees

As discussed above, one of Congress' concerns regarding fund of funds arrangements was that acquiring fund shareholders might pay excessive charges due to duplicative fees at the acquiring and acquired fund levels.[230] To prevent duplicative fees at the acquiring and acquired fund levels, the proposed rule would limit sales charges and service fees charged by the acquiring fund to those set forth in the Financial Industry Regulatory Authority's ("FINRA") sales charge rule, which takes into consideration fees charged at both levels of a fund of funds arrangement.[231] In addition, like all acquiring funds, funds that invest in ETFs would be subject

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228 As discussed above, the orders generally prohibit an acquired ETF from investing in other funds beyond the limits of section 12(d)(1)(A). Some of the orders include a few exceptions to this general prohibition. See supra note 225.

229 The proposed rule would allow an acquired ETF to invest in other funds, including ETFs, beyond the limits of section 12(d)(1)(A) in reliance on sections 12(d)(1)(F) and 12(d)(1)(G) and to invest in other ETFs beyond the limits of section 12(d)(1)(A) in reliance on the proposed rule. However, the proposed rule would limit an acquired ETF's aggregate investment in these funds to no more than 10 percent of the acquired ETF's assets. Proposed rule 12d1-4(a)(4).

230 See supra note 197 and accompanying text.

231 Proposed rule 12d1-4(a)(3). The proposed rule would limit the sales charge (including any 12b-1 fee) or service fee charged in connection with the purchase, sale, or redemption of securities issued by the acquiring fund to the FINRA fee limits for fund of funds set forth in NASD

(footnote continued)

apply the proposed fee limits to an acquiring fund when a separate account invests in an acquiring fund? Do our disclosure requirements provide sufficient information to investors to allow them to determine whether the total fees imposed on a fund of ETFs are consistent with their investment objectives?

C. Scope of Proposed Rule 12d1-4

1. Acquiring Funds and ETFs Eligible for Relief

Proposed rule 12d1-4 would permit open-end and closed-end management companies (including business development companies)[235] and UITs[236] that comply with the rule's conditions to invest in ETFs beyond the limits of section 12(d)(1).[237] Our orders to date have provided exemptions only for investments in ETFs by registered management funds and UITs.[238]

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supra note 197, at nn.65-67 and accompanying text.

235 A business development company is any closed-end company that: (i) is organized under the laws of, and has its principal place in, any state or states; (ii) is operated for the purpose of investing in securities described in section 55(a)(1)-(3) of the Act and makes available "significant managerial assistance" to the issuers of those securities, subject to certain conditions; and (iii) has elected under section 54(a) of the Act to be subject to the sections addressing activities of business development companies under the Act. See 15 U.S.C. 80a-2(a)(48). Section 60 of the Act extends the limits of section 12(d) to a business development company to the same extent as if it were a registered closed-end fund. Section 6(f) of the Act exempts business development companies that have made the election under section 54 of the Act from registration and other provisions of the Act. We similarly included business development companies within the scope of rule 12d1-1 to allow then to invest in money market funds beyond the limits of section 12(d)(1). See Fund of Funds Adopting Release, supra note 201, at nn.44-46 and accompanying text.

236 Because an ETF can be organized either as an open-end management company or UIT, see supra note 8, it could rely on the proposed rule to invest in other ETFs beyond the limits contained in section 12(d)(1).

237 Section 12(d)(1)(B)'s limits on sales of an acquired fund's securities apply only to shares of an ETF organized as an open-end investment company.

238 We have not had the opportunity to consider a request for an individual exemptive order for other types of investment companies. Our orders also have permitted funds to invest in ETFs organized as UITs (and as open-end funds). Proposed rule 12d1-4 would include relief for investments in ETFs that are organized as UITs as long as the UITs satisfy the criteria enumerated in proposed rule 6c-11(e)(4). Proposed rule 12d1-4(d)(2). As noted above, proposed rule 6c-11 would not include a UIT within its relief because we have not received an exemptive application for a new

(footnote continued)

We do not anticipate that providing a similar exemption for business development companies would raise particular concerns that section 12(d)(1) was designed to address.

We request comment on the inclusion of business development companies within the scope of proposed rule 12d1-4. Would these entities benefit from this exemption? Are there reasons not to extend the exemption to these companies? Do any special concerns arise with respect to extending the exemption to these companies?

2. Investments in Affiliated ETFs Outside the Fund Complex

In addition to providing an exemption from section 12(d)(1) of the Act, the proposed rule would provide exemptions from sections 17(a)(1), 17(a)(2), 57(a)(1) and 57(a)(2) of the Act. These provisions restrict a fund's ability to enter into transactions with affiliated persons.[239] They are designed to prevent affiliated persons from managing the fund's assets for their own benefit, rather than for the benefit of the fund's shareholders.[240] These provisions would

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ETF to be organized as a UIT in a number of years. See supra note 65 and accompanying text.

239 Section 17 of the Act limits transactions between a fund and its affiliated persons. Section 17(a) of the Act generally prohibits affiliated persons of a registered fund ("first-tier affiliates") or affiliated persons of the fund's affiliated persons ("second-tier affiliates") from selling securities or other property to or purchasing securities or other property from the fund (or any company the fund controls). Section 57 of the Act restricts certain transactions between business development companies and certain of their affiliates. An affiliated person of a fund includes: (i) any person directly or indirectly owning, controlling, or holding with power to vote, five percent or more of the outstanding voting securities of the fund; and (ii) any person five percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote by the fund. See 15 U.S.C. 80a-2(a)(3)(A), (B). Thus, if an acquiring fund holds five percent or more of the outstanding voting shares of the ETF, the acquiring fund is an affiliated person of the ETF and the ETF is an affiliated person of the acquiring fund.

240 See Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. On Banking and Currency, 76th Cong., 3d Sess. 37 (1940) (Statement of Commissioner Healy). Section 17 also would restrict an acquiring fund from investing in an ETF that is affiliated with the acquiring fund because both funds have a common investment adviser or other person exercising a controlling influence over the management or policies of the funds. See 15 U.S.C. 80a-2(a)(3)(C). The determination of whether a fund is under the control of its adviser, officers, or directors depends on all the relevant facts and circumstances. See Investment Company Mergers, Investment Company Act Release No. 25259 (Nov. 8, 2001) [66 FR 57602 (Nov. 15, 2001)], at n.11. For purposes of this release, we presume that funds with a common

(footnote continued)

otherwise effectively preclude a fund that acquires five percent or more of the securities of an ETF in another fund complex from making any additional purchases of shares from the ETF.[241] They also would prohibit an affiliated acquiring fund from depositing (i.e., "selling") securities identified in the creation basket. Permitting an acquiring fund to purchase additional ETF shares from the ETF at NAV on the same basis as any other purchaser of a creation unit, by itself, seems to provide little opportunity for the acquiring fund to manage the ETF for its own benefit.[242] Allowing the ETF to acquire securities identified in a creation basket from an affiliated acquiring fund on the same basis as any other investor also would not seem to implicate the concerns underlying section 17(a). Accordingly, we believe that exemptions from sections 17(a)(1), 17(a)(2), 57(a)(1), and 57(a)(2) of the Act for these transactions would be appropriate,

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investment adviser are under common control because funds that are not affiliated persons would not require, and thus not rely on, the exemptions from section 17(a). Although funds in the same group of investment companies generally are under common control of an investment adviser or other person exercising a controlling interest, these funds may rely on section 12d(1)(G) of the Act to invest in an ETF in the same group. See infra note 249 and accompanying text.

241 An ETF would be prohibited under section 17(a)(1) from selling its shares to an affiliated acquiring fund and under section 17(a)(2) from purchasing securities (i.e., securities designated in the creation basket) from the affiliated acquiring fund in exchange for ETF shares. An acquiring fund would be prohibited under section 17(a)(1) from selling any securities (i.e., securities identified in the creation basket) to an affiliated ETF in exchange for the ETF's shares. An acquiring fund also would be prohibited under section 17(a)(2) from purchasing (creation basket) securities from an affiliated ETF for the redemption of ETF shares. The ETF would be prohibited under section 17(a)(1) from selling the affiliated acquiring fund (creation basket) securities in exchange for ETF shares redeemed and under section 17(a)(2) from acquiring the ETF shares submitted for redemption by the affiliated acquiring fund.

242 The exemptive orders provide similar relief from sections 17(a)(1) and 17(a)(2) of the Act, including relief to allow the acquiring fund to redeem shares of an affiliated ETF. The proposed rule would not, however, provide an acquiring fund relief from sections 17(a)(2) and 57(a)(2) of the Act in order to redeem shares in excess of the three percent limit in section 12(d)(1)(A)(i) from an affiliated ETF. In addition, proposed rule 6c-11, which would permit persons affiliated with an ETF solely because they own five percent or more of the ETF's shares, to purchase and sell ETF shares in-kind (i.e., in exchange for securities designated in the creation basket) would not extend relief to certain redemptions by acquiring funds consistent with proposed rule 12d1-4(a). See supra Section III.C.3 and proposed rule 6c-11(d). As noted above, no orders have been issued to business development companies therefore no order includes relief from sections 57(a)(1) and 57(a)(2) of the Act. See supra note 238 and accompanying text.

in the public interest, and consistent with the protection of investors and the purposes of the Act.[243]

We seek comment on these exemptions. Are there risks other than the concerns we addressed with respect to section 12(d)(1) limitations, regarding the potential that the acquiring fund could manage the ETF, that would arise from the proposed exception allowing a fund to acquire more than five percent of the shares of an affiliated ETF in another complex?

3. Use of Affiliated Broker to Effect Sales

In order to allow acquiring funds to take full advantage of the exemptive relief, proposed rule 12d1-4 also would provide limited relief from section 17(e)(2) of the Act. If an investment company in one complex acquired more than five percent of the assets of an ETF in another complex, any broker-dealer affiliated with that ETF would become a (second-tier) affiliated person of the acquiring fund.[244] As a result of the affiliation, the broker-dealer's fee for effecting the sale of securities to (or by) the acquiring fund would be subject to the conditions set forth in rule 17e-1, including the quarterly board review and recordkeeping requirements with respect to certain securities transactions involving the affiliated broker-dealer.[245] We believe that it is

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[243] Our proposal would not provide an exemption for any transactions other than the sale of securities by an acquiring fund to an affiliated ETF for a creation unit of ETF shares. The proposed rule also would not provide an exemption for any other transactions between a business development company and an affiliated ETF that would be subject to section 57 limitations.

[244] See supra notes 239-240.

[245] Section 17(e)(2) of the Act prohibits an affiliated person (or second-tier affiliate) of a fund from receiving compensation for acting as a broker, in connection with the sale of securities to or by the fund if the compensation exceeds limits prescribed by the section. Rule 17e-1 sets forth a conditional exemption under which a commission, fee or other remuneration shall be deemed as not exceeding the "usual and customary broker's commission" for purposes of section 17(e)(2)(A) of the Act. Rule 17e-1(b)(3) requires the fund's board of directors, including a majority of the directors who are not interested persons under section 2(a)(19) of the Act, to determine at least quarterly that all transactions effected in reliance on the rule have complied with procedures which are reasonably designed to provide that the brokerage compensation is consistent with the rule's standards. Rule 17e-1(d)(2) specifies the records that must be

(footnote continued)

unlikely that a broker-dealer would be in a position to take advantage of the acquiring fund merely because that fund owned a position in an ETF affiliated with the broker-dealer.[246] Accordingly, the proposed rule would permit an acquiring fund to pay commissions, fees, or other remuneration to a (second-tier) affiliated broker-dealer without complying with the quarterly board review and recordkeeping requirements set forth in rules 17e-1(b)(3) and 17e-1(d)(2).[247] This relief would be available only if the broker-dealer and the acquiring fund are affiliated solely because of the acquiring fund's investment in the ETF.

We request comment on the proposed exemptions. Is the scope of the proposed exemptions from section 17 limitations sufficiently broad to allow funds to take full advantage of the proposed relief? Are the proposed exemptions from board review and recordkeeping requirements with respect to transactions with an affiliated broker-dealer necessary? Do funds engage in these transactions with broker-dealer affiliates of acquired ETFs? Is there additional section 17 relief that would be helpful in order for acquiring funds to take full advantage of the proposed exemption for investments in ETFs? If so, please be specific regarding the transactions that would prevent funds from relying on the proposed rule.

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maintained by each fund with respect to any transaction effected pursuant to rule 17e-1.

[246] We expect that the ETF's adviser would have no influence over the decisions made by the acquiring fund's adviser. In addition, because the interests of the adviser to the ETF and the adviser to the acquiring fund are directly aligned with their respective funds, transactions between the acquiring fund and a broker-dealer affiliate of the ETF are likely to be at arm's length.

[247] Proposed rule 12d1-4(c). The proposed relief is similar to relief we have provided in rule 12d1-1, which permits funds to invest in money market funds in excess of section 12(d)(1) limits. See Fund of Funds Adopting Release, supra note 201, at nn.32-36 and accompanying text. An acquiring fund relying on this exemption would be required to comply with all of the provisions of rule 17e-1, except for those in paragraphs (b)(3) and (d)(2). It does not appear that having to comply with the other provisions contained in rule 17e-1 would deter acquiring funds from taking full advantage of the exemption provided by proposed rule 12d1-4.

V. EXEMPTION FOR AFFILIATED FUND OF FUNDS INVESTMENTS

A. Affiliated Fund of Funds Investments in ETFs

As noted above, Congress recognized that the investment limits in section 12(d)(1) might restrict certain legitimate fund of funds arrangements, and included three exceptions to those limits.[248] One of these exceptions—section 12(d)(1)(G)—permits a registered open-end investment company or UIT to invest in other registered open-end investment companies or UITs (including ETFs) that are in the "same group of investment companies" ("affiliated funds") beyond the section 12(d)(1) limits.[249] A fund that invests in unaffiliated ETFs (i.e., ETFs in other fund groups) in many cases, however, is still subject to the section 12(d)(1) limits.[250] Section

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[248] For a full discussion of section 12(d)(1) limitations and the exceptions under sections 12(d)(1)(E), 12(d)(1)(F), and 12(d)(1)(G) of the Act, see Fund of Funds Proposing Release, supra note 197, at Section I.

[249] See 15 U.S.C. 80a-12(d)(1)(G). Section 12(d)(1)(G)(ii) of the Act defines "same group of investment companies" to mean "any 2 or more registered investment companies that hold themselves out to investors as related companies for purposes of investment and investor services." Section 12(d)(1)(G) imposes the following conditions on funds relying on this exception: (i) other investments are limited to short-term paper and government securities; (ii) acquired funds must have a policy against investing in shares of other funds in reliance on sections 12(d)(1)(F) or 12(d)(1)(G) (to prevent multi-tiered structures); and (iii) overall distribution expenses are limited.

[250] A fund could invest in unaffiliated funds in reliance on two other statutory exemptions. Under section 12(d)(1)(E) an investment company may acquire securities issued by another investment company provided that (i) the acquiring fund's depositor or principal underwriter is a broker or dealer registered under the Securities Exchange Act of 1934, (or a person the broker-dealer controls), (ii) the security is the only investment security the acquiring fund holds (or the securities are the only investment securities the acquiring investment company holds if it is a registered UIT that issues two or more classes or series of securities, each of which provides for the accumulation of shares of a different investment company), and (iii) the acquiring investment company is obligated (a) to seek instructions from its shareholders with regard to voting the acquired investment company's securities or to vote the acquired investment company's shares in the same proportion as the vote of all other acquired investment company shareholders, and (b) if unregistered, to obtain Commission approval before substituting the investment security. A fund relying on section 12(d)(1)(F) of the Act (and its affiliated persons) may acquire no more than three percent of another investment company's outstanding stock, cannot charge a sales load greater than 1½ percent; is restricted in its ability to redeem shares of the acquired investment company; and must vote shares of an acquired investment company either by seeking instructions from the acquiring fund's shareholders, or voting the shares in the same proportion as the vote of

(footnote continued)

12(d)(1)(G) restricts the other investments an acquiring fund investing in affiliated funds can make to government securities and short-term paper.[251]

When it added section 12(d)(1)(G) to the Act, Congress also gave us specific authority to provide certain exemptions from the limitations of section 12(d)(1) if the exemption is consistent with the public interest and the protection of investors.[252] In conjunction with the adoption of rule 12d1-1 in 2006 (allowing funds to invest in money market funds beyond the limits of section 12(d)(1)), we adopted rule 12d1-2, which allows funds relying on section 12(d)(1)(G) also to invest in: (i) unaffiliated money market funds when the acquisition is in reliance on rule 12d1-1; (ii) securities issued by unaffiliated funds (including ETFs), subject to the investment limits in sections 12(d)(1)(A) and 12(d)(1)(F) of the Act;[253] and (iii) securities not issued by an investment company. Under rule 12d1-2, therefore, a fund that invests in affiliated funds in reliance on section 12(d)(1)(G) and desires to invest in unaffiliated ETFs is subject to these statutory limitations (e.g., to acquiring no more than three percent of the acquired ETF's shares). There seems no reason, however, to maintain the statutory limitations on investments in ETFs in these circumstances when we are proposing to permit other types of funds to invest in ETFs in excess of section 12(d)(1) limits. No special issues appear to arise in connection with an acquiring fund's investments in an unaffiliated ETF simply because the acquiring fund also invests in

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all other shareholders of the acquired investment company.

[251] Congress imposed this limitation to restrict the use of the exemption provided by section 12(d)(1)(G) to a "bona fide" fund of funds. Congress permitted other investments to include only government securities and short-term paper, which provide the fund with a source of liquidity to redeem shares. See H.R. REP. NO. 622, supra note 200, at 42.

[252] Section 12(d)(1)(J) of the Act authorizes the Commission to exempt any person, security or transaction, or any class or classes of transactions, from section 12(d)(1) of the Act if the exemption is consistent with the public interest and the protection of investors. See supra note 214.

[253] See supra note 250.

affiliated funds. Accordingly, we propose to amend rule 12d1-2 to allow acquiring funds that invest in affiliated funds in reliance on section 12(d)(1)(G) to invest in unaffiliated ETFs beyond the statutory limitations as long as the funds comply with the conditions of proposed rule 12d1-4.[254] This is similar to the relief we provided to affiliated funds of funds to allow them to acquire shares in money market funds, if the acquisition is in reliance on rule 12d1-1.[255]

We request comment on the proposed amendment. Are there reasons not to extend the proposed relief to affiliated funds of funds? Do investments by an acquiring fund that invests in affiliated funds raise any special concerns if the acquiring fund also invests in unaffiliated ETFs? Are these concerns different than any other fund's investment in unaffiliated ETFs?

B. Affiliated Fund of Funds Investments in Other Assets

We also are proposing an amendment to rule 12d1-2 that would allow funds relying on section 12(d)(1)(G) to invest in assets other than securities. As discussed above, in 2006 we adopted rule 12d1-2 to permit affiliated funds of funds to acquire securities issued by other unaffiliated investment companies, as well as "securities (other than securities issued by an investment company)."[256] The rule was intended to allow an acquiring fund greater flexibility to meet investment objectives that may not be met as well by investments in affiliated funds. We noted that these investments would not seem to present any additional concerns that section 12(d)(1)(G) was intended to address.[257]

Since we adopted the rule, it has been brought to our attention that funds relying on section 12(d)(1)(G) wish to invest in other types of financial assets, including futures and other

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254 Proposed rule 12d1-2(a)(4).

255 See 17 CFR 270.12d1-2(a)(3).

256 See 17 CFR 270.12d1-2(a)(1), 17 CFR 270.12d1-2(a)(2).

257 See Fund of Funds Proposing Release, supra note 197, at n.80 and accompanying text.

financial instruments that might not be securities under the Act and thus may not be within the scope of rule 12d1-2.[258] Investments in these types of assets may allow an acquiring fund greater flexibility to meet investment objectives that may not be met as well by investments in securities. In addition, like investments in securities, investments in these assets do not appear to raise concerns that the investment limits on fund of funds arrangements contained in section 12(d)(1) were intended to address. Accordingly, we propose to amend rule 12d1-2 to allow funds relying on section 12(d)(1)(G) to invest in assets or instruments other than securities.[259] Under the proposed rule, funds relying on the exemptive relief in section 12(d)(1)(G) would be able to invest in, among other things, real estate, futures contracts, and other financial instruments that do not qualify as a security under the Act.[260] Those investments would, of course, have to be consistent with the fund's investment policies.[261]

We seek comment on this proposal. Would any concerns arise if a fund relying on section 12(d)(1)(G) could invest directly in non-securities? Do these concerns differ from a traditional fund that can invest in such assets and invests in other funds subject to the limits of

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[258] See 15 U.S.C. 80a-2(a)(36) (defining "security"). If a future or other financial instrument in which a fund relying on section 12(d)(1)(G) proposes to invest is included within the Act's definition of "security," investments in such an instrument would be permitted under current rule 12d1-2(a)(2).

[259] Proposed rule 12d1-2(a)(5).

[260] We have issued exemptive orders to funds that rely on section 12(d)(1)(G) to allow those funds to invest in futures contracts and other financial instruments. See, e.g., Schroder Series Trust, et al., Investment Company Act Release Nos. 28133 (Jan. 24, 2008) [73 FR 5603 (Jan. 30, 2008)] (notice) and 28167 (Feb. 25, 2008) (order); The UBS Funds, et al., Investment Company Act Release Nos. 28080 (Dec. 19, 2007) [72 FR 74372 (Dec. 31, 2007)] (notice) and 28122 (Jan. 16, 2008) (order); Vanguard Star Funds, et al., Investment Company Act Release Nos. 28009 (Sept. 28, 2007) [72 FR 56813 (Oct. 4, 2007)] (notice) and 28024 (Oct. 24, 2007) (order) (permitting funds relying on section 12(d)(1)(G) and rule 12d1-2 under the Act to invest in financial instruments that may not be securities within the meaning of section 2(a)(36) of the Act).

[261] See Item 4 of Form N-1A (requiring disclosure of funds' investment objectives and principal investment strategies).

section 12(d)(1)?

VI. REQUEST FOR COMMENT

The Commission requests comment on the rules, rule amendments, and Form N-1A amendments proposed in this release. The Commission also requests suggestions for additional changes to existing rules or forms, and comments on other matters that might have an effect on the proposals contained in this release. Commenters are requested to provide empirical data to support their views.

VII. PAPERWORK REDUCTION ACT

Certain provisions of proposed rule 6c-11 would result in new "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[262] The Commission is therefore submitting this proposal 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 requirements is "Rule 6c-11 under the Investment Company Act of 1940, 'Exchange-traded funds.'" If adopted, this collection would not be mandatory, but would be necessary for ETFs that seek to form and operate as open-end management companies without seeking individual exemptive orders. Responses to the collection of information requirements of proposed rule 6c-11 would not be kept confidential.

In addition, the Commission is proposing amendments to an existing collection of information requirement titled "Form N-1A under the Investment Company Act of 1940 and Securities Act of 1933, Registration Statement for Open-End Management Companies." Compliance with the disclosure requirements of Form N–1A is mandatory. Responses to the disclosure requirements are not kept confidential.

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[262] 44 U.S.C. 3501-3520.

Finally, proposed rule 12d1-4 would result in a new "collection of information" requirement within the meaning of the PRA. The Commission is therefore submitting the proposal for rule 12d1-4 to OMB for review. The title for the collection of information requirements is "Rule 12d1-4 under the Investment Company Act of 1940, 'Exemption for investments in exchange-traded funds.'" If adopted, this collection would not be mandatory, but would be a condition that an acquiring fund would have to satisfy in order for an ETF, its principal underwriter, a broker, or a dealer to rely on the safe harbor if an acquiring fund redeems ETF shares. Responses to the collection of information requirements of proposed rule 12d1-4 would not be kept confidential.

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. OMB has not yet assigned control numbers to the new collections for proposed rules 6c-11 and 12d1-4. The approved collection of information associated with Form N-1A, which would be revised by the proposed amendments, displays control number 3235-0307.

A. Proposed Rule 6c-11

Proposed rule 6c-11 would exempt ETFs from certain provisions of the Act, permitting them to begin operating without obtaining an exemptive order from the Commission. The proposed rule also would expand the relief we have issued in the past to index-based ETFs, and to transparent, actively managed ETFs. Each ETF seeking to rely on the proposed rule would have to disclose on a daily basis specific information to market participants: (i) the contents of its basket assets; (ii) the identities and weightings of the component securities and other assets in its portfolio if it does not track an index whose provider discloses its composition daily; and (iii) the prior business day's NAV, market closing price for its ETF shares and premium/discount

information.[263] In addition, each ETF would have to disclose in its registration statement: (i) the number of shares that comprise a creation unit; and (ii) the foreign holidays that would prevent timely satisfaction of redemption with respect to foreign securities in its basket assets.[264] An ETF that chooses not to disclose its portfolio would have to track an index whose provider discloses the identities and weightings of the securities and other assets that constitute the index in order to rely on the proposed rule. In addition, each ETF seeking to rely on the proposed rule also would have to, in any sales literature (as defined in the rule), identify itself as an ETF, which does not sell or redeem individual shares, and explain that investors may purchase or sell individual shares on national securities exchanges..

Two of the disclosure conditions in proposed rule 6c-11 would not result in a burden for purposes of the PRA. Disclosure of the contents of the basket assets that comprise a creation unit and the number of shares in each creation unit does not result in a burden because ETFs must disclose this information in the normal course of business.[265] Similarly, disclosure by an index provider of the identities and weightings of the component securities and other assets that comprise the index would not result in a burden because index providers disclose this information in the normal course of business.

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[263] Proposed rule 6c-11.

[264] Id.

[265] See Section II of this release for a discussion on the operation of ETFs. Disclosure of the contents of the basket assets and the number of shares that comprise a creation unit are critical to investors who seek to purchase or redeem creation units from the ETF and, therefore, to the operation of an ETF. To purchase a creation unit, an investor would need to know the securities and other assets that must be deposited with the ETF in exchange for a creation unit. To redeem a creation unit, an investor would need to know the number of ETF shares that comprise a creation unit in order to compile enough shares to redeem from the ETF. Disclosure of the contents of the basket assets also is important to the arbitrage mechanism of the ETF. Arbitrageurs compare the NAV of the basket to the NAV of ETF shares to determine whether to purchase or redeem creation units based on the relative values of ETF shares in the secondary market and the securities contained in the basket.

The remaining four disclosure requirements are collections of information. First, the proposed rule would require an ETF that does not track an index whose provider discloses its composition daily to provide daily disclosure of the identities and weightings of the component securities and other assets in the ETF's portfolio. Currently, two ETF registrants are required to disclose their portfolios daily under the terms of their exemptive orders.[266] The Commission staff estimates that an ETF each year would spend approximately 200 hours of professional time to update the relevant Internet Web page daily with this information, at a cost of $42,000.[267] The staff also estimates that each new ETF initially would spend 100 hours to develop the Web page for this disclosure. Staff estimates the initial cost would be $22,520 for internal ETF staff time to develop the Web page and $12,600 for an external Web site developer, for a total of $35,120.[268]

We seek comments on these estimates. If commenters believe these estimates are not reasonable, we request they provide data that would allow us to make more accurate estimates.

Second, the proposed rule also would require each ETF to disclose its prior business

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[266] ProShares Notice, supra note 113; Rydex ETF Trust, Investment Company Act Release No. 27703 (Feb. 20, 2007) [72 FR 8810 (Feb. 27, 2007)]. Together, these registrants offer 64 ETFs that are required to disclose their portfolios daily.

[267] Estimates on the number of burden hours and external costs associated with the collections of information are based on informal conversations between Commission staff and representatives of ETFs. The staff estimates the cost would be 200 hours for an internal Web site developer (at $211 per hour) (200 x $211 = $42,200). Hourly wages used for purposes of this PRA analysis are from the Securities Industry Association (now named Securities Industry and Financial Markets Association), SIA Report on Management & Professional Earnings in the Securities Industry 2006, modified to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

[268] Commission staff estimates the cost would equal 80 hours for Web site developers at the ETF (at $211 per hour) to develop the Web page and 20 hours for internal Web site managers (at $282 per hour) to review the Web page ((80 hours x $211) + (20 hours time x $282) = $22,520). In addition, based on discussions with industry representatives, the staff estimates that each ETF initially would spend an additional $12,600 to external Web site developers ($22,520 + 12,600 = $35,120).

day's NAV, market price for its shares, and premium/discount information, which would provide investors with information on the deviation, if any, between the price of ETF shares and the NAV of the underlying portfolio. Commission staff estimates that an ETF each year spends approximately 206 hours of professional time to update the relevant Internet Web page daily with this information. Based on staff estimates, we estimate the annual cost would be $43,466 for internal ETF staff time to update the Web page and $6,000 to acquire the data from external data providers.[269] The staff also estimates that each new ETF initially would spend 75 hours to develop the Web page for these disclosures. Based on staff estimates, we estimate the initial cost would be $16,890 for internal ETF staff time to develop the Web page and $9540 for an external Web site developer, for a total of $26,430.[270]

We seek comments on these estimates. If commenters believe these estimates are not reasonable, we request they provide data that would allow us to make more accurate estimates.

Third, in any sales literature each ETF must identify itself as an ETF that does not sell or redeem individual shares, and explain that investors may purchase or sell individual shares only on national securities exchanges. This condition is similar to the condition in our exemptive orders, which requires each ETF to agree not to market or advertise the ETF as an open-end fund or mutual fund and to explain that the ETF shares are not individually redeemable. Based on conversations with ETF representatives, Commission staff estimates that an ETF each year spends approximately 30 hours at a cost of $1704 to comply with the condition in our exemptive

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269 Commission staff estimates the cost would equal 206 hours for internal Web site developers at ($211 per hour) (206 x $211 = $43,466).

270 Commission staff estimates the cost would equal 60 hours for internal Web site developers (at $211 per hour) to develop the Web page and 15 hours for Web site managers (at $282 per hour) to review the Web page ((60 hours x $211) + (15 hours x $282) = $16,890). In addition, based on discussions with industry representatives, the staff estimates that each fund would spend an additional $9540 to external Web site developers ($16,890 + $9540 = $26,430).

orders.[271] Because the condition in the proposed rule is similar, the staff estimates that each new ETF also would spend 30 hours at a cost of $1704 to comply with the condition in the proposed rule.

We seek comment on this estimate. If commenters believe this estimate is not reasonable, we request they provide data that would allow us to make a more accurate estimate.

Finally, some ETFs that track foreign indexes have stated that local market delivery cycles for transferring foreign securities to redeeming investors, together with local market holiday schedules, require a delivery process in excess of the statutory seven days required by section 22(e) of the Act. The proposed rule would codify the disclosure requirement in existing exemptive orders that requires ETFs to disclose in their registration statements the foreign holidays that would prevent timely satisfaction of redemption.[272] The collection of information burden for this disclosure is discussed in the PRA analysis of proposed Form N-1A amendments in Section VI.B below.

As of December 2007, there were 601 ETFs.[273] The Commission staff estimates that each year 150 new ETFs will form and operate.[274] The staff estimates that each ETF each year would spend approximately 236 hours to comply with the conditions of proposed rule 6c-11. Each new ETF would spend an additional 75 hours to develop the Web sites for daily disclosure of its prior

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271 Commission staff estimates the cost would equal 2 hours for the ETF's internal counsel (at $292 per hour) to draft the disclosure and 28 hours for clerical staff (at $40 per hour) to input and copy check the marketing materials ((2 x $292) + (28 x $40) = $1704).

272 See supra notes 136-141 and accompanying text for a discussion of the proposed exemption from section 22(e) of the Act.

273 ICI ETF Statistics 2007, supra note 5.

274 To estimate the number of new ETFs each year for purposes of this PRA, the staff has used the approximate average of the number of new ETFs for the past three years ((50 + 153 + 244)/3 =149). ICI, Exchange-Traded Fund Assets December 2006, Jan. 31, 2007; ICI ETF Statistics 2007, supra note 5.

business day's NAV, market closing price for its shares, and premium/discount information. In addition, ETFs that provide the identities and weightings of the securities and other assets in their portfolios if they do not track an index whose provider discloses its composition daily would spend an additional 100 hours to develop the Web sites for this disclosure. Each of those ETFs also would spend an estimated 200 hours each year to update the disclosures of portfolio assets on its Web site. For purposes of this PRA, the staff estimates that one-half of all new ETFs (75 ETFs) would provide this disclosure. Based on staff estimates, we estimate that ETFs would, in the aggregate, spend 205,036 hours each year to comply with the requirements of proposed rule 6c-11.[275] We estimate further that ETFs would spend 18,750 hours initially to develop the Web page for these disclosures, amortized over three years for an annual burden of 6250 hours.[276] Thus, the estimated total annual burden is 211,286 hours.[277] We estimate the annual internal costs of ongoing compliance with these disclosure requirements would be $40 million and external costs would be $4.5 million.[278] We further estimate that initial internal costs to develop the Web page for these disclosures would be $4.2 million and external costs would be $2.3 million, or $1.4 million and $0.8 million, respectively, amortized over three years.[279]

B. Form N-1A

We are proposing amendments to Form N-1A to provide more useful information to

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275 Assuming all existing ETFs would rely on the proposed rule, these estimates are based on the following calculations: ((206 hours + 30) x 612 (existing plus estimated new index-based ETFs)) + (436 hours x 139 (existing plus estimated new actively managed ETFs) = 205,036).

276 This estimate is based on the following calculation: (75 hours x 75 (estimated new index-based ETFs)) + (175 hours x 75 (estimated new actively managed ETFs)) = 18,750.

277 This estimate is based on the following calculation: 205,036+ 6250 = 211,286.

278 These estimates are based on the following calculations: (($43,466 + $1704) x 612) + ($42,000 x 139) = $39,760,670; ($6000 x 612) + ($6000 x 139) = $4,506,000.

279 These estimates are based on the following calculations: ($16,890 x 75) + (($16,890 + $22,520) x 75) = $4,222,500; ($9540 x 75) + (($9540 + $12,600) x 75) = $2,376,000.

investors who purchase and sell ETF shares on national securities exchanges.

Creation Units. The proposed amendments would permit an ETF to exclude certain information from its prospectus that is not pertinent to investors purchasing individual ETF shares. Specifically, an ETF that has creation units of 25,000 shares or more may exclude from its prospectus: (i) information on how to purchase and redeem shares of the ETF;[280] and (ii) fee table fees and expenses for purchases and redemptions of creation units.[281] Based on conversations with industry representatives, Commission staff estimates that this proposed amendment would decrease the information collection burdens of an ETF that has creation units of 25,000 shares or more by an average of 1.4 hours per fund per filing of an initial registration statement or post-effective amendment to a registration statement.

The proposed amendment also would require disclosures designed to include important information for purchasers of individual ETF shares, as described below. An ETF would have to modify the narrative explanation preceding the example in the fee table in its prospectus and periodic reports to state that fund shares are sold on the secondary market rather than redeemed at the end of the periods indicated, and that investors in ETF shares may be required to pay brokerage commissions that are not reflected in the fee table.[282] We believe that the added information collection burdens associated with this statement, if any, would be negligible.

We request comment on these estimates. If commenters believe these estimates are not reasonable, we request they provide data that would allow us to make more accurate estimates.

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[280] Proposed Item 6(h)(1) of Form N-1A.

[281] Proposed Instruction 1(e)(i) to Item 3 of Form N-1A.

[282] Proposed Instruction 1(e)(ii) to Item 3 of Form N-1A; Proposed Instruction 1(e)(ii) to Item 22(d) of Form N-1A. The proposal also would require each ETF to identify the principal U.S. market on which its shares are traded and include a statement to the effect that ETF shares are bought and sold on national securities exchanges. We believe that the added information collection burdens associated with these very brief and specific statements, if any, would be negligible.

Total Returns. The proposed amendments would require each ETF to include a separate line item for returns based on the market price of ETF shares in the average annual total returns table in Item 2 of the Form.[283] This would codify, with modifications, a condition in ETF exemptive orders. The amendments also would require ETFs to calculate total return at market prices in addition to returns at NAV for their financial highlights tables.[284] One consequence of this proposed amendment is that ETFs would be required to include two bar charts under Item 2 of Form N-1A; one using market price returns and one using NAV returns.[285] We do not believe these added disclosures would increase the hourly burdens of ETFs. ETFs are currently required by our orders to calculate and present market price returns in the prospectus and, therefore, this disclosure would not present a new substantive requirement. The proposal would eliminate industry practice of including this disclosure in a supplemental section rather than the main body of the prospectus and, therefore, would integrate the disclosure within current Form N-1A requirements.[286] Staff estimates that the time it takes to prepare the new line items and the additional bar chart would be the same as the amount of time ETFs currently spend preparing the market price return disclosure that is included in the supplemental section. Based on discussions with industry representatives, the staff estimates that each ETF currently spends approximately 0.6 hours of professional time to prepare the market price returns disclosure required by our exemptive orders.

We request comment on this estimate. If commenters believe the estimate is not reasonable, we request they provide specific data that would allow us to make a more accurate

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283 Proposed Instruction 5(a) to Item 2(c)(2) of Form N 1A.

284 Proposed Instruction 3(f) to Item 8(a) of Form N-1A.

285 See Item 2(c)(2)(i) of Form N 1A.

286 See supra note 163.

estimate.

Premium/Discount Information. The amendments also would require ETFs to include premium/discount information in both the prospectus and annual report of each ETF. This proposed amendment codifies an existing exemptive order requirement. Based on discussions with industry representatives, the staff estimates that each ETF currently spends an average of 0.5 hours per filing of an initial registration statement or a post-effective amendment to a registration statement to include this disclosure.[287] The staff further estimates that each ETF also would spend 0.5 hours per annual report to include this disclosure.

We request comment on this estimate. If commenters believe the estimate is not reasonable, we request they provide specific data that would allow us to make a more accurate estimate.

Foreign Holidays. As noted above, proposed rule 6c-11 would require certain ETFs to disclose in their registration statements the foreign holidays that would prevent timely satisfaction of redemption. As of July 2007, there were 125 ETFs that provide exposure to international equity markets. Based on discussions with ETF representatives, the staff estimates that approximately 10% of these ETFs may need to delay satisfaction of redemption requests, and that each of those ETFs would spend approximately 0.3 hours to include the required information in its registration statement.

We request comment on these estimates. If commenters believe these estimates are not reasonable, we request they provide specific data that would allow us to make more accurate estimates.

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[287] This estimate is based on discussions with representatives of ETFs, which include premium/discount information as required by their exemptive orders.

The current burden for preparing an initial Form N-1A filing is 830.47 hours per portfolio. The current burden for preparing a post-effective amendment on Form N-1A is 111 hours per portfolio. The total annual hour burden approved for Form N-1A is 1,575,184. Based on Commission filings, Commission staff estimates that on an annual basis, ETFs file initial registration statements covering 98 ETF portfolios, and post-effective amendments covering 1441 ETF portfolios on Form N-1A. Based on staff estimates, we estimate that the proposed amendments would not increase the hour burden per ETF per filing on an initial registration or post-effective amendment to a registration statement.[288] Therefore, if the proposed amendments to Form N-1A were adopted, we estimate that the total annual hour burden for all ETFs for preparation and filing of initial registration statements would remain the same.

We request comment on these estimates. If commenters believe these estimates are not reasonable, we request they provide specific data that would allow us to make more accurate estimates.

C. Proposed Rule 12d1-4

Proposed rule 12d1-4 would permit an acquiring fund to acquire ETF shares in excess of the limits of section 12(d)(1) of the Act, subject to certain conditions.[289] In order to rely on the proposed rule for an exemption from section 12(d)(1)(B) limits, an ETF may not redeem and its principal underwriter, a broker, or dealer may not submit for redemption any of the ETF's shares that were acquired by an acquiring fund in excess of the limits of section 12(d)(1)(A)(i) of the

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[288] The proposed amendments would add approximately 1.4 hours (0.6 hours (total returns), 0.5 hours (premium/discount information), and 0.3 hours (foreign holidays)), which staff estimates would be offset by approximately 1.4 hours (elimination of description of creation units and associated fees).

[289] See discussion in Section IV.A – B supra.

Act in reliance on proposed rule 12d1-4.[290] The proposed rule provides a safe harbor for these entities if the entity has (i) received a representation from the acquiring fund that none of the ETF shares it is redeeming was acquired in excess of the limits of section 12(d)(1)(A)(i) in reliance on the rule, and (ii) no reason to believe that the acquiring fund is redeeming any ETF shares that the acquiring fund acquired in excess of the limits of section 12(d)(1)(A)(i) in reliance on the rule.[291] The representation required for the safe harbor would be a collection of information for purposes of the PRA.

Our understanding is that acquiring funds that invest in ETFs generally do not redeem their shares from the ETF, but rather sell them in secondary market transactions. We also believe that an acquiring fund that would not rely on proposed rule 12d1-4 to acquire ETF shares (i.e., an acquiring fund that acquires 3 percent or less of an ETF's outstanding voting securities) would be less likely to redeem shares because it would be less likely to have a sufficient number of shares to permit the acquiring fund to redeem its shares.[292] We estimate that ETFs, their principal underwriters, and brokers and dealers in the aggregate would choose to rely on the safe harbor to redeem or submit a redemption order with respect to ETF shares that were not acquired in reliance on proposed rule 12d1-4 on average two times each year with respect to each ETF.[293]

We request comment on this estimate. If commenters believe this estimate is not reasonable, we request they provide specific data that would allow us to make a more accurate

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290 See proposed rule 12d1-4(b)(1).

291 See proposed rule 12d1-4(b)(2).

292 ETF shares are redeemed only in creation unit aggregations. A creation unit typically consists of at least 25,000 shares. See supra note 113.

293 We recognize that some ETFs may receive more redemption requests from acquiring funds and may rely on the safe harbor more often, while other ETFs may receive no redemption requests or may not choose to rely on the safe harbor when they receive a redemption request from an acquiring fund.

estimate.

There were 601 ETFs as of the end of December 2007.[294] Based on our estimate, two acquiring funds each year would provide a representation to an ETF, its principal underwriter, a broker, or a dealer with respect to each ETF, for a total of 1202 representations. We estimate that each representation would take, on average no more than 0.2 hours to prepare and submit to the ETF, principal underwriter, broker, or dealer.[295] Accordingly, we believe that the total annual collection of information burden for proposed rule 12d1-4 would be 240 hours at a cost of $70,080.[296]

We request comment on these estimates. If commenters believe these estimates are not reasonable, we request they provide specific data that would allow us to make more accurate estimates.

D. Request for Comments

We request comment on whether these estimates are reasonable. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments in order to: (i) evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility; (ii) evaluate the accuracy of the Commission's estimate of the burden of the proposed collections of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the

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294 ICI ETF Assets 2007, supra note 5.

295 The proposed rule does not specify language that must appear in the representation. It simply requires the acquiring fund to represent that the shares submitted for redemption are not shares acquired in excess of the limits of section 12(d)(1)(A)(i) of the Act in reliance on proposed rule 12d1-4. Accordingly, we expect that while initial representations might take half an hour to draft, these representations would soon conform to an industry standard that would take no more than a few minutes to produce.

296 These estimates are based on the following calculations: 1202 representations x 0.2 hours = 240.4 hours; 240 hours x $292 (hourly rate for a fund attorney) = $70,080.

information to be collected; and (iv) minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements of the proposed amendments should direct them to the Office of Management and Budget, Attention Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 10102, New Executive Office Building, Washington, DC 20503, and should send a copy to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090, with reference to File No. S7-07-08. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this Release; therefore a comment to OMB is best assured of having its full effect if OMB receives it within 30 days after publication of this Release. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-07-08, and be submitted to the Securities and Exchange Commission, Public Reference Room, 100 F Street, NE, Washington, DC 20549-1520.

VIII. COST-BENEFIT ANALYSIS

The Commission is sensitive to the costs and benefits imposed by its rules. As discussed above, the proposed rules and rule amendments would permit funds to engage in activities and transactions that are otherwise prohibited under the Act without the expense and delay of obtaining an individual exemptive order. Specifically, proposed rule 6c-11 would permit ETFs to form and operate. Proposed rule 12d1-4 would permit a fund to invest in ETFs beyond the limits of section 12(d)(1) of the Act, and proposed amendments to rule 12d1-2 would expand the investment options available to funds that rely on the exemptive relief in section 12(d)(1)(G) of the Act. The proposed amendments to Form N-1A are designed to provide more useful

information to investors who purchase and sell ETF shares on national securities exchanges, while simplifying the form by permitting most, if not all, ETFs to exclude information related to the purchase and redemption of creation units.[297] This cost-benefit analysis examines the costs and benefits to ETFs, acquiring funds, and investors that would result from reliance on the proposed exemptive rules and rule and form amendments, in comparison to the costs and benefits associated with obtaining an exemptive order from the Commission.

A. Rule 6c-11

1. Benefits

Proposed rule 6c-11 would codify much of the relief and conditions of exemptive orders that we have issued to ETFs in the past.[298] Proposed rule 6c-11 would require an ETF that relies on the proposed rule either to (i) disclose on its Internet Web site each business day the identities and weightings of the component securities and other assets held by the fund, or (ii) have a stated objective of obtaining results that correspond to the returns of a securities index whose index provider discloses on its Internet Web site the identities and weightings of the component securities and other assets of the index.[299] An ETF that meets one of these requirements could redeem shares in creation unit aggregations, have its shares traded at current market prices, engage in in-kind transactions with certain affiliates, and in certain circumstances, redeem shares in more than seven days.[300]

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[297] As noted above, information on how creation units are offered to the public is required to be disclosed in the SAI. Item 18(a) of Form N-1A.

[298] The proposed rule does not codify exemptions previously provided to ETFs organized as UITs because the Commission has not received an exemptive application for a new ETF to be organized as a UIT since 2002. See discussion in Section III.A.3 of this release.

[299] Proposed rule 6c-11(e)(4)(v); see also discussion in Section III.B.1 of this release for a discussion of these conditions.

[300] Proposed rule 6c-11(a)-(d); see also discussion in Section III.C. of this release.

Elimination of Exemptive Order Costs. We anticipate that ETFs, their sponsors, and ETF investors would benefit from the proposed rule. ETFs and their sponsors increasingly have sought exemptive orders (which the Commission has granted) to form and operate as open-end management companies under the Act. The application process involved in obtaining exemptive orders imposes direct costs on ETFs and their sponsors, including preparation and revision of an application, as well as consultations with Commission staff. The proposed rule would benefit ETFs and their sponsors by eliminating the direct costs of applying to the Commission for an exemptive order to form and operate as permitted under the rule.[301] The rule would further benefit ETFs and their sponsors by eliminating the uncertainty that a particular applicant might not obtain relief to form and operate as permitted under the rule. We anticipate that the elimination of the direct costs of exemptive applications also may benefit ETF investors by enabling ETFs to lower their costs as a result of lower start-up costs.

We seek comment on whether the elimination of these direct costs would result in additional benefits to ETFs or their investors. Are there other costs of the proposed rule that would offset any cost savings resulting from not having to file an exemptive application?

The exemptive application process also involves other indirect costs. ETFs and their sponsors that apply for an order forgo potential market opportunities until they receive the order, while others forgo the market opportunity entirely rather than seek an exemptive order because they have concluded that the cost of seeking an exemptive order would exceed the anticipated benefit of the market opportunity.[302] These direct and indirect costs currently may prevent

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301 The cost to an ETF for submitting an application ranges from approximately $75,000 to $350,000. These figures are based on conversations with attorneys and ETF employees who have been involved in submitting applications to the Commission.

302 The time involved in obtaining an order from the Commission ranges from several months to several years depending on the nature, complexity, and de novo consideration of the exemptions

(footnote continued)

smaller ETFs and their sponsors from coming to market because they have determined that the cost of an exemptive application may exceed the potential benefit. Eliminating these costs may allow more ETFs, particularly smaller ETFs, to come to market.

We seek comment this analysis. Would removing the regulatory burdens facilitate greater innovation in the ETF market place, particularly with respect to smaller ETFs?

Increased Investment Options. We expect that the proposed rule also would benefit ETF investors to the extent it would remove a possible disincentive for some ETFs and their sponsors to form and operate as open-end funds and provide investors with additional investment choices. As noted above, the direct and indirect costs of the exemptive application process may discourage potential sponsors, particularly smaller sponsors interested in offering smaller, more narrowly focused ETFs which may serve the particular investment needs of certain investors. By eliminating the need for individual exemptive relief, we anticipate that the proposed rule would, over time, lead to an increase in ETFs. In those circumstances, the proposed rule would provide ETF investors with greater investment choices, while also providing them with the protections afforded by the Investment Company Act.

We seek comment on this analysis. Would the proposed rule result in increased investment options?

Elimination of Certain Exemptive Order Terms. Proposed rule 6c-11 also may benefit ETFs and their sponsors by eliminating certain terms contained in exemptive orders that we believe may be addressed by other provisions of the federal securities laws. We propose to eliminate the terms designed to prevent the communication of material non-public information between the ETF and its affiliated index provider because we believe that there are sufficient

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sought.

requirements under federal securities laws and the rules of national securities exchanges to protect against the abuses the terms were intended to address.[303] We anticipate that eliminating these regulatory burdens may reduce costs of operating an ETF and thereby facilitate greater competition and innovation among ETFs.

We request comment on this analysis. Are there any costs associated with eliminating these terms?

2. Costs

We do not expect the proposed rule would impose mandatory costs on any ETF. As discussed above, the proposed rule is exemptive, and we expect that a fund would not operate as an ETF in reliance on the rule if the anticipated benefits did not justify the costs. We expect the costs of relying on the proposed rule are likely to be the same as or less than the costs to an ETF that relies on an existing exemptive order because the proposed rule includes the same or fewer conditions than existing orders that provide equivalent exemptive relief.

The proposed rule would affect different types of ETFs and their sponsors in different ways. A sponsor or adviser that has not sought and would not seek exemptive relief to form and operate an ETF registered under the Act would not be affected by the rule. For an ETF and its sponsor that currently rely on an exemptive order, there may be one-time "learning costs" in determining the differences between the order and rule. After making this determination, we expect that the costs for this ETF would be the same as or less than the costs of relying on its exemptive order because the rule contains the same or fewer conditions than existing orders. In addition, an ETF and its sponsor that currently rely on an exemptive order could generally satisfy all the conditions of the rule that provide similar exemptive relief without changing its operation.

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[303] See Section III.B.4 of this release for a discussion of this condition.

Finally, a sponsor that has not relied on an exemptive order and that intends to rely on the proposed rule would bear the same or lower continuing costs of complying with conditions that it would have borne had it obtained an exemptive order. In that case, its total costs are likely to have been the same as or greater than the costs associated with the proposed rule.

We request comment on this analysis. Would ETFs that currently rely on an order bear lower costs if they relied on the proposed rule? Would an ETF have to change its operation in any way to comply with the proposed rule?

Prospectus Delivery. The proposed rule does not provide an exemption from prospectus delivery that most ETFs and their sponsors have requested and we have provided in our orders. Most of our orders have exempted broker-dealers selling ETF shares from the obligation to deliver prospectuses in most secondary market transactions.[304] Those applicants have represented that broker-dealers would instead deliver a "product description" containing basic information about the ETF and its shares.[305] Because proposed rule 6c-11 would not contain a similar exemption, broker-dealers would be required to deliver a prospectus meeting the requirements of section 10 of the Securities Act to investors purchasing ETF shares.[306] We

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[304] The orders have granted exemptions from section 24(d) of the Act, which makes inapplicable the dealer exception in section 4(3) of the Securities Act to transactions in redeemable securities issued by an open-end investment company. 15 U.S.C. 80a-24(d); 15 U.S.C. 77d(3); see, e.g., WisdomTree Order, supra note 12. ETFs that have this exemption, however continue to be subject to prospectus delivery requirements in connection with sales of creation units and other non-secondary market transactions. Our most recent orders, however, do not provide an exemption from prospectus delivery requirements. See Actively Managed ETF Orders, supra note 20.

[305] See, e.g., Ziegler Notice, supra note 110. The product description provides a summary of the salient features of the ETF and its shares, including the investment objectives of the fund, the manner in which ETF shares trade on the secondary market, and the manner in which creation units are purchased and redeemed. National securities exchanges on which ETFs are listed have adopted rules requiring the delivery of product descriptions. See, e.g., American Stock Exchange Rules 1000 and 1000A.

[306] 15 U.S.C. 77j. We also are proposing to amend our orders to exclude the section 24(d)

(footnote continued)

believe an exemption allowing broker dealers to deliver product descriptions would be unnecessary given our proposal regarding summary prospectus disclosure. If we adopt the Enhanced Disclosure Proposing Release, broker-dealers selling ETF shares could deliver a summary prospectus in secondary market transactions.[307] Although there may be costs associated with printing and delivering prospectuses to secondary market purchasers, we expect these costs to be minimal. We understand that many, if not most, broker-dealers selling ETF shares in secondary market transactions, in fact, transmit a prospectus to purchasers, and thus they may not have relied on the exemptions provided in the orders. In addition, we anticipate these costs could be offset by the fact that the ETFs would not have to prepare product descriptions and by the simplified prospectus disclosure in this proposal.[308]

We anticipate that any cost associated with this requirement may be justified by the benefits to ETF investors. Prospectuses provide ETF investors with standardized information about an investment in an ETF and the differences between an ETF and a traditional mutual fund. Because prospectuses are standardized forms the content of which has been prescribed by the Commission, their delivery could promote greater uniformity in the content and level of disclosure among existing and future ETFs. Finally, our proposed amendments to the prospectus should provide more useful information to investors who purchase and sell ETF shares on a national securities exchange, while simplifying prospectuses by permitting ETFs to exclude

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exemption we have issued to existing ETFs. Accordingly, the prospectus delivery requirement would apply to all ETFs, including ETFs operating under current exemptive orders. See supra Section III.E for a discussion of this proposed amendment to existing orders.

[307] See supra notes 145-152 and accompanying text. The summary prospectus would contain material information that may not appear in a product description, but like a product description, would be in a form that would be easy to use and readily accessible.

[308] The preparation of a product description can cost approximately $360 to $11,000 per ETF. These figures are based on conversations with attorneys and ETF employees.

information related to the purchase and redemption of creation units.

We request comment on this analysis. Are we correct in assuming that prospectus delivery costs would be offset by the elimination of product descriptions?

Conditions. All ETFs seeking to rely on the rule would have to be listed on an exchange that disseminates the per share NAV of the ETFs' baskets at regular intervals. This condition was included in our exemptive orders and, therefore, should not result in an increased cost to existing ETFs. Each ETF also must, in any sales literature (as defined in the rule), identify itself as an ETF, which does not sell or redeem individual shares, and explain that investors may purchase or sell individual shares on national securities exchanges. This condition is similar to one included in our exemptive orders and, therefore, should not result in an increased cost to existing ETFs. In addition, the ETF would be required either to (i) disclose on its Internet Web site each business day the identities and weightings of the component securities and other assets held by the fund, or (ii) have a stated objective of obtaining results that correspond to the returns of a securities index whose index provider discloses on its Internet Web site the identities and weightings of the component securities and other assets of the index.[309] Index-based ETFs comply with the latter requirement and, therefore, this condition should not result in an increased cost to ETFs that would track a transparent index. ETFs that choose to rely on the former condition, including the actively managed ETFs subject to the recent exemptive orders we issued, would incur costs in connection with developing a Web page for this disclosure and updating the disclosure daily.[310] We expect these costs to be of the same magnitude as the costs

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309 Proposed rule 6c-11(e)(4)(iv).

310 For purposes of the Paperwork Reduction Act, the staff estimated that each ETF would spend approximately $22,520 to develop the Web site. The staff also estimates that each ETF would spend 200 hours annually to update the site daily. See supra notes 267-268 and accompanying text.

borne by index providers in making their indexes transparent. Although this may be a reallocation of costs from index providers to those ETFs that choose to fully disclose their portfolios, we do not believe that this change would significantly affect the costs borne by ETF investors. The new disclosure costs for ETFs that choose to disclose their portfolios rather than track a transparent index would be offset by the lack of index licensing fees that are generally charged to index-based ETFs.

We request comment on whether investors in an actively managed ETF would incur any additional costs as a result of the portfolio disclosure. We also request comment on our analysis.

B. Amendments to Form N-1A

1. Benefits

As discussed above, most of our orders have exempted broker-dealers selling ETF shares from the obligation to deliver prospectuses in secondary market transactions. Applicants for those orders have represented that they would instead require that broker-dealers deliver a product description containing basic information about the ETF and its shares. We are not including a similar exemption in proposed rule 6c-11, and thus a broker-dealer would be required to deliver a prospectus meeting the requirements of section 10 of the Securities Act to investors purchasing ETF shares. In light of this requirement, we also are proposing amendments to Form N-1A, and the summary prospectus, designed to meet the needs of investors (including retail investors) who purchase shares in the secondary market rather than institutional investors purchasing creation units from the ETF.

Material Information to ETF Investors. We expect that the primary benefit of our proposed amendments would be to provide ETF investors purchasing shares in the secondary market with information on the investment that currently is not included in product descriptions,

such as the fund's fee table and the name and length of service of the portfolio manager. This should provide ETF investors with information necessary to understand an investment in an ETF. This information also may be helpful to investors in making portfolio allocation decisions.

Simplified Disclosure. Our proposed amendments are designed to simplify prospectus and periodic report disclosure in two ways. First, the proposal would allow ETFs to exclude from the prospectus information on how to purchase and redeem creation units, including information on fees and expenses associated with creation unit sales or purchases. Current ETF prospectuses and periodic reports include detailed information on how to purchase and redeem creation units. The fee table and example include information on transaction fees payable only by creation unit purchasers. Our proposed amendments would permit ETFs with creation units of at least 25,000 shares to exclude this information because it is not relevant (and potentially confusing) to investors purchasing in secondary market transactions.[311] This proposed provision should simplify ETF prospectuses without compromising the disclosure provided to investors who purchase ETF shares in secondary market transactions.

Second, the proposed amendment would incorporate current disclosure requirements mandated by our exemptive orders into the prospectus instead of in a supplemental section where ETFs currently locate it. Our exemptive orders require ETFs to include in their prospectuses and annual reports returns based on market price in addition to returns based on NAV, which as discussed above, may be different than the fund's NAV and better relate to an ETF investor's experience in the fund.[312] The condition in our exemptive orders did not specify where this information must be located in the prospectus. As a result, ETFs have included an additional

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311 See supra notes 158-161 and accompanying text for a discussion of this proposed amendment.

312 See supra notes 163-165 and accompanying text for a discussion of this proposed amendment.

table in the prospectus, rather than including market price returns in the average annual returns table required by Item 2 of the Form. The lack of specificity also resulted in ETFs using different time periods for the disclosure, with some using calendar years and others fiscal years. The proposed amendment would eliminate use of a second table, which may confuse investors. It also would require all ETFs to present the information using calendar years, standardizing the reporting period used by ETFs. The proposed amendments would mandate uniform disclosure in the prospectus, which should benefit investors by allowing them to compare ETFs more easily.

Similarly, our exemptive orders required ETFs to include in their prospectuses and annual reports premium/discount information to alert investors of the extent and frequency with which market prices deviated from the fund's NAV.[313] ETFs have generally included this information in a supplemental section of the prospectus and annual report.[314] The proposed amendments would incorporate this disclosure in the Shareholder Information section (Item 6 of Form N-1A) of the prospectus and the Management's Discussion of Fund Performance (Item 22(b)(7) of the annual report). We anticipate that this would benefit ETF investors by simplifying the prospectuses and annual reports of ETFs while codifying important disclosures mandated by our exemptive orders.

2. Costs

The primary goal of our proposed amendments is to provide investors in ETF shares with more valuable information regarding an investment in an ETF. We do not expect that the proposed amendments would result in significant additional costs to ETFs.[315] As noted above,

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313 See supra notes 166-170 and accompanying text for a discussion of this proposed amendment.

314 See e.g., iShares MSCI Series, Prospectus 62-65 (Jan. 1, 2007); iShares MSCI Series, 2006 Shareholders Annual Report 130-136 (Aug. 31, 2006).

315 Existing ETFs would face a one-time "learning cost" to determine the difference between the (footnote continued)

our proposed disclosure amendments generally would codify disclosure requirements in existing ETF exemptive orders. To the extent the proposed amendments contain new disclosure requirements, such as, for example, the requirement that ETFs include market price returns in addition to NAV returns in Item 8 of Form N-1A, any costs related to these additional disclosures should be offset by our proposal to exempt ETFs with creation units of 25,000 or more shares from including creation unit purchase and redemption information in their prospectuses and annual reports. Most, if not all ETFs, would be able to rely on this exemption.[316] We anticipate that future ETFs would offer creation units of 25,000 shares or more.

We request comment on this assumption. If ETFs are likely to offer smaller creation units, what is the fewest number of shares likely to be offered in a creation unit?

In addition to codifying disclosure requirements of existing exemptive orders, we are proposing several new disclosure requirements in Form N-1A. First, we propose to require that ETFs include an additional total return calculation under Item 8 using market price returns, which would result in an additional bar chart under Item 2(c)(2)(i) of Form N-1A.[317] Because most ETFs currently calculate and present market price returns in the prospectus pursuant to their exemptive orders, this additional bar chart should result in minimal additional costs because it only requires duplicating the presentation of information in another location. Second, we would require an index-based ETF to compare its performance to its underlying index rather than a

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current Form N-1A requirements as modified by their exemptive orders and the proposed amendments. We do not anticipate that this cost would be significant given the similarity of the amendments to the conditions in existing exemptive orders.

316 Existing ETFs typically offer creation units of 50,000 or more shares, and the lowest number of shares permitted under current exemptive orders is 25,000

317 See supra note 163.

benchmark index.[318] This amendment would permit use of a narrow-based or affiliated index and eliminate the opportunity for an index-based ETF to select an index different from its underlying index, which would better reflect whether the ETF's performance corresponds to the index which performance it seeks to track. This amendment replaces the type of index used to present performance data currently required under Form N-1A and, therefore, should not increase the compliance burden for ETFs. Finally, we would require each ETF to identify the principal U.S. market on which its shares are traded and include a statement to the effect that ETF shares are bought and sold on national securities exchanges and that ETF investors trading in these exchanges may be required to pay brokerage commissions.[319] Including these additional statements should present minimal, if any, printing costs.

As noted above, any additional costs incurred by an ETF in complying with these additional disclosures should be offset by the cost-savings of our proposal, which would allow most, if not all, ETFs to exclude creation unit purchase and redemption information in their prospectuses.[320]

C. Rule 12d1-4

1. Benefits

Proposed rule 12d1-4 would codify much of the relief in orders that we have issued permitting funds to invest in ETFs beyond the limits of section 12(d)(1), while eliminating most of the conditions included in the orders. Proposed rule 12d1-4 would permit fund investments in ETFs beyond the limits of section 12(d)(1) if: (i) the acquiring fund (and any entity in a control

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318 See supra notes 173-174 and accompanying text.

319 See supra note 161 and note 282 and accompanying text.

320 For purposes of our Paperwork Reduction Act analysis, we have estimated that our proposed amendments would not change the current Form N-1A compliance costs. See supra discussion at Section VII of this release.

relationship with the acquiring fund) could not control the ETF;[321] (ii) the acquiring fund does not redeem certain shares acquired in reliance on the rule;[322] (iii) the fees charged by the acquiring fund do not exceed the FINRA sales charge limits;[323] and (iv) the acquired ETF is not itself a fund of funds (i.e., the rule would prohibit a fund of funds of funds, or three-tier fund, structure).[324] In addition, an ETF could not redeem and its principal underwriter, a broker or a dealer could not submit an order for redemption of certain shares acquired by an acquiring fund in reliance on proposed rule 12d1-4.[325] The rule provides a safe harbor for any of those entities if it has: (i) a representation from an acquiring fund that none of the shares to be redeemed was acquired in excess of the limits of section 12(d)(1)(A)(i) of the Act in reliance on proposed rule 12d1-4; and (ii) no reason to believe that the shares to be redeemed were acquired in excess of the limits of section 12(d)(1)(A)(i) in reliance on the proposed rule.[326]

We anticipate that acquiring funds, acquired ETFs, investment advisers, and shareholders of both acquiring funds and acquired ETFs would benefit from the proposed rule. Acquiring funds would be able to purchase and ETFs would be able to sell ETF shares beyond the limits of section 12(d)(1) without obtaining an exemptive order, which can be costly to ETFs and their

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[321] Proposed rule 12d1-4(a)(1). See supra notes 215-219 and accompanying text for a discussion of the proposed condition.

[322] Proposed rule 12d1-4(a)(2) See supra note 220 and accompanying and following text for a discussion of the proposed condition.

[323] Proposed rule 12d1-4(a)(3). See supra notes 230-233 and accompanying text for a discussion of the proposed condition. Unlike the orders, however, the proposed rule would not require directors to make any special findings that investors are not paying multiple advisory fees for the same services.

[324] Proposed rule 12d1-4(a)(4). See supra notes 225-229 and accompanying text for a discussion of the proposed condition.

[325] Proposed rule 12d1-4(b)(1). See supra note 221 and accompanying text for a discussion of the proposed condition.

[326] Proposed rule 12d1-4(b)(2). See supra note 222 and accompanying text for a discussion of the proposed safe harbor.

shareholders.[327] The exemptive application process also involves other indirect costs. ETFs that apply for an order to permit other funds to make additional investments in the ETFs beyond the limits of section 12(d)(1) and funds that would rely on the order issued to the ETF forgo potentially beneficial investments until the ETFs receive the order,[328] while other ETFs (and funds that would rely on the order if issued to the ETF) forgo the investment entirely rather than seek an exemptive order because they have concluded that the cost of seeking an exemptive order would exceed the anticipated benefit of the investment.

Unlike the orders, proposed rule 12d1-4 would not provide an exemption permitting acquiring funds to redeem ETF shares acquired in excess of the three percent limit in section 12(d)(1)(A)(i) of the Act in reliance on the proposed rule. This was designed to limit the potential for an acquiring fund to threaten large-scale redemptions as a means of coercing an ETF.[329] Accordingly, the conditions in the proposed rule differ from those in the exemptive orders. The proposed rule would not include: (i) the participation agreement requirement; (ii) the transmission by an acquiring fund of a list of certain of its affiliates to the ETF; (iii) certain policies and procedures designed to limit the influence an acquiring fund can exert on the ETF; and (iv) limits on certain fees. Elimination of these conditions would reduce regulatory burdens and the cost of compliance for funds that seek to invest in ETFs, facilitating

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[327] We estimate, based on discussions with fund representatives, that the cost of obtaining an exemptive order permitting an acquiring fund to invest in an ETF beyond the limits of section 12(d)(1) ranges from approximately $75,000 to $200,000.

[328] Although these applications for relief are typically processed expeditiously, Commission staff estimates, based on orders issued in the past, that the exemptive application process (from initial filing to issuance of order) has taken on average about 15 months. During that time, Commission staff review and comment on applications, applicants submit responses to comments, and the completed application is summarized in a notice to the public. If an application contains a request for relief in addition to the relief from section 12(d)(1) of the Act, the application process has often taken longer than 15 months.

[329] See supra note 220 and accompanying and following text.

greater participation by funds in the purchase and sale of ETF shares both directly with the ETF and in secondary market transactions.[330] Although the proposed rule would not allow acquiring funds to redeem certain shares from the ETF, we understand that acquiring funds generally sell ETF shares in secondary market transactions, rather than redeem them. Accordingly, we believe that this prohibition would have minimal impact on acquiring funds. Moreover, the adoption of proposed rule 12d1-4 would not preclude an acquiring fund from continuing to rely on exemptive orders we have previously issued or seeking new orders to permit funds to invest in ETFs in excess of the limits of section 12(d)(1) but which do not restrict their ability to redeem ETF shares, subject to the conditions set forth in the orders and described above.

In order to allow acquiring funds to take full advantage of the exemptive relief, proposed rule 12d1-4 also would provide limited relief from rule 17e-1 under the Act. If an investment company in one complex acquired more than five percent of the assets of an ETF in another complex, any broker-dealer affiliated with that ETF would become a (second-tier) affiliated person of the acquiring fund.[331] As a result of the affiliation, the broker-dealer's fee for effecting the sale of securities to (or by) the acquiring fund would be subject to the conditions set forth in rule 17e-1, including the quarterly board review and recordkeeping requirements with respect to certain securities transactions involving the affiliated broker-dealer.[332] The proposed rule would permit an acquiring fund to pay commissions, fees, or other remuneration to a (second-tier) affiliated broker-dealer without complying with the quarterly board review and recordkeeping

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[330] Based on discussions with fund representatives, we estimate that the cost of negotiating and entering into a participation agreement (and for an acquiring fund preparing the initial list of affiliates) required by our exemptive orders ranges from approximately $5,000 to $10,000. We estimate that the cost to an acquiring fund to review and update its list of affiliates each year as required by our exemptive orders ranges from approximately $4,000 to $15,000.

[331] See supra note 239.

[332] See supra note 245.

requirements set forth in rules 17e-1(b)(3) and 17e-1(d)(2).[333] This relief would be available only if the broker-dealer and the acquiring fund became affiliated solely because of the acquiring fund's investment in the ETF. We believe that this relief would enable more funds to take advantage of the exemption provided by the proposed rule.

2. Costs

We do not believe that the rule will impose mandatory costs on any fund. As discussed above, the rule is exemptive, and we believe that a fund would not rely on it if the anticipated benefits did not justify the costs. We believe the costs of relying on the rule would be less than the costs to an acquiring fund (and ETF) that relies on an existing exemptive order to invest in (or sell) ETF shares because the rule includes substantially fewer conditions than existing orders that provide similar exemptive relief with respect to purchases and sales of ETF shares.

In order to rely on the proposed rule for an exemption from section 12(d)(1)(B) limits, an ETF may not redeem and its principal underwriter, or a broker or dealer may not submit for redemption any of the ETF's shares that were acquired by an acquiring fund in excess of the limits of section 12(d)(1)(A)(i) of the Act in reliance on proposed rule 12d1-4.[334] The proposed rule provides a safe harbor for these entities if the entity has (i) received a representation from the acquiring fund that none of the ETF shares it is redeeming was acquired in excess of the limits of section 12(d)(1)(A)(i) in reliance on the rule, and (ii) no reason to believe that the acquiring fund is redeeming any ETF shares that the acquiring fund acquired in excess of the limits of section 12(d)(1)(A)(i) in reliance on the rule.[335]

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[333] See supra note 247 and accompanying text.

[334] See proposed rule 12d1-4(b)(1).

[335] See proposed rule 12d1-4(b)(2). We believe that the costs associated with this safe harbor would not be significant. Only acquiring funds that intend to redeem less than three percent of an ETF's (footnote continued)

As noted above, we understand that acquiring funds that invest in ETFs generally do not redeem their shares from the ETF, but rather sell them in secondary market transactions. We also believe that an acquiring fund that would not rely on proposed rule 12d1-4 to acquire ETF shares (i.e., an acquiring fund that acquires 3 percent or less of an ETF's outstanding voting securities) would be less likely to redeem shares because it would be less likely to have a sufficient number of shares to permit the acquiring fund to redeem its shares.[336] We estimate that ETFs, their principal underwriters, and brokers and dealers in the aggregate would choose to rely on the safe harbor to redeem or submit a redemption order with respect to ETF shares that were not acquired in reliance on proposed rule 12d1-4 on average two times each year with respect to each ETF.[337] We believe that the total annual cost for making this representation would be $70,080.[338]

We request comment on these estimates. If commenters believe these estimates are not reasonable, we request they provide specific data that would allow us to make more accurate estimates.

The rule would affect different types of sponsors or advisers in different ways. A sponsor or adviser that has not sought and would not seek exemptive relief to permit another fund to invest in its shares beyond the limits of section 12(d)(1) of the Act would not be affected by the rule. The cost for a sponsor or adviser that currently relies on exemptive relief covered by the

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shares could provide the representations required under the safe harbor.

336 ETF shares are generally redeemed only in creation unit aggregations. A creation unit typically consists of at least 25,000 shares. See supra note 113.

337 We recognize that some ETFs may receive more redemption requests from acquiring funds and may rely on the safe harbor more often, while other ETFs may receive no redemption requests or may not choose to rely on the safe harbor when they receive a redemption request from an acquiring fund.

338 See supra notes 294-296 and accompanying text.

rule would be less than the costs of relying on its exemptive order because the proposed rule contains substantially fewer conditions than existing orders. In addition, a sponsor or adviser that currently relies on an exemptive order could satisfy all the conditions of the proposed rule that provides similar exemptive relief with respect to purchases and sales of ETF shares without changing its operation. Finally, a sponsor or adviser that has not relied on an exemptive order and that intends to rely on the proposed rule would avoid the cost of obtaining an exemptive order and would incur lower continuing costs to comply with the conditions included in the proposed rule than it would have borne had it obtained an exemptive order.

D. Amendments to Rule 12d1-2

1. Benefits

The proposed amendments to rule 12d1-2 would expand the type of investments that funds relying on the exemptive relief in section 12(d)(1)(G) of the Act could make. The proposed amendments would allow acquiring funds that invest in affiliated funds in reliance on section 12(d)(1)(G) to invest in unaffiliated ETFs beyond the statutory limitations as long as the funds comply with the conditions of proposed rule 12d1-4.[339] We also propose to amend rule 12d1-2 to allow funds relying on section 12(d)(1)(G) to invest in assets other than securities.[340] Under the proposed rule, funds relying on the exemptive relief in section 12(d)(1)(G) would be able to invest in, among other things, futures contracts, options, swaps, other derivative investments, and other financial instruments that do not qualify as a security under the Act. Those investments would, of course, have to be consistent with the fund's investment policies.[341]

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[339] Proposed rule 12d1-2(a)(4).

[340] Proposed rule 12d1-2(a)(5).

[341] See Item 4 of Form N-1A (requiring disclosure of funds' investment objectives and principal investment strategies).

We believe that including these types of investment opportunities would permit funds to allocate their investments more efficiently.

2. Costs

Rule 12d1-2 (and the proposed amendments to the rule) does not impose any conditions on its reliance and thus a fund would not incur any costs in relying on the rule.

E. Request for Comment

The Commission requests comment on the potential costs and benefits of the proposed rules and rule amendments. We also request comment on the potential costs and benefits of any alternatives suggested by commenters. We encourage commenters to identify, discuss, analyze, and supply relevant data regarding any additional costs and benefits. For purposes of the Small Business Regulatory Enforcement Act of 1996,[342] the Commission also requests information regarding the potential annual effect of the proposals on the U.S. economy. Commenters are requested to provide empirical data to support their views.

IX. CONSIDERATION OF PROMOTION OF EFFICIENCY, COMPETITION AND CAPITAL FORMATION

Section 2(c) of the Investment Company Act requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is consistent with the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[343]

A. Proposed Rules 6c-11

Proposed rule 6c-11 would codify much of the relief and conditions of exemptive orders that we have issued to ETFs. The rule would provide relief to ETFs by permitting an ETF to

342 Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996).

343 15 U.S.C. 80a-2(c).

operate without first obtaining an exemptive order from the Commission. As noted above, the direct and indirect costs of the exemptive application process may discourage potential ETF sponsors. The proposed rule also would not include conditions contained in exemptive orders designed to address particular concerns that we now believe are addressed by other provisions of the federal securities laws.[344] Eliminating the need for individual exemptive relief and compliance with specific conditions may reduce costs of introducing and operating an ETF, and may permit additional opportunities for sponsors to introduce new ETFs, particularly smaller sponsors interested in offering smaller, more narrowly focused ETFs which may serve particular investment needs of certain investors. We therefore anticipate that the proposed rule would, over time, lead to an increase in ETFs.

We expect that the proposal is likely to increase competition and efficiency. By making it easier for sponsors, particularly smaller sponsors, to introduce ETFs, the proposal should allow more sponsors to enter the marketplace, thereby increasing competition among ETF sponsors. The resulting increase in ETFs that we expect also should increase competition and innovation among funds. The proposal also should promote efficiency because the increase in ETFs should provide investors with more investments that may be specifically tailored to their particular investment objectives. We do not expect the proposed rule would have an adverse impact on capital formation.

B. Amendments to Form N-1A

The proposed amendments to Form N-1A are designed to provide more useful information to investors (including retail investors) who purchase shares in the secondary market, rather than institutional investors purchasing creation units from the ETF. The proposed

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344 See supra Section III.B.5. of this release for a discussion of these conditions.

amendments would require ETFs, in addition to providing returns based on NAV, to include returns based on the market price of fund shares, and to disclose in the ETF prospectus the number of trading days on which the market price of the ETF shares was greater than the ETF's NAV and the number of days it was less than the ETF's NAV (premium/discount information). This information should promote more efficient allocation of investments by investors and more efficient allocation of assets among competing ETFs because investors may compare and choose ETFs based on their market returns and deviations from NAV more easily. These amendments also should improve competition because they may prompt sponsors to launch ETFs that provide improved market price returns or lesser premiums/discounts. We do not believe the proposed amendments would have an adverse impact on capital formation.

C. Proposed Rule 12d1-4 and Amendments to Rule 12d1-2

Proposed rule 12d1-4 and the proposed amendments to rule 12d1-2 would expand the circumstances in which funds can invest in ETFs without the ETF first obtaining an exemptive order from the Commission, which can be costly and time-consuming. We anticipate that the proposed rule and amendments would promote efficiency and competition. Proposed rule 12d1-4 would permit funds to acquire shares of ETFs in excess of the limitations in section 12(d)(1) of the Act. This exemption should allow acquiring funds to allocate their investments more efficiently by expanding their investment options to include holdings in ETFs beyond the limits of section 12(d)(1) in order to meet the funds' investment objectives. We also anticipate that the proposed rule would promote efficiency because permitting funds to buy creation units might benefit other ETF investors buying and selling ETF shares in secondary market transactions by increasing the number of institutional investors participating in the arbitrage process. The proposed rule might promote competition by increasing the pool of ETFs that

accept investments by other funds beyond section 12(d)(1) limits. Proposed rule 12d1-4 would eliminate the need for ETFs to obtain an exemptive order from the Commission, the cost of which might discourage ETFs, particularly smaller ETFs, from accepting or seeking fund investments beyond section 12(d)(1) limits.[345]

The proposed rule would provide relief from section 17(e) for funds that execute transactions with certain broker-dealers affiliated with ETFs in which the acquiring funds invest. This relief, which is not included in our exemptive orders, should allow more funds to take full advantage of the exemption provided by the rule, thereby increasing the potential that the proposed rule would promote efficiency and competition.[346]

The proposed amendments to rule 12d1-2 expand the investment options for funds that rely on the exemption in section 12(d)(1)(G) of the Act to include investments in unaffiliated ETFs beyond the section 12(d)(1) limits and assets other than securities. This expansion of investment opportunities could permit funds to allocate their investments more efficiently. This may allow a fund to compete more effectively. We do not expect that proposed rule 12d1-4 or the proposed amendments to rule 12d1-2 would have an adverse impact on capital formation.[347]

X. INITIAL REGULATORY FLEXIBILITY ANALYSIS

This Initial Regulatory Flexibility Analysis ("IRFA") has been prepared in accordance with 5 U.S.C. 603. It relates to proposed new rules 6c-11 and 12d1-4 and proposed amendments

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345 As noted above, the proposed rule also would not incorporate many of the conditions contained in our exemptive orders. The compliance costs of such conditions might otherwise discourage ETFs, particularly small ETFs, from accepting or seeking fund investments beyond section 12(d)(1) limits. See supra note 330 and accompanying and following text. By eliminating most of the conditions from our exemptive orders, more ETFs may accept and seek fund investments in their shares.

346 See supra Section IV.C.3 for a discussion of the proposed exemption.

347 While proposed rule 12d1-4 may result in additional investments in ETFs, we do not anticipate that the rule would have a significant impact on capital formation.

to rule 12d1-2 under the Investment Company Act, and to Form N-1A under the Investment Company Act and the Securities Act.

A. Reasons for the Proposed Actions

1. ETFs

As described more fully in Sections I and III of this release, we are proposing rule 6c-11 to allow new ETFs to enter the market without first obtaining an exemptive order from the Commission.[348] The proposed rule would codify and expand upon the exemptive orders we have issued to ETFs allowing them to form and operate. In conjunction with proposed rule 6c-11, we also are proposing amendments to Form N-1A, as described more fully in Sections I and III.D of this release, to provide more useful information to investors who purchase and sell ETF shares on a securities exchange.

2. Investment Company Investments in ETFs

As described more fully in Sections I and IV of this release, we are proposing new rule 12d1-4 to permit funds to invest in shares of ETFs beyond the limits of section 12(d)(1)(A) without first obtaining an exemptive order from the Commission. The proposed rule would codify exemptions provided in orders we have issued permitting funds to invest in ETFs beyond the Act's limits. We also are proposing amendments to rule 12d1-2, as described more fully in Section V of this release, to expand the investment options available to funds that rely on Section 12(d)(1)(G) of the Act.

348 Our exemptive orders have provided ETFs with relief from a number of sections in the Act in order to allow them to operate. See supra Section III.C.

B. Objectives of the Proposed Actions

1. ETFs

As described more fully in Sections I and III of this release, the objectives of the proposed rule 6c-11 are to allow new ETF competitors to enter the market more easily and eliminate certain conditions contained in the outstanding orders that we now believe may be unnecessary. As described more fully in Sections I and III.D of this release, the objective of the proposed amendments to Form N-1A is to provide more useful information to individual investors who purchase and sell ETF shares on national securities exchanges.

2. Investment Company Investments in ETFs

As more fully described in Sections I and IV of this release, proposed rule 12d1-4 is intended to allow funds to invest more easily in ETFs beyond the limits of section 12(d)(1) of the Act subject to certain conditions designed to protect investors. As more fully described in Section V of this release, the proposed amendments to rule 12d1-2 are intended to expand the investments options available to funds that rely on section 12(d)(1)(G) to include: (i) investments in unaffiliated ETFs beyond the limits of section 12(d)(1) of the Act consistent with proposed rule 12d1-4; and (ii) other non-securities assets, which do not appear to raise concerns that the investment limits of section 12(d)(1)(G) were intended to address. The proposed amendments to rule 12d1-2 would provide funds relying on section 12(d)(1)(G) with greater flexibility to meet their investment objectives.

C. Legal Basis

The statutory authority for proposed rules 6c-11 and 12d1-4 and the proposed amendments to rule 12d1-2 and Form N-1A is set forth in Section XI of this release.

D. Small Entities Subject to the Proposed Rule and Amendments

A small business or small organization (collectively, "small entity") for purposes of the Regulatory Flexibility Act[349] is a fund that, together with other funds 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.[350] Of approximately 601 ETFs (593 registered open-end investment companies and 8 registered UITs), only 1 (an open-end fund) is a small entity.[351] There are approximately 145 fund complexes[352] and 43 business development companies[353] that are small entities that could choose to rely on proposed rule 12d1-4 to invest in ETFs beyond the limits of section 12(d)(1).

1. ETFs

Commission staff expects proposed rule 6c-11 and amendments to Form N-1A would have little impact on small entities. Like other funds, small entities would be affected by proposed rule 6c-11 and the proposed amendments to Form N-1A only if they determine to rely on rule 6c-11 to operate as an ETF. Small entities that are open-end ETFs and currently rely on an exemptive order also would be affected by the proposed amendments to Form N-1A. Commission staff estimates that only one of the 61 orders permitting funds to operate as ETFs was issued to a small entity. The staff anticipates that the number of funds, including small

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349 5 U.S.C. 601-612.

350 17 CFR 270.0-10.

351 For purposes of this IRFA, any series or portfolio of an ETF is considered a separate ETF. Therefore, there are 601 portfolios or series of registered investment companies operating as ETFs. For purposes of determining whether a fund is a small entity under the Regulatory Flexibility Act, however, the assets of funds (including each portfolio and series of a fund) in the same group of related investment companies are aggregated.

352 The 145 fund complexes contain in the aggregate 160 funds that are small entities. This estimate is derived from data reported on Forms N-SAR and N-CSR filed with the Commission for the period ending June 30, 2007.

353 This estimate is based on data reported on Forms 10-K and 10-Q filed with the Commission for the period ending June 30, 2007.

funds, that would operate as an ETF under proposed rule 6c-11 and also therefore be subject to the disclosure requirements contained in the proposed amendments to Form N-1A would increase as compared with the number of applicants. Nevertheless, the staff believes that the proportion of small entities compared to the total number of funds that operate as ETFs would remain small.

2. Investment Company Investments in ETFs

Commission staff expects proposed rule 12d1-4 and the proposed amendments to rule 12d1-2 to have little impact on small entities. Like other funds, small entities would only be affected by the rule and the amendments if they determine to rely on the exemptions provided by the proposed rule and amendments.[354] Commission staff estimates that none of the approximately 15 exemptive orders issued to ETFs allowing other funds to invest in the ETFs beyond the limits of section 12(d)(1) was issued to a small entity. Similarly, none of the applications that has sought to allow a fund that relied on section 12(d)(1)(G) of the Act to invest in securities other than funds in the same complex, government securities, and short-term paper was a small entity. The staff anticipates that the number of funds, including small funds, that would rely on the proposed rule and rule amendments would be greater than the number of funds that currently rely on exemptive orders. Nevertheless, the staff believes that the proportion of small entities compared to the total number of funds that would rely on the proposed rule and rule amendments would be small.

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[354] Small acquiring funds could choose to rely on the proposed rule to invest in ETFs beyond the limits of section 12(d)(1)(A) of the Act, and small ETFs could choose to rely on the rule to sell their shares to other funds beyond the limits of section 12(d)(1)(B) of the Act. Small acquiring funds that rely on section 12(d)(1)(G) of the Act could choose to rely on the proposed amendments to rule 12d1-2 to invest in ETFs in reliance on proposed rule 12d1-4 and to invest in assets other than securities.

E. Reporting, Recordkeeping, and Other Compliance Requirements

1. ETFs

Proposed rule 6c-11 would not impose any recordkeeping requirements on any person and would not materially increase other compliance requirements. Proposed rule 6c-11 would impose reporting requirements on funds that choose to rely on the rule.[355] Funds relying on the rule would have to disclose: (i) the foreign holidays that would prevent timely satisfaction of a redemption request;[356] (ii) the basket assets;[357] (iii) the number of shares in a creation unit;[358] (iv) the fund's NAV, the market closing price for its shares, and the premium/discount between its NAV and the market closing price daily on its Internet Web site;[359] and (v) the identities and weightings of the component securities and other assets held by the fund.[360] The proposed rule also would impose compliance requirements on ETFs that are essential to the operation of an ETF. A fund that chose to rely on the proposed rule would be required to have (i) its shares

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[355] In addition to the reporting requirements, the proposed rule, unlike most of the ETF exemptive orders, would not include relief from section 24(d) of the Act and thus broker-dealers would be required to deliver prospectuses to investors in secondary market transactions. We also propose to amend the existing ETF exemptive orders issued to open-end funds to eliminate the section 24(d) exemptions and require ETFs relying on the orders to satisfy their prospectus delivery requirements. We understand that many, if not most, broker-dealers selling ETF shares in secondary market transactions, in fact, transmit a prospectus to purchasers. Therefore, we anticipate that the proposed amendment to the ETF orders would have little if any impact on ETFs, including small ETFs.

[356] Proposed rule 6c-11(c)(1). Funds would have to disclose this information in their registration statements (Form N-1A) and in any sales literature.

[357] Proposed rule 6c-11(e)(1).

[358] Proposed rule 6c-11(e)(3). Funds would have to disclose this information in their registration statements (Form N-1A) and in any sales literature.

[359] Proposed rule 6c-11(e)(4)(iii), (iv).

[360] Proposed rule 6c-11(e)(4)(iv)(A). If the fund has a stated investment objective of obtaining returns that correspond to the returns of a securities index, reliance on the proposed rule would be conditioned on the ETF tracking an index whose provider discloses on its Internet Web site the identities and weightings of the component securities and other assets of the index in lieu of disclosure on the fund's Internet Web site. Proposed rule 6c-11(e)(4)(iv)(B).

approved for listing and trading on a national securities exchange,[361] and (ii) the Intraday Value of the basket assets disseminated at regular intervals during the day by a national securities exchange.[362]

Proposed rule 6c-11 may benefit fund shareholders by allowing funds to operate as ETFs without incurring the costs and delays associated with the exemptive application process and without having to comply with some of the conditions included in the exemptive orders. While the rule would require ETFs to comply with reporting and compliance requirements, these requirements would not involve any new costs for ETFs because these requirements (as well as additional requirements) are included in the ETF exemptive orders.

The proposed amendments to Form N-1A would impose reporting requirements on open-end funds that operate as ETFs. The proposed amendments would require an ETF to disclose in its prospectus and annual reports: (i) returns based on the market price of its shares;[363] (ii) the number of trading days on which the market price of its shares was greater than its NAV and the number of days it was less than its NAV (premium/discount information);[364] and (iii) a

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361 Proposed rule 6c-11(e)(4)(iii).

362 Proposed rule 6c-11(e)(4)(i).

363 Proposed Instruction 5(a) to Item 2(c)(2) of Form N-1A; Proposed Instruction 3(f) to Item 8(a) of Form N-1A; Proposed Instruction 12(b) to Item 22(b)(7) of Form N-1A. Form N-1A currently only requires an ETF to disclose in its prospectus its return based on its NAV. The annual reports also would have to contain a new line graph comparing the initial and subsequent account values using market price, following the line graph using NAV required by Item 22(b)(7)(ii)(A) of Form N-1A. Proposed Instruction 12(a) to Item 22(b)(7) of Form N-1A.

364 Proposed Item 6(h)(4) of Form N-1A (requiring proposed premium/discount information in the prospectus to span the most recently completed calendar year and quarters since that year); Proposed Item 22(b)(7)(iv) of Form N-1A (requiring proposed premium/discount information disclosed in annual reports to span five fiscal years). The ETF would be required to present premiums or discounts as a percentage of NAV and to explain that shareholders may pay more than NAV when purchasing shares and receive less than NAV when selling, because shares are bought and sold at market prices. Proposed Instructions 2,3 to Item 6(h)(4) of Form N-1A; Proposed Instruction (b), (c) to Item 22(b)(7)(iv).

comparison of its performance, if it is an index-based ETF, to its underlying index rather than a benchmark index.[365] The proposed amendments also would require the ETF to disclose in its prospectus the trading symbol(s) and principal U.S. market(s) on which its shares are traded.[366]

The proposed amendments to Form N-1A also would eliminate some disclosure requirements for ETFs with creation units of 25,000 or more shares and replace them with fewer disclosures. Under the proposed amendments, those ETFs would not have to: (i) disclose information on how to buy and redeem shares of ETF;[367] or (ii) include in its fee table in its prospectus or annual and semi-annual reports fees and expenses for purchases or sales of creation units.[368]

The amendments to Form N-1A are designed to accommodate the use of the form by ETFs and to meet the needs of investors (including retail investors) who purchase ETF shares in secondary market transactions rather than institutional investors purchasing creation units directly from the ETF. We believe that the amendments would have a negligible impact (if any) on the disclosure burdens on ETFs while providing necessary information to ETF investors. We do not believe that the proposed amendments to Form N-1A would disproportionately impact small funds.

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365 Proposed Instruction 5(b) to Item 2(c)(2) of Form N-1A; Proposed Instruction 12(c) to Item 22(b)(7) of Form N-1A.

366 Proposed Item 6(h)(2) of Form N-1A.

367 Proposed Item 6(h)(1) of Form N-1A. Instead ETF prospectuses could simply state that individual fund shares can only be bought and sold on the secondary market through a broker-dealer. Proposed Item 6(h)(3) of Form N-1A.

368 Proposed Instruction 1(e)(i) to Item 3 of Form N-1A; Proposed Instruction 1(e)(i) to Item 22(d) of Form N-1A. An ETF would instead modify the narrative explanation preceding the example in the fee table to state that fund shares are sold on the secondary market rather than redeemed at the end of the periods indicated, and that investors in its shares may be required to pay brokerage commissions that are not reflected in the fee table. Proposed Instruction 1(e)(ii) to Item 3 of Form N-1A; Proposed Instruction 1(e)(ii) to Item 22(d) of Form N-1A.

2. Investment Company Investments in ETFs

Proposed rule 12d1-4 and the proposed amendments to rule 121-2 would not impose any reporting or recordkeeping requirements. The proposed amendments to rule 12d1-2 also would not impose any new compliance requirements on any person. Proposed rule 12d1-4 would impose compliance requirements on funds that choose to rely on it. Proposed rule 12d1-4 would permit fund investments in ETFs beyond the limits of section 12(d)(1) if: (i) the acquiring fund (and any entity in a control relationship with the acquiring fund) does not control the ETF;[369] (ii) the acquiring fund does not redeem certain shares acquired in reliance on the proposed rule;[370] (iii) the fees charged by the acquiring fund do not exceed the FINRA sales charge limits;[371] and (iv) the acquired ETF is not itself a fund of funds (i.e., the rule would prohibit a fund of funds of funds, or three-tier fund, structure).[372] In addition, an ETF could not redeem, and its principal underwriter, a broker or a dealer could not submit for redemption ETF shares acquired in reliance on proposed rule 12d1-4.[373] These compliance requirements, however, would not impose any new costs on acquiring funds or ETFs. Most of these conditions (as well as number of other conditions which are not included in the proposed rule) are included in the exemptive orders that currently permit fund investments in ETFs beyond the limits of section 12(d)(1). We do not anticipate that the additional conditions prohibiting redemptions would impose

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369 Proposed rule 12d1-4(a)(1). See supra notes 215-219 and accompanying text for a discussion of the proposed condition.

370 Proposed rule 12d1-4(a)(2). See supra note 220 and accompanying and following text for a discussion of the proposed condition.

371 Proposed rule 12d1-4(a)(3). See supra notes 230-233 and accompanying text for a discussion of the proposed condition.

372 Proposed rule 12d1-4(a)(4). See supra notes 225-229 and accompanying text for a discussion of the proposed condition.

373 Proposed rule 12d1-4(b)(1). See supra note 221 and accompanying text for a discussion of the proposed condition.

significant, if any, new costs on acquiring funds or ETFs because we understand that most funds do not redeem shares with ETFs, but sell their shares in secondary market transactions.

F. Duplicative, Overlapping, or Conflicting Federal Rules

The Commission has not identified any federal rules that duplicate, overlap, or conflict with the proposed rules or rule amendments.

G. Significant Alternatives

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. In connection with the proposed rules and amendments, 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 rule for small entities; (iii) the use of performance rather than design standards; and (iv) an exemption from coverage of the rule, or any part thereof, for small entities.

1. ETFs

Proposed rule 6c-11 is exemptive and compliance with the rule would be voluntary. We therefore do not believe that special compliance, timetable, or reporting requirements, or an exemption from coverage of the proposed rule for small entities would be appropriate. In addition, as discussed above, only one fund that meets the definition of a small entity currently relies on an exemptive order to operate as an ETF. Therefore, few of the entities that would be affected by the proposed rule would be considered to be small entities. The Commission also believes that proposed rule 6c-11 would decrease burdens on small entities by making it unnecessary for them to seek an exemptive order from the Commission allowing them to operate

as ETFS and by eliminating some of the conditions included in the exemptive orders from the proposed rule. As a result, we do not anticipate the potential impact of the proposed rule on small entities would be significant. For these reasons, alternatives to the proposed rule appear unnecessary and in any event are unlikely to minimize any impact that the proposed rule might have on small entities.

The proposed amendments to Form N-1A would only apply to funds that choose to rely on proposed rule 6c-11 or that rely on an exemptive order to operate as an ETF. As discussed above, the proposed amendments to Form N-1A are designed to accommodate the use of the form by ETFs and to meet the needs of investors (including retail investors) who purchase ETF shares in secondary market transactions rather than institutional investors purchasing creation units directly from the ETF. Therefore, we believe that any further clarification, consolidation, or simplification of the proposed amendments would not be consistent with the protection of investors. An exemption for small entities also would defeat the purposes of the amendments.

2. Investment Company Investments in ETFs

Proposed rule 12d1-4 and the proposed amendments to rule 12d1-2 are exemptive and compliance with proposed rule 12d1-4 and the proposed amendments to rule 12d1-2 would be voluntary. We therefore do not believe that special compliance, timetable, or reporting requirements, or an exemption from coverage of the proposed rule or the proposed amendments to rule 12d1-2 for small entities would be appropriate. The Commission believes that proposed rule 12d1-4 and the proposed amendments to rule 12d1-2 would decrease burdens on small entities by making it unnecessary for them to seek an exemptive order from the Commission allowing them to sell their shares to other funds beyond the limits in section 12(d)(1)(B) of the Act or to allow small entities that rely on section 12(d)(1)(G) to invest in assets other than

securities and ETFs beyond the limits of section 12(d)(1). In addition, proposed rule 12d1-4 has a limited number of conditions, most of which are included in the exemptive orders. The proposed amendments to rule 12d1-2 do not impose any compliance requirements. As a result the potential impact of the proposed rule and amendments on small entities should not be significant. For these reasons, alternatives to the proposed rule and amendments seem unnecessary and, in any event, unlikely to minimize any impact that the proposed rule and amendments might have on small entities.

H. Solicitation of Comments

The Commission encourages the submission of comments with respect to any aspect of this IRFA. Comment is specifically requested on the number of small entities that would be affected by the proposed rules and amendments, 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 its extent. These comments will be considered in connection with any adoption of the proposed rule and amendments, and reflected in a Final Regulatory Flexibility Analysis.

Comments should be submitted in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090. Comments also may be submitted electronically to the following e-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7-07-08, and this file number should be included on the subject line if e-mail is used.[374] Comment letters will be available for public inspection and copying in the Commission's Public Reference Room, 100 Fifth Street, NE, Washington, DC 20549-1520, on official business days between the hours of 10:00 am and 3:00 pm.

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374 Comments on the IRFA will be placed in the same public file that contains comments on the proposed rules and amendments.

Electronically submitted comment letters also will be posted on the Commission's Internet Web site (http://www.sec.gov).

XI. STATUTORY AUTHORITY

The Commission is proposing rule 6c-11 pursuant to the authority set forth in sections 6(c) and 38(a) of the Investment Company Act [15 U.S.C. 80a-6(c) and 80a-37(a)]. The Commission is proposing amendments to rule 12d1-2 and new rule 12d1-4 pursuant to the authority set forth in sections 6(c), 12(d)(1)(J), and 38(a) of the Investment Company Act [15 U.S.C. 80a-6(c), 80a-12(d)(1)(J), and 80a-37(a)]. The Commission is proposing amendments to registration form N-1A under the authority set forth in sections 6, 7(a), 10 and 19(a) of the Securities Act of 1933 [15 U.S.C. 77f, 77g(a), 77j, 77s(a)], and sections 8(b), 24(a), and 30 of the Investment Company Act [15 U.S.C. 80a-8(b), 80a-24(a), and 80a-29].

List of Subjects

17 CFR Part 239

Reporting and recordkeeping requirements, Securities.

17 CFR Parts 270 and 274

Investment companies, Reporting and recordkeeping requirements, Securities.

TEXT OF PROPOSED RULES AND FORM AMENDMENTS

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

PART 239 – FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

1. The authority citation for Part 239 continues to read, in part, as follows:

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

80a-26, 80a-29, 80a-30, and 80a-37, unless otherwise noted.

* * * * *

PART 270--RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

2. The authority citation for Part 270 is amended by adding the following citation to read as follows:

Authority: 15 U.S.C. 80a-1 et seq., 80a-34(d), 80a-37, and 80a-39, unless otherwise noted.

* * * * *

Section 270.6c-11 is also issued under 15 U.S.C. 80a-6(c) and 80a-37(a).

* * * * *

3. The specific authority citation for §§ 270.12d1-1, 270.12d1-2 and 12d1-3 is revised to read as follows:

Authority: * * *

* * * * *

Sections 270.12d1-1, 270.12d1-2, 270.12d1-3, and 12d1-4 are also issued under 15 U.S.C. 80a-6(c), 80a-12(d)(1)(J), and 80a-37(a).

* * * * *

4. Section 270.6c-11 is added to read as follows:

§ 270.6c-11 Exchange-traded funds.

(a) Redeemable securities. Exchange-traded fund shares are considered "redeemable securities" for purposes of section 2(a)(32) of the Act (15 U.S.C. 80a-2(a)(32)).

(b) Pricing. A dealer in exchange-traded fund shares is exempt from section 22(d) of the Act (15 U.S.C. 80a-22(d)) and § 270.22c-1(a) with regard to purchases, sales and repurchases of

exchange-traded fund shares in the secondary market at the current market price.

(c) Postponement of redemption. If an exchange-traded fund includes a foreign security in its basket assets and a foreign holiday prevents timely delivery of the foreign security in response to a redemption request, the fund is exempt, with respect to the foreign security, from the prohibition in section 22(e) of the Act (15 U.S.C. 80a-22(e)) against postponing the date of satisfaction upon redemption for more than seven days after the tender of a redeemable security, if:

(1) The exchange-traded fund discloses in its registration statement the foreign holidays that it expects may prevent timely delivery of foreign securities, and the maximum number of days that it anticipates it will need to deliver the foreign securities; and

(2) Foreign securities are delivered no later than 12 calendar days after the tender of the exchange-traded fund shares.

(d) Affiliated transactions. A person who is an affiliated person of an exchange-traded fund solely by reason of holding with the power to vote 5 percent or more, or more than 25 percent, of securities issued by the exchange-traded fund (or who is an affiliated person of such a person), or issued by an investment company under common control with the exchange-traded fund, is exempt from sections 17(a)(1) and 17(a)(2) of the Act (15 U.S.C. 80a-17(a)(1) and (a)(2)) with regard to the deposit and delivery of basket assets. An investment company that has acquired exchange-traded fund shares in reliance on § 270.12d1-4 may not rely on this paragraph with regard to the purchase of basket assets.

(e) Definitions. For purposes of this section:

(1) Basket assets are the securities or other assets specified each business day in name and number by an exchange-traded fund as the securities or assets in exchange for which it will

issue or in return for which it will redeem exchange-traded fund shares; provided that the fund may require or permit a purchaser (or redeemer) of a creation unit to substitute cash for some or all of the securities in the basket assets.

(2) Business day means, with respect to an exchange-traded fund, any day that the fund is open for business, including any day on which it is required to make payment under section 22(e) of the Act (15 U.S.C. 80a-22(e)).

(3) Creation unit is a specified number of exchange-traded fund shares disclosed in the exchange-traded fund's prospectus that the fund will issue (or redeem) in exchange for the deposit (or delivery) of basket assets. The creation unit must be reasonably designed to facilitate the purchase (or redemption) of shares from the exchange-traded fund with an offsetting sale (or purchase) of shares on a national securities exchange at as nearly the same time as practicable for the purpose of taking advantage of a difference in the current value of basket assets on a per share basis and the current market price of the shares.

(4) Exchange-traded fund is a registered open-end management company that:

(i) Issues (or redeems) creation units in exchange for the deposit (or delivery) of basket assets the current value of which is disseminated on a per share basis by a national securities exchange at regular intervals during the trading day;

(ii) In any sales literature, identifies itself as an exchange-traded fund, which does not sell or redeem individual shares, and explains that investors may purchase or sell individual exchange-traded fund shares on a national securities exchange;

(iii) Issues shares that are approved for listing and trading on a national securities exchange under section 12(d) (15 U.S.C. 78l(d)) of the Securities Exchange Act of 1934 and rule 12d1-1 (17 CFR 240.12d1-1) thereunder;

(iv) Discloses each business day on its Internet Web site, which is publicly accessible at no charge, the prior business day's net asset value and closing market price of the fund's shares, and the premium or discount of the closing market price against the net asset value of the fund's shares as a percentage of net asset value; and

(v) Either:

(A) Discloses each business day on its Internet Web site, which is publicly accessible at no charge, the identities and weightings of the component securities and other assets held by the fund, or

(B) Has a stated investment objective of obtaining returns that correspond to the returns of a securities index specified in the fund's registration statement, and the index provider discloses on its Internet Web site, which is publicly accessible at no charge, the identities and weightings of the component securities and other assets of the index.

(5) Exchange-traded fund share is an equity security issued by an exchange-traded fund.

(6) Foreign security is any security issued by a government or any political subdivision of a foreign country, a national of any foreign country, or a corporation or other organization incorporated or organized under the laws of any foreign country, and for which there is no established United States public trading market as that term is used in Item 201 of Regulation S-K under the Securities Exchange Act of 1934 (17 CFR 229.201).

(7) Index provider is the person that determines the securities and other assets that comprise a securities index.

(8) Sales literature means any advertisement, pamphlet, circular, form letter, or other sales material addressed to or intended for distribution to prospective investors other than a registration statement filed with the Commission under section 8 of the Act (15 U.S.C. 80a-8).

(9) Weighting of the component security is the percentage of the index's value represented, or accounted for, by such component security.

5. Section 270.12d1-2 is amended by:

a. Revising the heading to paragraph (a);

b. Removing "and" at the end of paragraph (a)(2);

c. Removing the period at the end of paragraph (a)(3) and adding a ";";

d. Adding paragraphs (a)(4) and (a)(5); and

e. Revising paragraph (b).

The additions and revisions read as follows:

§ 270.12d1-2 Exemptions for investment companies relying on section 12(d)(1)(G) of the Act.

(a) Exemption to acquire other securities and assets. * * *

(4) Securities issued by an exchange-traded fund, when the acquisition is in reliance on § 270.12d1-4; and

(5) Other assets.

(b) Definitions. For purposes of this section, "exchange-traded fund" has the same meaning as in § 270.12d1-4(d)(2) and "money market fund" has the same meaning as in § 270.12d1-1(d)(2).

6. Section 270.12d1-4 is added to read as follows:

§ 270.12d1-4 Exemptions for investments in exchange-traded funds.

(a) Exemptions for acquisition of exchange-traded fund shares. Notwithstanding sections 12(d)(1)(A), 17(a)(1), and 57(a)(1) of the Act (15 U.S.C. 80a-12(d)(1)(A), 15 U.S.C. 80a-17(a)(1), and 15 U.S.C. 80a-56(a)(1)), an investment company ("acquiring fund") may

acquire exchange-traded fund shares if:

(1) Control. No acquiring fund or any of its investment advisers or depositors, and any company controlling, controlled by or under common control with the acquiring fund, or any of its investment advisers or depositors, each individually or together in the aggregate:

(i) Controls the exchange-traded fund; and

(ii) If, as a result of a decrease in the outstanding voting securities of the exchange-traded fund, any of those persons, each individually or together in the aggregate, become holders of more than 25 percent of the outstanding voting securities of the exchange-traded fund, each of those holders of shares issued by the exchange-traded fund will vote its shares of the exchange-traded fund in the manner prescribed by section 12(d)(1)(E) of the Act (15 U.S.C. 80a-12(d)(1)(E)).

(2) No redemption. An acquiring fund that relies on paragraph (a) of this section to acquire exchange-traded fund shares in excess of the limits of section 12(d)(1)(A)(i) of the Act (15 U.S.C. 80a-12(d)(1)(A)(i)) does not redeem any of those shares. For purposes of this paragraph, an acquiring fund will be deemed to have redeemed or sold the most recently acquired exchange-traded fund shares first.

(3) Fees.

(i) Any sales charge, as defined in rule 2830(b)(8) of the Conduct Rules of the NASD ("sales charge"), or service fee, as defined in rule 2830(b)(9) of the Conduct Rules of the NASD ("service fee"), charged in connection with the purchase, sale, or redemption of securities issued by the acquiring fund does not exceed the limits set forth in rule 2830(d)(3) of the Conduct Rules of the NASD; and

(ii) With respect to a separate account that invests in an acquiring fund:

(A) The acquiring fund and exchange-traded fund do not charge a sales load;

(B) Any asset-based sales charge, as defined in rule 2830(b)(8)(A) of the Conduct Rules of the NASD, or service fee is charged only by the acquiring fund or the exchange-traded fund; and

(C) The fees associated with a variable insurance contract that invests in the acquiring fund and the sales charges and service fees charged by the acquiring fund and the exchange-traded fund, in the aggregate, must be reasonable in relation to the services rendered, the expenses expected to be incurred and, with respect to the variable insurance contract, the risks assumed by the insurance company.

(4) Complex fund structures. The exchange-traded fund has a disclosed policy that prohibits it from investing more than 10 percent of its assets in:

(i) Other investment companies in reliance on section 12(d)(1)(F) or section 12(d)(1)(G) of the Act (15 U.S.C. 80a-12(d)(1)(F) or 15 U.S.C. 80a-12(d)(1)(G)) or this section; and

(ii) Any other company that would be an investment company under section 3(a) of the Act (15 U.S.C. 80a-3(a)) but for the exceptions to that definition provided in sections 3(c)(1) and 3(c)(7) of the Act (15 U.S.C. 80a-3(c)(1) and 80a-3(c)(7)).

(b) Exemptions for sale of exchange-traded fund shares.

(1) Notwithstanding sections 12(d)(1)(B), 17(a)(1), 17(a)(2), 57(a)(1), and 57(a)(2) of the Act (15 U.S.C. 80a-12(d)(1)(B), 15 U.S.C. 80a-17(a)(1), 15 U.S.C. 80a-56(a)(1), and 15 U.S.C. 80a-56(a)(2)), an exchange-traded fund, any principal underwriter thereof, and a broker or a dealer may sell or otherwise dispose of exchange-traded fund shares if the exchange-traded fund does not redeem, or the principal underwriter, broker or dealer does not submit for redemption any of the exchange-traded fund's shares that were acquired by an acquiring fund in

excess of the limits of section 12(d)(1)(A)(i) of the Act (15 U.S.C. 80a-12(d)(1)(A)(i)) in reliance on paragraph (a) of this section. For purposes of this paragraph, an acquiring fund will be deemed to have redeemed or sold the most recently acquired exchange-traded fund shares first.

(2) An exchange-traded fund, a principal underwriter thereof, or broker or dealer will be deemed to have complied with the condition in paragraph (b)(1) of this section if it has:

(i) Received a representation from the acquiring fund that none of the exchange-traded fund shares it is redeeming was acquired in excess of the limits of section 12(d)(1)(A)(i) of the Act (15 U.S.C. 80a-12(d)(1)(A)(i)) in reliance on paragraph (a) of this section; and

(ii) No reason to believe that the acquiring fund is redeeming any exchange-traded fund shares that the acquiring fund acquired in excess of the limits of section 12(d)(1)(A)(i) of the Act (15 U.S.C. 80a-12(d)(1)(A)(i)) in reliance on paragraph (a) of this section.

(c) Exemption from certain monitoring and recordkeeping requirements under § 270.17e-1. Notwithstanding the requirements of §§ 270.17e-1(b)(3) and 270.17e-1(d)(2), the payment of a commission, fee, or other remuneration to a broker shall be deemed as not exceeding the usual and customary broker's commission for purposes of section 17(e)(2)(A) of the Act (15 U.S.C. 80a-17(e)(2)(A)) if:

(1) The commission, fee, or other remuneration is paid in connection with the sale of securities to or by an acquiring fund;

(2) The broker and the acquiring fund are affiliated persons because each is an affiliated person of the same exchange-traded fund; and

(3) The acquiring fund is an affiliated person of the exchange-traded fund solely because the acquiring fund owns, controls, or holds with power to vote five percent or more of the

outstanding securities of the exchange-traded fund.

(d) Definitions.

(1) Depositor includes the person primarily responsible for the organization of the unit investment trust, the person who has continuing functions or responsibilities with respect to the administration of the affairs of the trust, and the sponsor or manager of the trust.

(2) Exchange-traded fund has the same meaning as in § 270.6c-11(e)(4) and also includes a registered unit investment trust that satisfies the criteria set forth in § 270.6c-11(e)(4).

(3) Exchange-traded fund share has the same meaning as in § 270.6c-11(e)(5).

PART 239 – FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

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

7. 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.

*   *   *   *   *

8. Form N-1A (referenced in §§ 239.15A and 274.11A) is amended by:

a. Adding the definitions "Exchange-Traded Fund" and "Market Price" in alphabetical order to General Instructions A.;

b. Adding paragraph 5 to the Instructions to Item 2 paragraph (c)(2);

c. Adding paragraph 1(e) to the Instructions to Item 3;

d. Revising paragraph 1(a) and adding paragraph (h) to Item 6;

e. Adding paragraph 3(f) to the Instructions to Item 8(a); and

f. Adding paragraph 12 to the Instructions to paragraphs (b)(7)(i) and (ii), paragraph (iv) to paragraph (b)(7), and paragraph 1(e) to the Instructions to paragraph (d) of Item 22.

The additions and revisions read as follows:

Note: The text of Form N-1A does not, and this amendment will not, appear in the Code of Federal Regulations.

Form N-1A

* * * * *

General Instructions

A. Definitions

* * * * *

"Exchange-Traded Fund" means a Fund whose shares are traded on a national securities exchange and satisfies the criteria set forth in rule 6c-11(e)(4) (17 CFR 270.6c-11(e)(4)).

* * * * *

"Market Price" refers to the last price at which Exchange-Traded Fund shares trade on the principal U.S. market on which the Fund's shares are traded during a regular trading session.

* * * * *

Item 2. Risk/Return Summary: Investments, Risks, and Performance

* * * * *

(c) Principal risks of investing in the Fund

* * * * *

(2) Risk/Return Bar Chart and Table

* * * * *

Instructions

* * * * *

5. Exchange-Traded Funds.

(a) Add a caption in the "Average Annual Total Returns" table directly above the caption titled "Index". Title the caption "Returns—Market Price". Disclose in the caption the Fund's average annual total return based on the Market Price for the periods indicated. In a footnote to the caption, explain how Market Price returns are calculated and how they differ from NAV returns.

(b)_If the Fund has an investment objective of obtaining returns that correspond to the returns of a securities index, the table must show the average annual total returns of the securities index specified in its registration statement for the same periods. The Fund may exclude the returns of an appropriate broad-based securities market index as defined in Instruction 5 to Item 22(b)(7) for the same periods.

Item 3. Risk/Return Summary: Fee Table

* * * * *

Instructions

1. General.

* * * * *

(e) (i) If the Fund is an Exchange-Traded Fund and issues or redeems shares in creation units of not less than 25,000 shares each, exclude any fees charged for the purchase and redemption of the Fund's creation units.

(ii) Modify the narrative explanation to state that Fund shares are sold on a national securities exchange at the end of the time periods indicated, and that brokerage commissions for buying and selling Fund shares through a broker are not reflected.

* * * * *

Item 6. Shareholder Information

(a) * * *

(1) An explanation that the price of Fund shares is based on the Fund's net asset value and the method used to value Fund shares (market price, fair value, or amortized cost); except that if the Fund is an Exchange-Traded Fund, an explanation that the price of Fund shares is based on Market Price.

* * * * *

(h) Exchange-Traded Funds.

(1) If the Fund issues or redeems Fund shares in creation units of not less than 25,000 shares each, the Fund may omit from the prospectus the information required by Items 6(a)(2), (b) and (c).

(2) Identify the principal U.S. market or markets on which the Fund shares are traded and the trading symbol(s) for those shares, unless the information appears on the front cover page.

(3) Specify the number of Fund shares that the Fund will issue (or redeem) in exchange for the deposit (or delivery) of basket assets as defined in rule 6c-11 [17 CFR 270.6c-11] (i.e., a creation unit) and explain that individual Fund shares may only be purchased and sold on a national securities exchange through a broker-dealer.

(4) Premium/Discount Information. Provide a table showing the number of days the Market Price of the Fund shares was greater than the Fund's net asset value and the number of days it was less than the Fund's net asset value for the most recently completed calendar year, and the most recently completed calendar quarters since that year, or the life of the Fund (if shorter).

Instructions.

1. Provide the information in tabular form.

2. Express the information as a percentage of the net asset value of the Fund, using separate columns for the number of days the Market Price was greater than the Fund's net asset value and the number of days it was less than the Fund's net asset value. Round all percentages to the nearest hundredth of one percent.

3. Adjacent to the table, provide a brief explanation that: shareholders may pay more than net asset value when they buy Fund shares and receive less than net asset value when they sell those shares, because shares are bought and sold at current market prices.

4. Include a statement that the data presented represents past performance and cannot be used to predict future results.

* * * * *

Item 8. Financial Highlights Information

(a) * * *

Instructions.

* * * * *

3. Total Return. * * *

(f) Exchange-Traded Funds. (i) Change the caption "Total Return" to "Total Return—NAV".

(ii) Add a caption following "Total Return—NAV" titled "Total Return—Market Price". Disclose in the caption the Fund's total return using Market Price, assuming a purchase of Fund shares at the Market Price on the first day and a sale of the shares on the last day of each period shown.

*   *   *   *   *

Item 22. Financial Statements

*   *   *   *   *

(b) Annual Report.   *   *   *

(7) Management's Discussion of Fund Performance.   *   *   *

Instructions.

12. Exchange-Traded Funds.

(a) Include a second line graph immediately following the line graph required by paragraph (b)(7)(ii)(A) of this Item, assume an initial investment of $10,000 was made at the Market Price on the business day before the first day of the first fiscal year, and base the subsequent account values on the Market Price on the last business day of the first and each subsequent fiscal year. Calculate the final account value by assuming the investor sold all Exchange-Traded Fund shares at the Market Price on the last business day of the most recent fiscal year.

(b) For purposes of the table required by paragraph (b)(7)(ii)(B) of this Item, add a caption titled "Returns—Market Price". Disclose in the caption the Fund's average annual total return based on Market Price for the periods indicated. In a footnote to the caption, explain how Market Price returns are calculated and how they differ from returns based on net asset value.

(c) If the Fund has an investment objective of obtaining returns that correspond to the returns of a securities index, the table must show the average annual total returns of the securities index specified in its registration statement for the same periods. The Fund may exclude the returns of an appropriate broad-based securities

market index as defined in Instruction 5 to paragraph (b)(7)(i) and (ii) of this Item for the same periods.

* * * * *

(iv) Premium/Discount Information. Provide a table showing the number of days the Market Price of the Fund shares was greater than the Fund's net asset value and the number of days it was less than the Fund's net asset value for the most recently completed five fiscal years (or the life of the Fund if shorter), but only for periods subsequent to the effective date of the Fund's registration statement.

Instructions.

(a) Provide the information in tabular form.

(b) Express the information as a percentage of the net asset value of the Exchange-Traded Fund, using separate columns for the number of days the Market Price was greater than the Fund's net asset value and the number of days it was less than the Fund's net asset value. Round all percentages to the nearest hundredth of one percent.

(c) Adjacent to the table, provide a brief explanation that: shareholders may pay more than net asset value when they buy Fund shares and receive less than net asset value when they sell those shares, because shares are bought and sold at current market prices.

(d) Include a statement that the data presented represents past performance and cannot be used to predict future results.

* * * * *

(d) Annual and Semi-Annual Reports. * * *

Instructions.

1. General.

*   *   *   *   *

(e) (i) If the Fund is an Exchange-Traded Fund and issues or redeems shares in creation units of not less than 25,000 shares each, exclude from the narrative explanation and the Example any fees charged for the purchase and redemption of the Fund's creation units.

(ii) Modify the narrative explanation to state that Fund shares are sold on a national securities exchange at the end of the time periods indicated, and that brokerage commissions for buying and selling Fund shares through a broker are not reflected.

*   *   *   *   *

By the Commission.

Nancy M. Morris
Secretary

Dated: March 11, 2008

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Rel. No. 8902 / March 11, 2008

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 57475 / March 11, 2008

INVESTMENT ADVISERS ACT OF 1940
Rel. No. 2719 / March 11, 2008

INVESTMENT COMPANY ACT OF 1940
Rel. No. 28194 / March 11, 2008

Admin. Proc. File No. 3-12559

In the Matter of GREGORY O. TRAUTMAN	ORDER GRANTING REQUEST FOR PROTECTIVE ORDER

On February 26, 2008, Gregory O. Trautman submitted personal financial information to the Commission in connection with his petition for review of an administrative law judge's initial decision and requested a protective order limiting disclosure of this information. 1/ Under Commission Rule 322, any party "may file a motion requesting a protective order to limit from disclosure to other parties or to the public documents or testimony that contain confidential information." 2/ "A motion for a protective order shall be granted only upon a finding that the harm resulting from disclosure would outweigh the benefits of disclosure." 3/ The Division of Enforcement has not opposed Trautman's request for a protective order.

The Commission recognizes that the documents Trautman submitted contain sensitive information. At this stage in the proceeding, we believe that the harm resulting from complete disclosure outweighs the benefits. However, we have determined that disclosure of certain information included in the documents will be necessary to the resolution of the issues before us.

1/ 17 C.F.R. § 201.322.

2/ 17 C.F.R. § 201.322(a).

3/ 17 C.F.R. § 201.322(b).

Accordingly, IT IS ORDERED that:

1. Except as otherwise provided in this Order, the documents Trautman provided shall be disclosed only to the parties to this action, their counsel, the Commission, any staff advising the Commission in its deliberative processes with respect to this proceeding, and in the event of an appeal of the Commission's determination, any staff acting for the Commission in connection with that appeal.

2. All persons who receive access to these documents or the information contained in these documents shall keep them confidential and, except as provided in this Order, shall not divulge the documents or information to any person.

3. No person to whom the documents or information covered by the Order is disclosed shall make any copies or otherwise use such documents or information, except in connection with this proceeding or any appeal thereof.

4. The Office of the Secretary shall place the documents in sealed envelopes or other sealed containers marked with the title of this action, identifying each document and marked "CONFIDENTIAL."

5. The requirements of sealing and confidentiality shall not apply to any reference to the existence of the documents or to citation of particular information contained therein in testimony, oral argument, briefs, opinions, or in any other similar use directly connected with this action or any appeal thereof.

6. The Commission expressly reserves the authority to reach a different conclusion regarding the confidentiality of the documents or information covered by this Order at any time before it determines the issues raised in the proceeding.

By the Commission.

Nancy M. Morris
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 2718 / March 11, 2008

INVESTMENT COMPANY ACT OF 1940
Release No. 28192 / March 11, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12986

In the Matter of **MICHAEL R. DONNELL,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTIONS 203(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940 AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940 AS TO MICHAEL R. DONNELL**

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 Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act"), and Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act") against Michael R. Donnell ("Donnell" or "Respondent").

II.

In anticipation of the institution of these public administrative proceedings, Donnell has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purposes of these proceedings and any other proceedings brought by or on behalf of the Commission or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over himself and the subject matter of these proceedings, which are admitted, Donnell 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 203(f) and 203(k) of the Investment Advisers Act of 1940 and Section 9(b) of the Investment Company Act of 1940 as to Michael R. Donnell ("Order").

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III.

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

Summary

This matter concerns the failure of Michael Donnell to disclose the conflict of interest arising from a sub-adviser's payment of substantial "referral fees" to his mother. Donnell was a vice president of Mercantile Capital Advisors, Inc. ("Mercantile Advisors"), a registered investment adviser. Mercantile Advisors manages a "fund of hedge funds" investment company (the "Mercantile Fund") that is registered with the Commission, and Donnell was also a vice president of the Mercantile Fund. Donnell and his supervisor were responsible for finding a sub-adviser to manage the Mercantile Fund's portfolio. Donnell recommended hiring a sub-adviser which, he knew, had promised to pay a substantial portion of any sub-advisory fees to his mother as a "referral fee," if it was retained by the Mercantile Fund. The proposed payments created a conflict of interest, but Donnell did not disclose the conflict or the proposed payments to anyone at Mercantile Advisors or to the board of directors of the Mercantile Fund. Eventually, Donnell's mother received payments of about $78,000, which was over one-third of the fees received by the sub-adviser. The arrangement ended when Mercantile Advisor's parent company, Mercantile Bankshares Corp. ("Mercantile Bank"), and the Commission received an anonymous letter disclosing the payments.

Respondent

1. Michael R. Donnell, age 37, is a resident of Miami, Florida. Donnell was a vice president at Mercantile Advisors from March 2002 until his termination in March 2004, and he was a vice-president of the Mercantile Fund.

Other Relevant Entity

2. Mercantile Capital Advisors, Inc. is a Maryland corporation and a wholly-owned subsidiary of Mercantile Safe Deposit & Trust Co., which was the largest affiliate of Mercantile Bank. Mercantile Advisors is registered with the Commission as an investment adviser under the Advisers Act (File No. 801-60093). On March 2, 2007, Mercantile Bank merged with and into the PNC Financial Services Group, Inc. ("PNC"), with PNC as the surviving entity. PNC is a diversified financial services company headquartered in Pittsburgh, Pennsylvania; its common stock is registered with the Commission pursuant to Section 12(b) of the Securities Exchange Act of 1934.

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

Background

Mercantile Bank Enters Hedge Fund Business

3. In 2001, Mercantile Bank began to develop in-house hedge fund products for sale to its customers. In 2002, Mercantile Bank hired Donnell as a consultant to the hedge funds project. In March 2002, Mercantile Advisors hired Donnell as a Managing Director with the title Vice President – Alternative Investments Distribution. In this capacity, Donnell's chief responsibility was to organize the creation of three "fund of hedge funds" investment companies and to market the new product line to Mercantile Bank's customers. The three investment companies each appointed Donnell vice-president as well.

4. Mercantile Advisors planned to manage, administer and advise the three investment companies, which would register with the Commission under the Investment Company Act. Each of the three registered investment companies would invest in unregistered hedge funds engaged in a variety of investments. Mercantile Bank invested $25 million in seed capital in each of the three investment companies.

Mercantile Advisors Hires a Sub-Adviser on Donnell's Recommendation

5. With his supervisor, Donnell undertook the task of locating appropriate candidates to serve as sub-advisers to the funds. The sub-advisers would be responsible for carrying out the funds' investment strategies; specifically, they would research and identify appropriate investments, and thereafter review, supervise and administer the investments. A friend of Donnell's family worked at an investment advisory firm and had experience with investing in hedge funds. On Donnell's recommendation, Mercantile Bank officials met with the friend and another official of the friend's firm. Thereafter, Donnell conducted due diligence on the friend's firm in anticipation of selecting the firm as sub-adviser to the Mercantile Fund. Donnell prepared a due diligence memorandum for his superiors at Mercantile Bank, recommending that Mercantile Advisors and the Mercantile Fund hire his friend's firm as sub-adviser. On October 28, 2002, following a presentation by Donnell and his supervisor recommending the hiring of the friend's firm, the Mercantile Fund's board of directors approved hiring the sub-adviser.

6. At the time that Donnell made the presentation, he was also helping his mother negotiate with the proposed sub-adviser an agreement to pay her a fee or fees for referring the sub-adviser to the Mercantile Fund. In these negotiations, Donnell learned the amounts and terms of the proposed payments to his mother. However, Donnell did not disclose to anyone at Mercantile Advisors or the Mercantile Fund the proposed agreement between his mother and the sub-adviser, or his role in their negotiations. Outside of a brief telephone call to the sub-adviser alerting it to the possible business, Donnell's mother performed no services for the sub-adviser, the Mercantile Fund or Mercantile Advisors.

7. The Mercantile Fund filed a Form N-2 registration statement with the Commission on November 22, 2002, and two post-effective amendments on December 30, 2002 and July 7, 2003. On December 30, 2002, the Mercantile Fund commenced operations.

8. On January 1, 2003, the sub-adviser, Mercantile Advisors and the Mercantile Fund signed an Investment Advisory Agreement (the "Advisory Agreement"). Pursuant to the Advisory Agreement, Mercantile Advisors agreed to pay the sub-adviser 50% of the management fee that it received from the Mercantile Fund. The management fee was a quarterly payment of 0.3125% of the fund's net assets (1.25% per year); therefore, the fee was based on the amount of money invested by the public in the fund. Mercantile Bank began offering the Mercantile Fund to its clients after the second post-effective amendment was filed, in July 2003. By March 31, 2004, Mercantile Bank's customers had invested approximately $21 million in the fund.

9. Pursuant to the Advisory Agreement, Mercantile Advisors made the following payments to the sub-adviser for its work on the fund:

May 2003	$39,712
August 2003	$48,275
November 2003	$30,700
December 2003	$23,600
February 2004	$66,462
Total:	$208,749

The Sub-Adviser Pays Over One-Third of Its Fees to Michael Donnell's Mother

10. On January 15, 2003, the sub-adviser sent a letter to Donnell's supervisor, disclosing that the sub-adviser planned to pay a "referral fee" to Donnell's mother in connection with the sub-advisory engagement, absent any objection from Mercantile Advisers. Donnell's supervisor discussed the letter with Donnell. Donnell falsely claimed that he had no prior knowledge of the proposed payment. Donnell knew, but did not disclose to his supervisor, the material terms of the agreement between his mother and the sub-adviser or his role in assisting his mother in negotiating the terms of her agreement with the sub-adviser. Donnell also knew, but did not disclose, that the payments to his mother would be continuous and would increase if the assets in the Mercantile Fund exceeded $60 million.

11. On March 10, 2003, the sub-adviser and Donnell's mother executed a written agreement in which the sub-adviser agreed to pay Donnell's mother 50% of the management fee it received from Mercantile Advisors on the first $25 million of assets in the Mercantile Fund, and 20% of any fee it received on fund assets in excess of $60 million.

12. The sub-adviser made the following payments to Donnell's mother:[2]

May 2003	$19,531
August 2003	$19,531
December 2003	$9,765
January 2004	$9,765
February 2004	$19,530
Total:	$78,122

13. Beyond the conversation with his immediate supervisor, Donnell did not disclose the existence of the agreement between his mother and the sub-adviser or the payments made thereunder to anyone else at Mercantile Advisors or the Mercantile Fund. Neither the Mercantile Fund's filings with the Commission nor its offering documents disclosed the agreement or the payments.

14. In March 2004, Mercantile Advisors' parent company received an anonymous letter disclosing the payments to Donnell's mother by the sub-adviser to the Mercantile Fund. Soon thereafter Mercantile Advisors terminated both Donnell and the agreement with the sub-adviser.

Donnell Willfully Aided and Abetted and Caused Mercantile Advisors'
Violations of Sections 206(1) and 206(2) of the Advisers Act

15. As a result of the conduct described above, Mercantile Advisors violated Sections 206(1) and 206(2) of the Advisers Act, and Donnell willfully aided and abetted and caused Mercantile Advisers' violations. Sections 206(1) and 206(2) of the Advisers Act make it unlawful for any investment adviser to employ any device, scheme, or artifice to defraud, or to engage in any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client. The arrangement between the sub-adviser and Donnell's mother created a material conflict between the interests of Mercantile Advisors (and its associated person, Donnell) and those of the Mercantile Fund. The knowledge that Donnell's mother stood to benefit financially would have been material to the decision of the Mercantile Fund to accept Donnell's recommendation of the friend's firm as sub-adviser. Mercantile Advisors violated Sections 206(1) and 206(2) of the Advisers Act when it failed to disclose that conflict to the Mercantile Fund's board of directors. Donnell failed to disclose this conflict of interest to the Mercantile Fund, even though he played a major role in the selection of the sub-adviser to the Mercantile Fund and he was directly involved in the ongoing evaluation of the sub-adviser's performance after the fund became operational. Donnell therefore willfully aided and abetted and caused Mercantile Advisers' violations.

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[2] In August 2003, the family friend and an investment partnership formed a new corporation, which purchased the Mercantile Fund's sub-adviser. The Mercantile Fund and Mercantile Advisors agreed to retain the new corporation as sub-adviser, and the new sub-adviser agreed to continue the payment of fees to Donnell's mother. Both entities are referred to in this Order as "sub-adviser."

IV.

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

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

A. Donnell cease and desist from committing or causing any violation of and any future violations of Sections 206(1) and 206(2) of the Advisers Act;

B. Donnell be, and hereby is, barred from association with any investment adviser, and is prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter, with the right to reapply for association after three years to the appropriate self-regulatory organization, or if there is none, to the Commission;

C. Any reapplication for association by Donnell 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 Donnell, 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. It is further ordered that Donnell shall pay a civil money penalty in the amount of $50,000. Such payment shall be made as follows: $20,000 within 10 days of the entry of the Order and 11 payments of $1,000 each every 30 days thereafter with one final twelfth payment of $19,000 to be made on the first year anniversary of the entry of the Order. All payments shall be made 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 Donnell 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 Kara N. Brockmeyer, Division of Enforcement, Securities and Exchange Commission, 100 F St., N.E., Washington, D.C. 20549-8549.

Donnell agrees that if the full amount of any payment described above is not made by the date the payment is required by this Order, the entire amount of the civil penalty plus any interest accrued pursuant to 31 U.S.C. Section 3717, minus payments made, if any, is due and payable immediately without further application.

By the Commission.

Nancy M. Morris
Secretary

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-57478; File Nos. SR-NASDAQ-2007-004 and SR-NASDAQ-2007-080)

March 12, 2008

Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Notice of Filing of Amendment No. 2 to a Proposed Rule Change and Order Granting Accelerated Approval to a Proposed Rule Change, as Amended, to Establish Rules Governing the Trading of Options on the NASDAQ Options Market; Order Approving a Proposed Rule Change Relating to the LLC Agreement Establishing the NASDAQ Options Market LLC and Delegation Agreement Delegating to NOM LLC the Authority to Operate the NASDAQ Options Market; Order Granting an Application of The NASDAQ Stock Market LLC for an Exemption Pursuant to Section 36(a) of the Exchange Act from the Requirements of Section 19(b) of the Exchange Act; and Order Granting an Exemption for the NASDAQ Options Market LLC from Section 11A(b) of the Exchange Act

I. Introduction

On January 30, 2007, The NASDAQ Stock Market LLC ("Nasdaq" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),[1] and Rule 19b-4 thereunder,[2] a proposed rule change ("Trading Rules Proposal") to adopt rules governing participation in and trading on The NASDAQ Options Market ("NOM"), which will be an options exchange facility of Nasdaq operated by The Nasdaq Options Market LLC ("NOM LLC"). The proposed rule change, as modified by Amendment No. 1, was published for comment in the Federal Register on May 1, 2007.[3] The Commission received five comment letters regarding the proposed rule change.[4] Nasdaq responded to the commenters in a letter dated December 13,

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

[2] 17 CFR 240.19b-4.

[3] See Securities Exchange Act Release No. 55667 (April 25, 2007), 72 FR 23869 ("Trading Rules Proposal Notice").

[4] See letters to Nancy M. Morris, Secretary, Commission, from Stephen Schuler, Managing Member, Global Electronic Trading Company ("GETCO"), and Daniel Tierney, Managing Member, GETCO, dated July 20, 2007 ("GETCO Letter"); Michael J. Simon,

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2007,[5] and filed Amendment No. 2 to the proposal on December 13, 2007. This notice and order provides notice and solicits comments from interested persons regarding Amendment No. 2 and approves the Trading Rules Proposal, as amended, on an accelerated basis.

Also, on September 17, 2007, the Exchange filed with the Commission a proposed rule change, pursuant to Section 19(b)(1) of the Act[6] and Rule 19b-4 thereunder,[7] to establish, through a limited liability company agreement, NOM LLC, and to delegate to NOM LLC the authority to operate NOM as a facility of Nasdaq ("Corporate Structure Proposal," and, with the Trading Rules Proposal, the "Proposals"). The proposed rule change was published for comment in the Federal Register on October 12, 2007.[8] The Commission received no comments on the proposal. This order approves the Corporate Structure Proposal.

On December 13, 2007, Nasdaq requested that the Commission grant NOM LLC a permanent exemption from the requirement under Section 11A(b) of the Act and Rule 609 thereunder that a securities information processor ("SIP") acting as an exclusive processor

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Secretary, The International Securities Exchange, LLC ("ISE"), dated June 15, 2007 ("ISE Letter"); John C. Nagel, Director and Associate General Counsel, Citadel Investment Group L.L.C. ("Citadel"), dated June 11, 2007 ("Citadel Letter"); Michael T. Bickford, Senior Vice President, Options, American Stock Exchange LLC ("Amex"), dated May 24, 2007 ("Amex Letter"); and Christopher Nagy, Chair, Securities Industry and Financial Markets Association ("SIFMA") Options Committee, dated May 22, 2007 ("SIFMA Letter").

5 See letter from Jeffrey S. Davis, Vice President and Deputy General Counsel, Nasdaq, to Nancy M. Morris, Secretary, Commission, dated December 13, 2007 ("Nasdaq Response").

6 15 U.S.C. 78s(b)(1).

7 17 CFR 240.19b-4.

8 See Securities Exchange Act Release No. 56604 (October 3, 2007), 72 FR 58137 ("Corporate Structure Proposal Notice").

register with the Commission.[9] Further, on December 13, 2007, Nasdaq asked the Commission to exempt Nasdaq from the rule filing requirements of Section 19(b) of the Act for changes to NOM rules that are effected solely by virtue of a change to a Chicago Board Options Exchange ("CBOE"), New York Stock Exchange ("NYSE"), or Financial Industry Regulatory Authority ("FINRA") rule that NOM has incorporated by reference. This order grants these exemptions.

II. Discussion and Commission Findings

After careful review of the Trading Rule Proposal, as amended, and consideration of the comment letters and Nasdaq's response to the commenters, and the Corporate Structure Proposal, the Commission finds that the Trading Rules Proposal, as amended, and the Corporate Structure Proposal are consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.[10] Specifically, the Commission finds that the Proposals are consistent with Section 6(b)(5) of the Act,[11] which requires, among other things, that the rules of a national securities exchange be designed to prevent fraudulent and manipulative acts and practices; to promote just and equitable principles of trade; to foster cooperation and coordination with persons engaged in regulating, clearing, settling, and processing information with respect to, and facilitating transactions in securities; to remove impediments to and perfect the mechanism of a free and open market and a national market system; and, in general, to protect investors and the public interest. Section 6(b)(5) also requires that the rules of an exchange not be designed to permit unfair discrimination among

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9 15 U.S.C. 78k-1(b). Rule 609 under the Act, 17 CFR 242.609, requires that the registration of a securities information processor be on Form SIP, 17 CFR 249.1001.

10 In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

11 15 U.S.C. 78f(b)(5).

customers, issuers, brokers, or dealers. Further, the Commission finds that the Proposals are consistent with Sections 6(b)(1) of the Act,[12] which requires, among other things, that a national securities exchange be so organized and have the capacity to carry out the purposes of the Act, and to comply and enforce compliance by its members and persons associated with its members, with the provisions of the Act, the rules and regulation thereunder, and the rules of the exchange, and Section 6(b)(2) of the Act,[13] which requires, in part, that the rules of an exchange assure a fair representation of its members in the selection of its directors and administration of its affairs.

Overall, the Commission believes that approving Nasdaq's Proposals could confer important benefits on the public and market participants. In particular, NOM's entry into the marketplace could provide market participants with an additional venue for executing orders in standardized options, enhance innovation, and increase competition between and among the options exchanges, resulting in better prices and executions for investors.

This discussion does not review every detail of the proposed rule changes, but focuses on the comments received and the most significant rules and policy issues considered in review of the proposals.

A. Corporate Structure

In connection with the establishment of NOM, Nasdaq has entered into a limited liability company agreement ("NOM LLC Agreement") to establish NOM LLC as a Delaware limited liability company that will operate NOM as a facility of Nasdaq, as that term is defined in

[12] 15 U.S.C. 78f(b)(1).

[13] 15 U.S.C. 78f(b)(2).

Section 3(a)(2) of the Act.[14] Nasdaq and NOM LLC also will enter into a delegation agreement ("NOM Delegation Agreement"), pursuant to which Nasdaq will delegate to NOM LLC certain limited responsibilities and obligations with respect to the operation of NOM as an options facility of Nasdaq.[15]

Nasdaq, a registered national securities exchange, is the wholly-owned subsidiary of The NASDAQ Stock Market, Inc. ("Nasdaq Holding Company"). NOM LLC will be a direct, wholly-owned subsidiary of Nasdaq, and, pursuant to the NOM LLC Agreement, Nasdaq may not transfer or assign, in whole or in part, its interest in NOM LLC.[16] Further, NOM will be operated as a facility of the Exchange and Nasdaq will retain self-regulatory responsibility for NOM.

1. Changes in Control of NOM; Ownership and Voting Limitations

The Commission notes that the Nasdaq Holding Company's Restated Certificate of Incorporation imposes limits on direct and indirect changes in control, which are designed to prevent any shareholder from exercising undue control over the operation of the Exchange and to

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14 15 U.S.C. 78c(a)(2). Pursuant to Section 3(a)(2), a "facility" "with respect to an exchange includes its premises, tangible or intangible property whether on the premises or not, any right to the use of such premises or property or any service thereof for the purpose of effecting or reporting a transaction on an exchange (including, among other things, any system of communication to or from the exchange, by ticker or otherwise, maintained by or with the consent of the exchange), and any right of the exchange to the use of any property or service."

15 The form of each of the NOM LLC Agreement and NOM Delegation Agreement are available at the Commission's Web site http://www.sec.gov.

16 See NOM LLC Agreement, Section 19. Also, Nasdaq Holding Company may not transfer or assign its interest in Nasdaq, other than to an affiliate of Nasdaq Holding Company. See Limited Liability Company Agreement of The NASDAQ Stock Market LLC, Section 20. Any change to Nasdaq's status as the sole member of NOM LLC, or to Nasdaq Holding Company's status as the sole member of Nasdaq, would have to be filed pursuant to Section 19(b) of the Act. 15 U.S.C. 78s.

ensure that the Exchange and the Commission are able to carry out their regulatory obligations under the Act. Specifically, no person who beneficially owns shares of common stock, preferred stock, or notes in excess of five percent of the securities generally entitled to vote may vote shares in excess of five percent.[17]

The Exchange's rules also prohibit Exchange members and persons associated with Exchange members from beneficially owning more than 20 percent of the then-outstanding voting securities of Nasdaq Holding Company.[18] Members that trade on an exchange or through the facility of an exchange traditionally have ownership interests in such exchange or facility. The Commission has noted in the past, however, that a member's interest in an exchange could become so large as to cast doubt on whether the exchange can fairly and objectively exercise its self-regulatory responsibilities with respect to that member.[19] A member that is a controlling shareholder of an exchange might be tempted to exercise that controlling influence by directing the exchange to refrain from, or the exchange may hesitate to, diligently monitor and surveil the member's conduct or diligently enforce its rules and the federal securities laws with respect to conduct by the member that violates such provisions.

The Commission believes that the proposed corporate structure for NOM is consistent

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[17] See Nasdaq Holding Company Restated Certificate of Incorporation, Article Fourth, C. The Nasdaq Holding Company board of directors may approve an exemption from the five percent voting limitation for any person that is not a broker-dealer, an affiliate of a broker-dealer, or a person subject to a statutory disqualification under Section 3(a)(39) of the Act. See id. Any such exemption from the five percent voting limitation would not be effective until approved by the Commission pursuant to Section 19 of the Act. See Nasdaq Holding Company By-Laws, Article XII, Section 12.5.

[18] See Exchange Rule 2130.

[19] See Securities Exchange Act Release No. 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006) (order approving Nasdaq's application to register as a national securities exchange) ("Registration Approval Order") at note 42 and accompanying text.

with the Act. The voting restrictions imposed on shareholders of Nasdaq Holding Company will flow through to NOM LLC by virtue of the fact that NOM LLC will be a wholly-owned subsidiary of Nasdaq, which is a wholly-owned subsidiary of Nasdaq Holding Company. The ownership limitation on members of Nasdaq will apply to NOM participants by virtue of the fact that all NOM participants must be members of the Exchange. These ownership and voting restrictions are designed to minimize the potential that a person could improperly interfere with or attempt to restrict the ability of the Commission or the Exchange to effectively carry out their regulatory oversight responsibilities under the Act.

2. Fair Representation

NOM LLC will not have its own board of directors or committees separate from the board and committees of the Exchange. The Commission believes that because NOM LLC does not have a separate board, and because all NOM participants will be Exchange members, the composition of and selection process for the Exchange board continues to satisfy the requirement in Section 6(b)(3) of the Act that the rules of the Exchange provide for the fair representation of members in the selection of directors and the administration of the Exchange.[20]

3. Regulatory Independence

As noted above, NOM LLC will not have its own board or committees separate from those of the Exchange. Additionally, pursuant to the NOM LLC Agreement, management of the company is vested in the Exchange, and the officers of NOM LLC will be the officers of the Exchange.[21] As a result, NOM LLC may only act through the Exchange and its officers and

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[20] See Registration Approval Order, supra note 19, at 3553.

[21] See NOM LLC Agreement, Sections 9 and 10, respectively. See also Section 9(b) of the NOM LLC Agreement which requires NOM LLC and the Exchange to comply with federal securities laws and the rules and regulations thereunder, and to cooperate with the Commission and NOM pursuant to their regulatory authority.

directors.

The Commission notes that certain provisions of the Exchange's and Nasdaq Holding Company's corporate documents are designed to maintain the independence of Nasdaq's self-regulatory function, enable the Exchange to operate in a manner that complies with federal securities laws, including the objectives of Sections 6(b) and 19(g) of the Act, and facilitate the ability of Nasdaq and the Commission to fulfill their regulatory and oversight obligations under the Act.[22] As a facility of Nasdaq, the protections afforded by these provisions in the corporate documents of the Exchange and Nasdaq Holding Company extend to the operation of NOM.

Similar provisions also are included in the NOM Delegation Agreement. For example, NOM agrees: (1) to keep confidential non-public information relating to Nasdaq and not to use such information for any commercial purposes; (2) to provide the Commission and Nasdaq access to NOM's books and records at all times and to maintain such books and records within the United States; (3) that the books, records, premises, officers, and employees of NOM shall be deemed to be those of Nasdaq for purposes of the Act; and (4) to cooperate with, and take reasonable steps to cause its agents to cooperate with, the Commission and Nasdaq pursuant to their regulatory authority. In addition, NOM and its officers and employees submit to the jurisdiction of the Commission and agree to give due regard to the preservation of the self-regulatory function of Nasdaq.[23] Further, the NOM Delegation Agreement may not be amended unless such amendment is filed with, or filed with and approved by, the Commission pursuant to

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22 A discussion of Nasdaq's corporate structure and the protections afforded by the corporate documents of Nasdaq and Nasdaq Holding Company, is set forth in the Registration Approval Order, supra note 19. The corporate documents of Nasdaq and Nasdaq Holding Company are not being amended by this proposed rule change.

23 See NOM Delegation Agreement, II.B.

Section 19 of the Act.[24] The Commission believes that these provisions, which are designed to assist Nasdaq in fulfilling its self-regulatory obligations and in administering and complying with the requirements of the Act, are consistent with the Act, in particular Sections 6(b)(1) and 19(g).

B. Status of NOM as a Facility of Nasdaq and Delegation of Authority to NOM LLC

As a facility of Nasdaq, NOM will be subject to the Commission's oversight and examination. Consequently, the Commission will have the same authority to oversee the premises, personnel, and records of NOM LLC as it currently has with respect to Nasdaq. In addition, Nasdaq will be fully responsible for all activity that takes place through NOM, and NOM participants will be subject to Nasdaq's rules and oversight.

As described in detail in the Notice, the NOM Delegation Agreement provides that Nasdaq will delegate to NOM LLC performance of certain limited responsibilities and obligations of Nasdaq with respect to the operation of NOM as an options trading facility. Nasdaq, however, expressly retains ultimate responsibility for the fulfillment of its statutory and self-regulatory obligations under the Act. Accordingly, as described more fully below, Nasdaq will retain ultimate responsibility for such delegated responsibilities and functions, and any actions taken pursuant to delegated authority will remain subject to review, approval or rejections by Nasdaq's board of directors in accordance with procedures established by Nasdaq's board of directors. Nasdaq has filed the NOM Delegation Agreement as part of its rules.

Pursuant to the Delegation Agreement, Nasdaq expressly retains the authority to (1) delegate authority to NOM LLC to take actions on behalf of the Exchange, and (2) direct NOM LLC to take action necessary to effectuate the purposes and functions of Nasdaq, consistent with the independence of Nasdaq's regulatory functions, exchange rules, policies and procedures, and

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[24] See NOM Delegation Agreement, III.

the federal securities laws.[25] NOM LLC will have delegated authority to, among other things, operate NOM, develop and adopt governing listing standards applicable to options listed on NOM in consultation with Nasdaq, and establish and assess listing fees, transaction fees, market data fees and other fees for the products and services offered by NOM.[26] In addition, NOM LLC will have the authority to act as a SIP for quotations and transaction information related to securities traded on NOM and any trading facilities operated by NOM LLC.[27]

NOM LLC also will have authority to develop, adopt, and administer rules governing participation in NOM,[28] but the Exchange represents that it will have ultimate responsibility for the operations, rules and regulations developed by NOM LLC, as well as their enforcement. Further, the Exchange represents that actions taken by NOM LLC pursuant to its delegated authority will remain subject to review, approval or rejection by the Exchange's board of directors.[29] In addition, NOM LLC will be responsible for referring to Nasdaq any complaints of a regulatory nature involving potential rule violations by member organizations or employees,[30] and Nasdaq will retain overall responsibility for ensuring that the statutory and self-regulatory functions of the Exchange are fulfilled.[31]

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25 See Corporate Structure Proposal Notice, supra note 8, at 58140 and NOM Delegation Agreement, I.

26 See Corporate Structure Proposal Notice, supra note 8, at 58140 and NOM Delegation Agreement, II.A.

27 See NOM Delegation Agreement, II.A.3.

28 Id.

29 See Corporate Structure Proposal Notice, supra note 8, at 58140.

30 See NOM Delegation Agreement, II.A.9.

31 See NOM Delegation Agreement, I.1.

The Commission finds that it is consistent with the Act for Nasdaq to delegate the operation of NOM to NOM LLC, while retaining ultimate responsibility for statutory and self-regulatory obligations and ensuring that NOM's business is conducted in a manner consistent with the requirements of the Act.

C. Access to NOM

Only Options Participants ("Options Participants" or "Participants") may transact business on NOM via the System.[32] There are two categories of Participants: (1) Options Order Entry Firms ("OEFs"), which represent customer orders as agent or conduct proprietary trading; and (2) Options Market Makers ("Options Market Makers" or "Market Makers"). A Participant must be a member of Nasdaq and of another registered options exchange that is not registered solely under Section 6(g) of the Act.[33] As Nasdaq members, Participants must satisfy the requirements of the Nasdaq Rule 1000 Series (Membership, Registration, and Qualification Requirements), as well as additional requirements set forth in the NOM rules.[34] Further, an OEF

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32 See NOM Rules, Chapter II, Section 1(a). An Options Participant is a firm or organization registered with Nasdaq pursuant to Chapter II of the NOM Rules for purposes of participating in options trading on NOM as an Order Entry Firm or Options Market Maker. See NOM Rules, Chapter I, Section 1(a)(40).

33 15 U.S.C. 78f(g). See NOM Rules, Chapter II, Sections 1(a)(iii) and 2(f). In Amendment No. 2, Nasdaq proposes to eliminate from Chapter II, Section 1(b)(iii) a provision stating that a Nasdaq member would automatically become a NOM Participant upon completing a NOM Application and paying the applicable fees. Nasdaq believes that this provision did not accurately reflect the intended scope of review of NOM applicants, and that eliminating the provision will improve the quality of regulation of NOM. The Commission finds that this change is consistent with the Act.

34 See NOM Rules, Chapter II. Nasdaq's rules apply to Participants unless a specific NOM rule governs or unless the context otherwise requires. See NOM Rules, Chapter I, Section 2. Among others, Participants will be able to provide sponsored access to NOM to a non-member ("Sponsored Participant") pursuant to Nasdaq Rule 4611(d), which Nasdaq adopted in 2007. See Securities Exchange Act Release Nos. 55061 (January 8, 2007), 72 FR 2052 (January 17, 2007) (notice of filing and immediate effectiveness of File No. SR-Nasdaq-2006-061) (adopting Nasdaq Rule 4611(d)); and 55550 (March 28, 2007), 72 FR

may transact business with Public Customers only if it is a member of another registered national securities exchange or association with which Nasdaq has entered into an agreement under Rule 17d-2 under the Act[35] pursuant to which the other exchange or association is the designated options examining authority for the OEF.[36] In addition, Options Participants that transact business with customers must be members of FINRA.[37]

Among other things, each Participant must be registered as a broker-dealer and have as the principal purpose of being a Participant the conduct of a securities business, which shall be deemed to exist if and so long as: (1) the Participant has qualified and acts in respect of its business on NOM as either an OEF or an Options Market Maker or both; and (2) all transactions effected by the Participant are in compliance with Section 11(a) of the Act[38] and the rules and regulations thereunder.[39] Participants may trade options for their own proprietary accounts or, if authorized to do so under applicable law, may conduct business on behalf of customers.[40]

1. OEFs

OEFs are Participants representing customer orders as agent on NOM or trading as

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16389 (April 4, 2007) (notice of filing and immediate effectiveness of File No. SR-Nasdaq-2007-010) (revising Nasdaq Rule 4211(d)).

35 17 CFR 240.17d-2.

36 See NOM Rules, Chapter XI, Section 1. See also notes 240 to 241, infra, and accompanying text for a discussion of Rule 17d-2.

37 See NOM Rules, Chapter II, Section 2(f).

38 15 U.S.C. 78k(a).

39 See NOM Rules, Chapter II, Section 2(e).

40 See NOM Rules, Chapter II, Section 1(a).

principal on NOM.[41] OEFs also may register as Market Makers. A Market Maker that engages in specified Other Business Activities, or that is affiliated with a broker-dealer that engages in Other Business Activities, including functioning as an OEF, must have an Information Barrier between the market making activities and the Other Business Activities.[42]

One commenter believes that the ability of OEFs, like Market Makers, to enter orders on both sides of the market for the same customer raises questions concerning the rights and responsibilities of the OEF and the customer. In particular, the commenter asks whether Market Makers will have exclusive access to certain NOM systems or other tools, or otherwise have rights that differ from the rights of these customers. The commenter also asserts that NOM's proposal lacks clarity regarding its Participants' responsibility for surveillance of the activities of these market participants.[43]

In response, Nasdaq stated its belief that the NOM market model is similar to Nasdaq's equity market structure and does not raise any unique or challenging issues for order entry firms and investors. Nasdaq further believes that most Participants will be familiar with the regulatory and surveillance requirements associated with access to NOM from their businesses in equity securities.[44] Nasdaq represents that, within the System, Market Makers will not have any special priorities or other privileges.[45]

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41 See NOM Rules, Chapter VII, Section 1.

42 See NOM Rules, Chapter VII, Section 10.

43 See SIFMA Letter, supra note 4, at 2.

44 See Nasdaq Response, supra note 5, at 2.

45 Id. at 5. Registered market makers do, however, receive certain benefits for carrying out their responsibilities. For example, a lender may extend credit to a broker-dealer without regard to the restrictions in Regulation T of the Board of Governors of the Federal Reserve System if the credit is used to finance the broker-dealer's activities as a

The Commission believes that it is consistent with the Act for an options exchange not to prohibit a user of its market from effectively operating as a market maker by holding itself out as willing to buy and sell options contracts on a regular or continuous basis without registering as a market maker.[46] The Commission notes that although an entity that effectively acts as a market maker but is not registered as such will not be required to comply with any rules applicable to a Market Maker, it also will not be eligible to receive certain benefits of being a Market Maker.[47] The Commission also agrees with Nasdaq's assertion that NOM does not raise any unique issues related to surveillance or the responsibilities of OEFs, and notes that all Options Participants must also be members of Nasdaq. Further, the Commission notes that an entity that acts as a "dealer," as defined in Section 3(a)(5) of the Act,[48] would be required to register with the Commission under Section 15 of the Act,[49] and the rules and regulations thereunder, or qualify for any exception or exemption from registration.[50]

2. Market Makers

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specialist or market maker on a national securities exchange (see 12 CFR 221.5(c)(6)). In addition, market makers are excepted from the prohibition in Section 11(a) of the Act.

46 See Securities Exchange Act Release No. 38054 (December 16, 1996), 61 FR 67365 (December 20, 1996) (order approving File No. SR-CBOE-95-48).

47 See infra notes 76 and 84 and accompanying text.

48 15 U.S.C. 78c(a)(5).

49 15 U.S.C. 78o.

50 Activity that may cause a person to be deemed a dealer includes "'quoting a market in or publishing quotes for securities (other than quotes on one side of the market on a quotations system generally available to non-broker-dealers, such as a retail screen broker for government securities).'" 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, Securities Exchange Act Release No. 47364, 68 FR 8685, 8689, note 26 (February 24, 2003) (quoting OTC Derivatives Dealers, Securities Exchange Act Release No. 40594, 63 FR 59362, 59370, note 61 (November 3, 1998)).

a. Registration of Market Makers

An Options Market Maker is a Participant registered with Nasdaq as a Market Maker.[51] To register as a Market Maker, a Participant must file a written application with Nasdaq Regulation, which will consider an applicant's market making ability and other factors it deems appropriate in determining whether to approve an applicant's registration.[52] All Market Makers are designated as specialists on NOM for all purposes under the Act or rules thereunder.[53] The NOM Rules place no limit on the number of qualifying entities that may become Market Makers.[54] The good standing of a Market Maker may be suspended, terminated, or withdrawn if the conditions for approval cease to be maintained or the Market Maker violates any of its agreements with Nasdaq or any provisions of the NOM Rules.[55] A Participant that has qualified as a Market Maker may register to make markets in individual series of options.[56]

The Commission finds that NOM Market Maker qualifications requirements are consistent with the Act, and notes that they are similar to those of other options exchanges.[57]

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51 See NOM Rules, Chapter VII, Section 2.

52 See NOM Rules, Chapter VII, Section 2(a).

53 See NOM Rules, Chapter VII, Section 2.

54 See NOM Rules, Chapter VII, Rule 2(c). However, Nasdaq may limit access to the System based on system constraints, capacity restrictions, or other factors relevant to protecting the integrity of the System, pending action required to address the issue of concern. To the extent that Nasdaq places limitations on access to the System on any Participant(s), such limits shall be objectively determined and submitted to the Commission for approval pursuant to a rule change filed under Section 19(b) of the Act. See NOM Rules, Chapter VII, Section 2(c).

55 See NOM Rules, Chapter VII, Section 4(b).

56 See NOM Rules, Chapter VII, Section 3(a).

57 See, e.g., BOX Rules, Chapter VI, Section 2 and ISE Rule 804.

Further, the Commission believes that allowing NOM Market Makers to register by series, rather than by class, will permit Market Makers to select the options series they are most interested in trading. This is designed to help to reduce the number of quotes submitted by such Market Makers, and therefore could help to mitigate NOM's quote message traffic and capacity.[58]

b. Market Maker Obligations

Pursuant to NOM rules, the transactions of a Market Maker in its market making capacity must constitute a course of dealings reasonably calculated to contribute to the maintenance of a fair and orderly market.[59] Further, among other things, a Market Maker must: (1) on a daily basis participate in the pre-opening phase and maintain a two-sided market on a continuous basis in at least 75% of the options series in which it is registered;[60] (2) enter a size of at least ten contracts for its best bid and its best offer;[61] and (3) maintain minimum net capital in accordance with Commission and Nasdaq rules.[62] In addition, Nasdaq may call upon a Market Maker to submit a single bid or offer or to maintain continuous bids and offers in one or more of the series

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58 See Securities Exchange Act Release No. See Securities Exchange Act Release No. 55027 (December 29, 2006), 72 FR 1358 (January 11, 2007) (order approving File No. SR-Phlx-2006-53). Further, one commenter believes that series-by-series registration will allow market makers to target the series for which they are most apt to provide liquidity, which in turn will create greater liquidity across the entire market. See GETCO Letter, supra note 4, at 2.

59 See NOM Rules, Chapter VII, Section 5(a). Amendment No. 2 replaces the provisions in the NOM proposal related to the Exchange's ability to automatically cancel all bids and offers posted by a Market Maker under certain circumstances with provisions allowing any Options Participant to ask NOM staff to simultaneously cancel all of the Options Participant's bids, offers, and orders in all series. See NOM Rules, Chapter VII, Section 11. The Commission believes that the proposed change is reasonably designed to enable Participants to limit their risk and is consistent with the Act.

60 See NOM Rules, Chapter VII, Section 6(d)(i).

61 See NOM Rules, Chapter VII, Section 6(a).

62 See NOM Rules, Chapter VII, Section 4(a)(i).

in which the Market Maker is registered if, in Nasdaq's judgment, it is necessary to do so in the interest of fair and orderly markets.[63] If Nasdaq finds any substantial or continued failure by a Market Maker to engage in a course of dealings as specified in Chapter VII, Section 5(a) of the NOM Rules, such Market Maker will be subject to disciplinary action or suspension or revocation of registration in one or more of the securities in which the Market Maker is registered.[64]

One commenter notes that NOM's rules do not appear to assure that there will be continuous quotes in a particular series because a Market Maker could cease disseminating quotes for a series at any time during the trading day, and requests that Nasdaq clarify a market maker's continuous quoting obligations.[65] In response, Nasdaq notes that other options markets face the possibility that a registered market maker will withdraw its quotes during the trading day, and that NOM's rules permit Nasdaq to require a market maker to quote continuously in a series in which it is registered.[66] Nasdaq further notes that it intends to provide functionality that will allow its Market Makers to instruct the NOM System to automatically input a quotation on the side of the market that has been depleted. In addition, Nasdaq represents that it will bring an appropriate disciplinary action against a Market Maker that fails to meet its quoting obligations.[67]

This commenter also requests clarification of NOM's treatment of options series without

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63 See NOM Rules, Chapter VII, Section 6(d)(ii).

64 See NOM Rules, Chapter VII, Section 5(c).

65 See SIFMA Letter, supra note 4, at 1.

66 See Nasdaq Response, supra note 5, at 3, and NOM Rules, Chapter VII, Section 6(d)(ii).

67 See Nasdaq Response, supra note 5, at 3.

a Market Maker. In particular, the commenter questions the actions NOM will take if a Market Maker withdraws from making markets in a series, including whether NOM will continue to match orders in the series.[68] To the extent that the commenter is questioning what will happen if a Market Maker registered in a series does not have a quote in that series (as opposed to the Market Maker withdrawing from registration in the series),[69] Nasdaq states that NOM will continue to route and execute orders in that series. In addition, Nasdaq states that, if an order is received by NOM when its quote is not at the NBBO, NOM will route the order automatically to a market at the NBBO. An order displayed on NOM that becomes marketable will be accessible through the Linkage.[70]

The definition of a "market maker" includes a dealer who holds itself out as being willing to buy and sell a security for his account on a regular or continuous basis.[71] Therefore, although under NOM's proposal certain series may not have continuous quotes disseminated by NOM, the Commission believes that the obligations imposed by the NOM Rules on Market Makers fall within the definition of market maker because they will require a NOM Market Maker to hold itself out as being willing to buy and sell a security for its account on a regular basis. The Commission therefore believes that the obligations imposed by the NOM Rules on Market Makers are consistent with the Act.[72]

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68 See SIFMA Letter, supra note 4, at 2.

69 See discussion infra notes 77 to 79 and accompanying text.

70 See Nasdaq Response, supra note 5, at 3.

71 See 15 U.S.C. 78c(a)(38) (definition of "market maker").

72 The Commission notes that in approving the rules of the Boston Options Exchange ("BOX"), the Commission acknowledged that certain options series might not have continuous quotes disseminated by BOX, but concluded that the obligations imposed on market makers under the BOX Rules were consistent with the Act. The Commission also

The commenter also asserts that other options exchanges generally require market makers to provide two-sided quotations for 80% of the classes in which a market maker is registered, and that uniform quotation requirements among the options markets would be desirable.[73] In its response letter, Nasdaq states that NOM's Market Maker participation standard, which will allow Market Makers to register in particular options series rather than an entire class, should result in active participation in all series for which a Market Maker registers voluntarily.[74] In addition, Nasdaq maintains that its approach is numerically superior to other options exchanges, noting that the BOX Rules effectively require market makers to maintain continuous two-sided quotes in only 72% of the series in which they are registered, or at times in only 60% of the series in which they are registered.[75]

Market makers receive certain benefits for carrying out their responsibilities. For example, a lender may extend credit to a broker-dealer without regard to the restrictions in Regulation T of the Board of Governors of the Federal Reserve System if the credit is used to finance the broker-dealer's activities as a specialist or market maker on a national securities exchange.[76] In addition, market makers are excepted from the prohibition in Section 11(a) of the Act. The Commission believes that a market maker must have sufficient affirmative obligations,

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noted that the CBOE's Hybrid trading system had market maker obligations comparable to those proposed for BOX and also did not require market makers to quote all series. See Securities Exchange Act Release No. 49068 (January 13, 2004), 69 FR 2775 (January 20, 2004) (order approving File No. SR-BSE-2002-15) ("BOX Approval Order").

[73] See SIFMA Letter, supra note 4, at 2.

[74] See Nasdaq Response, supra note 5, at 5.

[75] See id. and BOX Rules, Chapter VI, Section 6(d)(i).

[76] 12 CFR 221.5(c)(6).

including the obligation to hold itself out as willing to buy and sell options for its own account on a regular or continuous basis, to justify this favorable treatment. The Commission further believes that the rules of all U.S. options markets need not provide the same standards for market maker participation, so long as they impose affirmative obligations that are consistent with the Act. The Commission believes that NOM's market maker participation requirements impose sufficient affirmative obligations on NOM Market Makers and, accordingly, that NOM's requirements are consistent with the Act.

Nasdaq will open trading in an options series only if there is at least one Market Maker registered for trading in that series.[77] One commenter requests clarification of NOM's treatment of options series without a Market Maker. In particular, the commenter questions the actions NOM will take if a Market Maker withdraws from making markets in a series, including whether NOM will continue to match orders in the series.[78] In response, Nasdaq states that it is amending proposed Chapter IV, Section 5 to provide that, in the event a sole Market Maker for a series withdraws its registration and ceases making markets, NOM will place the series in a non-regulatory suspension and halt trading until such time as a member registers to make markets in that series.[79]

In addition, the commenter notes that the proposal does not address a Market Maker's use

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[77] See NOM Rules, Chapter IV, Section 5.

[78] See SIFMA Letter, supra note 4, at 2.

[79] See Nasdaq Response, supra note 5, at 3. Nasdaq further notes that, in Amendment No.2, it proposes to clarify that in such circumstances, NOM will not execute orders on its book and will have no rights and privileges under the Linkage Plan to accept inbound orders from away markets. Nasdaq will continue to accept and route Participant orders that are designated for routing and execution at the best price in away markets. Id.

of the matching system for new customer orders after it has withdrawn as a Market Maker.[80] To the extent that the commenter is asking whether a Market Maker can enter a customer order when it is not quoting in a series in which it is registered, Nasdaq notes that the NOM Rules require that, if a Market Maker enters a bid in a series in which he is registered, he must also enter an offer,[81] and that therefore a Market Maker will not be able to enter customer orders without submitting a quote on the other side of the market from the customer order.[82] Further, Nasdaq notes that the NOM Rules prohibit a Market Maker from acting as an OEF without instituting appropriate information barriers.[83] To the extent that the commenter is asking whether an entity that withdraws as a Market Maker in a series can then act as an OEF in that series, Nasdaq notes that a Participant that has withdrawn as a Market Maker and is participating in NOM as an OEF would not receive favorable margin treatment under Regulation T.[84]

The Commission believes that Nasdaq has adequately clarified NOM's treatment of options series when either (1) a registered Market Maker is not quoting in that series or (2) a registered Market Maker withdraws from registration in the series.

c. Single Market Maker Requirement

One commenter believes that Nasdaq should require at least two market makers for an options series to be listed and traded on NOM so that adequate depth and liquidity will be

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80 See SIFMA Letter, supra note 4, at 2.

81 See NOM Rules, Chapter VII, Section 6(b), which states that a Market Maker that enters a bid (offer) in a series in which he is registered on NOM must enter an offer (bid).

82 See Nasdaq Response, supra note 5, at 4.

83 See NOM Rules, Chapter VII, Section 10.

84 See Nasdaq Response, supra note 5, at 4.

available to market participants.[85] The commenter also believes that, in the context of the order exposure requirements established in Chapter VII, Section 14 of the NOM Rules,[86] there will not be meaningful order exposure with a "trading crowd" of fewer than two market makers.[87] In addition, the commenter believes that the term "trading crowd" may be a misnomer if the trading crowd consists of only one market maker.[88]

In response, Nasdaq asserts that neither the Act nor Commission rules require a market to provide for more than one market maker, and, in fact, the specialist system is an example of a one market maker market model.[89] Nasdaq believes that the NOM structure fulfills the objectives of Section 11A of the Act by providing a trading platform that will allow customer orders to meet without the intervention of a dealer.[90] Nasdaq further maintains that lower barriers to participation will attract liquidity and market depth from order entry firms and other market participants. Nasdaq also notes that it intends to provide an environment whereby robust competition between multiple market makers will provide depth and liquidity, but that it does not believe market participants should be prevented from trading directly with one another due to the

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85 See Amex Letter, supra note 4, at 2.

86 Amendment No. 2 renumbers this provision as Chapter VII, Section 12 of the NOM Rules.

87 See Amex Letter, supra note 4, at 1.

88 Id. at 2. Amex also questions the meaning of the term "trading crowd" in Chapter III, Section 4(f) of the NOM Rules. Nasdaq notes that it has deleted the term "trading crowd" from this rule to make clear that the electronic crowd will be composed of all NOM Participants, as is the case for other electronic markets. See Nasdaq Response, supra note 5, at note 9.

89 See Nasdaq Response, supra note 5, at 8 to 9.

90 Id. at 8.

absence of multiple dealers.[91]

The Commission agrees that the Act does not mandate a particular market model for national securities exchanges, and believes that many different types of market models could satisfy the requirements of the Act. The Commission does not believe that the Act requires an exchange to have market makers.[92] Although Market Makers could be an important source of liquidity on NOM, they likely will not be the only source. In particular, the NOM System is designed to match buying and selling interest of all Participants on NOM. The Commission therefore believes that the NOM structure is consistent with the Act.

D. NOM Trading System

1. Overview

NOM will be a fully automated electronic system ("System") for trading standardized options, and will be a facility of Nasdaq, as defined in Section 3(a)(2) of the Act.[93] Participants

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[91] Id. at 9.

[92] In its release adopting Regulation ATS, the Commission rejected the suggestion that a guaranteed source of liquidity was a necessary component of an exchange. See Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844 (December 22, 1998) ("Regulation ATS Release"). See also Securities Exchange Act Release No. 44983 (October 25, 2001), 66 FR 55225 (November 1, 2001) (File No. SR-PCX-00-25) (order approving Archipelago Exchange as the equities trading facility of the Pacific Exchange), at Section IV.B.

[93] 15 U.S.C. 78c(a)(2). The System includes: (1) an order execution service that allows Participants to automatically execute transactions in securities listed and traded on NOM; (2) a trade reporting service that submits locked-in trades to a registered clearing agency for clearance and settlement, transmits last sale reports to the Options Price Reporting Authority, if required, for dissemination to the public and industry, and provides Participants with monitoring and risk management capabilities; and (3) a data feed(s) that can be used to display without attribution to Participants' MPIDs Displayed Orders on both the bid and offer side of the market for price levels within NOM using the minimum price variation applicable to the security. See NOM Rules, Chapter VI, Section 1(a). See Trading Rules Proposal Notice, supra note 3, for a more complete description of NOM operation and rules. The Commission notes that the Plan for Reporting of Consolidated Options Last Sale Reports and Quotation Information ("OPRA Plan") requires each party

will be able to enter Displayed Orders on NOM at single and multiple price levels for the following order types:[94] Market Orders; Limit Orders; Reserve Orders;[95] Minimum Quantity Orders;[96] Discretionary Orders;[97] and Price Improving Orders.[98] Participants may designate orders to be routed to other market centers when trading interest is not present on NOM or to be

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to the plan to collect and promptly transmit to OPRA all last sale reports relating to its market. See OPRA Plan, Section V(a).

94 NOM does not propose to trade complex orders at this time. Participants may enter orders with the following time-in-force designations: Expire Time; Immediate or Cancel ("IOC"); DAY; and Good Til Cancelled. See NOM Rules, Chapter VI, Section 1(g).

95 A Reserve Order is a limit order with displayed size and an additional non-displayed amount, both of which are available for execution against incoming orders. If the displayed portion of a Reserve Order is executed fully, the System will replenish the display portion from reserve up to the size of the original display amount. The System creates a new time stamp for the replenished portion of an order each time it is replenished from reserve, while the reserve portion retains the time stamp of its original entry. See NOM Rules, Chapter VI, Section 1(e)(1).

96 A Minimum Quantity Order must be designated as IOC and requires that a specified minimum number of contracts be traded. A Minimum Quantity Order received prior to the Opening Cross or after the market close will be cancelled. See NOM Rules, Chapter VI, Section 1(e)(3).

97 A Discretionary Order has both a displayed price and size and a non-displayed discretionary price range at which the entering party is willing to buy or sell. The non-displayed interest is not entered into the System book but is converted, along with the displayed size, into an IOC buy (sell) order at the highest (lowest) price in the discretionary price range when displayed contracts become available on the opposite side of the market or an execution takes place at any price within the discretionary price range. If more than one Discretionary Order is available for conversion into an IOC order, the System will convert and process all such orders in the same order as they were entered. If an IOC order is not executed in full, the unexecuted portion of the order is reposted automatically and displayed in the System book with a new time stamp at its original displayed price and with its non-displayed discretionary price range. See NOM Rules, Chapter VI, Section 1(e)(4).

98 A Price Improving Order is an order to buy or sell an option at a specified price smaller than the minimum price variation ("MPV") in the security. Price Improving Orders may be entered in increments as small as one cent. A Price Improving Order will be displayed at the MPV in that security and rounded up for sell orders and down for buy orders. See NOM Rules, Chapter VI, Section 1(e)(6).

executed only on NOM.[99] Nasdaq also had originally proposed to allow Participants to enter Non-Displayed Orders.[100] Commenters expressed concerns about the use of Non-Displayed Orders in the options markets.[101] Nasdaq in Amendment No. 2 has proposed to eliminate Non-Displayed Orders.[102] Because Nasdaq has proposed to eliminate this order type, this order does not make any findings with respect to Non-Displayed Orders.

All trading interest on NOM will be automatically executable. The NOM System and rules provide for the ranking, display, and execution of all orders in price/time priority without regard to the status of the entity entering an order.[103] Displayed Orders will have priority over non-displayed interest at the same price.[104] Any price improvement resulting from an execution in the System will accrue to the party taking liquidity.[105]

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99 See NOM Rules, Chapter VI, Section 11(a). See also Amendment No. 2 and the Trading Rules Proposal Notice, supra note 3, at 23871.

100 A Non-Displayed Order was defined as a limit order that is not displayed in the System but is available for execution against all incoming orders until executed in full or cancelled.

101 See Citadel Letter, supra note 4, at 3, and Amex Letter, supra note 4, at 2.

102 Nasdaq has made corresponding changes throughout the NOM Rules to reflect the deletion of this order type.

103 See NOM Rules, Chapter VI, Section 10. In Amendment No. 2, Nasdaq made a technical change to Chapter VI, Section 10 to clarify that the System will execute trading interest at the best price in the System before executing trading interest at the next best price. This change does not alter the execution algorithm as it was proposed. See Amendment No. 2.

104 See NOM Rules, Chapter VI, Section 10(1). At each price, trading interest will be executed in the following order: (A) Displayed Orders; (B) the Non-Displayed portion of Reserve Orders, in time priority among such interest; and (C) the discretionary portion of Discretionary Orders, in time priority among such interest.

105 See NOM Rules, Chapter VI, Section 10. One commenter maintains that the original proposal did not define "taker of liquidity" and failed to specify how price improvement would accrue to the taker of liquidity. See Amex Letter, supra note 4, at 3. In response, Amendment No. 2 modifies NOM's rules to indicate that any price improvement will

The Commission believes that NOM's proposed execution priority rules are consistent with the Act. The Commission notes that one commenter specifically supported NOM's price/time priority algorithm, noting its belief that "flat and open" systems encourage better executions and provide increased liquidity to the market.[106] The Commission also believes that NOM's proposed order types are consistent with the Act, and discusses several particular order types below.

2. Attributable Orders

A Displayed Order may be entered with attribution to a Participant's MPID (an Attributable Order) or on an anonymous basis (a Non-Attributable Order).[107] One commenter expresses concern that Attributable Orders could result in discrimination against particular members.[108] The commenter believes, for example, that it is beneficial for a firm to identify itself when facilitating customer order flow since an exchange and its members may want to allow particular members to trade against more than the minimum guaranteed amount of the order to encourage the member to send more order flow to that exchange.[109]

The commenter also expressed concern that identifying the entering firm could encourage internalization. The commenter also asserts that Attributable Orders would defeat the anti-internalization function of the information barriers between a firm's market making and

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accrue to the party removing liquidity previously posted to the Book. See NOM Rules, Chapter VI, Section 10(3). The Commission believes that this change clarifies NOM's rules and is consistent with the Act.

[106] See GETCO Letter, supra note 4, at 1.

[107] See NOM Rules, Chapter VI, Section 1(d).

[108] See ISE Letter, supra note 4, at 2.

[109] Id. at note 3.

customer order entry activities.[110] The commenter believes that the internalization concern is particularly significant in the context of Nasdaq's "first-in-first out" market model, where orders at a given price will be executed in sequence, with no priority for customer orders at the best price or pro rata distribution among participants quoting at that price. With no customer priority or pro rata allocation among Participants quoting at the best price, the commenter believes that a Participant that sees its firm's order at the top of the book would be able to execute against, and internalize, all of the displayed order.[111]

In its response letter, Nasdaq notes that Attributable Orders are a voluntary feature of the System, and that no firm will be required to reveal its identity.[112] Nasdaq also argues that there is no selective disclosure; Nasdaq will publish the identity of the NOM Participant only when the order is posted on the NOM book, and that disclosure will be made simultaneously to all market participants in a proprietary data feed.[113] Further, Nasdaq notes that information barriers are designed to prevent a Market Maker from obtaining and using information about customer orders prior to execution, and that OEFs must route customer orders to the best available market, even if that is the market displaying the firm's Attributable Order.[114] Nasdaq also believes that its price/time algorithm allows less internalization than ISE's pro rata allocation, which guarantees 40% of the order to a market maker under certain conditions. Nasdaq further notes that there is always the possibility that an incoming order trades with a Price Improving Order, rather than a

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110 Id. at 2-3.

111 Id. at 3.

112 See Nasdaq Response, supra note 5, at 7.

113 Id.

114 Id.

displayed Attributable Order.

To the extent that a market participant is concerned that its order would be discriminated against, as Nasdaq notes, the market participant can choose to enter a Non-Attributable Order. In addition, the Commission does not believe that it is likely that participants in a fully electronic market, such as NOM, will refrain from trading with a particular Participant's Attributable Orders in order to allow that Participant to do so, particularly in light of their best execution obligations.

Moreover, the Commission does not believe that a member's use of Attributable Orders, by itself, will cause a Market Maker to violate NOM's information barrier rule. The purpose of requiring information barriers is to prohibit the flow of material non-public information between the market making activities and other business activities of a firm. With respect to Attributable Orders, a Market Maker will learn the identity of an Attributable Order at the same time as all other Participants – that is, once it is displayed on NOM and disseminated over NOM's proprietary data feed. The Market Maker will not have any knowledge of the order prior to that time. The Commission does not believe that allowing Market Makers to see this information once it is posted on the book undermines the policy of having information barriers. The Commission might reach a different conclusion, however, if order attribution information were disclosed preferentially to certain Participants or if Market Makers had a systemic or other advantage that allowed them to receive this information in a more timely manner.

3. Reserve Orders and Price Improving Orders[115]

Nasdaq proposes to allow participants to enter Reserve Orders, which are limit orders

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115 Nasdaq has proposed in Amendment No. 2 to eliminate the Non-Displayed Order type. Therefore, this approval order does not discuss Non-Displayed Orders. See supra notes 100 to 102 and accompanying text.

with displayed size and an additional non-displayed amount, both of which are available for execution against incoming orders. If the displayed portion of a Reserve Order is executed fully, the System will replenish the display portion from reserve up to the size of the original display amount. The non-displayed portion of a Reserve Order has lower priority than any displayed order.

In addition, Nasdaq proposes a new order type called a Price Improving Order. A Price Improving Order has a specified price smaller than the minimum price variation ("MPV") in the option. Price Improving Orders may be entered in increments as small as one cent. Price Improving Orders will be displayed at the MPV in that security and rounded up for sell orders and down for buy orders. For the reasons discussed below, the Commission finds Reserve Orders and Price Improving Orders consistent with the Act.

a. Quote Rule

One commenter argues that Price Improving Orders would violate Rule 602 of Regulation NMS (the "Quote Rule") because Nasdaq will not disseminate its best bid or offer.[116]

The Quote Rule requires a national securities exchange to collect, process, and make available to vendors the best bid, the best offer, and aggregate quotation sizes for each subject security that is communicated on any national securities exchange by a responsible broker or dealer. A "bid" or "offer" is defined as "the bid price or the offer price communicated by a member of a national securities exchange or member of a national securities association to any broker or dealer, or to any customer…."[117] Because the non-displayed size of a Reserve Order or

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116 See ISE Letter, supra note 4, at 2 (incorporating by reference the commenter's June 1, 2007, letter from Michael J. Simon, Secretary, ISE, to Nancy M. Morris, Secretary, Commission, regarding File No. SR-CBOE-2007-39 ("ISE June 2007 Letter")).

117 17 CFR 242.600(a)(8).

the non-displayed price of a Price Improving Order is sent to NOM but not communicated to anyone, it is not a bid, offer, or quotation. Thus, the Quote Rule does not require this information to be disseminated.[118]

The Quote Rule also requires responsible brokers and dealers to be firm for their quotes.[119] In Amendment No. 2 Nasdaq has proposed to modify Chapter VII, Section 6(c)(1) of the NOM Rules to explicitly state that all quotes and orders entered into NOM by Options Participants, including the non-displayed portions of Reserve Orders and Price Improving Orders, must be firm under NOM rules and Rule 602 of Regulation NMS.

b. Transparency, Quote Competition, and Internalization

Several commenters expressed concern about the impact of Price Improving Orders and Reserve Orders on market quality. In particular, one commenter believes such orders will undermine transparency in the options markets and that, because the prices and sizes of such orders are not disseminated, it will be impossible for market participants to know the true best trading interest on NOM.[120] This commenter argues that Price Improving Orders will discourage market participants from quoting their best prices and submitting displayable limit orders because contra-side orders could be "pennied" by Price Improving Orders at opportune moments. The commenter believes that these disincentives ultimately will reduce price competition in the U.S. options markets.[121] Another commenter expresses a concern that no one will know the

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118 See also Citadel Letter, supra note 4, at 4 supporting this analysis.

119 17 CFR 242.602(b)(2) and (c)(3).

120 See Citadel Letter, supra note 4, at 1-3.

121 See Citadel Letter, supra note 4, at 3. The commenter further believes that the concerns raised by Hidden Orders exceed those raised by the auction facilities on other options exchanges (including BOX's PIP and the International Securities Exchange's PIM) because Hidden Orders would be a fundamental component of NOM rather than a

actual prices communicated to the exchange, which are prices at which transactions can take place.[122] This commenter is concerned that if other options markets adopted similar order types, there would be a trading environment in which there would be no way for customers to make intelligent pricing decisions or for broker-dealers to fulfill their best execution obligations.[123]

One commenter expresses the concern that Price Improving Orders will enable Participants to internalize their order flow without the possibility of real order interaction. This commenter argues that the purpose of the requirement that a member display a customer order and wait three seconds before trading against the order is to provide other market participants with a chance to trade with the order before the member internalizes it. The commenter argues that, because only the Participant that enters the Price Improving Order will know the true price of the order, only that member can accurately run its pricing model to determine whether it is economically viable to trade against the order. The commenter does not believe this is a level playing field.[124] Similarly, another commenter asserts that permitting Price Improving Orders to satisfy NOM's order exposure requirement[125] will "invite rampant internalization" by Participants, who will be able to trade with their agency orders without the market having a

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separate auction facility operating parallel to the regular options market. Id.

122 See ISE Letter, supra note 4, at note 1-2.

123 Id. at 2.

124 See ISE June 2007 Letter, supra note 116, at 3.

125 See NOM Rules, Chapter VII, Section 12. Chapter VII, Section 12 of the NOM Rules prohibits a Participant from executing as principal an order its represents as agent unless (1) the order is exposed on NOM for at least three seconds, or (2) the Participant has been bidding or offering on NOM for at least three seconds prior to receiving the agency order that is executable against such bid or offer.

meaningful opportunity to compete for the orders.[126]

On the other hand, another commenter asserts that the use of non-displayed and reserve orders, which have been available for years in the equity markets, has not diminished competition or liquidity in these markets.[127] This commenter believes that Reserve Orders will encourage liquidity providers to bring their interest to the market in a manner best suited to their trading requirements. The commenter further believes that the increased use of reserve orders in the options markets would help to mitigate concerns regarding the effect of penny increments on institutional investors.[128]

Price Improving Orders will allow market participants to submit an order priced between the MPV that will be rounded to the nearest MPV for display.[129] Without this order type, market participants would not be able to submit orders priced between the MPV. Instead, orders, if submitted, would be priced (and displayed) at the MPV. Thus, the Price Improving Order type will not "take away" transparency that would already exist. The Commission recognizes that Price Improving Orders will not be displayed at their actual penny price. Price

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126 See Citadel Letter, supra note 4, at 3. This commenter further argues that Nasdaq should amend Chapter VII, Section 12, Commentary .04 to provide that a Participant cannot inform another Options Participant or any other third party of the terms of an order submitted to NOM after, as well as prior to, submitting the order to NOM. Nasdaq has made this change in Amendment No. 2.

127 See GETCO Letter, supra note 4, at 2-3.

128 Id. at 3. The commenter also notes that the Commission previously approved a reserve order type for NYSE Arca Options, citing to NYSE Arca Options Rule 6.62(c)(3). Id. at note 6 and accompanying text.

129 Price Improving Orders are defined as orders to buy or sell at a specified increment smaller than the MPV in a security, and they may be entered in increments as small as one cent. See NOM Rules, Chapter VI, Section 1(e)(6). Because a Price Improving Order can only be entered in an increment smaller than the MPV in an options series, and cannot be entered in an increment smaller than one cent, Participants will not be able to enter Price Improving Orders in options series for which the MPV is a penny.

Improving Orders, however, will provide for investors the opportunity to trade at a better price than would otherwise be available – inside the disseminated best bid and offer for a security. The Commission believes that this opportunity for investors to receive executions inside the disseminated best bid or offer could result in better executions for investors, and that Price Improving Orders are consistent with the Act.

In response to a commenter's concern about broker-dealers' ability to fulfill their best execution obligations,[130] as just discussed, the Commission believes that Price Improving Orders likely will provide another opportunity for investors to receive executions inside the disseminated best bid or offer for a security, which could result in better executions for investors. The availability of this price improvement feature will be a factor to be considered in a broker-dealer's best execution routing determination, similar to other factors a broker-dealer must consider in connection with its best execution obligation.

The duty of best execution requires a broker-dealer to seek the most favorable terms reasonably available under the circumstances for a customer's transaction.[131] The Commission has not viewed the duty of best execution as requiring automated routing on an order-by-order basis to the market with the best quoted price at that time. Rather, the duty of best execution requires broker-dealers to periodically assess the quality of competing markets to assure that order flow is directed to markets providing the most beneficial terms for their customer orders.[132]

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[130] See ISE Letter, supra note 4, at note 1-2.

[131] See, e.g., Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996) ("Order Handling Rules Release").

[132] Order Handling Rules Release, 61 FR at 48322-48333 ("In conducting the requisite evaluation of its internal order handling procedures, a broker-dealer must regularly and rigorously examine execution quality likely to be obtained from different markets or market makers trading a security."). See also Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266, at 271, 274 (3d Cir.), cert. denied, 525 U.S. 811 (1998);

Broker-dealers must examine their procedures for seeking to obtain best execution in light of market and technology changes and modify those practices if necessary to enable their customers to obtain the best reasonably available terms.[133] In doing so, broker-dealers must take into account price improvement opportunities, and whether different markets may be more suitable for different types of orders or particular securities.[134]

The Commission also believes that Price Improving Orders will provide market participants with an additional tool to submit trading interest to the Exchange. This order type may serve to increase liquidity to the extent that market participants find the order type to be useful and result in better executions. Further, market participants may be incented to compete by putting forth their best price - priced in a penny increment - to potentially match or better any other Price Improving Orders resident in the System. This may result in more aggressive, rather than less aggressive, trading interest.

The Commission also believes that Reserve Orders will provide market participants with an additional tool to submit trading interest to the exchange. Specifically, the ability to enter an order with a certain size displayed and additional size not displayed may provide market participants greater choice to submit trading interest in a manner best suited to their

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Payment for Order Flow, Securities Exchange Act Release No. 34902 (October 27, 1994), 59 FR 55006, at 55009 (November 2, 1994).

133 Order Handling Rules, 61 FR at 48323.

134 Order Handling Rules, 61 FR at 48323. For example, in connection with orders that are to be executed at a market opening price, "[b]roker-dealers are subject to a best execution duty in executing customer orders at the opening, and should take into account the alternative methods in determining how to obtain best execution for their customer orders." Disclosure of Order Execution and Routing Practices, Securities Exchange Act Release No. 43590 (November 17, 2000), 65 FR 75414, 75422 (December 1, 2000) (adopting new Exchange Act Rules 11Ac1-5 and 11Ac1-6 and noting that alternative methods offered by some Nasdaq market centers for pre-open orders included the mid-point of the spread or at the bid or offer).

trading needs. This in turn may encourage market participants to bring liquidity to the exchange that they might not otherwise have submitted.

Moreover, the Commission believes that the ability to "fish" inside the displayed quote, coupled with the restriction on the Participant that initially submitted the Price Improving Order from trading with that order until after three seconds has elapsed, will provide a meaningful opportunity for interaction prior to the time at which the submitting Participant can interact with the order. The Commission also notes that a Participant that would like to trade against its customer order runs the risk that the customer order, if entered as a Price Improving Order, will execute against another Price Improving Order (or Discretionary Order) resident in the system. The Commission does not believe that the availability and use of Price Improving Orders will reduce the quality or competitiveness of the options markets by increasing the level of internalization in the options markets.

c. Linkage Plan

One commenter believes that the Trading Rules Proposal fails to address how Reserve Orders and Price Improving Orders will interact with the requirements of the Plan for the Purpose of Creating and Operating an Intermarket Options Linkage ("Linkage Plan").[135] Specifically, this commenter notes that, because such orders are not disseminated, they presumably will not trigger other options markets' obligations to avoid trading through or obligate other markets to send orders to NOM through the Linkage.[136] Accordingly, the commenter believes that away markets will fail to benefit from superior prices available on

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135 See Citadel Letter, supra note 4, at 3. Another commenter generally states its belief that the concept of a Non-Displayed Order is inconsistent with the obligations required by the Linkage Plan. See Amex Letter, supra note 4, at 2.

136 See Citadel Letter, supra note 4, at 3.

NOM, and Non-Displayed Orders and Price Improving Orders will undermine market-wide trade-through protection.[137]

In its response, Nasdaq states that incoming orders from the intermarket linkage will interact with Price Improving Orders. Such incoming orders will automatically execute against any such order with a better price than the displayed bid or offer.[138]

The Commission believes that NOM's Rules adequately address how its market will interact with the Linkage Plan. The Linkage Plan, and SRO rules adopted pursuant to the Plan, provide trade through protection to the national best bid and offer ("NBBO").[139] The NBBO will not include the non-displayed price of a Price Improving Order or the reserve size of a Reserve Order. Therefore, the non-displayed price of a Price Improving Order and the non-displayed size of a Reserve Order are not subject to trade through protection under the Linkage Plan.

d. Penny Pilot

One commenter believes that the Trading Rules Proposal will circumvent the industry efforts with respect to the Penny Pilot Program by moving to hidden penny quoting without the benefit of careful study of the data yielded in the Pilot.[140] Another commenter believes that the appropriate way to address penny pricing in options is through the current Penny Pilot. This

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137 Id.

138 See Nasdaq Response, supra note 5, at 13.

139 The national best bid or offer is defined in the Linkage Plan as the national best bid and offer in an options series calculated by a Participant. See Section 2(19) of the Linkage Plan.

140 See Citadel Letter, supra note 4, at 4.

commenter recommends that the Commission consider any expansion of penny quoting only through review of the experience under the Pilot.[141]

As discussed above and below, the Commission finds that the Trading Rules Proposal, as amended, is consistent with the Act. The Commission previously has approved proposals by other options exchanges to trade in penny increments.[142] The Commission does not believe it is appropriate to prohibit Nasdaq from implementing another initiative designed to allow limited trading, not quoting, in penny increments.

4. Opening and Halt Cross

Nasdaq had originally proposed a single price opening and reopening via an electronic cross, modeled on the Opening and Halt Crosses Nasdaq developed for the trading of equities.[143] Nasdaq in Amendment No. 2 proposes to revise the procedures it will use to resume trading in an option following the conclusion of a trading halt in the underlying security. Specifically, rather than using a single price reopening following a trading halt, as originally proposed, Nasdaq proposes to process orders in time priority according to the execution algorithm provided in the NOM Rules.[144] According to Nasdaq, the proposal to use

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141 See ISE June 2007 Letter, supra note 116, at 3.

142 See, e.g., Securities Exchange Act Release Nos. 54229 (July 27, 2006), 71 FR 44508 (August 3, 2006) (File No. SR-CBOE-2005-90) (order approving CBOE's Simple Auction Liaison system); 50819 (December 8, 2004), 69 FR 75093 (December 15, 2004) (File No. SR-ISE-2003-06) (order approving ISE's Price Improvement Mechanism); and BOX Approval Order, supra note 72 (approving BOX's Price Improvement Period).

143 See NOM Rules, Chapter VI, Section 8. See Trading Rules Proposal Notice, supra note 3, for a detailed description of the proposed Opening and Halt Crosses.

144 See NOM Rules, Chapter VI, Section 10(4).

NOM's regular processing following a trading halt is designed to respond to comments from industry participants that options prices are based on the prices of the underlying security.[145]

The Commission believes that NOM's rules for an Opening Cross will help to ensure that the opening of NOM is conducted in a fair and orderly fashion and is consistent with the Act. The Commission further believes that the proposed change to NOM's procedure for re-opening trading in an option following the conclusion of a trading halt in the underlying security is reasonably designed to provide for an orderly re-opening of trading in the option and is consistent with the Act.

5. Closing Cross

At the close of trading, NOM will conduct a single price Closing Cross.[146] One commenter notes that the rules, as originally proposed, provided that the Closing Cross for all options would occur at 4:00 p.m., although options on fund shares and broad-based indexes trade until 4:15 p.m., and did not indicate when the Closing Cross would terminate.[147] In response, Nasdaq in Amendment No. 2 revised Chapter VI, Section 9(b) of the NOM Rules to indicate that the Closing Cross for options on broad-based indexes and fund shares will occur at 4:15 p.m. In addition, Nasdaq indicated that the Closing Cross occurs automatically and generally takes place in under one second, although the process may take several seconds on high-volume trading days.[148] The Commission believes that these changes adequately clarify the timing of the Closing Cross.[149]

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145 See Amendment No. 2 at 7.

146 See NOM Rules, Chapter VI, Section 9. See also Trading Rules Proposal Notice, supra note 3, for a more detailed description of the proposed Closing Cross.

147 See Amex Letter, supra note 4, at 3.

148 See Nasdaq Response, supra note 5, at 10.

One commenter notes that the NOM Rules indicate that an MOC order might not be executed. The commenter believes that an MOC order is a market order, and the operation of the Closing Cross will alter the nature of a market order as generally understood by market participants. The commenter further believes that Nasdaq should better explain the operation of MOC orders.[150] In response, Nasdaq acknowledges that MOC orders are not guaranteed to execute during the Closing Cross but notes that MOC orders receive the highest execution priority during the Closing Cross process.[151] Thus, Nasdaq states that MOC orders should execute at the cross price provided that there is adequate trading interest on the other side of the market.[152]

As noted above, the NOM Closing Cross is modeled on the Closing Cross that Nasdaq uses in its equity market.[153] Like the NOM Closing Cross, the Nasdaq Closing Cross includes MOC orders, which might not be executed during the Nasdaq Closing Cross.[154] The Commission believes that NOM's rules adequately explain the operation of MOC orders.

Nasdaq proposes to disseminate in connection with the Opening Cross and Closing

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149 In Amendment No. 2, Nasdaq proposes changes to the definitions of Imbalance Only ("IO"), Market on Close ("MOC"), and Limit on Close ("LOC") orders to replace certain times specified in the rules (e.g., 3:50:00 p.m.) with more general descriptions (e.g., 10 minutes prior to the close).

150 See Amex Letter, supra note 4, at 3.

151 See Nasdaq Response, supra note 5, at 10 to 11. See also NOM Rules, Chapter VI, Section 9(b)(3).

152 See Nasdaq Response, supra note 5, at 11.

153 See Nasdaq Rule 4754.

154 See Nasdaq Rule 4754(b)(3).

Cross an Order Imbalance Indicator.[155] The Order Imbalance Indicator for the Closing Cross will disseminate, in part, the following information: (1) a Current Reference Price, which is the single price that is at or within the current NOM best bid and offer at which the maximum number of contracts of MOC, LOC, IO, and Close Eligible Interest[156] can be paired;[157] (2) a Far Clearing Price, which is an indicative price at which MOC, LOC, and IO orders would execute if the Closing Cross were to occur at that time; and (3) a Near Clearing Price, which is an indicative price at which MOC, LOC, IO, and Close Eligible Interest would execute if the Closing Cross were to occur at that time.[158]

One commenter notes that the Order Imbalance Indicator would show the price in penny increments at which certain orders would execute at the time the Order Imbalance Indicator is

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[155] See proposed Chapter VI, Sections 8(a)(2) and 9(a)(7) of the NOM Rules. For the Opening Cross, Nasdaq will disseminate the Order Imbalance Indicator every five seconds beginning at 9:25 a.m. For the Closing Cross, Nasdaq will disseminate the Order Imbalance Indicator every five seconds for 10 minutes prior to the Closing Cross. See proposed NOM Rules, Chapter VI, Sections 8(a)(2) and 8(b)(1) and 9(a)(7) and 9(b)(1) for a detailed description of the Order Imbalance Indicator.

[156] Close Eligible Interest is defined to mean any quotation or any order that may be entered into the system and designated with a time-in-force of DAY, GTC, or EXPR. See proposed Chapter VI, Section 9(a)(1) of NOM Rules.

[157] If more than one price exists pursuant to this calculation, the Current Reference Price is the price that minimizes any Imbalance. If more than one price exists under that calculation, the Current Reference Price is the entered price at which contracts will remain unexecuted in the cross. And, if more than one price exists under that calculation, the Current Reference Price is the price that minimizes the distance from the bid-ask midpoint of the inside quotation prevailing within the NOM System at the time of the order imbalance indicator dissemination. See proposed Chapter VI, Section 9(a)(7)(A) of the NOM Rules.

[158] For the Opening Cross, the Far Clearing Price and Near Clearing Price will be the same as the Current Reference Price. See proposed Chapter VI, Section 8(a)(2)(A) and (E) of the NOM Rules.

disseminated.[159] The commenter believes that the Order Imbalance Indicator is inconsistent with the options Penny Pilot Program and that the Order Imbalance Indicator should be disseminated in the applicable minimum price variation for an option, rather than in penny increments.[160]

In its response, Nasdaq states that the Order Imbalance Indicator will benefit investors and improve transparency by providing market participants with information that will allow them to route customer orders to the best market.[161] To ensure that the Order Imbalance Indicator fully complies with Rule 602 of Regulation NMS, however, Nasdaq proposes in Amendment No. 2 to modify the proposed NOM Rules relating to the Closing Cross to state that the Current Reference Price and Near Clearing Price[162] will be disseminated in the minimum price increment applicable to the option in question and never at a price that would expose undisplayed trading interest that is available for execution on the NOM Book. Nasdaq states that only the Current Reference Price and Near Clearing Price are affected by this restriction because they are the only aspects of the Order Imbalance Indicator that may include information based on non-displayed orders resting on the NOM book.[163] Nasdaq further states that the remaining data elements of the Order Imbalance Indicator do not transmit information regarding the pricing of specific

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159 See Amex Letter, supra note 4, at 2.

160 Id. The Penny Pilot Program of the various options exchanges allows the exchanges to quote certain options classes in one-cent or five-cent increments, depending on the price of the option. See, e.g., Securities Exchange Act Release No. 56567 (September 28, 2007), 72 FR 56396 (October 3, 2007) (order approving File No. SR-Amex-2007-96).

161 See Nasdaq Response, supra note 5, at 9.

162 See NOM Rules, Chapter VI, Sections 9(a)(7)(A) and 9(a)(7)(E)(ii).

163 This is because the Current Reference Price and Near Clearing Price take into account the Close Eligible Interest, which is defined as any quotation or any order that may be entered into the System and designated with a time-in-force of DAY, GTC, or EXPR. Thus, Close Eligible Interest includes orders, including non-displayed orders, on the NOM Book.

orders and therefore do not implicate Rule 602 of Regulation NMS.[164]

The Commission agrees with Nasdaq's analysis and believes that the Order Imbalance Indicator, as proposed to be amended in Amendment No. 2, is consistent with Rule 602 of Regulation NMS. Nasdaq will not disseminate the prices of non-displayed orders resting on the NOM book after the Opening Cross[165] and therefore, such non-displayed orders will not be bids or offers[166] required to be made available to vendors by the Exchange under Rule 602. Further, the Commission does not believe that the Order Imbalance Indicator, as amended, is inconsistent with the Penny Pilot because it will not make available during regular trading hours information in a pricing increment other than the MPV.

6. Obvious Errors

The Commission believes that in most circumstances trades that are executed between parties should be honored. On rare occasions, the price of the executed trade indicates an "obvious error" may exist, suggesting that it is unlikely that the parties to the trade had come to a meeting of the minds regarding the terms of the transaction. In the Commission's view, the determination of whether an "obvious error" has occurred should be based on specific and objective criteria and subject to specific and objective procedures.[167]

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164 See Nasdaq Response, supra note 5, at 6 and 9.

165 The Commission does not believe that the Order Imbalance Indicator disseminated prior to the Opening Cross (and thus disseminated prior to the 9:30 a.m. EST) raises the same issues under the Quote Rule because the information will be disseminated prior to the commencement of trading on the exchange. See Rule 602(a)(1)(i)(B) of Regulation NMS, 17 CFR 242.602(a)(1)(i)(B).

166 See Rule 600(b)(8) of Regulation NMS, 17 CFR 242.600(b)(8).

167 See, e.g., Securities Exchange Act Release Nos. 54608 (October 16, 2006), 71 FR 62021 (October 20, 2006) (File No. SR-Amex-2005-60) (order approving changes to Amex's obvious error rule); 47628 (April 3, 2003), 68 FR 17697 (April 10, 2003) (File No. SR-CBOE-00-55) (order approving CBOE Direct); and BOX Approval Order, supra note 72.

In Amendment No. 2, Nasdaq revised its proposed rule dealing with options obvious errors. Specifically, Nasdaq amended Chapter V, Section 6, Obvious Errors, to: (1) apply the obvious error rule solely to obvious price errors and to series quoted no bid; (2) streamline the procedures governing review of obvious error requests by the Market Operations Review Committee ("MORC"); and (3) add a provision stating that the MORC must include representatives of one member engaged in market making and two industry representatives not engaged in market making, and that at no time shall members engaged in market making constitute more than 50% of the MORC. The Commission believes that the provisions of Nasdaq's obvious error rule, as revised by Amendment No. 2, are consistent with the Act and, in particular, with Section 6(b)(5), in that they provide clear and objective standards and procedures for determining whether an obvious error has occurred. The Commission also believes that the revised proposed rule is consistent with obvious error rules previously approved by the Commission for other exchanges.[168]

One commenter seeks clarification as to who will be responsible for trade errors in the context of the Linkage.[169] Nasdaq states that NOM's Rules recognize only Obvious Errors, as defined in Chapter VI, Section 6 of the NOM Rules. If a trade does not meet the definition of an Obvious Error, NOM will take no action with respect to the trade. In the event of an Obvious Error on NOM involving an away market, the away market is authorized as a party to the

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[168] See e.g., Securities Exchange Release Nos. 54228 (July 27, 2006), 71 FR 44066 (August 3, 2006) (File No. SR-ISE-2006-14) (approving current version of ISE Rule 7.20 (options obvious error rule)); 54070 (June 29, 2006), 71 FR 38441 (July 6, 2006) (File No. SR-Phlx-2005-73) (approving current version of Phlx Rule 1092 (options obvious error rule)); and 56487 (September 20, 2007), 72 FR 54956 (September, 27, 2007) (File No. SR-CBOE-2007-04) (approving current version of CBOE Rule 6.25 (options obvious error rule)).

[169] See SIFMA Letter, supra note 4 at 2.

transaction to file with NOM for review of the Obvious Error. In the event of an Obvious Error on an away market, NOM's Obvious Error rule authorizes NOM to file for review of that Obvious Error on behalf of the NOM Participant. If necessary, NOM will file for such review through NOS or the member of the away market which it used to route the order.[170]

7. Miscellaneous

One commenter believes that, under the NOM Rules, quotes are the same as orders and therefore reads Chapter VI, Section 5(b) of the NOM Rules to mean that Nasdaq proposes to trade all options series on NOM in penny increments, in violation of the Penny Pilot Program.[171]

In response, Nasdaq states that the commenter has misread the proposal and that Nasdaq does not propose to quote all options on NOM in penny increments. In this regard, Nasdaq notes that Chapter VI, Section 5(a) of the NOM Rules governs quotation increments and is consistent with the Penny Pilot Program, while Section 5(b) specifies the minimum trading increment on NOM.[172] The Commission believes that Nasdaq has clarified that it does not propose to quote all options on NOM in penny increments and that the NOM Rules are consistent with the Penny Pilot Program. The Commission also does not believe that trading in penny increments is inconsistent with the Penny Pilot Program.[173]

In response to questions from commenters regarding the NOM closing time,[174] Nasdaq in Amendment No. 2 proposes to modify the NOM Rules to provide that the NOM closing time

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170 See Nasdaq Response, supra note 5, at 9, and Amendment No. 2.

171 See Amex Letter, supra note 4, at 2.

172 See Nasdaq Response, supra note 5, at 7.

173 See supra note 142 and accompanying text.

174 See Amex Letter, supra note 4, at 4, and SIFMA Letter, supra note 4, at 2.

will be 4:00 p.m. ET, except for options on broad-based indexes and Fund Shares, which will close at 4:15 p.m. ET.[175] The Commission believes that these modifications will make NOM's closing time consistent with the rules of the other U.S. options exchanges.[176]

E. Order Routing

With respect to securities traded on NOM ("System Securities"),[177] Participants may designate orders to be routed to another market center when trading interest is not available on NOM or to execute only on NOM.[178] Orders that are designated to be routed will be routed to another options market when NOM is not at the NBBO, consistent with the locked and crossed market and trade through provisions of the Linkage Plan.[179] Orders routed by the System to other markets do not retain time priority with respect to other orders in the System and the System will continue to execute other orders while routed orders are away at another market center.[180] If a routed order is returned, in whole or in part, that order (or its remainder) will receive a new time stamp reflecting the time of its return to the System.[181] Participants whose orders are routed to away markets will be obligated to honor such trades to the same extent they

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175 See NOM Rules, Chapter VI, Section 2.

176 See, e.g., ISE Rule 700 and CBOE Rules 6.1 and 24.6. In addition, in Amendment No. 2 Nasdaq proposes to revise Chapter VI, Section 2 of the NOM Rules to indicate that the System will be available to accept bids, offers, and orders beginning at 9:00 a.m., rather than 8:00 a.m. Similarly, Nasdaq proposes in Amendment No. 2 to revise Chapter VI, Section 9 of the NOM Rules to indicate that IO orders, LOC orders, and MOC orders may be entered beginning at 9:00 a.m., rather than 8 a.m.

177 See NOM Rules, Chapter VI, Section 1(b).

178 See NOM Rules, Chapter VI, Section 11(a) and Amendment No. 2.

179 See id. and infra note 195 and accompanying text.

180 See NOM Rules, Chapter VI, Section 11(c).

181 Id.

will be obligated to honor a trade executed on NOM.[182]

One commenter believes that NOM's rules, as proposed, provided different order routing attributes for "system" and "non-system" securities, but failed to adequately define these terms, resulting in confusion regarding the operation of the order routing mechanism.[183]

In response, Nasdaq, in Amendment No. 2, proposes to revise proposed Chapter VI, Section 1(b) of the NOM Rules to define "System Securities" as all options currently trading on NOM, and to define "Non-System Securities" as all other options. Nasdaq states it will accept orders in Non-System Securities for routing but will not execute these orders in the System.[184] Nasdaq represents that System and Non-System Securities will be identified clearly via the NOM data feed and in a daily list posted on the NOM web site.[185] Nasdaq further states that the System will be programmed to differentiate between System Securities and Non-System Securities and will process each in accordance with the NOM Rules.[186] The Commission believes that Nasdaq's proposed changes and response adequately clarify the operation of the order routing mechanism for "System Securities" and "Non-System Securities."

In Amendment No. 2, Nasdaq further proposes to amend proposed Chapter VI, Section 11(e) of the NOM Rules to establish Nasdaq Options Services LLC ("NOS") as NOM's exclusive order router. NOS will perform only two functions, the routing of orders with respect to System Securities and the routing of orders with respect to Non-System Securities. Nasdaq

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182 See NOM Rules, Chapter VI, Section 11(d).

183 See Amex Letter, supra note 4, at 3.

184 See Nasdaq Response, supra note 5, at 11. See also NOM Rules, Chapter VI, Section 11(a).

185 See Nasdaq Response, supra note 5, at 11.

186 Id.

states that NOS will be a facility of Nasdaq only with respect to the routing of orders for System Securities.[187] NOS will be programmed to follow the algorithm and order type instructions established in the NOM Rules and will not have discretion to change the terms of an order or the order routing instructions.[188]

NOS will be a member of an SRO unaffiliated with Nasdaq that is its designated examining authority, and NOM will establish and maintain procedures and internal controls reasonably designed to restrict the flow of confidential and proprietary information between Nasdaq and its facilities, including NOS, and any other entity.[189] In addition, the books, records, premises, officers, directors, agents, and employees of NOS, as a facility of Nasdaq, will be deemed to be those of the Exchange for purposes of and subject to oversight pursuant to the Act.[190] Further, Participants are not required to use NOS to route orders, and a Participant may route its orders through any available router it selects.[191]

The Commission agrees with the Exchange that routing with respect to System Securities will be a "facility" of the Exchange, and, consequently, the operation of NOS in this capacity will be subject to Exchange oversight, as well as Commission oversight. The Commission notes that the functionality to be provided by NOS is not the exclusive means for accessing better-priced orders in other market centers. Accordingly, NOS's routing services are optional, and a

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187 See NOM Rules, Chapter VI, Section 11(e) and Nasdaq Response, supra note 5, at 11.

188 See Nasdaq Response, supra note 5, at 11.

189 See NOM Rules, Chapter VI, Section 11(e).

190 Id. In addition, the books and records of NOS, as a facility of the Exchange, will be subject at all times to inspection and copying by the Exchange and the Commission. Id.

191 See Nasdaq Response, supra note 5, at 11. See also NOM Rules, Chapter VI, Section 1(b) (allowing Participants to designate orders as available for routing or not available for routing).

NOM Participant is free to route its orders to other market centers through alternative means. In light of the protections discussed above, including the regulation of NOS as a facility of the Exchange with respect to the routing of orders for System Securities, the Commission believes that Nasdaq's rules and procedures regarding the use of NOS to route orders to away markets are consistent with the Act.[192]

F. Linkage

As described above, Nasdaq proposes to use NOS to route orders to other options exchanges. NOM will, however, participate in the Linkage Plan to receive orders from options exchanges that use the Linkage to route orders. To receive orders through the Linkage, Nasdaq proposes to adopt rules relating to the Linkage Plan that are substantially similar to the rules of the other options exchanges that participate in the Linkage Plan. In general, the proposed rules include relevant definitions; establish the conditions pursuant to which Market Makers may enter Linkage orders; impose obligations on the Exchange regarding how it must process incoming Linkage orders; establish a general standard that Participants should avoid trade-throughs; establish potential regulatory liability for Participants that engage in a pattern or practice of trading through other exchanges; and establish obligations with respect to locked and crossed markets.[193]

One commenter questioned how NOM will ensure that orders designated for execution solely on NOM will not create a trade-through or locked or crossed market. In particular, the commenter requests clarification regarding the treatment of an order that locks or crosses the

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192 In addition, the Commission notes that the Nasdaq rules and procedures applicable to NOS are similar to the rules and procedures adopted by other exchanges to govern their order routers. See, e.g., ISE Rule 2108; NYSE Rule 17; and Phlx Rule 185(g).

193 See NOM Rules, Chapter XII.

NBBO, NOM's responsibility for such an order, and the action NOM will take if the market already is locked or crossed when it receives an order.[194]

In response, Nasdaq states that Chapter VI, Section 7(b)(3)(C) of the NOM Rules sets forth the procedures that NOM will use to ensure compliance with the trade through and locked and crossed market provisions of the Linkage Plan.[195] Nasdaq proposes in Amendment No. 2 to state explicitly in the NOM Rules that an order will not be executed at a price that trades through another market or displayed at a price that would lock or cross another market. Nasdaq further proposes to add in Amendment No. 2 that an order that is designated as routable will be routed in compliance with applicable trade through and locked and crossed markets restrictions.[196] With respect to non-routable orders, Nasdaq notes that the System will re-price a Displayed Order that, at the time of entry, would cause a locked or crossed market or a trade through violation, to the current national best offer (for bids) or the current national best bid (for offers) and display the order at one minimum price variation below (for bids) or above (for offers) the national best price.[197] These do-not-ship orders will remain on Nasdaq's book until cancelled or executed by

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194 See Amex Letter supra note 4, at 3.

195 See Nasdaq Response, supra note 5, at 10.

196 See NOM Rules, Chapter VI, Section 7(b)(3)(C).

197 See NOM Rules, Chapter VI, Section 7(b)(3)(C). As originally proposed, Chapter VI, Section 7(b)(3)(C) of the NOM Rules provided that if a Displayed Order that the entering party has elected not to make eligible for routing would cause a locked or crossed market or a trade through violation at the time of entry, the System would re-price the order to one minimum price variation ("MPV") below the current national best offer (for bids) or one MPV above the current national best bid (for offers). In Amendment No. 2, Nasdaq proposes to revise the rule to provide that the System will re-price such an order to the current national best offer (for bids) or the current national best bid (for offers) and display the order at one MPV below (for bids) or above (for offers) the national best price. Nasdaq believes that the procedure proposed in Amendment No. 2 is superior to the original procedure, which would have converted the re-priced order into a Non-Displayed Order.

another NOM Participant or market center.[198] Nasdaq states that the System, therefore, will systemically avoid executing an order at a price that would trade through a price on another market and will prevent Nasdaq from displaying a quotation that would lock or cross a quotation displayed by another market.[199] In addition, Nasdaq represents that it will program the System to avoid joining a locked or crossed market when the market is already locked or crossed.[200]

The Commission believes that Nasdaq has responded adequately to the commenter's questions regarding NOM's procedures and rules for complying with the Linkage Plan, and that NOM's rules, as amended, are reasonably designed to comply with the locked and crossed market and trade through provisions of the Linkage Plan.

As noted above, Nasdaq intends to use NOS to route orders to other markets. To allow Nasdaq to use the Linkage to send orders to other markets, if it wanted to do so, NOM Rules provide that one Options Market Maker per eligible series will be designated as the "InterMarket Linkage Market Maker" or "ILM" to be responsible for P/A and Satisfaction orders that would be sent to away markets through the Linkage for options trading on NOM. The ILM responsible for such orders will be required to adhere to the responsibilities of an Eligible Market Maker, as set forth in the Linkage Plan.[201]

The ILM will be required to act with due diligence with regard to the interests of orders entrusted to it and fulfill other duties of an agent, including, but not limited to, ensuring that such

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198 See Nasdaq Response, supra note 5, at 10.

199 Id.

200 Id.

201 See NOM Rules, Chapter VII, Section 5(a)(ix). The ILM will perform substantially similar functions that the BOX InterMarket Linkage Market Maker performs on BOX. See BOX Rules, Chapter VI, Section 5(a)(ix), and Chapter XII.

orders, regardless of their size or source, receive proper representation and timely execution in accordance with the terms of the orders and the rules of the Exchange. The ILM must provide NOM with written instructions for the routing of any P/A orders it may send through the InterMarket Linkage. NOM will immediately route all P/A orders on behalf of the ILM according to these instructions.[202]

One commenter seeks clarification as to who would fulfill the role of the ILM if the ILM is excused temporarily from its responsibilities, and who would be responsible for trade throughs.[203]

In response, Nasdaq states that it intends to use NOS to fulfill Nasdaq's order routing obligations under the Linkage Plan.[204] Although Nasdaq believes that it therefore will rarely, if ever, need to appoint an ILM, Nasdaq notes that Chapter VII, Rule 5(a)(ix) of the NOM Rules provides Nasdaq with the ability to designate a market maker as the ILM for a particular series.[205] In the event that the ILM substantially fails to engage in a course of dealings under this rule, Nasdaq Regulation may bring a disciplinary action.[206] In addition, Nasdaq states that neither Nasdaq or any Participant will face liability for trade throughs because NOM is

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202 The order would be generated automatically by NOM and routed to the away exchange with the required clearing information included. Each execution received from an away exchange would result in the automatic generation of a trade execution on NOM between the original order and the ILM.

203 See SIFMA Letter, supra note 4, at 2.

204 See Nasdaq Response, supra note 5, at 4.

205 See Nasdaq Response, supra note 5, at 4. The Commission notes that if there is no Market Maker registered in a particular series, NOM will place that series in a non-regulatory suspension and halt trading until such time as a member registers to make markets in that series. See supra note 79 and accompanying text.

206 See NOM Rules, Chapter VII, Section 5(c).

programmed to comply with the requirements of the Linkage Plan. If NOM has a System malfunction that results in a trade through, Nasdaq believes that such an occurrence would fall under the exception in Section 8(c)(iii) of the Linkage Plan. If Nasdaq receives a Satisfaction Order from an away market, NOM will execute the order against trading interest available on the NOM Book.[207]

The Commission notes that NOM's rules and the NOM System are designed to comply with the requirements of the Linkage Plan, including the trade through requirements. The Commission believes that the proposed NOM rules regarding the Intermarket Linkage are consistent with the requirements of the Linkage Plan and the Act. The Commission reminds Nasdaq, however, that to the extent trades are executed on NOM that do not comply with the trade through requirements of the Linkage Plan, Nasdaq, as a Plan Participant, will have the obligation to comply with the requirements of the Linkage Plan, including responding to Satisfaction Orders. Further, before Nasdaq can begin operating NOM, Nasdaq must become a participant in the Linkage Plan.

G. Strike Prices

Nasdaq proposes to participate in the $2.50 Strike Price Program[208] and in the $1 Strike

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207 See Nasdaq Response, supra note 5, at 4.

208 The $2.50 strike price program allows the options exchanges to list options in up to 200 classes at $2.50 strike price intervals for strike prices greater than $25 but less than $75. See, e.g., Securities Exchange Act Release Nos. 40662 (November 12, 1998), 63 FR 64297 (November 19, 1998) (order approving File Nos. SR-Amex-98-21; SR-CBOE-98-29; SR-PCX-98-31; and SR-Phlx-98-26) ("1998 Order") and 52893 (December 5, 2005), 70 FR 73488 (December 12, 2005) (order approving File No. SR-Amex-2005-067). The 200 classes eligible for the $2.50 Strike Price Program were allocated among the options exchanges pursuant to a formula approved by the Commission as part of the permanent approval of the program. Each options exchange may list options with $2.50 strike price intervals on any options class that another exchange selects as part of its program. Any modification to the $2.50 Strike Price Program would require the filing of a proposed rule change with the Commission pursuant to Section 19(b) of the Act.

Price Program.[209] Amendment No. 2 proposes to amend the NOM Rules to reflect the expansion of the $2.50 Strike Price Program to include strike prices between $50 and $75 under certain conditions and to indicate that NOM's $1 Strike Price Program will expire on June 5, 2008, rather than June 5, 2007.[210] These changes conform NOM's rules to the existing rules of the other options markets.[211]

One commenter believes that the terms of NOM's participation in the $2.50 Strike Price Program and the $1 Strike Price Program are unclear.[212] In particular, the commenter questions whether NOM will trade only those classes currently included in the $2.50 Strike Price Program and in the $1 Strike Price Program.[213] NOM's rules provide that it may list $1 strikes in options classes on five individual stocks, as designated by NOM, as well as any options class specifically

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209 Under the $1 Strike Price Program, each options exchange may select a total of five individual stocks on which options series may be listed at $1 intervals, and each exchange may list $1 strikes on any options class designated by another exchange as part of its $1 Strikes Program. See, e.g., Securities Exchange Act Release No. 55714 (May 7, 2007), 72 FR 26853 (May 11, 2007). See NOM Rules, Chapter IV, Section 6, Supplementary Material .03 and Supplementary Material .02. The Commission notes that several of the options exchanges have amended their rules, in part, to allow the exchanges to select a total of ten individual stocks on which options series may be listed at $1 intervals. See, e.g., Securities Exchange Act Release Nos. 57049 (December 27, 2007), 73 FR 528 (January 8, 2008) (order approving File No. SR-CBOE-2007-125) and 57110 (January 8, 2008) (notice of filing and order granting accelerated approval of File No. SR-Amex-2007-141) (together, the "1 Strike Price Orders").

210 See NOM Rules, Chapter IV, Section 6, Supplementary Material .03(b) and Supplementary Material .02.

211 The Commission notes that several of the options exchanges have recently amended their rules to make the $1 Strike Price Program permanent. See, e.g., $1 Strike Price Orders, supra note 209.

212 See Amex Letter, supra note 4, at 3-4.

213 Id. at 4.

designated by another exchange that employs a similar $1 strike price program.[214] NOM's rules also provide that Nasdaq may list series at $2.50 strike price intervals in any multiply traded option once another exchange has selected that option to be a part of the program.[215] The Commission believes that Nasdaq's proposal, as amended, makes clear that NOM will participate in the $2.50 Strike Price Program and the $1 Strike Price Program on the same terms and conditions as the other options exchanges.[216] The Commission also believes that Nasdaq's proposed rules relating to the $2.50 Strike Price and $1 Strike Price Programs will provide investors with flexibility in tailoring their options positions to meet their investment objectives while avoiding the unnecessary proliferation of illiquid options series.[217]

H. Securities Traded on NOM

Nasdaq proposes to adopt initial and continued listing standards for equity and index options[218] that are substantially similar to the listing standards adopted by other options exchanges.[219] In Amendment No. 2, Nasdaq proposes to revise proposed Chapter IV, Section 3

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214 See NOM Rule, Chapter IV, Section 6, Supplementary Material .02(a).

215 See NOM Rule, Chapter IV, Section 6, Supplementary Material .03(a).

216 As noted above, several of the options exchanges have recently expanded and made permanent their $1 Strike Price Programs. See supra notes 209 and 211.

217 See, e.g. 1998 Order, supra note 208, and Securities Exchange Act Release Nos. 47991 (June 5, 2003), 68 FR 35243 (June 12, 2003) (File No. SR-CBOE-2001-60) (order approving CBOE's $1 Strike Price Program through June 5, 2004) and 48024 (June 12, 2003), 68 FR 36617 (June 18, 2003) (File No. SR-Amex-2003-36) (order approving Amex's $1 Strike Price Program through June 5, 2004).

218 See NOM Rules, Chapters IV and XIV.

219 See, e.g., BOX Rules, Chapters IV and XIV. In response to a commenter's concern that its proposed definition of "index option" could have included exchange-traded funds, as well as index options (see Amex Letter, supra note 4, at 4), Nasdaq proposes in Amendment No. 2 to revise its definition "index option" to mean an option on a broad-based, narrow-based, or micro narrow-based index of equity securities prices. See NOM

of the NOM Rules to allow NOM to list and trade an option on an underlying equity security that does not satisfy certain of the criteria for initial listing in the NOM Rules provided that: (1) the underlying security meets the criteria for continued listing set forth in the NOM Rules; and (2) options on such underlying security are listed and traded on at least one other registered national securities exchange.[220] This proposed change to the proposed NOM Rules, which is narrowly tailored to address the circumstances where an equity option class is currently ineligible for initial listing on NOM even though it meets NOM's continued listing standards and is trading on another options exchange, is substantially similar to rules adopted by other options exchanges.[221]

The Commission believes that NOM's proposed initial and continued listing standards, as amended, are consistent with the Act, including Section 6(b)(5), in that they are designed to protect investors and the public interest and to promote just and equitable principles of trade. Nasdaq's operation of NOM as an options exchange, however, is conditioned on Nasdaq becoming a Plan Sponsor in the Plan for the Purpose of Developing and Implementing Procedures Designed to Facilitate the Listing and Trading of Standardized Options Submitted Pursuant to Section 11A(a)(3)(B) of the Securities Exchange Act of 1934 ("OLPP"). In addition,

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Rules, Chapter I, Section 1(a)(21). The Commission finds that the proposed change is consistent with the Act because it clarifies the definition of "index option." In addition, Nasdaq proposes in Amendment No. 2 to revise Chapter IV, Section 5 of the NOM Rules to indicate that if an options class has been approved for listing on NOM and there is not at least one series in that class open for trading, the listing will be placed in a non-regulatory suspension until a series is opened in that class.

220 See NOM Rules, Chapter IV, Section 3(k) and Amendment No. 2. Nasdaq also proposes to state that it shall employ the same procedures to determine whether a particular underlying security meets NOM's continued equity options listing criteria in this instance as it employs when determining whether an underlying security meets NOM's initial listing criteria. See id.

221 See, e.g., Amex Rule 915, Commentary .01(6); CBOE Rule 5.3, Interpretation and Policy .01(c); and ISE Rule 502(b)(6).

Nasdaq will need to become a participant in the Options Clearing Corporation.

I. Regulation of NOM and Options Participants

Nasdaq represents that it has the ability to discharge all regulatory functions related to the facility that it has undertaken to perform by virtue of forming NOM as a facility of Nasdaq.[222] In connection with its regulatory functions, the Exchange represents that its regulatory oversight committee and its chief regulatory officer ("CRO") will assume responsibility for regulating quoting and trading on NOM and conduct by NOM participants.[223] The Exchange's CRO has general supervision of the regulatory operations of the Exchange, including overseeing surveillance, examination, and enforcement functions, and administers a regulatory services agreement ("Regulatory Contract") between the Exchange and FINRA.[224]

Pursuant to the Regulatory Contract, FINRA will perform many of the initial disciplinary processes on behalf of the Exchange. Additionally, the Exchange's By-Laws and rules provide that it has disciplinary jurisdiction over its members so that it can enforce its members' compliance with its rules and the federal securities laws.[225] The Exchange's rules also permit it to sanction members for violations of its rules and violations of the federal securities laws by, among other things, expelling or suspending members, limiting members' activities, functions, or operations, fining or censuring members, or suspending or barring a person from being

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222 See Corporate Structure Proposal Notice, supra note 8, at 58138.

223 See Corporate Structure Proposal Notice, supra note 8, at 58139.

224 Pursuant to the RSA, FINRA performs certain regulatory functions on behalf of the Exchange. In addition to performing certain membership functions for the Exchange, FINRA performs certain disciplinary and enforcement functions for the Exchange. Generally, FINRA investigates members, issue complaints, and conducts hearings pursuant to the Exchange's rules. Appeals of disciplinary hearings, however, will be handled by the Nasdaq Review Council. Id.

225 See e.g. Exchange By-Laws, Article IX, Section 2.

associated with a member.[226] Nasdaq's Rules also provide for the imposition of fines for minor rule violations in lieu of commencing disciplinary proceedings.[227]

Furthermore, the Exchange has an independent regulatory department, Nasdaq Regulation, which carries out many of the Exchange's regulatory functions, including administering its membership and disciplinary rules, and is functionally separate from the Exchange's business lines. Nasdaq Regulation includes Market Watch, which performs real-time intraday surveillance over all Exchange-listed companies and all Exchange market participants. The Exchange represents that Nasdaq Regulation, including Market Watch, will perform the same regulatory role with respect to NOM, including operating automated detection systems to perform real-time surveillance of quoting and trading on NOM and to maintain a fair and orderly market.[228] Specifically, Nasdaq Regulation will perform options listing regulation and will monitor trading on the NOM on a real-time basis to identify unusual trading patterns and determine whether particular trading activity requires further regulatory investigation by FINRA. In addition, Nasdaq Regulation will oversee the process for determining and implementing trading halts, identifying and responding to unusual market conditions, and administering Nasdaq's process for identifying and remediating "obvious errors" by and among Options Participants. The NOM rules governing halts, unusual market conditions, extraordinary

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[226] See e.g. Exchange Rule 8310. Nasdaq rules apply to Options Participants and the trading of options contracts on NOM. See NOM Rules, Chapter I, Section 2. Prospective Options Participant must, among other things, be an existing member or become a member of the Exchange, pursuant to the Nasdaq 1000 Rule Series, as well as maintain a membership on at least one other options national securities exchange. See NOM Rules, Chapter II, Sections 1(b)(iii) and 2(f).

[227] See infra notes 243 to 250 and accompanying text.

[228] See Corporate Structure Proposal Notice, supra note 8, at 58139.

market volatility, and audit trail are modeled on the approved rules of BOX.[229]

The Commission finds that the Exchange's proposed rules and regulatory structure with respect to NOM are consistent with the requirements of the Act, and in particular with Section 6(b)(1) of the Act, which requires an exchange to be so organized and have the capacity to be able to carry out the purposes of the Act and to comply, and to enforce compliance by its members and persons associated with its members, with the Act and the rules and regulations thereunder, and the rules of the Exchange,[230] and with Sections 6(b)(6) and 6(b)(7) of the Act,[231] which require an Exchange to provide fair procedures for the disciplining of members and persons associated with members.

1. Regulatory Contract

The Exchange represents that the Regulatory Contract between the Exchange and FINRA governs the Exchange and its facilities. Therefore, because NOM will be a facility of Nasdaq, the Regulatory Contract will govern NOM.[232] The Exchange and FINRA, however, have modified the Regulatory Contract to capture certain aspects of regulation of NOM and the regulation and discipline of Options Participants.[233] The Commission notes that Nasdaq will

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229 See BOX Rules, Chapter V.

230 15 U.S.C. 78f(b)(1).

231 15 U.S.C. 78f(b)(6) and (b)(7).

232 The Commission notes that the NOM Proposed Rules provide that "NOM rules that refer to Nasdaq Regulation, Nasdaq Regulation staff, NOM staff, and NOM departments should be understood as also referring to [National Association of Securities Dealers, Inc. ("NASD") (n/k/a Financial Industry Regulatory Authority, Inc. or FINRA)], NASD staff, NASD Regulation staff, and NASD departments acting on behalf of Nasdaq pursuant to the Regulatory Contract." See NOM Rules, Chapter 1, Article 3.

233 Nasdaq and FINRA are parties to an agreement pursuant to Section 17(d) of the Act and Rule 17d-2 thereunder, dated July 11, 2006 ("Bilateral 17d-2 Agreement"). A regulatory matter involving a NOM Participant that is also a FINRA member that is governed by

continue to bear ultimate regulatory responsibility for functions performed on Nasdaq's behalf under the Regulatory Contract. Further, the Exchange retains ultimate legal responsibility for the regulation of its members (including those members that are NOM Participants) and its market (including its facility, NOM).

The Commission believes that it is consistent with the Act to and the public interest to allow the Exchange to contract with FINRA to perform membership, disciplinary, and enforcement functions.[234] Membership, discipline, and enforcement are fundamental elements to a regulatory program, and constitute core self-regulatory functions. It is essential to the public interest and the protection of investors that these functions are carried out in an exemplary manner. With respect to certain regulatory functions contracted to FINRA by the Exchange, including membership, disciplinary and enforcement functions, the Commission noted in the Registration Approval Order its belief that FINRA has the expertise and experience to perform such functions on behalf of the Exchange, and that the contracting of such functions to FINRA is consistent with the Act and the public interest.[235] The Commission continues to believe this is true with respect to the inclusion in the Regulatory Contract of regulation of NOM and the

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both the Regulatory Contract and the Bilateral 17d-2 Agreement will be administered by FINRA pursuant to the Bilateral 17d-2 Agreement, not the Regulatory Contract. Telephone conversation between Jeffrey S. Davis, Vice President and Deputy General Counsel, Nasdaq, and Heather Seidel, Assistant Director, Division of Trading and Markets ("Division"), Commission, on December 21, 2007.

234 See e.g., Regulation ATS Release, supra note 92. See also Securities Exchange Act Release Nos. 50122 (July 29, 2004), 69 FR 47962 (August 6, 2004) (order approving File No. SR-Amex-2004-32) ("Amex Approval Order"); 42455 (February 24, 2000), 65 FR 11388 (March 2, 2000) (File No. 10-127) (approving ISE's registration as a national securities exchange) ("ISE Exchange Registration Order") at III(D)(2); and Registration Approval Order, supra note 19.

235 See Registration Approval Order, supra note 19, at notes 10 and 11 and accompanying text.

conduct of NOM Participants.

At the same time, the Exchange, unless relieved by the Commission of its responsibility,[236] bears the responsibility for self-regulatory conduct and primary liability for self-regulatory failures, not the SRO retained to perform regulatory functions on the Exchange's behalf.[237] In performing these functions, however, FINRA may nonetheless bear liability for causing or aiding and abetting the failure of the Exchange to perform its regulatory functions.[238] Accordingly, although FINRA will not act on its own behalf under its SRO responsibilities in carrying out these regulatory services for Nasdaq relating to the operation of NOM, FINRA also may have secondary liability if, for example, the Commission finds the contracted functions are being performed so inadequately as to cause a violation of the federal securities laws by Nasdaq.[239]

2. 17d-2 Agreement

Rule 17d-2 allows SROs to file with the Commission plans under which the SROs allocate among themselves the responsibility to receive regulatory reports from, and examine and enforce compliance with, specified provisions of the Act and rules thereunder and SRO rules by firms that are members of more than one SRO ("common members"). An SRO that is a party to an effective 17d-2 plan is relieved of regulatory responsibility as to any common member for

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236 See Section 17(d)(1) of the Act and Rule 17d-2 thereunder. 15 U.S.C. 78q(d)(1); and 17 CFR 240.17d-2. See also infra note 240 and accompanying text. The Commission notes that it is not approving the Regulatory Contract.

237 See Registration Approval Order, supra note 19, at notes 112 and 113 and accompanying text; Amex Approval Order, supra note 234; and ISE Registration Approval Order, supra note 234, at III(D)(2).

238 Id.

239 Id.

whom responsibility is allocated under the plan to another SRO.[240]

All of the options exchanges, the NASD, and the NYSE have entered into the Options Sales Practices Agreement, a Rule 17d-2 agreement ("17d-2 Agreement" or "Agreement"). This Agreement allocates to certain SROs ("examining SROs") regulatory responsibility for common members with respect to certain options-related sales practice matters. For example, the Agreement allocates responsibility to conduct options-related sales practice examinations of a firm, and investigate options-related customer complaints and terminations for cause of associated persons of that firm. The Commission notes that Nasdaq has become a party to the 17d-2 Agreement,[241] which will cover Nasdaq members acting as Options Participants.[242]

3. Minor Rule Violation Plan

The Commission approved Nasdaq's Minor Rule Violation Plan ("MRVP") in 2006.[243] Nasdaq's MRVP specifies those uncontested minor rule violations with sanctions not exceeding $2,500 that would not be subject to the provisions of Rule 19d-1(c)(1) under the Act[244] requiring

240 Rule 17d-2 provides that any two or more SROs may file with the Commission a plan for allocating among such SROs the responsibility to receive regulatory reports from persons who are members or participants of more than one of such SROs to examine such persons for compliance, or to enforce compliance by such persons, with specified provisions of the Act, the rules and regulations thereunder, and the rules of such SROs, or to carry out other specified regulatory functions with respect to such persons. 17 CFR 240.17d-2.

241 The Commission today is approving an amendment to the 17d-2 Agreement that adds Nasdaq as a party to the Agreement. See Securities Exchange Act Release No. 57481 (March 12, 2008) (File No. S7-966).

242 NOM rules contemplate participation in this Agreement by requiring that any Options Participant that transacts business with Public Customers also be a member of at least one of the examining SROs. See NOM Rules, Chapter XI, Section 1.

243 See Securities Exchange Act Release No. 53623 (April 10, 2006), 71 FR 19769 (April 17, 2006) (File No. 4-514) ("MRVP Order").

244 17 CFR 240.19d-1(c)(1).

that an SRO promptly file notice with the Commission of any final disciplinary action taken with respect to any person or organization.[245] Nasdaq's MRVP includes the policies and procedures included in Nasdaq Rule 9216(b), "Procedure for Violations under Plan Pursuant to SEC Rule 19d-1(c)(2)," and the rule violations included in Nasdaq IM-9216, "Violations Appropriate for Disposition Under Plan Pursuant to SEC Rule 19d-1(c)(2)."

The Trading Rules Proposal, as originally filed, included Chapter X, Section 7 of the NOM Rules, "Penalty for Minor Rule Violations," which lists the options rules that Nasdaq intended to include in its MRVP. However, the Trading Rules Proposal did not propose a corresponding amendment to Nasdaq IM-9216 to include the rules in proposed Chapter X, Section 7 of the NOM Rules in Nasdaq's MRVP. Accordingly, in Amendment No. 2, Nasdaq proposes to amend Nasdaq IM-9216 to include proposed Chapter X, Section 7 of the NOM Rules.[246] The Commission believes that this change is consistent with the Act because it clarifies that the proposed rules listed in Chapter X, Section 7 of the NOM Rules will be included in Nasdaq's MRVP.

The Commission notes that the rules included in Chapter X, Section 7 of the NOM Rules

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245 The Commission adopted amendments to paragraph (c) of Rule 19d-1 to allow SROs to submit for Commission approval plans for the abbreviated reporting of minor disciplinary infractions. See Securities Exchange Act Release No. 21013 (June 1, 1984), 49 FR 23829 (June 8, 1984). Any disciplinary action taken by an SRO against any person for violation of a rule of the SRO which has been designated as a minor rule violation pursuant to such a plan filed with the Commission will not be considered "final" for purposes of Section 19(d)(1) of the Act if the sanction imposed consists of a fine not exceeding $2,500 and the sanctioned person has not sought an adjudication, including a hearing, or otherwise exhausted his administrative remedies.

246 In the MRVP Order, the Commission noted that Nasdaq proposed that any amendments to IM-9216 made pursuant to a rule filing submitted under Rule 19b-4 of the Act would automatically be deemed a request by Nasdaq for Commission approval of a modification to its MRVP. See MRVP Order, supra note 243, at note 6.

are similar to the rules included in the MRVPs of other options exchanges.[247] The Commission finds that Nasdaq's MRVP, as amended to include the rules listed in Chapter X, Section 7 of the NOM Rules, is consistent with Sections 6(b)(1), 6(b)(5) and 6(b)(6) of the Act, which require, in part, that an exchange have the capacity to enforce compliance with, and provide appropriate discipline for, violations of the rules of the Commission and of the exchange.[248] In addition, because Nasdaq Rule 9216(b) will offer procedural rights to a person sanctioned for a violation listed in Chapter X, Section 7 of the NOM Rules, the Commission believes that Nasdaq's rules provides a fair procedure for the disciplining of members and associated persons, consistent with Section 6(b)(7) of the Act.[249]

The Commission also finds that the proposal to include the rules listed in Chapter X, Section 7 of the NOM Rules in Nasdaq's MRVP is consistent with the public interest, the protection of investors, or otherwise in furtherance of the purposes of the Act, as required by Rule 19d-1(c)(2) under the Act,[250] because it should strengthen Nasdaq's ability to carry out its oversight and enforcement responsibilities as an SRO in cases where full disciplinary proceedings are unsuitable in view of the minor nature of the particular violation.

In approving the proposed change to Nasdaq's MRVP, the Commission in no way minimizes the importance of compliance with NOM rules and all other rules subject to the imposition of fines under Nasdaq's MRVP. The Commission believes that the violation of any SRO rules, as well as Commission rules, is a serious matter. However, the Nasdaq MRVP

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[247] See, e.g., BOX Rules, Chapter X, Section 2, and ISE Rule 1614.

[248] 15 U.S.C. 78f(b)(1), 78f(b)(5) and 78f(b)(6).

[249] 15 U.S.C. 78f(b)(7).

[250] 17 CFR 240.19d-1(c)(2).

provides a reasonable means of addressing rule violations that do not rise to the level of requiring formal disciplinary proceedings, while providing greater flexibility in handling certain violations. The Commission expects that Nasdaq will continue to conduct surveillance with due diligence and make a determination based on its findings, on a case-by-case basis, whether a fine of more or less than the recommended amount is appropriate for a violation under Nasdaq's MRVP or whether a violation requires a formal disciplinary action under the Nasdaq Rule 9200 Series.

J. Quote Mitigation

Nasdaq originally proposed a rule that would provide for the bundling of certain order and quote updates sent to OPRA for low volume options that have been listed on NOM for more than ten trading days.[251] In Amendment No. 2, Nasdaq proposes to eliminate the rule as proposed and provide that: (1) On a monthly basis, NOM will determine the average daily volume ("ADV") of each series listed on NOM and delist the current series and not list the next series after expiration where the ADV is less than 100 contracts;[252] (2) NOM will implement a "replace on queue" functionality that will monitor outgoing messages and will not send a message that is about to be sent if a more current message for the same series is available for sending;[253] (3) NOM will prioritize price update messages and send out price updates before sending size update messages; and (4) when the size associated with a bid or offer increases by an amount less than or equal to a percentage (never to exceed 20%) of the size associated with a

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[251] The period for which updates would be bundled would not have exceeded one second. This rule was based on a similar rule of BOX. See BOX Rules, Chapter V, Section 32.

[252] The ADV refers to the ADV on NOM. Telephone conversation between Heather Seidel, Assistant Director, Division of Trading and Markets, and Jeffrey S. Davis, Vice President and Deputy General Counsel, Nasdaq, on January 9, 2008.

[253] This functionality will be applied in real time and will not delay the sending of any messages.

previously disseminated bid or offer, NOM will not disseminate the new bid or offer.[254] Nasdaq also represents that when NOM detects that a Participant is disseminating significantly more quotes than is normal for that Participant, NOM will contact that Participant and alert it to such activity. Such monitoring may reveal that the Participant may have internal system issues or incorrectly-set system parameters that are not immediately apparent. NOM believes that, even without uncovering problems, alerting a Participant to possible excessive quoting will lead the Participant to take steps to reduce the number of its quotes.[255]

The Commission notes that several of the options exchanges have adopted similar rules that provide for the delisting of options classes when the ADV of the class falls below a certain threshold.[256] In addition, Nasdaq's proposal to not disseminate a new bid or offer when the size associated with a bid or offer increases by an amount less than or equal to a percentage (never to exceed 20%) of the size associated with a previously disseminated bid or offer is substantially similar to a Phlx rule previously approved by the Commission.[257] Further, Nasdaq's monitoring

254 See NOM Rules, Chapter VI, Section 17.

255 See Amendment No. 2 at 9.

256 See Securities Exchange Act Release Nos. 55161 (January 24, 2007), 72 FR 4754 (February 1, 2007) (File No. SR-ISE-2006-62) (ISE Penny Pilot Approval Order) (approving ISE policy to delist equity options with an ADV of less than 20 contracts, but noting that ISE's current policy is to do so for options with an ADV of less than 50 contracts); 55162 (January 24, 2007), 72 FR 4738 (February 1, 2007) (File No. SR-Amex-2006-106) (Amex Penny Pilot Approval Order) (approving Amex policy to delist options classes with an ADV of less than 25 contracts); 55154 (January 23, 2007), 72 FR 4743 (February 1, 2007) (File No. SR-CBOE-2006-92) (CBOE Penny Pilot Approval Order) (approving CBOE policy to delist equity option classes with an ADV of less than 20 contracts); and 56154 (July 27, 2007), 72 FR 43303 (August 3, 2007) (File No. SR-CBOE-2007-85) (approving an exception to CBOE's delisting policy if the option class scheduled for delisting experiences a significant increase in trading volume).

257 See Securities Exchange Act Release No. 55153 (January 23, 2007), 72 FR 4553 (January 31, 2007) (File No. SR-Phlx-2006-74) (order approving, in part, a Phlx rule providing that it will disseminate an updated bid or offer when, among other things, the

strategy is substantially similar to a policy adopted by ISE.[258] The Commission also believes that Nasdaq's proposed "replace on queue" functionality and its proposal to prioritize price update messages and send out price updates before sending size update messages are reasonable measures to attempt to mitigate quote message traffic because they will more efficiently provide for the dissemination of the most recent quote information.

Although Nasdaq's rules do not include a "holdback timer" or similar quote mitigation strategy like those adopted by four of the other options exchanges,[259] the Commission believes that the totality of Nasdaq's proposed market structure, market making obligations, and quote mitigation strategies are comparable to the quote mitigation efforts of the other options markets. More specifically, Nasdaq has proposed to allow Market Makers to register by series, as opposed to class. As noted above, the Commission believes that this will permit Market Makers to select the options series in which they are most interested. This is designed to reduce the number of quotes submitted by such Market Makers, and therefore likely will help to mitigate NOM's quote message traffic and capacity.[260] In addition, NOM Rules provide that a market maker's continuous quoting obligations will not be applicable in options series until the time to expiration is less than nine months.[261]

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size associated with it's bid or offer increases by an amount greater than or equal to a percentage (never to exceed 20%)).

[258] See ISE Penny Pilot Approval Order, supra note 256. See also CBOE Penny Pilot Approval Order and Amex Penny Pilot Approval Order, supra note 256.

[259] See Amex Penny Pilot Approval Order, CBOE Penny Pilot Approval Order, and ISE Penny Pilot Approval Order, supra note 256; and Securities Exchange Act Release No. 55155 (January 23, 2007), 72 FR 4741 (February 1, 2007) (File No. SR-BSE-2006-49) (approving BOX's Penny Pilot program).

[260] See supra notes 57 to 58 and accompanying text.

[261] See NOM Rules, Chapter IV, Section 8(a). See also CBOE Rule 8.7; PHLX Rule

Further, Nasdaq has proposed that it will open at least one expiration month for each class of option open for trading on NOM, and a minimum of one series of options in that class.[262] These requirements provide for fewer mandatory expiration months and series than the rules of other options exchanges, and may therefore contribute to less quote message traffic on NOM to the extent that NOM has fewer series open for trading. And, as detailed above, Nasdaq has proposed four quote mitigation strategies, several of which are substantially similar to those in place at other markets.

K. Section 11(a) of the Act

Section 11(a)(1) of the Act[263] prohibits a member of a national securities exchange from effecting transactions on that exchange for its own account, the account of an associated person, or an account over which it or its associated person exercises discretion (collectively, "covered accounts") unless an exception applies. Rule 11a2-2(T)[264] under the Act, known as the "effect versus execute" rule, provides exchange members with an exemption from the Section 11(a)(1) prohibition. Rule 11a2-2(T) permits an exchange member, subject to certain conditions, to effect transactions for covered accounts by arranging for an unaffiliated member to execute transactions on the exchange. To comply with Rule 11a2-2(T)'s conditions, a member: (i) must transmit the order from off the exchange floor; (ii) may not participate in the execution of the

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1014(b)(ii)(D)(4); and Amex Rules 993-ANTE(c)(ii) and 994-ANTE(c)(iv).

262 See NOM Rules, Chapter IV, Sections 6(b) and 6(e). In Amendment No. 2, Nasdaq proposes to revise Chapter IV, Section 6(b) of the NOM Rules to provide that at the commencement of trading of an options class, NOM will list a minimum of one options series in that class, rather than a minimum of three series for each expiration month in the class, as originally proposed.

263 15 U.S.C. 78k(a)(1).

264 17 CFR 240.11a2-2(T).

transaction once it has been transmitted to the member performing the execution;[265] (iii) may not be affiliated with the executing member; and (iv) with respect to an account over which the member has investment discretion, neither the member nor its associated person may retain any compensation in connection with effecting the transaction except as provided in the Rule.

In a letter to the Commission, Nasdaq requests that the Commission concur with Nasdaq's conclusion that Participants that enter orders into NOM satisfy the requirements of Rule 11a2-2(T).[266] For the reasons set forth below, the Commission believes that Participants entering orders into NOM would satisfy the conditions of the Rule.

The Rule's first condition is that orders for covered accounts be transmitted from off the exchange floor. The NOM System receives orders electronically through remote terminals or computer-to-computer interfaces. In the context of other automated trading systems, the Commission has found that the off-floor transmission requirement is met if a covered account order is transmitted from a remote location directly to an exchange's floor by electronic means.[267] Because the NOM System receives orders electronically through remote terminals or

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265 The member may, however, participate in clearing and settling the transaction.

266 See letter from Jeffrey S. Davis, Vice President and Deputy General Counsel, Nasdaq, to Nancy M. Morris, Secretary, Commission, dated December 13, 2007 ("Nasdaq 11(a) Letter").

267 See, e.g., Registration Approval Order, supra note 19; BOX Approval Order, supra note 72; and Securities Exchange Act Release Nos. 44983 (October 25, 2001), 66 FR 55225 (November 1, 2001) (order approving the Archipelago Exchange as an electronic trading facility of the Pacific Exchange ("PCX")); 29237 (May 24, 1991), 56 FR 24853 (May 31, 1991) (regarding NYSE's Off-Hours Trading Facility); 15533 (January 29, 1979), 44 FR 6084 (January 31, 1979) (regarding the American Stock Exchange ("Amex") Post Execution Reporting System, the Amex Switching System, the Intermarket Trading System, the Multiple Dealer Trading Facility of the Cincinnati Stock Exchange, the PCX Communications and Execution System, and the Philadelphia Stock Exchange's Automated Communications and Execution System ("1979 Release")); and 14563 (March 14, 1978) 43 FR 11542 (March 17, 1978) (regarding the NYSE's Designated Order Turnaround System ("1978 Release")).

computer-to-computer interfaces, the Commission believes that the NOM System satisfies the off-floor transmission requirement.

Second, the Rule requires that the member not participate in the execution of its order. Nasdaq represented that at no time following the submission of an order is a Participant able to acquire control or influence over the result or timing of an order's execution. According to Nasdaq, the execution of a member's order is determined solely by what other orders, bids, or offers are present in the NOM System at the time the Participant submits the order and on the priority of those orders, bids, and offers.[268] Accordingly, the Commission believes that a Participant does not participate in the execution of an order submitted to the NOM System.

Third, Rule 11a2-2(T) requires that the order be executed by an exchange member who is unaffiliated with the member initiating the order. The Commission has stated that this requirement is satisfied when automated exchange facilities, such as the NOM System, are used, as long as the design of these systems ensures that members do not possess any special or unique trading advantages in handling their orders after transmitting them to the exchange.[269] Nasdaq

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[268] See Nasdaq 11(a) Letter, supra note 266, at 7. The Participant may cancel or modify the order, or modify the instruction for executing the order, but only from off the floor. The Commission has stated that the non-participation requirement is satisfied under such circumstances so long as such modifications or cancellations are also transmitted from off the floor. See 1978 Release, supra note 267 (stating that the "non-participation requirement does not prevent initiating members from canceling or modifying orders (or the instructions pursuant to which the initiating member wishes orders to be executed) after the orders have been transmitted to the executing member, provided that any such instructions are also transmitted from off the floor").

[269] In considering the operation of automated execution systems operated by an exchange, the Commission noted that while there is not an independent executing exchange member, the execution of an order is automatic once it has been transmitted into the systems. Because the design of these systems ensures that members do not possess any special or unique trading advantages in handling their orders after transmitting them to the exchange, the Commission has stated that executions obtained through these systems satisfy the independent execution requirement of Rule 11a2-2(T). See 1979 Release,

has represented that the design of the NOM System ensures that no member has any special or unique trading advantage in the handling of its orders after transmitting its orders to the Exchange.[270] Based on Nasdaq's representation, the Commission believes that the NOM System satisfies this requirement.

Fourth, in the case of a transaction effected for an account with respect to which the initiating member or an associated person thereof exercises investment discretion, neither the initiating member nor any associated person thereof may retain any compensation in connection with effecting the transaction, unless the person authorized to transact business for the account has expressly provided otherwise by written contract referring to Section 11(a) of the Act and Rule 11a2-2(T).[271] Nasdaq represents that Participants trading for covered accounts over which they exercise investment discretion must comply with this condition in order to rely on the rule's exemption.[272]

III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 2, including whether Amendment No. 2 is consistent with the Act. Comments

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supra note 267.

270 See Nasdaq 11(a) Letter, supra note 266, at 8.

271 17 CFR 240.11a2-2(T)(a)(2)(iv). In addition, Rule 11a2-2(T)(d) requires a member or associated person authorized by written contract to retain compensation, in connection with effecting transactions for covered accounts over which such member or associated persons thereof exercises investment discretion, to furnish at least annually to the person authorized to transact business for the account a statement setting forth the total amount of compensation retained by the member in connection with effecting transactions for the account during the period covered by the statement. See 17 CFR 240.11a2-2(T)(d). See also 1978 Release, supra note 267 (stating "[t]he contractual and disclosure requirements are designed to assure that accounts electing to permit transaction-related compensation do so only after deciding that such arrangements are suitable to their interests").

272 See Nasdaq 11(a) Letter, supra note 266, at 8.

may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/sro.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-NASDAQ-2007-004 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-NASDAQ-2007-004. 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, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of the Amex. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-NASDAQ-2007-004 and should be submitted on or before [insert date 21 days from publication

in the Federal Register].

IV. Exemption from Section 19(b) of the Act with Regard to CBOE, NYSE, and FINRA Rules Incorporated by Reference

Nasdaq proposes to incorporate by reference as NOM Rules certain rules of the CBOE, NYSE, and FINRA.[273] Thus, for certain NOM rules, NOM members will comply with a NOM rule by complying with the CBOE, NYSE, or FINRA rule referenced. In connection with its proposal to incorporate CBOE, NYSE, and FINRA rules by reference, Nasdaq requested, pursuant to Rule 240.0-12,[274] an exemption under Section 36 of the Act from the rule filing requirements of Section 19(b) of the Act for changes to those NOM rules that are effected solely by virtue of a change to a cross-referenced CBOE, NYSE, or FINRA rule.[275] Nasdaq proposes to incorporate by reference categories of rules (rather than individual rules within a category) that are not trading rules. Nasdaq agrees to provide written notice to Participants prior to the

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273 Specifically, Nasdaq proposes to incorporate by reference: (1) CBOE rules governing position and exercise limits for equity and index options, which are cross-referenced in Chapter III, Sections 7 and 9 of the NOM Rules and Chapter XIV, Sections 5 and 7 of the NOM Rules, respectively; (2) the margin rules of the CBOE or the NYSE, which are referenced in Chapter XIII, Section 3 of the NOM Rules; and (3) FINRA's rules governing communications with the public, which are referenced in Chapter XI, Section 22 of the NOM Rules. With respect to position limits, one commenter believes that each options exchange should be required to develop its own expertise and establish specific requirements in its own rules to provide for proper disclosure to members and to further the exchange's compliance and surveillance functions. See Amex Letter, supra note 4, at 4. Nasdaq believes that its reliance on the position and exercise limit rules of CBOE assures equal regulation among markets. See Nasdaq Response, supra note 5, at 2. The Commission does not believe that requiring each options exchange to develop its own position limits would promote the efficient use of SRO and Commission resources. In addition, as discussed below, Nasdaq will notify Participants whenever the CBOE proposes to change a position limit rule that has been incorporated by reference into the NOM Rules.

274 17 CFR 240.0-12.

275 See letter from Jeffrey S. Davis, Vice President and Deputy General Counsel, Nasdaq, to Nancy Morris, Secretary, Commission, dated December 13, 2007 ("Nasdaq 19(b) Exemption Letter").

launch of NOM of the specific CBOE, NYSE, and FINFRA rules that it will incorporate by reference.[276] In addition, Nasdaq will notify Participants whenever CBOE, NYSE, or FINRA proposes a change to a cross-referenced CBOE, NYSE, or FINRA rule.[277]

Using its authority under Section 36 of the Act, the Commission previously exempted certain SROs from the requirement to file proposed rule changes under Section 19(b) of the Act.[278] Each such exempt SRO agreed to be governed by the incorporated rules, as amended from time to time, but is not required to file a separate proposed rule change with the Commission each time the SRO whose rules are incorporated by reference seeks to modify its rules.

In addition, each SRO incorporated by reference only regulatory rules (e.g., margin, suitability, arbitration), not trading rules, and incorporated by reference whole categories of rules (i.e., did not "cherry-pick" certain individual rules within a category). Each exempt SRO had reasonable procedures in place to provide written notice to its members each time a change is proposed to the incorporated rules of another SRO in order to provide its members with notice of a proposed rule change that affects their interests, so that they would have an opportunity to comment on it.

The Commission is granting Nasdaq's request for exemption, pursuant to Section 36 of

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276 See Nasdaq 19(b) Exemption Letter, supra note 275, at 2.

277 NOM will provide such notice through a posting on the same web site location where NOM will post its own rule filings pursuant to Rule 19b-4(l) under Act, within the time frame required by that Rule. The web site posting will include a link to the location on the CBOE, NYSE, or FINRA web site where those SROs' proposed rule changes are posted. See Nasdaq 19(b) Exemption Letter, supra note 275, at note 4 and accompanying text.

278 See Securities Exchange Act Release No. 49260 (February 17, 2004), 69 FR 8500 (February 24, 2004). See also Registration Approval Order, supra note 19.

the Act, from the rule filing requirements of Section 19(b) of the Act with respect to the rules that Nasdaq proposes to incorporate by reference into NOM's Rules.[279] This exemption is conditioned upon Nasdaq providing written notice to NOM participants whenever the CBOE, NYSE, or FINRA proposes to change a rule that NOM has incorporated by reference. The Commission believes that this exemption is appropriate in the public interest and consistent with the protection of investors because it will promote more efficient use of Commission and SRO resources by avoiding duplicative rule filings based on simultaneous changes to identical rule text sought by more than one SRO. Consequently, the Commission grants Nasdaq's exemption request for NOM.

V. Exemption from the Requirement to Register as a SIP

As described above, NOM LLC will be delegated the authority to act as a SIP for quotations and transaction information related to securities traded on NOM and any trading facilities operated by NOM LLC. In a letter dated December 13, 2007 ("Request Letter")[280] submitted in conjunction with Nasdaq's proposal, Nasdaq, on behalf of NOM LLC, requested that the Commission grant NOM LLC a permanent exemption from the requirement under Section 11A(b) of the Act and Rule 609 thereunder that a securities information processor acting as an exclusive processor register with the Commission.[281] For the reasons discussed below, the Commission grants the requested exemption, subject to the conditions specified in this order.

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279 As discussed above, Nasdaq has represented that it will notify Participants whenever the CBOE, NYSE, or FINRA proposes a change to a cross-referenced CBOE, NYSE, or FINRA rule. See supra note 277 and accompanying text.

280 See letter from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, to Dr. Erik Sirri, Director, Division of Trading and Markets, Commission, dated December 13, 2007.

281 15 U.S.C. 78k-1(b). Rule 609 under the Act, 17 CFR 242.609, requires that the registration of a securities information processor be on Form SIP, 17 CFR 249.1001.

A. Overview

Pursuant to Nasdaq's proposal being approved today, NOM LLC will be a wholly owned subsidiary, established for the purpose of operating a Nasdaq facility for the trading of options. Nasdaq will delegate the performance of certain of its market functions to NOM LLC with respect to the quoting and trading of options, including the authority to act as a securities information processor for quoting and trading information related to options traded on NOM and any trading facilities operated by NOM LLC. Because NOM LLC will be engaging, on an exclusive basis on behalf of Nasdaq, in collecting, processing, or preparing for distribution or publication information with respect to transactions or quotations on, or effected or made by means of, a facility of Nasdaq, it will be an exclusive processor required to register pursuant to Section 11A(b) of the Act. Nevertheless, as further described in the Request Letter, Nasdaq and NOM LLC believe that the purposes of Section 11A(b) of the Act are not served by requiring NOM LLC to register as an exclusive processor under Section 11A(b) of the Act because Section 11A(b) subjects registered securities information processor to a regulatory regime to which NOM will be subject in all material respects as a facility of a registered national securities exchange.

B. Discussion

Sections 11A(b)(1) and (2) of the Act and Rule 609 thereunder (formerly Rule 11Ab2-1) provide that a securities information processor[282] that is acting as an exclusive processor[283]

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[282] Section 3(a)(22) of the Act, 15 U.S.C. 78c(a)(22)(A), defines the term securities information processor to mean any person engaged in the business of (i) collecting, processing, or preparing for distribution or publication, or assisting, participating in, or coordinating the distribution or publication of, information with respect to transactions in or quotations for any security (other than an exempted security) or (ii) distributing or publishing (whether by means of a ticker tape, a communications network, a terminal display device, or otherwise) on a current and continuing basis, information with respect to such transactions or quotations.

register with the Commission by filing an application for registration on Form SIP. Section 11A(b)(1) of the Act and Rule 609(c) thereunder allow the Commission, by rule or order, to conditionally or unconditionally exempt any securities information processor from any provision of Section 11A(b) of the Act or the rules or regulations thereunder, if the Commission finds that such exemption is consistent with the public interest, the protection of investors, and the purposes of Section 11A(b).[284]

In its release adopting Rule 609, the Commission provides a framework for the consideration of exemption requests pursuant to Section 11A(b)(1) of the Act.[285] Specifically, the Commission indicates that the need for registration of an exclusive processor should be considered in respect of Sections 11A(b)(1), (b)(3) and (b)(5) and Sections 17(a) and (b) of the Act, insofar as they provide a framework for the surveillance and regulation of registered securities information processors. The Commission stated that any application for an exemption from registration should show not only how such exemption would be consistent with the statutory purposes discussed in the release, but also should demonstrate why, by virtue of the applicant's organization, operation or other characteristics, the applicant should be exempted

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283 Under Section 3(a)(22)(B) of the Act, 15 U.S.C. 78c(a)(22)(B), an exclusive processor is defined as any securities information processor or self-regulatory organization which, directly or indirectly, engages on an exclusive basis on behalf of any national securities exchange or registered securities association, or any national securities exchange or registered securities association which engages on an exclusive basis on its own behalf, in collecting, processing, or preparing for distribution or publication any information with respect to (i) transactions or quotations on or effected or made by means of any facility of such exchange or (ii) quotations distributed or published by means of any electronic system operated or controlled by such association.

284 See 15 U.S.C. 78k-1(b)(1) and 17 CFR 242.609(c).

285 See Securities Exchange Act Release No. 11673 (September 23, 1975), 40 FR 45422 (October 2, 1975) (adopting Commission Rule 11Ab2-1, which has been redesignated as Rule 609).

from registration, the requirements of Section 11A(b) and the Commission's authority under Sections 17(a) and 17(b) of the Act.[286]

The Commission believes that NOM LLC will be acting as an exclusive processor as defined in Section 3(a)(22)(B) of the Act because it will engage on an exclusive basis on behalf of Nasdaq, in collecting, processing, or preparing for distribution or publication information with respect to transactions or quotations on, or effected or made by means of, a facility of Nasdaq. Further, NOM LLC, in carrying out market functions of Nasdaq, will operate (and will be regulated) as a facility of Nasdaq, which is a national securities exchange registered under Section 6 of the Act and the rules and regulations thereunder.[287] In the Request Letter, Nasdaq represents that NOM LLC will not perform any exclusive processor functions other than in its capacity as a facility for Nasdaq.[288]

As discussed below, with respect to its operation as a facility of a registered national securities exchange, NOM LLC already will be subject to regulation and Commission oversight under the Act as a facility of a registered exchange.[289] Oversight and regulation of registered exchanges encompass and exceed the oversight and regulation to which NOM LLC will be

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286 Id. at 45423.

287 Section 3(a)(2) of the Act, 15 U.S.C. 78c(a)(2), defines the term facility, with respect to an exchange, to include its premises, tangible or intangible property whether on the premises or not, any right to use such premises or property or any service thereof for the purpose of effecting or reporting a transaction on an exchange (including, among other things, any system of communication to or from the exchange, by ticker or otherwise, maintained by or with the consent of the exchange), and any right of the exchange to the use of any property or service.

288 Request Letter, supra note 280, at 3.

289 The definition of an exchange under the Act includes "the market facilities maintained by such exchange." See Section 3(a)(1) of the Act, 15 U.S.C. 78c(a)(1). The functions and operation of a national securities exchange encompass the collection, processing, and dissemination of information related to securities trading.

subject pursuant to registration under Section 11A(b)(1) of the Act and the rules and regulations thereunder. Accordingly, the Commission believes that registration of NOM LLC as an exclusive processor under Section 11A(b)(1) of the Act with respect to those functions that it will carry out as a facility of Nasdaq would not further the purposes of the Act.

1. Denial of Access to Services Provided by a Securities Information Processor or a National Securities Exchange

Section 11A(b)(5)(A) of the Act (1) requires a registered securities information processor to promptly file notice with the Commission if the processor prohibits or limits any person in respect of access to services offered, directly or indirectly, by the processor, and (2) provides that any such prohibition or limitation will be subject to Commission review, on its own motion or upon application by any person aggrieved.[290] If the prohibition or limitation is reviewed, the Commission shall dismiss the proceeding if it finds (after notice and opportunity a hearing) that such prohibition or limitation is consistent with the provisions of the Act and the rules and regulations thereunder and that such person has not been discriminated against unfairly. If the Commission does not make such a finding, or if it finds that such prohibition or limitation imposes any burden on competition not necessary or appropriate in furtherance of the purposes of the Act, the Commission shall set aside the prohibition or limitation and require the securities information processor to permit such person access to services offered by the processor.[291]

NOM LLC, however, will be subject to similar Commission regulation and oversight pursuant to Sections 6(b)(7), 6(d), 19(d), and 19(f) of the Act with respect to its activities as a facility of Nasdaq.[292] Section 19(d)(1) requires, in part, that an exchange promptly file notice

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290 See 15 U.S.C. 78k-1(b)(5)(A).

291 See Section 11A(b)(5)(B) under the Act, 15 U.S.C. 78k-1(b)(5)(B).

292 15 U.S.C. 78f(b)(7) and (d) and 78s(d) and (f).

with the Commission if the exchange prohibits or limits any person in respect to access to services offered by such exchange or member thereof.[293] Any such action for which the exchange must file notice is subject to Commission review.[294]

Section 19(f) of the Act, among other things, allows the Commission to set aside an SRO's prohibition or limitation with respect to access to services offered by the SRO if the Commission finds that the prohibition or limitation imposes any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.

Section 6(b)(7) of the Act provides that the rules of an exchange, among other things, must provide a fair procedure for the prohibition or limitation by the exchange of any person with respect to access to services offered by the exchange or a member thereof.[295]

Section 6(d) of the Act requires, among other things, that a national securities exchange that initiates a proceeding to determine whether to prohibit or limit a person's access to services offered by the exchange notify the person of the specific grounds for the prohibition or limitation and provide an opportunity to be heard. In addition, Section 6(d) provides that an exchange's determination to prohibit or limit a person's access to the exchange's services must be supported by a statement setting for the specific grounds on which the prohibition or limitation is based.

The Commission therefore believes that regulation of Nasdaq as a national securities exchange provides for equivalent regulation and Commission oversight of actions that NOM LLC may take in its capacity as a facility to deny access to services as would be the case were it

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293 15 U.S.C. 78s(d)(1).

294 15 U.S.C. 78s(d)(2). See also Section 19(f) of the Act, 15 U.S.C. 78s(f).

295 15 U.S.C. 78f(b)(7). Section 6(d)(2), 15 U.S.C. 78f(d)(2), provides procedural requirements for any such proceeding by an exchange.

to register as an exclusive processor under Section 11A(b) of the Act.

2. Limitation on Activities of a Securities Information Processor or a National Securities Exchange

Section 11A(b)(6) of the Act grants the Commission authority to censure or place limitations on the activities, functions, or operations of any registered securities information processor or suspend for a period not exceeding twelve months or revoke the registration of any such processor.[296] Likewise, Section 19(h)(1) of the Act grants the Commission authority to suspend for a period not exceeding twelve months or revoke the registration of an exchange, or to censure or impose limitations upon the activities, functions, and operations of an exchange.[297] The Commission therefore has the authority to place limitations on the activities of NOM LLC as a facility of a registered national securities exchange.

3. Access to Books and Records of a Securities Information Processor or a National Securities Exchange

Section 17(a)(1) of the Act requires that national securities exchanges and registered securities information processors 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 the Act.[298] Section 17(b) of the Act requires that

296 15 U.S.C. 78k-1(b)(6).

297 15 U.S.C. 78s(h)(1). See also Sections 19(h)(2), (h)(3), and (h)(4) of the Act, 15 U.S.C. 78s(h)(2), (h)(3), and (h)(4).

298 15 U.S.C. 78q(a). The Commission has promulgated rules pursuant to Section 17(a) of the Act that apply to national securities exchanges, but not registered securities information processors. See, e.g., Rule 17a-1 under the Act, 17 CFR 240.17a-1 (requiring in part a national securities exchange to preserve, for a period of not less than five years, the first two in an easily accessible place, at least one copy of all documents that are made or received by it in the course of its business as such and in the conduct of its self-regulatory activity, and to furnish copies of such records to any representative of

such records be subject at any time, or from time to time, to such reasonable periodic, special, or other examinations by representatives of the Commission and the appropriate regulatory agency for such persons.[299]

The record retention and production requirements set out in Sections 17(a) and (b) of the Act therefore will be applicable to NOM LLC with respect to its activities as a facility of Nasdaq. Thus, requiring NOM LLC to register as an exclusive processor with respect to its activities as a facility of a registered exchange would serve no additional regulatory purpose in this instance.

C. Conclusion

On the basis of the foregoing, the Commission finds that, with respect to its activities as a facility of Nasdaq, granting an exemption to NOM LLC from the requirement to register as a securities information processor pursuant to Section 11A(b) of the Act is consistent with the public interest, the protection of investors, and the purposes of Section 11A(b) of the Act, including maintenance of fair and orderly markets in securities and the removal of impediments to, and perfection of the mechanism of, a national market system. This exemption is limited only to the exclusive processor activities that NOM LLC performs as a facility of Nasdaq.

VI. Accelerated Approval of the Trading Rules Proposal, as Amended

The Commission finds good cause for approving the Trading Rules Proposal, as amended, prior to the thirtieth day after the date of publication of notice of filing of the amended proposal in the Federal Register.

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the Commission upon request). Form SIP, the application for registration of a securities information processor, does require that a securities information processor provide the Commission with certain information relating to its business organization, financial information, operational capability, and access to services. 17 CFR 249.1001.

[299] 15 U.S.C. 78q(b).

As discussed above, the Commission believes that the changes proposed in Amendment No. 2 strengthen and clarify the Trading Rules Proposal. In addition to making non-substantive and technical changes, Amendment No. 2 incorporates changes designed to make NOM's rules consistent with or substantially similar to rules adopted by the other options exchanges or the provisions of the Linkage Plan.[300] Other changes in Amendment No. 2 are designed to clarify NOM's rules,[301] provide additional protections,[302] address non-substantive issues or address

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[300] See, e.g., the addition of rules in Chapter II providing for registration as a Limited Principal and as a Limited Representative in options and security futures; changes in Chapter IV, Section 3, to allow NOM to list an option that does not meet its initial listing standards if the option is listed on another national securities exchange and meets certain other conditions (see supra notes 220 to 221 and accompanying text); changes to Chapter IV, Commentaries .02 and .03, relating to the $1 Strike Price Program and the $2.50 Strike Price Program, respectively (see supra notes 208 to 213 and accompanying text); changes to the obvious error provisions of Chapter V, Section 6 (see supra note 168 and accompanying text); and changes to various provisions of the Intermarket Linkage Rules in Chapter XII to require a response time of five seconds rather than three seconds.

[301] See, e.g., revisions to Nasdaq IM-9216 to include Chapter X, Section 7 of the NOM Rules in Nasdaq's MRVP (see supra notes 243 to 249 and accompanying text); changes to Chapter I, Section 1 to clarify the definition of "primary market;" changes to Chapter III, Section 15 to clarify that the provisions of the rule apply only to options clearing Participants; changes to Chapter VI, Section 10 to more clearly articulate NOM's price/time execution algorithm; the deletion of a proposed provision in Chapter VII relating to short sales by options market makers; and changes to Chapter VIII, Sections 1(b) and 1(d) to require Participants to submit contrary exercise advices to the Options Clearing Corporation rather than to NOM.

[302] See, e.g., changes to Chapter III, Section 4(f) to prohibit a Participant with knowledge of an order being facilitated or submitted to NOM for price improvement (e.g., price improving orders) from entering an order to buy or sell the underlying security, as provided in the rule; a modification to the position and exercise limits in Chapter III, Sections 7 and 9 to clarify that the incorporation of CBOE rules applies to the trading of options listed on both CBOE and Nasdaq; modifications to the Closing Cross procedures in Chapter VI, Section 9 that, among other things, provide that the Current Reference Price and the Near Clearing Price will be disseminated in an option's minimum price variation and never at a price that would expose undisplayed interest on the NOM book (see supra notes 162 to 164 and accompanying text); additions to Chapter VI, Section 11 relating to NOS as a facility of Nasdaq, which, among other things, require that an SRO other than Nasdaq be the designated examining authority for NOS, and that NOM establish procedures and controls designed to restrict the flow of confidential and

concerns raised by commenters.[303] For these reasons, the Commission finds good cause for approving the Trading Rules Proposal, as amended, on an accelerated basis, pursuant to Section 19(b)(2) of the Act.

VII. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[304] that the Trading Rules Proposal (SR-NASDAQ-2007-004), as amended, be, and hereby is, approved on an accelerated basis, except for the $1 Strike Price Program, which is approved on a pilot basis through June 5, 2008; and that the Corporate Structure Proposal (SR-NASDAQ-2007-080) be, and hereby is, approved.

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proprietary information between Nasdaq and its facilities, including NOS (see supra notes 187 to 191 and accompanying text); the addition to Chapter VI, Section 11 of a requirement that Participants whose orders are routed to away markets honor such trades to the same extent that they would be obligated to honor a trade executed on NOM; a change to Chapter XI, Section 21 to state that a Participant must expedite the transfer of a customer's account pursuant to Nasdaq Rules IM-2110-7 and 11870; changes to Chapter XIV to add position limit provisions for Micro-Narrow Based Index options and to refer to the applicable NOM rules for position limits on broad-based index options traded on NOM but not on the CBOE.

303 See, e.g., the proposed change to eliminate Non-Displayed Orders (see supra notes 100 to 102 and accompanying text); the revised definition of "index option" (see supra note 219); the changes in Chapter IV, Section 5 to clarify NOM's procedures and status with respect to the Linkage Plan when an options class that has been approved for listing on NOM has no series open for trading, and when the sole Market Maker in a series withdraws its registration (see supra notes 78 to 79 and accompanying text); the changes in Chapter VI to clarify the definitions and order routing procedures for "System Securities" and "Non-System Securities" (see supra notes 183 to 186 and accompanying text); the clarification in Chapter VI, Section 9 of the time of the Closing Cross for options on fund shares and broad-based indexes (see supra notes 147 to 149 and accompanying text); the change in Chapter VI, Section 10, to identify the taker of liquidity as the party that removes liquidity previously posted to the Book; and the change in Chapter VII, Section 12, Commentary .04 to indicate that a Participant may not inform another Participant or other third party of any of the terms of an order after submitting the order to NOM.

304 15 U.S.C. 78s(b)(2).

Although the Commission's approval of the Trading Rules Proposal, as amended, and the Corporate Structure Proposal is final and the proposed rules are therefore effective,[305] it is further ordered that the operation of NOM is conditioned on the satisfaction of the requirements below:

A. Participation in National Market System Plans Relating to Options Trading. Nasdaq must join the Options Price Reporting Authority; the OLPP; the Linkage Plan; and the National Market System Plan of the Options Regulatory Surveillance Authority.

B. Examination by the Commission. Nasdaq must have, and represent in a letter to the staff in the Commission's Office of Compliance Inspections and Examinations ("OCIE") that it has, adequate surveillance procedures and programs in place to effectively regulate NOM.

C. Delegation Agreement. Nasdaq and NOM LLC must enter into the Delegation Agreement as described above.[306]

IT IS FURTHER ORDERED, pursuant to Section 11A(b) of the Act,[307] that NOM LLC shall be exempt from registering as a securities information processor, subject to the conditions specified in this order.

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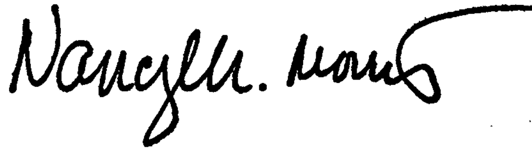
[305] As noted above, the $1 Strike Price Program, which is part of the Trading Rules Proposal, is approved on a pilot basis through June 5, 2008.

[306] See supra note 15 and accompanying text.

[307] 15 U.S.C. 78k-1(b).

IT IS FURTHER ORDERED, pursuant to Section 36 of the Act,[308] that Nasdaq shall be exempt from the rule filing requirements of Section 19(b) of the Act[309] with respect to the rules that Nasdaq proposes to incorporate by reference into NOM's Rules, subject to the conditions specified in this order.

By the Commission.



Nancy M. Morris
Secretary

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308 15 U.S.C. 78mm.

309 15 U.S.C. 78s(b).

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 57490 / March 13, 2008

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2797 / March 13, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12989

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

I.

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

II.

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

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

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

these proceedings, and the findings contained in paragraph III.3 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions (the "Order"), as set forth below.

III.

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

1. Scherping, CPA, age 48, was a certified public accountant licensed to practice in the State of Colorado from June 29, 1988 to May 31, 1998, when his license lapsed. He was Executive Vice President of Finance and Chief Financial Officer of Quovadx, Inc. ("Quovadx" or the "Company") from approximately September 2000 until April 2004.

2. Quovadx, a Delaware corporation headquartered in Englewood, Colorado, was a software company that licensed software and sold related services to the healthcare industry. At all relevant times, Quovadx's common stock was registered with the Commission under Section 12(g) of the Securities Exchange Act of 1934 (the "Exchange Act") and traded on the NASDAQ.

3. On February 29, 2008, a final judgment was entered against Scherping, permanently enjoining him from violating, directly or indirectly, Section 17(a) of the Securities Act of 1933 (the "Securities Act"), Sections 10(b) and 13(b)(5) of the Exchange Act and Rules 10b-5, 13a-14, 13b2-1 and 13b2-2 thereunder, and from aiding and abetting any violation of Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder, in the civil action entitled Securities and Exchange Commission v. Gary Thomas Scherping, Civil Action No. 1:07-cv-01511-WYD-MEH, in the United States District Court for the District of Colorado. Scherping was also ordered to pay a $70,000 civil money penalty and prohibited from acting as an officer or director for five years.

4. The Commission's Complaint alleged, among other things, that between the second and fourth quarters of 2003, Quovadx fraudulently recognized over $12 million in software licensing revenue from transactions with three different third parties, overstating its software licensing revenue by proportions ranging from approximately 9 percent to nearly 180 percent. The Complaint alleged that Scherping knew or was reckless in not knowing that Quovadx could not recognize the revenue from these transactions. The Complaint also alleged that Quovadx prematurely recognized $250,000 in revenue into the third quarter of 2002, overstating its software licensing revenue by 10 percent for that quarter. The Complaint alleged that Scherping knowingly provided substantial assistance to Quovadx in improperly accelerating this revenue. The Complaint further alleged that Scherping made false representations in letters to Quovadx's auditors about these transactions and that he signed false disclosure certifications in connection with the Company's reports on Form 10-Q for the pertinent quarters and its annual report on Form 10-K for 2003. Finally, the Complaint alleged that Scherping circumvented internal accounting controls and falsified books and records in connection with these transactions.

IV.

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

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

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

B. After five years from the date of this order, Scherping 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 (the "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

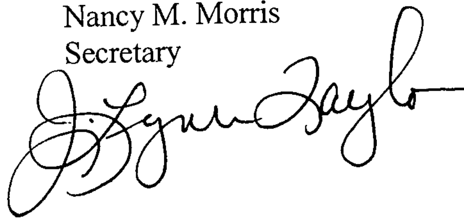
(d) Respondent acknowledges his responsibility, as long as Respondent appears or practices before the Commission as an independent accountant, to comply with all requirements of the Commission and the Board including, but not limited to, all requirements relating to registration, inspections, concurring 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. 57491 / March 13, 2008

INVESTMENT ADVISERS ACT OF 1940
Release No. 2721 / March 13, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12990

In the Matter of JEFFREY A. RICHIE, Respondent.	ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Jeffrey A. Richie ("Richie" or "Respondent").

II.

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

1.9 235

1934 and Section 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

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

1. Jeffrey A. Richie was the president and chief executive officer of Fortress Financial Group, Inc. ("Fortress"), which during the relevant period owned Fortress Financial Securities Corp., a registered broker-dealer, and Fortress Investment Advisers, Inc., a registered investment adviser. Richie held Series 6, 7, 24, 63 and 65 licenses. Richie, 42 years old, is a resident of Temecula, California.

2. On February 25, 2008, a final judgment was entered by consent against Respondent permanently enjoining him from future violations of Sections 5(a), 5(c), and 17(a) of the Securities Act of 1933 ("Securities Act") and Section 10(b) of the Exchange Act and Rules 10b-5 and 10b-9 thereunder, in the civil action entitled *Securities and Exchange Commission v. Jeffrey A. Richie and Fortress Financial Group, Inc.*, Civil Action Number EDCV 06-63-VAP (JCRx), in the United States District Court for the Central District of California.

3. The Commission's complaint alleged that, from March 2000 to April 2001, Richie sold unregistered securities in Fortress and in connection with the offering, made materially false and misleading statements and omitted to disclose material information to investors.

IV.

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

Accordingly, it is hereby ORDERED:

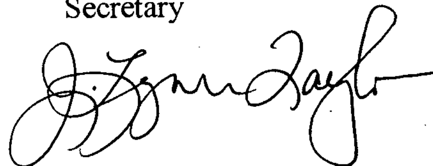
Pursuant to Section 15(b)(6) of the Exchange Act and Section 203(f) of the Advisers Act, that Richie be, and hereby is, barred from associating with any broker or dealer, or investment adviser, with the right to reapply for association after three years to the appropriate self-regulatory organization, or if there is none, to the Commission.

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

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

By the Commission.

Nancy M. Morris
Secretary



By: J. Lynn Taylor
Assistant Secretary

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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
March 13, 2008

In the Matter of	
Andros Isle Development Corporation Asante Networks, Inc. Beluga Composites Corporation Cobra Energy Inc. Complete Care Medical, Inc. Disability Access Corporation El Alacran Gold Mine Corp. Extreme Fitness Inc. Gaming Transactions Inc. Global Equity Fund, Inc. HealthSonix Inc. IQ Webquest Inc. JSX Energy Inc. Kensington Industries, Inc. Kingslake Energy Inc. L International Computers Inc. Let's Talk Recovery Inc. Mobilestream Oil, Inc. Mvive Inc. Native American Energy Group Inc. Paramount Gold and Silver Corp. Regal Technologies, Inc. Remington Ventures, Inc. Straight Up Brands Inc. Transglobal Oil Corp. Turquoise Development Company	**ORDER OF SUSPENSION OF TRADING**
File No. 500-1	

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Andros Isle Development Corporation, which is quoted on the Pink Sheets under the ticker symbol AVPJ. Trading in the securities of Andros Isle Development Corporation appears to be predicated on apparent misstatements. Certain persons appear to have usurped the identity of a defunct or inactive publicly traded corporation, initially by incorporating a new entity using the same name, and then by obtaining a new CUSIP number and ticker symbol based on the

apparently false representation that they were duly authorized officers, directors and/or agents of the original publicly traded corporation.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Asante Networks, Inc., which is quoted on the Pink Sheets under the ticker symbol ASTN. Trading in the securities of Asante Networks, Inc. appears to be predicated on apparent misstatements. Certain persons appear to have usurped the identity of a defunct or inactive publicly traded corporation, initially by incorporating a new entity using the same name, and then by obtaining a new CUSIP number and ticker symbol based on the apparently false representation that they were duly authorized officers, directors and/or agents of the original publicly traded corporation.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Beluga Composites Corporation, which is quoted on the Pink Sheets under the ticker symbol BGCC. Trading in the securities of Beluga Composites Corporation appears to be predicated on apparent misstatements. Certain persons appear to have usurped the identity of a defunct or inactive publicly traded corporation, initially by incorporating a new entity using the same name, and then by obtaining a new CUSIP number and ticker symbol based on the apparently false representation that they were duly authorized officers, directors and/or agents of the original publicly traded corporation.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Cobra Energy Inc., which is quoted on the Pink Sheets under the ticker symbol CBNG. Trading in the securities of Cobra Energy Inc. appears to be predicated on apparent misstatements. Certain persons appear to have usurped the identity of a defunct or inactive publicly traded corporation, initially by incorporating a new entity using the same name, and then by obtaining a new CUSIP number and ticker symbol based on the apparently false representation that they were duly authorized officers, directors and/or agents of the original publicly traded corporation.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Complete Care Medical, Inc., which is quoted on the Pink Sheets under the ticker symbol CCMI. Trading in the securities of Complete Care Medical, Inc. appears to be predicated on apparent misstatements. Certain persons appear to have usurped the identity of a defunct or inactive publicly traded corporation, initially by incorporating a new entity using the same name, and then by obtaining a new CUSIP number and ticker symbol based on the apparently false representation that they were duly authorized officers, directors and/or agents of the original publicly traded corporation.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Disability Access Corporation, which is quoted on the Pink Sheets under the ticker symbol DBYC. Trading in the securities of Disability Access Corporation appears to be predicated on apparent misstatements. Certain

persons appear to have usurped the identity of a defunct or inactive publicly traded corporation, initially by incorporating a new entity using the same name, and then by obtaining a new CUSIP number and ticker symbol based on the apparently false representation that they were duly authorized officers, directors and/or agents of the original publicly traded corporation.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of El Alacran Gold Mine Corp., which is quoted on the Pink Sheets under the ticker symbol EAGM. Trading in the securities of El Alacran Gold Mine Corp. appears to be predicated on apparent misstatements. Certain persons appear to have usurped the identity of a defunct or inactive publicly traded corporation, initially by incorporating a new entity using the same name, and then by obtaining a new CUSIP number and ticker symbol based on the apparently false representation that they were duly authorized officers, directors and/or agents of the original publicly traded corporation.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Extreme Fitness Inc., which is quoted on the Pink Sheets under the ticker symbol EXTF. Trading in the securities of Extreme Fitness Inc. appears to be predicated on apparent misstatements. Certain persons appear to have usurped the identity of a defunct or inactive publicly traded corporation, initially by incorporating a new entity using the same name, and then by obtaining a new CUSIP number and ticker symbol based on the apparently false representation that they were duly authorized officers, directors and/or agents of the original publicly traded corporation.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Gaming Transactions Inc., which is quoted on the Pink Sheets under the ticker symbol GGTS. Trading in the securities of Gaming Transactions Inc. appears to be predicated on apparent misstatements. Certain persons appear to have usurped the identity of a defunct or inactive publicly traded corporation, initially by incorporating a new entity using the same name, and then by obtaining a new CUSIP number and ticker symbol based on the apparently false representation that they were duly authorized officers, directors and/or agents of the original publicly traded corporation.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Global Equity Fund, Inc., which is quoted on the Pink Sheets under the ticker symbol GEQF. Trading in the securities of Global Equity Fund, Inc. appears to be predicated on apparent misstatements. Certain persons appear to have usurped the identity of a defunct or inactive publicly traded corporation, initially by incorporating a new entity using the same name, and then by obtaining a new CUSIP number and ticker symbol based on the apparently false representation that they were duly authorized officers, directors and/or agents of the original publicly traded corporation.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of HealthSonix Inc., which is quoted on the Pink Sheets under the ticker symbol HSXI. Trading in the securities of HealthSonix Inc. appears to be predicated on apparent misstatements. Certain persons appear to have usurped the identity of a defunct or inactive publicly traded corporation, initially by incorporating a new entity using the same name, and then by obtaining a new CUSIP number and ticker symbol based on the apparently false representation that they were duly authorized officers, directors and/or agents of the original publicly traded corporation.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of IQ Webquest Inc., which is quoted on the Pink Sheets under the ticker symbol IQWB. Trading in the securities of IQ Webquest Inc. appears to be predicated on apparent misstatements. Certain persons appear to have usurped the identity of a defunct or inactive publicly traded corporation, initially by incorporating a new entity using the same name, and then by obtaining a new CUSIP number and ticker symbol based on the apparently false representation that they were duly authorized officers, directors and/or agents of the original publicly traded corporation.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of JSX Energy Inc., which is quoted on the Pink Sheets under the ticker symbol JSXG. Trading in the securities of JSX Energy Inc. appears to be predicated on apparent misstatements. Certain persons appear to have usurped the identity of a defunct or inactive publicly traded corporation, initially by incorporating a new entity using the same name, and then by obtaining a new CUSIP number and ticker symbol based on the apparently false representation that they were duly authorized officers, directors and/or agents of the original publicly traded corporation.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Kensington Industries, Inc., which is quoted on the Pink Sheets under the ticker symbol KSGT. Trading in the securities of Kensington Industries, Inc. appears to be predicated on apparent misstatements. Certain persons appear to have usurped the identity of a defunct or inactive publicly traded corporation, initially by incorporating a new entity using the same name, and then by obtaining a new CUSIP number and ticker symbol based on the apparently false representation that they were duly authorized officers, directors and/or agents of the original publicly traded corporation.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Kingslake Energy Inc., which is quoted on the Pink Sheets under the ticker symbol KGLJ. Trading in the securities of Kingslake Energy Inc. appears to be predicated on apparent misstatements. Certain persons appear to have usurped the identity of a defunct or inactive publicly traded corporation, initially by incorporating a new entity using the same name, and then by obtaining a new CUSIP number and ticker symbol based on the apparently false representation that they were duly authorized officers, directors and/or agents of the original publicly traded corporation.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of L International Computers Inc., which is quoted on the Pink Sheets under the ticker symbol LITL. Trading in the securities of L International Computers Inc. appears to be predicated on apparent misstatements. Certain persons appear to have usurped the identity of a defunct or inactive publicly traded corporation, initially by incorporating a new entity using the same name, and then by obtaining a new CUSIP number and ticker symbol based on the apparently false representation that they were duly authorized officers, directors and/or agents of the original publicly traded corporation.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Let's Talk Recovery Inc., which is quoted on the Pink Sheets under the ticker symbol LKRV. Trading in the securities of Let's Talk Recovery Inc. appears to predicated on apparent misstatements. Certain persons appear to have usurped the identity of a defunct or inactive publicly traded corporation, initially by incorporating a new entity using the same name, and then by obtaining a new CUSIP number and ticker symbol based on the apparently false representation that they were duly authorized officers, directors and/or agents of the original publicly traded corporation.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Mobilestream Oil, Inc., which is quoted on the Pink Sheets under the ticker symbol MSRM. Trading in the securities of Mobilestream Oil, Inc. appears to be predicated on apparent misstatements. Certain persons appear to have usurped the identity of a defunct or inactive publicly traded corporation, initially by incorporating a new entity using the same name, and then by obtaining a new CUSIP number and ticker symbol based on the apparently false representation that they were duly authorized officers, directors and/or agents of the original publicly traded corporation.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Mvive Inc., which is quoted on the Pink Sheets under the ticker symbol MVIV. Trading in the securities of Mvive Inc. appears to be predicated on apparent misstatements. Certain persons appear to have usurped the identity of a defunct or inactive publicly traded corporation, initially by incorporating a new entity using the same name, and then by obtaining a new CUSIP number and ticker symbol based on the apparently false representation that they were duly authorized officers, directors and/or agents of the original publicly traded corporation.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Native American Energy Group Inc., which is quoted on the Pink Sheets under the ticker symbol NVMG. Trading in the securities of Native American Energy Group Inc. appears to be predicated on apparent misstatements. Certain persons appear to have usurped the identity of a defunct or inactive publicly traded corporation, initially by incorporating a new entity using the same name,

and then by obtaining a new CUSIP number and ticker symbol based on the apparently false representation that they were duly authorized officers, directors and/or agents of the original publicly traded corporation.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Paramount Gold and Silver Corp., which is quoted on the American Stock Exchange under the ticker symbol PZG. Trading in the securities of Paramount Gold and Silver Corp. appears to be predicated on apparent misstatements. Certain persons appear to have usurped the identity of a defunct or inactive publicly traded corporation, initially by incorporating a new entity using the same name, and then by obtaining a new CUSIP number and ticker symbol based on the apparently false representation that they were duly authorized officers, directors and/or agents of the original publicly traded corporation.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Regal Technologies, Inc., which trades in the grey market under the ticker symbol RGTN. Trading in the securities of Regal Technologies, Inc. appears to be predicated on apparent misstatements. Certain persons appear to have usurped the identity of a defunct or inactive publicly traded corporation, initially by incorporating a new entity using the same name, and then by obtaining a new CUSIP number and ticker symbol based on the apparently false representation that they were duly authorized officers, directors and/or agents of the original publicly traded corporation.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Remington Ventures, Inc., which is quoted on the Pink Sheets under the ticker symbol REMV. Trading in the securities of Remington Ventures, Inc. appears to be predicated on apparent misstatements. Certain persons appear to have usurped the identity of a defunct or inactive publicly traded corporation, initially by incorporating a new entity using the same name, and then by obtaining a new CUSIP number and ticker symbol based on the apparently false representation that they were duly authorized officers, directors and/or agents of the original publicly traded corporation.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Straight Up Brands Inc., which is quoted on the Pink Sheets under the ticker symbol STRU. Trading in the securities of Straight Up Brands Inc. appears to be predicated on apparent misstatements. Certain persons appear to have usurped the identity of a defunct or inactive publicly traded corporation, initially by incorporating a new entity using the same name, and then by obtaining a new CUSIP number and ticker symbol based on the apparently false representation that they were duly authorized officers, directors and/or agents of the original publicly traded corporation.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Transglobal Oil Corp., which is

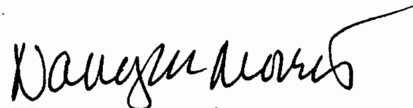
quoted on the Pink Sheets under the ticker symbol TRGO. Trading in the securities of Transglobal Oil Corp. appears to be predicated on apparent misstatements. Certain persons appear to have usurped the identity of a defunct or inactive publicly traded corporation, initially by incorporating a new entity using the same name, and then by obtaining a new CUSIP number and ticker symbol based on the apparently false representation that they were duly authorized officers, directors and/or agents of the original publicly traded corporation.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Turquoise Development Company, which is quoted on the Pink Sheets under the ticker symbol TQDC. Trading in the securities of Turquoise Development Company appears to be predicated on apparent misstatements. Certain persons appear to have usurped the identity of a defunct or inactive publicly traded corporation, initially by incorporating a new entity using the same name, and then by obtaining a new CUSIP number and ticker symbol based on the apparently false representation that they were duly authorized officers, directors and/or agents of the original publicly traded corporation.

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

Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the above-listed companies is suspended for the period from 9:30 a.m. EST on March 13, 2008, through 11:59 p.m. EST on March 27, 2008.

By the Commission.



Nancy M. Morris
Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR PARTS 200, 239 and 240

[RELEASE NOS. 34-55146A; IC-27671A; 34-56135A; IC-27911A; 33-7759A; 33-7760A; 34-42054A; 34-42055A; 39-2378A; IC-24107A; IS-1208A; FILE NOS. S7-10-05; S7-03-07; S7-28-98 and S7-29-98]

RIN 3235-AJ47; 3235-AG84 and 3235-AD97

INTERNET AVAILABILITY OF PROXY MATERIALS; REGULATION OF TAKEOVERS AND SECURITY HOLDER COMMUNICATIONS; CROSS-BORDER TENDER AND EXCHANGE OFFERS, BUSINESS COMBINATIONS AND RIGHTS OFFERINGS; CERTAIN OTHER RELATED RULE CORRECTIONS

AGENCY: Securities and Exchange Commission.

ACTION: Final rule; technical amendments.

SUMMARY: This release contains technical amendments to Rule 14a-3(a)(3)(i), which was published in the Federal Register of Wednesday, August 1, 2007 (72 FR 42221), and Rule 14a-16(m), which was published in the Federal Register of Monday, January 29, 2007 (72 FR 4147). The rules do not permit, or require, the use of the notice and access model regarding internet availability of proxy materials with respect to business combination transactions. We are also making technical amendments to Rules 14b-1 and 14b-2, which were published in the Federal Register of Wednesday, August 1, 2007 (72 FR 42221), to correct references in those rules. Further, we are making technical corrections to rules that were modified in Release Nos. 33-7759 and 33-7760, which were published in the Federal Register on November 10, 1999 (64 FR 61382 and 64 FR 61408, respectively). The amended rules revised the rules and regulations applicable to takeover transactions, including tender offers, mergers, acquisitions and similar extraordinary transactions, and, in order to facilitate U.S. investor participation, modified the rules

relating to cross-border tender and exchange offers, business combinations and rights offerings relating to the securities of foreign private issuers. This document corrects certain cross-references in the regulatory text of the adopting releases, removes a reference to an inapplicable statute, otherwise corrects certain typographical errors, updates the contact information for the agency and amends the delegated authority of the Divisions of Corporation Finance and Market Regulation relating to issuer tender offers.

EFFECTIVE DATE: [Insert date of publication in the Federal Register].

FOR FURTHER INFORMATION CONTACT: Celeste M. Murphy, Special Counsel, Office of Mergers and Acquisitions at (202) 551-3440 or Ray Be, Special Counsel, Office of Rulemaking at (202) 551-3430, in the Division of Corporation Finance, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington DC 20549.

SUPPLEMENTARY INFORMATION: We are amending Forms F-4, F-8, F-9, F-10, F-80 and CB under the Securities Act of 1933;[1] Rules 0-11,[2] 13e-3,[3] 13e-4,[4] 14a-2,[5] 14a-3,[6] 14a-14,[7] 14a-16,[8] 14b-1,[9] 14b-2,[10]

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1 See 17 CFR 239.34, 17 CFR 239.38, 17 CFR 239.39, 17 CFR 239.40, 17 CFR 239.41, 17 CFR 239.800.

2 17 CFR 240.0-11.

3 17 CFR 240.13e-3.

4 17 CFR 240.13e-4.

5 17 CFR 240.14a-2.

6 17 CFR 240.14a-3.

7 17 CFR 240.14a-14.

8 17 CFR 240.14a-16.

9 17 CFR 240.14b-1.

10 17 CFR 240.14b-2.

14d-1,[11] 14d-3,[12] 14d-9,[13] and 14e-1,[14] the title to Regulation 13D,[15] and Schedules 13D,[16] 13G,[17] 13E-4F,[18] TO,[19] 14D-9,[20] 14D-1F[21] and 14D-9-F[22] under the Securities Exchange Act of 1934;[23] and Rules 30-1[24] and 30-3[25] of the Rules of Organization and Program Management.[26]

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11 17 CFR 240.14d-1.

12 17 CFR 240.14d-3.

13 17 CFR 240.14d-9.

14 17 CFR 240.14e-1.

15 17 CFR 240.13d-1 - 240.13f-1.

16 17 CFR 240.13d-101.

17 17 CFR 240.13d-102.

18 17 CFR 240.13e-102.

19 17 CFR 240.14d-100.

20 17 CFR 240.14d-101.

21 17 CFR 240.14d-102.

22 17 CFR 240.14d-103.

23 15 U.S.C. 78a et seq.

24 17 CFR 200.30-1.

25 17 CFR 200.30-3.

26 This authority relates to determining the applicability of the rules relating to issuer tender offers, which used to be interpreted by the Division of Market Regulation (now the Division of Trading and Markets). For several years, issuer tender offers have been handled only by the Division of Corporation Finance.

I. Background to Internet Availability of Proxy Materials; Correction

A. Rules 14a-3(a)(3)(i) and 14a-16(m)

On January 22, 2007, the Commission adopted,[27] among other things, new Rule 14a-16(m)[28] under the Securities Exchange Act of 1934. On July 26, 2007, [29] the Commission adopted amendments to Rule 14a-3(a)(3).[30] These rules do not permit, or require, the use of the notice and access model regarding internet availability of proxy materials with respect to business combination transactions.

After the adoption of the rules, questions arose regarding whether the business combination transaction exclusion applied to all such certain transactions, including cash mergers. Although the discussion of this provision in the adopting release makes it clear that such transactions are covered by the exclusion, the regulatory text does not state that such transactions are excluded by virtue of its failure to reference applicable rule provisions. The proposing release had an identical discrepancy.[31] Specifically, the discussion in the adopting release stated:

> As adopted, the notice and access model is not available with regard to proxy materials related to a business combination transaction, which includes transactions covered by Rule 165 under the Securities Act, as well as transactions for cash consideration requiring disclosure under Item 14 of Schedule 14A. (emphasis added)

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27 See Release No. 34-55416 (Jan. 22, 2007) [72 FR 4147].

28 17 CFR 240.14a-16(m).

29 See Release No. 34-56135 (July 26, 2007) [72 FR 42221].

30 17 CFR 240.14a-3(a)(3).

31 See Release No. 34-52926 (Dec. 8, 2005) [70 FR 74598].

However, the regulatory text as adopted describes the business combination transactions excluded from the notice and access model as those defined in Rule 165.[32]

Accordingly, the amendments set forth in this release clarify that Rules 14a-3(a)(3)(i) and 14a-16(m) do not permit, or require, the use of the notice and access model with respect to business combination transactions as defined in Rule 165 under the Securities Act, as well as transactions for cash consideration requiring disclosure under Item 14 of Schedule 14A.[33] This change is a technical correction to clarify the rule as described in the original adopting release.

B. Rules 14b-1 and 14b-2

On June 20, 2007, the Commission adopted, among other things, amendments to Rules 14b-1 and 14b-2 under the Exchange Act.[34] The amendatory language in that release erroneously contained references to "Legends 1 and 2" in paragraph (d)(5)(iii)(A) of each of those rules. These references should have been to "Legends 1 and 3," consistent with the corresponding Rule 14a-16(n)(4)(i). All of these references address the legends not required in the Notice of Internet Availability of Proxy Materials. As we stated in the adopting release, the intent of this provision is to indicate that the issuer need not include the part of the prescribed legend relating to security holder requests for copies of the documents and instructions on how to request a copy of the proxy materials. The relevant legends are Legends 1 and 3, rather than Legends 1 and 2. Therefore, we are correcting those references.

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32 17 CFR 230.165.

33 17 CFR 240.14a-101.

34 See Release No. 34-56135 (July 26, 2007) [72 FR 42221].

II. Discussion of Corrections to Regulation of Takeovers and Security Holder Communications; Cross-Border Tender and Exchange Offers, Business Combinations and Rights Offerings; and Certain Other Related Rule Corrections

A. Cross-references to old Schedules 14D-1 and 13E-4 and related disclosure items

The amendments to Forms F-8, F-9, F-10 and F-80 under the Securities Act, Rules 0-11, 13e-4, and 14e-1 and Schedules 13D, 13G, 3E-4F and 14D-1F under the Exchange Act and Rule 30-1 under the Rules of Organization and Program Management are necessary to correct inaccurate cross-references to a disclosure schedule that is no longer in use. We adopted changes to integrate the disclosure schedules for issuer and third-party tender offers so that one disclosure schedule is applicable to both types of tender offers.[35] Those changes combined prior Schedules 13E-4 and 14D-1, the prior disclosure schedules for issuer and third-party tender offers, respectively, into a new Schedule TO. Forms F-8, F-9, F-10 and F-80 under the Securities Act, Rule 14e-1(e) and Schedules 13D, 13G and 14D-1F under the Exchange Act and Rule 30-1 under the Rules of Organization and Program Management continue to refer to former Schedule 14D-1; Rule 13e-4 and Schedule 13E-4F under the Exchange Act continue to refer to former Schedule 13E-4. We are correcting these errors by changing the references to refer to Schedule TO. Rule 0-11 continues to refer to filings made pursuant to former Schedule 14D-1. We are correcting that error by referring to filings made under Section 14(d)(1) of the Exchange Act, consistent with similar references in Rule 0-11.

For similar reasons, the amendments to Form F-4 under the Securities Act and to Rule 14e-1 under the Exchange Act are necessary to correct inaccurate cross-references

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35 See Regulation of Takeovers and Security Holder Communications, Release No. 33-7760 (Oct. 22, 1999) [64 FR 61408] (the "Regulation M-A Adopting Rule Release") at II.F.1.

to disclosure requirements that were relocated and redesignated in the Regulation M-A Adopting Rule Release. As part of our effort to integrate the disclosure regimes applicable to issuer tender offers, third-party tender offers and going-private transactions, we adopted changes to combine all of the disclosure requirements in one central location in a subpart of Regulation S-K, referred to as Regulation M-A.[36] This eliminated the need for the disclosure schedules themselves to contain disclosure requirements, as the schedules could simply refer to the comprehensive disclosure requirements located in Regulation M-A. Form F-4 under the Securities Act continues to refer to Item 9(b)(1) - (6) of Schedule 13E-3 when it should refer to Item 1015(b) of Regulation M-A. Rule 14e-1(e) under the Exchange Act continues to refer to Item 11 of former Schedule 14D-1 when it should refer to Item 12 of Schedule TO and Item 1016(a) of Regulation M-A. We are correcting these erroneous cross-references by inserting the redesignated disclosure items.

B. Repeal of the Public Utility Holding Company Act of 1935

The amendments to Rules 13e-3, 14a-2 and 14a-14 under the Exchange Act are necessary to remove references to a statute that has been repealed. Rules 13e-3 and 14a-2 contain exceptions to the applicability of the going private and proxy solicitation rules, respectively, under specified circumstances involving holding companies registered under the Public Utility Holding Company Act of 1935.[37] Rule 14a-14 refers to several statutes, including the Public Utility Holding Company Act, to direct readers of the rule

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36 Id.

37 17 CFR 240.13e-3(g)(3) and 17 CFR 240.14a-2(a)(5).

to certain defined terms.[38] The Public Utility Holding Company Act of 1935 was repealed effective February 8, 2006.[39] We are removing these references to the Public Utility Holding Company Act in these rules.

C. Typographical errors

The amendments to Rules 13e-4, 14d-1 and 14d-3 and Schedules TO and 14D-9 under the Exchange Act are necessary to correct certain typographical errors. In one instance, the rule contains a duplicate reference to "15 U.S.C." in the citation to Section 10(a) of the Securities Act.[40] In two instances, where the rule provides a definition, the term being defined "United States" is stated twice, unlike the rest of the definitions provided in the same subsection of the rules.[41] Further, in one instance, a rule contains a cross-reference to Rule 14d-6(e)(2)(i) and (ii) when the cross-reference should be to Rule 14d-6(d)(2)(i) and (ii), because subparagraph (e) does not exist and the context in which the cross-reference is being made – giving telephonic notice of the tender offer to national securities exchanges and the National Association of Securities Dealers, Inc. ("NASD")[42] – indicates that the reference should be to subparagraph (d), which discusses the information required for summary publication.[43] In two more instances, the rules similarly contain erroneous cross-references to Rule 14d-1(f) when the cross-reference

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38 17 CFR 240.14a-14(b).

39 42 U.S.C. 16451 et seq.

40 See Rule 13e-4(e)(2) (17 CFR 240.13e-4(e)(2)).

41 See Instruction 3 to Rule 13e-4(h)(8) and (i) (17 CFR 240.13e-4) and Instruction 4 to Rule 14d-1(c) and (d) (17 CFR 240.14d-1).

42 The name of NASD has been changed to the Financial Industry Regulatory Authority, Inc. ("FINRA").

43 See Rule 14d-3(a)(3) (17 CFR 240.14d-3(a)(3)).

should be to Rule 14d-1(h).[44] Subparagraph (h) of Rule 14d-1 discusses the requirements for signatures and was previously located under subparagraph (f) but was redesignated when we added provisions to the tender offer rules to include exemptions from Regulation 14D in certain instances in order to facilitate the participation of U.S. holders.[45] We are correcting these typographical errors by removing the duplicative references or changing the cross-reference to the correct rule, as applicable.

D. Cross-references to former Rule 10b-13

The amendments to Schedules 13E-4F and 14D-1F under the Exchange Act are necessary to correct inaccurate cross-references to a rule that was amended and redesignated. Rule 10b-13 was redesignated as Rule 14e-5.[46] Schedules 13E-4F and 14D-1F continue to refer to Rule 10b-13. We are correcting these errors by changing the references to refer to Rule 14e-5.

E. Title to Rules 13d-1 through 13d-7

The amendment to the title of Rules 13d-1 through 13d-7, which set forth the disclosure requirements for reporting beneficial ownership, is necessary to change the reference from Regulation 13D to Regulation 13D-G. We adopted changes to those rules to, among other things, add a new schedule – Schedule 13G – that sets forth the disclosure requirements for reporting beneficial ownership and related information of certain equity securities that are held by specific investors, such as institutional

44 See Instruction to Signature for Schedules TO and 14D-9.

45 See Cross-Border Tender and Exchange Offers, Business Combinations and Rights Offerings, Release No. 33-7759 (Oct. 22, 1999) [64 FR 61382] ("Cross-Border Release").

46 See the Regulation M-A Adopting Rule Release at II.G.5.a.

investors.[47] At that time, we integrated the filing requirements for all beneficial owners under Rule 13d-1, and described this as the "initial step in the adoption of an integrated ownership reporting system to be denominated as Regulation 13D-G."[48] We are amending the title to these rules to reflect our prior intentions.

F. Reduction of paper submissions of Form CB

The amendment to the instructions for submitting Form CB reduces the number of copies of paper submissions currently required under the rule from five to two. This change is necessary to alleviate the cost of providing a number of copies of paper submissions that we have found to be unnecessary.

G. Elimination of paper submission of amendments on Schedule 14D-9

The amendment to Rule 14d-9(c)(1) under the Exchange Act is necessary to eliminate references to paper submissions because Schedule 14D-9 and amendments thereto are now filed electronically. This is consistent with the other rules relating to tender offer filings.

H. Relocation of agency

The amendments to Forms F-8, F-9, F-10, F-80 and CB and Schedules 13E-4F, 14D1-F and 14D-9F are necessary to update the contact information for the headquarters of the agency in light of its relocation. These changes will remove and update contact information so as to facilitate communications with the agency.

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47 See Filing and Disclosure Requirements Relating to Beneficial Ownership, Release No. 33-5925 (April 21, 1978) [43 FR 18484].

48 Id. See also Filing and Disclosure Requirements Relating to Beneficial Ownership, Release No. 34-15348 (Nov. 22, 1978) [43 FR 55751] where we also stated that "'Regulation 13D' is re-captioned 'Regulation 13D-G'..."

I. Delegation of Authority to the Director of the Division of Corporation Finance

Finally, we are amending the Rules of Organization and Program Management governing Delegations of Authority by removing certain delegated authority from the Division of Market Regulation and transferring part of it to the Division of Corporation Finance. Specifically, the Director of the Division of Market Regulation had the authority to grant exemptions from the issuer tender offer rules and determine the applicability of the issuer tender offer rules pursuant to Exchange Act Rule 13e-4(g) to any exchange or tender offer for which an exemptive order has been granted by a Canadian federal, provincial or territorial regulatory authority. Currently, the Division of Corporation Finance administers the application of the issuer tender offer rules, so it is not necessary for the Director of the Division of Market Regulation to have this delegated authority. We are removing the authority to grant exemptions from the issuer tender offer rules from the Director of the Division of Market Regulation and transferring the authority to determine the applicability of the issuer tender offer rules to tender and exchange offers made by issuers pursuant to Exchange Act Rule 13e-4(g) from the Director of the Division of Market Regulation to the Director of the Division of Corporation Finance.[49] The staff may submit matters to the Commission for consideration as it deems appropriate.

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49 This transfer of authority is consistent with the broader authority that was granted to the Director of the Division of Corporation Finance in Rule 30-1(e)(16)(i) to grant or deny exemptions from the tender offer provisions of Rule 13e-4 of the Exchange Act. See Cross-Border Release. Because the broader authority contained in Rule 30-1(e)(16)(i), which covers issuer and third-party tender offers, was granted after the authority in Rule 30-1(e)(13) was granted, which covered only third-party tender offers, it is appropriate to include issuer tender offers in the authority in Rule 30-1(e)(13).

III. Certain Findings

Under the Administrative Procedure Act, a notice of proposed rulemaking is not required "(A) [for] interpretive rules, general statements of policy, or rules of agency organization, procedure, or practice; or (B) when the agency for good cause finds (and incorporates the finding and a brief statement of reasons therefore in the rules issued) that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest."[50] The correcting amendments to Forms F-4, F-8, F-9, F-10, F-80 and CB under the Securities Act and Rules 0-11, 13e-3, 13e-4, 14a-2, 14a-3, 14a-14, 14a-16, 14b-1, 14b-2, 14d-1, 14d-3, 14d-9, and 14e-1, the title to Regulation 13D, and Schedules TO, 13E-4F, 13D, 13G, 14D-9, 14D-1F and 14D-9F under the Exchange Act are technical changes that conform the regulatory text to the intent of the Commission and correct certain cross-references and typographical errors. For these reasons, the Commission finds that there is no need to publish notice of these amendments. The amendments to the instructions for submitting Form CB, the amendment to Rule 14d-9(c)(1) under the Exchange Act, and the amendments to Rules 30-1 and 30-3 under the Rules of Organization and Program Management relate to agency organization, procedure, or practice. As such, notice of proposed rulemaking is not required.

For similar reasons, the amendments do not require an analysis under the Regulatory Flexibility Act or analysis of major status under the Small Business Regulatory Enforcement Fairness Act.[51]

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50 5 U.S.C. 553(b).

51 See 5 U.S.C. 601(2) (for purposes of Regulatory Flexibility Act analysis, the term "rule" means any rule for which the agency publishes a general notice of proposed rulemaking) and 5 U.S.C. 804(3)(C) (for purposes of congressional review of agency rulemaking, the term "rule" does not include any rule of agency organization, procedure, or practice that does not substantially affect the rights or obligations of non-agency parties).

The Administrative Procedures Act also requires publication of a rule at least 30 days before its effective date unless the agency finds otherwise for good cause.[52] For the same reasons described with respect to opportunity for notice and comment, the Commission finds there is good cause for the amendments to take effect on [insert date of publication in the Federal Register].

IV. Need for Correction

As published, certain regulations referenced in this release contain errors which may prove to be misleading and are in need of clarification.

TEXT OF AMENDMENTS

List of Subjects

17 CFR Part 200

Administrative practice and procedure; Authority delegations (Government Agencies).

17 CFR Parts 239 and 240

Reporting and recordkeeping requirements, Securities.

Text of the Adopted Rules

Accordingly, Title 17 Chapter II of the Code of Federal Regulation is corrected by making the following amendments:

PART 200 – ORGANIZATION; CONDUCT AND ETHICS; AND INFORMATION AND REQUESTS

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

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52 See 5 U.S.C. 553(d)(3).

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

* * * * *

2. Amend §200.30-1 by revising paragraph (e)(13) to read as follows:

§200.30-1 Delegation of authority to Director of Division of Corporation Finance.

* * * * *

(e) * * *

(13) To determine with respect to a tender or exchange offer otherwise eligible to be made pursuant to rule 13e-4(g) (§240.13e-4(g) of this chapter) or rule 14d-1(b) (§240.14d-1(b) of this chapter) whether, in light of any exemptive order granted by a Canadian federal, provincial or territorial regulatory authority, application of certain or all of the provisions of section 13(e)(1) and sections 14(d)(1) through 14(d)(7) of the Exchange Act, rule 13e-4, Regulation 14D (§§240.14d-1 – 240.14d-103 of this chapter) and Schedules TO and 14D-9 thereunder (§§240.14d-100 and 240.14d-101 of this chapter), and rule 14e-1 of Regulation 14E (§§240.14e-1 – 240.14f-1 of this chapter), to such offer is necessary or appropriate in the public interest.

* * * * *

3. Amend §200.30-3 by removing and reserving paragraph (a)(35).

PART 239 – FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

4. The authority citation for Part 239 continues to read, in part, as follows:

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

* * * * *

5. Amend Form F-4 (referenced in §239.34) paragraph (b) of Item 4 in Part I, revise the phrase "Item 9(b)(1) through (6) of Schedule 13E-3 (§240.13e-100 of this chapter)" to read "Item 1015(b) of Regulation M-A (§229.1015(b) of this chapter)".

Note: The text of Form F-4 does not, and this amendment will not, appear in the Code of Federal Regulations.

6. Amend Form F-8 (referenced in §239.38) by:

a. In paragraph C. of General Instruction IV., second and third sentences, revise the phrase "(202) 942-8900." to read "(202) 551-8900." and revise the phrase "(202) 942-2940." to read "(202) 551-3610."; and

b. In paragraph D. of General Instruction V., first sentence, revise the phrase "Schedule 14D-1" to read "Schedule TO".

Note: The text of Form F-8 does not, and this amendment will not, appear in the Code of Federal Regulations.

7. Amend Form F-9 (referenced in §239.39) by:

a. In paragraph D. of General Instruction II., second and third sentences, revise the phrase "(202) 942-8900." to read "(202) 551-8900." and the phrase "(202) 942-2940." to read "(202) 551-3610."; and

b. In paragraph D. of General Instruction III., first sentence, revise the phrase "Schedule 14D-1" to read "Schedule TO".

Note: The text of Form F-9 does not, and this amendment will not, appear in the Code of Federal Regulations.

8. Amend Form F-10 (referenced in §239.40) by:

a. In paragraph D. of General Instruction II., second and third sentences, revise the phrase "(202) 942-8900." to read "(202) 551-8900." and the phrase "(202) 942-2940." to read "(202) 551-3610."; and

b. In paragraph D. of General Instruction III., first sentence, revise the phrase "Schedule 14D-1" to read "Schedule TO".

Note: The text of Form F-10 does not, and this amendment will not, appear in the Code of Federal Regulations.

9. Amend Form F-80 (referenced in §239.41) by:

a. In paragraph C. of General Instruction IV., second and third sentences, revise the phrase "(202) 942-8900." to read "(202) 551-8900." and the phrase "(202) 942-2940." to read "(202) 551-3610."; and

b. In paragraph D. of General Instruction V., first sentence, revise the phrase "Schedule 14D-1" to read "Schedule TO".

Note: The text of Form F-80 does not, and this amendment will not, appear in the Code of Federal Regulations.

10. Amend Form CB (referenced in §239.800) by:

a. In paragraph A.(1), General Instruction II., second and third sentences, revise the phrase "(202) 942-8900." to read "(202) 551-8900." and the phrase "(202) 942-2940." to read "(202) 551-3610.";

b. In paragraph A.(4), first sentence, revise the phrase "you must furnish five copies" to read "you must furnish two copies"; and

c. In paragraph B., second sentence, "Instructions for Submitting Form" remove the phrase "and at least one copy".

Note: The text of Form CB does not, and this amendment will not, appear in the Code of Federal Regulations.

PART 240 – GENERAL RULES AND REGULATIONS; SECURITIES EXCHANGE ACT OF 1934

11. 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.

* * * * *

12. Amend §240.0-11 by revising:

a. The heading to paragraph (d) "Schedule 14D-1 filings." to read "Section 14(d)(1) filings."; and

b. In paragraph (d), first sentence, the phrase "At the time of filing a Schedule 14D-1," to read "At the time of filing such statement as the Commission may require pursuant to section 14(d)(1) of the Act,".

13. Revise the undesignated center heading "Regulation 13D" preceding §240.13d-1 to read "Regulation 13D-G".

14. Amend §240.13d-101, Schedule 13D, second paragraph, first sentence of the Notes that follow the Instructions for Cover Page by revising the cite "(Schedule 13D, 13G, or 14D-1)" in the to read "(Schedule 13D, 13G, or TO)"and remove the authority citations following the section.

15. Amend §240.13d-102, Schedule 13G, second paragraph, first sentence, of the Notes that follow the Instructions for Cover Page by revising the phrase " (Schedule 13D,

13G or 14D-1)" to read " (Schedule 13D, 13G or TO)" and removing the authority citations following the section.

16. Amend §240.13e-3 by removing and reserving paragraph (g)(3) and removing the authority citations following the section.

17. Amend §240.13e-4 by:

a. In paragraph (a)(3), second sentence, revise the cite "Schedule 13E-4" to read "Schedule TO";

b. In paragraph (e)(2), first sentence, revise the cite "(15 U.S.C. (15 U.S.C. 77j(a))" to read "(15 U.S.C. 77j(a))"; and

c. Revise Instruction 3 to Instructions to paragraph (h)(8) and (i).

The revision reads as follows:

§240.13e-4 Tender offers by issuers.

* * * * *

Instructions to paragraphs (h)(8) and (i) of this section:

* * * * *

3. United States means the United States of America, its territories and possessions, any State of the United States, and the District of Columbia.

* * * * *

18. Amend §240.13e-102, Schedule 13E-4F, by:

a. Revising the phrase "(202) 942-8900." to read "(202) 551-8900." and the phrase "(202) 942-2940." to read "(202) 551-3610."in General Instruction II.A(1), second and third sentences;

b. Revising the phrase "Schedule 13E-4" to read "Schedule TO" in General Instruction III.A. each time it appears;

c. Revising the phrase "provisions of section 13(e)(1)" to read "provisions of section 13(e)(1) of the Exchange Act" in General Instruction III.A.;

d. Revising the phrase "Rule 10b-13 under the Exchange Act (§240.10b-13)" to read "Rule 14e-5 under the Exchange Act (§240.14e-5)" in General Instruction III.C., first sentence; and

e. Revising the phrase "Rule 10b-13" to read "Rule 10b-13, the predecessor to Rule 14e-5" in General Instruction III.C., second sentence.

19. Amend §240.14a-2 by removing and reserving paragraph (a)(5).

20. Revise paragraph (a)(3)(i) of §240.14a-3 to read as follows:

§240.14a-3 Information to be furnished to security holders.

(a) * * *

(3) * * *

(i) The solicitation relates to a business combination transaction as defined in §230.165 of this chapter, as well as transactions for cash consideration requiring disclosure under Item 14 of §240.14a-101.

*****

21. Amend §240.14a-14, paragraph (b), last sentence, by removing the phrase "the Public Utility Holding Company Act of 1935,".

22. Revise paragraph (m) of §240.14a-16 to read as follows:

§ 240.14a-16 Internet availability of proxy materials.

* * * * *

(m) This section shall not apply to a proxy solicitation in connection with a business combination transaction, as defined in §230.165 of this chapter, as well as transactions for cash consideration requiring disclosure under Item 14 of §240.14a-101.

* * * * *

23. Revise paragraph (d)(5)(iii)(A) of §240.14b-1 to read as follows:

§240.14b-1 Obligation of registered brokers and dealers in connection with the prompt forwarding of certain communications to beneficial owners.

* * * * *

(d) * * *

(5) * * *

(iii) * * *

(A) Legends 1 and 3 in §240.14a-16(d)(1); and

* * * * *

24. Revise paragraph (d)(5)(iii)(A) of §240.14b-2 to read as follows:

§240.14b-2 Obligation of banks, associations and other entities that exercise fiduciary powers in connection with the prompt forwarding of certain communications to beneficial owners.

* * * * *

(d) * * *

(5) * * *

(iii) * * *

(A) Legends 1 and 3 in §240.14a-16(d)(1); and

* * * * *

25. Amend §240.14d-1 by revising paragraph 4. of the <u>Instructions to paragraphs (c) and (d)</u> to read as follows:

§240.14d-1 Scope of and definitions applicable to Regulations 14D and 14E.

* * * * *

Instructions to paragraphs (c) and (d):

* * * * *

4. United States means the United States of America, its territories and possessions, any State of the United States, and the District of Columbia.

* * * * *

26. Amend §240.14d-3 by revising the introductory text of paragraph (a)(3) to read as follows:

§240.14d-3 Filing and transmission of tender offer statement.

(a) * * *

(3) Gives telephonic notice of the information required by Rule 14d-6(d)(2)(i) and (ii) (§240.14d-6(d)(2)(i) and (ii)) and mails by means of first class mail a copy of such Schedule TO, including all exhibits thereto:

* * * * *

27. Amend §240.14d-9, paragraph (c)(1), by removing the phrase "eight copies of" and removing the citations following the section.

28. Amend §240.14d-100, last sentence, in the Instruction to Signature by revising the phrase "240.14d-1(f)" to read "240.14d-1(h)".

29. Amend §240.14d-101, last sentence in the Instruction to Signature, revise the phrase "See § 240.14d-1(f)" to read "See §240.14d-1(h)".

30. Amend §240.14d-102 Schedule 14D1-F, by:

a. Revising the phrase "(202) 942-8900." to read "(202) 551-8900." and the phrase "(202) 942-2940." to read "(202) 551-3610." in the second and third sentences of General Instruction II.A.(1);

b. Revising each phrase "Schedule 14D-1" to read "Schedule TO" in General Instruction III.A.;

c. Revising the phrase "with the provisions of sections 14(d)(1) through 14(d)(7)" to read "with the provisions of sections 14(d)(1) through 14(d)(7) of the Exchange Act," in General Instruction III.A.;

d. Revising the phrase "Rule 10b-13" to read "Rule 14e-5" in General Instruction III.C., first sentence;

e. Revising the phrase "§240.10b-13" to read "§240.14e-5" in General Instruction III.C. first sentence; and

f. Revising the phrase "Rule 10b-13" to read "Rule 10b-13, the predecessor to Rule 14e-5" in General Instruction III.C., second sentence.

* * * * *

31. Amend §240.14d-103, second and third sentences of General Instruction II.A.(1), revise the phrase "(202) 942-8900." to read "(202) 551-8900." and the phrase "(202) 942-2940." to read "(202) 551-3610.".

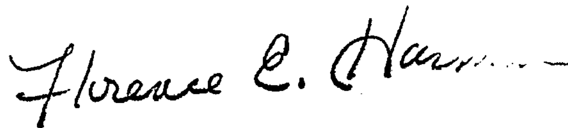
32. Amend §240.14e-1 to revise paragraph (e) to read as follows:

§240.14e-1 Unlawful tender offer practices.

* * * * *

(e) The periods of time required by paragraphs (a) and (b) of this section shall be tolled for any period during which the bidder has failed to file in electronic format, absent

a hardship exemption (§§232.201 and 232.202 of this chapter), the Schedule TO Tender Offer Statement (§240.14d-100), any tender offer material required to be filed by Item 12 of that Schedule pursuant to paragraph (a) of Item 1016 of Regulation M-A (§229.1016(a) of this chapter), and any amendments thereto. If such documents were filed in paper pursuant to a hardship exemption (see §232.201 and §232.202(d)), the minimum offering periods shall be tolled for any period during which a required confirming electronic copy of such Schedule and tender offer material is delinquent.



By the Commission.

Florence E. Harmon
Deputy Secretary

Date: March 17, 2008

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
March 17, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12992

In the Matter of **Anscott Industries, Inc.,** **Respondent.**	**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") against Respondent Anscott Industries, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENT

1. Anscott Industries, Inc. ("Anscott") (CIK No. 1047733) is a Florida corporation located in Wayne, New Jersey, with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Anscott is delinquent in its periodic filings with the Commission having not filed any periodic reports since it filed a Form 10-QSB for the period ended December 31, 2004, in which Anscott reported a net loss of $475,031 for that period. As of February 7, 2008, the common stock of Anscott (symbol "ASCT.PK") was traded on the Pink Sheets, had thirteen market makers, and was eligible for the piggyback exemption of Exchange Act Rule 15c2-11(f)(3).

B. DELINQUENT PERIODIC FILINGS

2. As discussed above, Respondent is delinquent in its periodic filings with the Commission, having repeatedly failed to meet its obligation to file timely periodic reports.

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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 the foregoing, Respondent failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder.

III.

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

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

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

IV.

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

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

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

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

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

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

By the Commission.

Nancy M. Morris
Secretary

By: Florence E. Harmon
Deputy Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR PART 240

[Release No. 34-57511; File No. S7-08-08]

RIN 3235-AK08

"Naked" Short Selling Anti-Fraud Rule

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission ("Commission") is proposing an anti-fraud rule under the Securities Exchange Act of 1934 ("Exchange Act") to address fails to deliver securities that have been associated with "naked" short selling. The proposed rule is intended to highlight the liability of persons that deceive specified persons about their intention or ability to deliver securities in time for settlement, including persons that deceive their broker-dealer about their locate source or ownership of shares and that fail to deliver securities by settlement date.

DATES: Comments should be received on or before [insert date 60 days after publication in the Federal Register].

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

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-08-08 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 S7-08-08. 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, on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: James A. Brigagliano, Associate Director, Josephine J. Tao, Assistant Director, Victoria L. Crane, Branch Chief, Joan M. Collopy, Special Counsel, Todd E. Freier and Christina M. Adams, Staff Attorneys, Office of Trading Practices and Processing, Division of Trading and Markets, 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 proposed Rule 10b-21 under the Exchange Act.

I. Introduction

The Commission is proposing an anti-fraud rule, Rule 10b-21, aimed at short sellers, including broker-dealers acting for their own accounts, who deceive specified persons, such as a broker or dealer, about their intention or ability to deliver securities in time for settlement and that fail to deliver securities by settlement date. Among other things, proposed Rule 10b-21 would target short sellers who deceive their broker-dealers about their source of borrowable shares for purposes of complying with Regulation SHO's "locate" requirement.[1] The proposed rule would also apply to sellers who misrepresent to their broker-dealers that they own the shares being sold.

A seller misrepresenting its short sale locate source or ownership of shares may intend to fail to deliver securities in time for settlement and, therefore, engage in abusive "naked" short selling. Although abusive "naked" short selling is not defined in the federal securities laws, it refers generally to selling short without having stock available for delivery and intentionally failing to deliver stock within the standard three-day settlement cycle.[2]

Although abusive "naked" short selling as part of a manipulative scheme is always illegal under the general anti-fraud provisions of the federal securities laws, including Rule 10b-5 under the Exchange Act,[3] proposed Rule 10b-21 would highlight the specific liability of persons that deceive specified persons about their intention or ability to deliver securities in time for settlement, including persons that deceive their broker-dealer about their locate source or

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1 See 17 CFR 242.203(b)(1).

2 See Exchange Act Release No. 56212 (Aug. 7, 2007), 72 FR 45544 (Aug. 14, 2007) ("2007 Regulation SHO Amendments"); Exchange Act Release No. 54154 (July 14, 2006), 71 FR 41710 (July 21, 2006) ("2006 Regulation SHO Proposed Amendments").

3 17 CFR 240.10b-5.

ownership of shares.[4] We believe that a rule highlighting the illegality of these activities would focus the attention of market participants on such activities. The proposed rule would also highlight that the Commission believes such deceptive activities are detrimental to the markets and would provide a measure of predictability for market participants.

All sellers of securities should promptly deliver, or arrange for delivery of, securities to the respective buyer and all buyers of securities have a right to expect prompt delivery of securities purchased. Thus, the proposal takes direct aim at an activity that may create fails to deliver. Those fails can have a negative effect on shareholders, potentially depriving them of the benefits of ownership, such as voting and lending. They also may create a misleading impression of the market for an issuer's securities. Proposed Rule 10b-21 would also aid broker-dealers in complying with the locate requirement of Regulation SHO and, thereby, potentially reduce fails to deliver. In addition, the proposed rule could help reduce manipulative schemes involving "naked" short selling.

II. Background

A. Regulation SHO

Short selling involves a sale of a security that the seller does not own and that is consummated by the delivery of a security borrowed by or on behalf of the seller.[5] In a "naked" short sale, a seller does not borrow or arrange to borrow securities in time to make delivery to the buyer within the standard three-day settlement period.[6] As a result, the seller fails to deliver

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4 This conduct is also in violation of other provisions of the federal securities laws, including the anti-fraud provisions.

5 17 CFR 242.200(a).

6 See Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (Aug. 6, 2004) ("2004 Regulation SHO Adopting Release") (stating that "naked" short selling generally refers to selling short without having borrowed the securities to make delivery).

securities to the buyer when delivery is due (known as a "fail" or "fail to deliver").[7] Sellers sometimes intentionally fail to deliver securities as part of a scheme to manipulate the price of a security,[8] or possibly to avoid borrowing costs associated with short sales.

Although the majority of trades settle within the standard three-day settlement period,[9] the Commission adopted Regulation SHO[10] in part to address problems associated with persistent fails to deliver securities and potentially abusive "naked" short selling.[11] Rule 203 of Regulation SHO, in particular, contains a "locate" requirement that provides that, "[a] broker or

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[7] Generally, investors complete or settle their security transactions within three business days. This settlement cycle is known as T+3 (or "trade date plus three days"). T+3 means that when the investor purchases a security, the purchaser's payment generally is received by its brokerage firm no later than three business days after the trade is executed. When the investor sells a security, the seller generally delivers its securities, in certificated or electronic form, to its brokerage firm no later than three business days after the sale. The three-day settlement period applies to most security transactions, including stocks, bonds, municipal securities, mutual funds traded through a brokerage firm, and limited partnerships that trade on an exchange. Government securities and stock options settle on the next business day following the trade. In addition, Rule 15c6-1 prohibits broker-dealers from effecting or entering into a contract for the purchase or sale of a security that provides for payment of funds and delivery of securities later than the third business day after the date of the contract unless otherwise expressly agreed to by the parties at the time of the transaction. 17 CFR 240.15c6-1; Exchange Act Release No. 33023 (Oct. 7, 1993), 58 FR 52891 (Oct. 13, 1993). However, failure to deliver securities on T+3 does not violate Rule 15c6-1.

[8] In 2003, the Commission settled a case against certain parties relating to allegations of manipulative short selling in the stock of a corporation. The Commission alleged that the defendants profited from engaging in massive naked short selling that flooded the market with the stock, and depressed its price. See Rhino Advisors, Inc. and Thomas Badian, Lit. Rel. No. 18003 (Feb. 27, 2003); see also, SEC v. Rhino Advisors, Inc. and Thomas Badian, Civ. Action No. 03 civ 1310 (RO) (S.D.N.Y) (Feb. 26, 2003).

[9] According to the NSCC, 99% (by dollar value) of all trades settle within T+3. Thus, on an average day, approximately 1% (by dollar value) of all trades, including equity, debt, and municipal securities fail to settle on time. The vast majority of these fails are closed out within five days after T+3. In addition, fails to deliver may arise from either short sales or long sales of securities. There may be legitimate reasons for a fail to deliver. For example, human or mechanical errors or processing delays can result from transferring securities in custodial or other form rather than book-entry form, thus causing a fail to deliver on a long sale within the normal three-day settlement period. The Commission's Office of Economic Analysis ("OEA") estimates that, on an average day between May 1, 2007 and January 31, 2008, trades in "threshold securities," as defined in Rule 203(b)(c)(6) of Regulation SHO, that fail to settle within T+3 account for approximately 0.6% of dollar value of trading in all securities.

[10] 17 CFR 242.200. Regulation SHO became effective on January 3, 2005.

[11] See 2007 Regulation SHO Amendments, 72 FR at 45544 (stating that "[a]mong other things, Regulation SHO imposes a close-out requirement to address persistent failures to deliver stock on trade settlement date and to target potentially abusive "naked" short selling in certain equity securities").

dealer may not accept a short sale order in an equity security from another person, or effect a short sale in an equity security for its own account, unless the broker or dealer has: (1) Borrowed the security, or entered into a bona-fide arrangement to borrow the security; or (2) Reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due; and (3) Documented compliance with this paragraph (b)(1)."[12] In the 2004 Regulation SHO Adopting Release, the Commission explicitly permitted broker-dealers to rely on customer assurances that the customer has identified its own source of borrowable securities, provided it is reasonable for the broker-dealer to do so.[13] We are concerned, however, that some short sellers may have been deliberately misrepresenting to broker-dealers that they have obtained a legitimate locate source.[14]

In addition, we are concerned that some short sellers may have made misrepresentations to their broker-dealers about their ownership of shares as an end run around Regulation SHO's locate requirement.[15] Some sellers have also misrepresented that their sales are long sales in order to circumvent Rule 105 of Regulation M,[16] which prohibits certain short sellers from purchasing securities in a secondary or follow-on offering.[17] Under Rule 200(g)(1) of Regulation SHO, "[a]n order to sell shall be marked "long" only if the seller is deemed to own

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12 17 CFR 242.203(b). Market makers engaged in bona fide market making in the security at the time they effect the short sale are excepted from this requirement.

13 See 2004 Regulation SHO Adopting Release, 69 FR at 48014.

14 See, e.g., Sandell Asset Management Corp., Lars Eric Thomas Sandell, Patrick T. Burke and Richard F. Ecklord, Securities Act Release No. 8857 (Oct. 10, 2007) (settled order).

15 See id.

16 17 CFR 242.105.

17 See Goldman Sachs Execution and Clearing L.P., Exchange Act Release No. 55465 (Mar. 14, 2007) (settled order).

the security being sold pursuant to paragraphs (a) through (f) of this section[18] and either: (i) the security to be delivered is in the physical possession or control of the broker or dealer; or (ii) it is reasonably expected that the security will be in the physical possession or control of the broker or dealer no later than the settlement of the transaction."[19]

Under Regulation SHO, the executing or order-entry broker-dealer is responsible for determining whether there are reasonable grounds to believe that a security can be borrowed so that it can be delivered on the date delivery is due on a short sale, and whether a seller owns the security being sold and can reasonably expect that the security will be in the physical possession or control of the broker-dealer no later than settlement date for a long sale. However, a broker-dealer relying on a customer that makes misrepresentations about its locate source or ownership of shares may not receive shares when delivery is due. For example, sellers may be making misrepresentations to their broker-dealers about their locate sources or ownership of shares for securities that are very difficult or expensive to borrow. Such sellers may know that they cannot deliver securities by settlement date due to, for example, a limited number of shares being available to borrow or purchase, or they may not intend to obtain shares for timely delivery because the cost of borrowing or purchasing may be high. This result undermines the Commission's goal of addressing concerns related to "naked" short selling and extended fails to deliver.

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[18] Rule 200(b) of Regulation SHO provides that a seller is deemed to own a security if, "(1) The person or his agent has title to it; or (2) The person has purchased, or has entered into an unconditional contract, binding on both parties thereto, to purchase it, but has not yet received it; or (3) The person owns a security convertible into or exchangeable for it and has tendered such security for conversion or exchange; or (4) The person has an option to purchase or acquire it and has exercised such option; or (5) The person has rights or warrants to subscribe to it and has exercised such rights or warrants; or (6) The person holds a security futures contract to purchase it and has received notice that the position will be physically settled and is irrevocably bound to receive the underlying security."

[19] 17 CFR 242.200(g)(1).

B. Concerns about "Naked" Short Selling

We are concerned about persons that sell short securities and deceive specified persons about their intention or ability to deliver the securities in time for settlement, or deceive their broker-dealer about their locate source or ownership of shares, or otherwise engage in abusive "naked" short selling. Commission enforcement actions have contributed to our concerns about the extent of misrepresentations by short sellers about their locate sources and ownership of shares. For example, the Commission recently announced a settled enforcement action against hedge fund adviser Sandell Asset Management Corp. ("SAM"), its chief executive officer, and two employees in connection with allegedly (i) improperly marking some short sale orders "long" and (ii) misrepresenting to executing brokers that SAM personnel had located sufficient stock to borrow for short sale orders.[20]

As we have stated previously, we are concerned that fails to deliver may have a negative effect on the market and shareholders.[21] For example, fails to deliver may deprive shareholders of the benefits of ownership, such as voting and lending.[22] In addition, where a seller of securities fails to deliver securities on settlement date, in effect the seller unilaterally converts a securities contract (which should settle within the standard three-day settlement period) into an undated futures-type contract, to which the buyer might not have agreed, or that might have been

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20 See Sandell Asset Management Corp., Securities Act Release No. 8857; see also Goldman Sachs Execution and Clearing L.P., Exchange Act Release No. 55465; U.S. v. Naftalin, 441 U.S. 768 (1979) (discussing a market manipulation scheme in which brokers suffered substantial losses when they had to purchase securities to replace securities they had borrowed to make delivery on short sale orders received from an individual investor who had falsely represented to the brokers that he owned the securities being sold).

21 See 2007 Regulation SHO Amendments, 72 FR at 45544; 2006 Regulation SHO Proposed Amendments, 71 FR at 41712; Exchange Act Release No. 56213 (Aug. 7, 2007), 72 FR 45558, 45558-45559 (Aug. 14, 2007) ("2007 Regulation SHO Proposed Amendments").

22 See id.

priced differently.[23] Moreover, sellers that fail to deliver securities on settlement date may be subject to fewer restrictions than sellers that are required to deliver the securities by settlement date, and such sellers may attempt to use this additional freedom to engage in trading activities that are designed to improperly depress the price of a security.[24] For example, by not borrowing securities and, therefore, not making delivery within the standard three-day settlement period, the seller does not incur the costs of borrowing.

In addition, issuers and investors have expressed concerns about fails to deliver in connection with "naked" short selling. For example, in response to proposed amendments to Regulation SHO in 2006[25] designed to further reduce the number of persistent fails to deliver in certain equity securities by eliminating Regulation SHO's "grandfather" provision, and limiting the duration of the rule's options market maker exception, the Commission received a number of comments that expressed concerns about "naked" short selling and extended delivery failures.[26]

To the extent that fails to deliver might be indicative of manipulative "naked" short selling, which could be used as a tool to drive down a company's stock price,[27] such fails to

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[23] See id.

[24] See id.

[25] See 2006 Regulation SHO Proposed Amendments.

[26] See, e.g., letter from Patrick M. Byrne, Chairman and Chief Executive Officer, Overstock.com, Inc., dated Sept. 11, 2006 ("Overstock"); letter from Daniel Behrendt, Chief Financial Officer, and Douglas Klint, General Counsel, TASER International, dated Sept. 18, 2006 ("TASER"); letter from John Royce, dated April 30, 2007 ("Royce"); letter from Michael Read, dated April 29, 2007 ("Read"); letter from Robert DeVivo, dated April 26, 2007 ("DeVivo"); letter from Ahmed Akhtar, dated April 26, 2007 ("Akhtar").

[27] See supra, note 8 (discussing a case in which the Commission alleged that the defendants profited from engaging in massive naked short selling that flooded the market with the company's stock, and depressed its price); see also 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 (2d 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).

deliver may undermine the confidence of investors.[28] These investors, in turn, may be reluctant to commit capital to an issuer they believe to be subject to such manipulative conduct.[29] In addition, issuers may believe that they have suffered unwarranted reputational damage due to investors' negative perceptions regarding fails to deliver in the issuer's security.[30] Any unwarranted reputational damage caused by fails to deliver might have an adverse impact on the security's price.[31]

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[28] In response to the 2006 Regulation SHO Proposed Amendments, the Commission received comment letters discussing the impact of fails to deliver on investor confidence. See, e.g., letter from Mary Helburn, Executive Director, National Coalition Against Naked Shorting, dated Sept. 30, 2006 ("NCANS"); letter from Richard Blumenthal, Attorney General, State of Connecticut, dated Sept. 19, 2006 ("Blumenthal").

[29] In response to the 2006 Regulation SHO Proposed Amendments, the Commission received comment letters expressing concern about the impact of potential "naked" short selling on capital formation, claiming that "naked" short selling causes a drop in an issuer's stock price and may limit the issuer's ability to access the capital markets. See, e.g., letter from Congressman Tom Feeney - Florida, U.S. House of Representatives, dated Sept. 25, 2006 ("Feeney"); see also letter from Zix Corporation, dated Sept. 19, 2006 ("Zix") (stating that "[m]any investors attribute the Company's frequent re-appearances on the Regulation SHO list to manipulative short selling and frequently demand that the Company "do something" about the perceived manipulative short selling. This perception that manipulative short selling of the Company's securities is continually occurring has undermined the confidence of many of the Company's investors in the integrity of the market for the Company's securities.").

[30] Due in part to such concerns, some issuers have taken actions to attempt to make transfer of their securities "custody only," thus preventing transfer of their stock to or from securities intermediaries such as the Depository Trust Company ("DTC") or broker-dealers. See Exchange Act Release No. 48709 (Oct. 28, 2003), 68 FR 62972, at 62975 (Nov. 6, 2003). Some issuers have attempted to withdraw their issued securities on deposit at DTC, which makes the securities ineligible for book-entry transfer at a securities depository. See id. Withdrawing securities from DTC or requiring custody-only transfers would undermine the goal of a national clearance and settlement system, designed to reduce the physical movement of certificates in the trading markets. See id. We note, however, that in 2003 the Commission approved a DTC rule change clarifying that its rules provide that only its participants may withdraw securities from their accounts at DTC, and establishing a procedure to process issuer withdrawal requests. See Securities Exchange Act Release No. 47978 (June 4, 2003), 68 FR 35037 (June 11, 2003).

[31] See also 2006 Regulation SHO Proposed Amendments, 71 FR at 41712; 2007 Regulation SHO Amendments, 72 FR at 45544; 2007 Regulation SHO Proposed Amendments, 72 FR at 45558-45559 (providing additional discussion of the impact of fails to deliver on the market); see also Exchange Act Release No. 48709 (Oct. 28, 2003), 68 FR 62972, 62975 (Nov. 6, 2003) ("2003 Regulation SHO Proposing Release") (discussing the impact of "naked" short selling on the market).

III. Discussion of Proposed Rule

A. Proposed Anti-Fraud Rule

To further address potentially abusive "naked" short selling and fails to deliver, we are proposing a narrowly-tailored rule, Rule 10b-21, which would specify that it is unlawful for any person to submit an order to sell a security if such person deceives a broker-dealer, participant of a registered clearing agency, or purchaser[32] regarding its intention or ability to deliver the security on the date delivery is due, and such person fails to deliver the security on or before the date delivery is due.[33] Scienter would be a necessary element for a violation of the proposed rule.[34]

The proposed rule would cover those situations where a seller deceives a broker-dealer, participant of a registered clearing agency, or a purchaser about its intention to deliver securities by settlement date, its locate source, or its share ownership, and the seller fails to deliver securities by settlement date. Proposed Rule 10b-21 would apply to the deception of persons participating in the transaction – broker-dealers, participants of registered clearing agencies, or purchasers. Further, because one of the principal goals of proposed Rule 10b-21 is to reduce

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[32] The term "participant" has the same meaning as in section 3(a)(24) of the Exchange Act. See 15 U.S.C. 78c(a)(24). The term "registered clearing agency" means a clearing agency, as defined in section 3(a)(23) of the Exchange Act, that is registered as such pursuant to section 17A of the Exchange Act. See 15 U.S.C. 78c(a)(23)(A), 78q-1 and 15 U.S.C. 78q-1(b), respectively.

[33] Proposed Rule 10b-21.

[34] Ernst & Ernst v. Hochfelder, et. al., 425 U.S. 185 (1976). Scienter has been defined as "a mental state embracing the intent to deceive, manipulate or defraud." Id. at 193, n.12. While the Supreme Court has not decided the issue (see Aaron v. SEC, 446 U.S. 686 (1980); Ernst & Ernst, 425 at 193 n.12), federal appellate courts have concluded that scienter may be established by a showing of either knowing conduct or by "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.'" Dolphin & Bradbury v. SEC, 512 F.3d 634 (D.C. Cir. Jan. 11, 2008) (quoting Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1045 (7th Cir. 1977)).

fails to deliver, violation of the proposed rule would occur only if a fail to deliver results from the relevant transaction.

For purposes of the proposed rule, broker-dealers (including market makers) acting for their own accounts would be considered sellers. For example, a broker-dealer effecting short sales for its own account would be liable under the rule if it does not obtain a valid locate source and fails to deliver securities to the purchaser. Such broker-dealers defraud purchasers that may not receive delivery on time, in effect unilaterally forcing the purchaser into accepting an undated futures-type contract.[35]

As noted above, under Regulation SHO, the executing or order-entry broker-dealer is responsible for determining whether there are reasonable grounds to believe that a security can be borrowed so that it can be delivered on the date delivery is due on a short sale.[36] In the 2004 Regulation SHO Adopting Release, the Commission explicitly permitted broker-dealers to rely on customer assurances that the customer has identified its own locate source, provided it is reasonable for the broker-dealer to do so.[37] If a seller elects to provide its own locate source to a broker-dealer, the seller is representing that it has contacted that source and reasonably believes that the source can or intends to deliver the full amount of the securities to be sold short by settlement date. In addition, if a seller enters a short sale order into a broker-dealer's direct market access or sponsored access system ("DMA") with any information purporting to identify

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[35] See 2007 Regulation SHO Amendments, 72 FR at 45544; 2006 Regulation SHO Proposed Amendments, 71 FR at 41712; 2007 Regulation SHO Proposed Amendments, 72 FR at 45558-45559.

[36] See 17 CFR 242.203(b)(3)(1).

[37] See 2004 Regulation SHO Adopting Release, 69 FR at 48014.

a locate source obtained by the seller, the seller would be making a representation to a broker-dealer for purposes of proposed Rule 10b-21.[38]

If a seller deceives a broker-dealer about the validity of its locate source, the seller would be liable under proposed Rule 10b-21 if the seller also fails to deliver securities by the date delivery is due. For example, a seller would be liable for a violation of proposed Rule 10b-21 if it represented that it had identified a source of borrowable securities, but the seller never contacted the purported source to determine whether shares were available and could be delivered in time for settlement and the seller fails to deliver securities by settlement date. A seller would also be liable if it contacted the source and learned that the source did not have sufficient shares for timely delivery, but the seller misrepresented that the source had sufficient shares that it could deliver in time for settlement and the seller fails to deliver securities by settlement date; or, if the seller contacted the source and the source had sufficient shares that it could deliver in time for settlement, but the seller never instructed the source to deliver the shares in time for settlement and the seller otherwise refused to deliver shares on settlement date such that the sale results in a fail to deliver.

If, however, a seller is relying on a broker-dealer to comply with Regulation SHO's locate obligation and to make delivery on a sale, the seller would not be representing at the time it submits an order to sell a security that it can or intends to deliver securities on the date delivery is due. For example, a seller might be relying on its broker-dealer to borrow or arrange to borrow the security to make delivery by settlement date. Alternatively, a seller might be relying on a broker-dealer's "Easy to Borrow" list. If a seller in good faith relies on a broker-dealer's

[38] Broker-dealers may offer DMA to customers by providing them with electronic access to a market's execution system using the broker-dealer's market participant identifier. The broker-dealer, however, retains the ultimate responsibility for the trading activity of its customer.

"Easy to Borrow" list to satisfy the locate requirement, the seller would not be deceiving the broker-dealer at the time it submits an order to sell a security that it can or intends to deliver securities on the date delivery is due. In discussing the locate requirement of Regulation SHO, in the 2004 Regulation SHO Adopting Release, the Commission stated that "absent countervailing factors, 'Easy to Borrow' lists may provide 'reasonable grounds' for a broker-dealer to believe that the security sold short is available for borrowing without directly contacting the source of the borrowed securities."[39]

In addition, a market maker engaged in bona fide market making activity would not be making a representation at the time it submits an order to sell short that it can or intends to deliver securities on the date delivery is due, because such market makers are excepted from the locate requirement of Regulation SHO. Regulation SHO excepts from the locate requirement market makers engaged in bona-fide market making activities because market makers need to facilitate customer orders in a fast moving market without possible delays associated with complying with the locate requirement.[40] Thus, at the time of submitting an order to sell short, market makers that have an exception from the locate requirement of Regulation SHO may know that they may not be able to deliver securities on the date delivery is due.

Under proposed Rule 10b-21, a seller would be liable if it deceives a broker-dealer, participant of a registered clearing agency, or purchaser about its ownership of shares or the deliverable condition of owned shares and fails to deliver securities by settlement date. For example, a seller would be liable for a violation of proposed Rule 10b-21 for causing a broker-dealer to mark an order to sell a security "long" if the seller knows or recklessly disregards that it

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[39] 2004 Regulation SHO Adopting Release, 69 FR at 48014.

[40] See 2004 Regulation SHO Adopting Release, 69 FR at 48015, n. 67.

is not "deemed to own" the security being sold, as defined in Rules 200(a) through (f) of Regulation SHO[41] or if the seller knows or recklessly disregards that the security being sold is not, or cannot reasonably be expected to be, in the broker-dealer's physical possession or control by the date delivery is due, and the seller fails to deliver the security by settlement date. Broker-dealers acting for their own accounts would also be liable under the proposed rule for marking an order "long" if the broker-dealer knows or recklessly disregards that it is not "deemed to own" the security being sold or that the security being sold is not, or cannot reasonably be expected to be, in the broker-dealer's physical possession or control by the date delivery is due, and the broker-dealer fails to deliver the security by settlement date.[42]

However, a seller would not be making a representation at the time it submits an order to sell a security that it can or intends to deliver securities on the date delivery is due if the seller submits an order to sell securities that are held in a margin account but the broker-dealer has loaned out the shares pursuant to the margin agreement. Under such circumstances, it would be reasonable for the seller to expect that the securities will be in the broker-dealer's physical possession or control by settlement date.

Although the proposed rule is primarily aimed at sellers that deceive specified persons about their intention or ability to deliver shares or about their locate sources and ownership of shares, as with any rule, broker-dealers could be liable for aiding and abetting a customer's fraud under the proposed rule. In addition, broker-dealers would remain subject to liability under Regulation SHO and the general anti-fraud provisions of the federal securities laws.

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41 17 CFR 242.200(a)-(f).

42 Such broker-dealers would also be liable under Regulation SHO.

Proposed Rule 10b-21 is narrowly tailored to apply when a seller, including a broker-dealer trading for its own account, deceives specified persons about its ability or intention to deliver securities in time for settlement, or about its locate source or ownership of shares and that fails to deliver securities by settlement date. While "naked" short selling as part of a manipulative scheme is already illegal under the general anti-fraud provisions of the federal securities laws, we believe that the proposed anti-fraud rule would highlight the specific liability of persons that deceive specified persons about their intention or ability to deliver securities in time for settlement, including persons that deceive their broker-dealer about their locate source or ownership of shares. Proposed Rule 10b-21 would also aid broker-dealers in complying with the locate requirement of Regulation SHO and, thereby, potentially reduce fails to deliver.[43]

Request for Comment

The Commission seeks comment generally on all aspects of proposed Rule 10b-21. In addition, we seek comment on the following:

- Proposed Rule 10b-21 would apply to sales in all equity securities. Should we narrow the scope of the proposed rule to apply only to sales of "threshold securities" as that term is defined in Rule 203(c)(6) of Regulation SHO[44] or to certain types of securities? Why or why not? If so, to what types of securities should the proposed rule apply? If we narrow the proposed rule to apply only to certain types of securities, should exchange traded funds or other basket securities be excluded? Why or why not?

43 The Commission would continue to monitor the effect of "naked" short selling practices to determine whether additional rulemaking is warranted.

44 Rule 203(c)(6) defines "threshold securities" as "any equity security of an issuer that is registered pursuant to section 12 of the Exchange Act (15 U.S.C. 78l) or for which the issuer is required to file reports pursuant to section 15(d) of the Exchange Act (15 U.S.C. 78o(d))." 17 CFR 242.203(c)(6).

- The proposed rule highlights the specific liability of persons that deceive broker-dealers, participants of a registered clearing agency, or purchasers about their intention or ability to deliver securities in time for settlement. Are there other entities that could be deceived about a seller's intention or ability to deliver securities in time for settlement that should be included in the proposed rule? As an alternative to listing who must be deceived, should the proposed rule provide that a person would be liable if it deceives "another person" about its intention or ability to deliver securities in time for settlement? Please explain.
- The proposed rule includes a person failing to deliver securities when delivery is due as an element for a violation of the proposed rule. What are the costs and benefits, including to broker-dealers or customers, for including delivery as an element of the violation? Would the inclusion of a fail to deliver as an element of the proposed rule encourage broker-dealers, as a service to customers, to deliver securities on behalf of customers to prevent customers from failing to deliver securities by settlement date? Would broker-dealers feel any additional obligation to purchase or borrow securities on behalf of their customers to deliver on a customer's sale? What would be the costs to broker-dealers if they were to take such actions, particularly if the sale involves an expensive or hard to borrow security? Would the inclusion of failing to deliver as an element for a violation of the proposed rule increase costs for customers for inadvertent fails? Should delivery be excluded as a required element for a violation? For example, should the rule language instead be: "It shall constitute a "manipulative or deceptive device or contrivance" as used in section 10(b) of this Act for any person to submit an order to sell a security if such person deceives a broker or dealer,

participant of a registered clearing agency, or a purchaser about its intention or ability to deliver the security on the date delivery is due"? What would be the costs and benefits of excluding delivery as an element for a violation of the proposed rule? Would excluding failing to deliver as an element for liability under the proposed rule affect a self-regulatory organization's ability to surveil for violations of the rule?

- In the 2004 Regulation SHO Adopting Release, the Commission stated that a broker-dealer could satisfy the locate requirement of Regulation SHO by obtaining an assurance from a customer that the customer can obtain securities from another identified source in time to settle the trade, provided the broker-dealer reasonably believes the customer's assurance. Proposed Rule 10b-21 is aimed, in part, at sellers who make misrepresentations to their broker-dealers about their locate sources. Should we instead no longer permit a broker-dealer to rely on such customer assurances in satisfying the locate requirement of Regulation SHO? What would be the costs and benefits of removing the ability of broker-dealers to rely on such customer assurances? What would be the impact on market participants (such as broker-dealers, stock lenders, investors)? Would smaller entities be affected more or less adversely than larger entities?
- What procedures do broker-dealers currently have in place to assist in making the determination that there are reasonable grounds to believe that customers' representations regarding a locate source are accurate? How do those procedures help to provide confidence regarding the accuracy of such representations?
- What procedures do broker-dealers currently have in place to determine the accuracy of a seller's representations that it owns the securities being sold and that the

securities are reasonably expected to be in the broker-dealer's physical possession or control by settlement?

- Are there other types of transactions to which proposed Rule 10b-21 should not apply?
- Are there any issues with respect to the application of the proposed rule in the context of the use of DMAs? If so, please explain.
- Are there any issues with respect to the application of the proposed rule to trades submitted to, or effected on, electronic communications networks?
- To what extent, if any, would the proposed rule encourage or result in fewer executing broker-dealers relying on customer assurances to satisfy the locate requirement of Regulation SHO? To what extent would such a result of the proposed rule impact prime brokerage relationships? Please explain.
- Although the type of activity that would be illegal under the proposed rule is already prohibited by the general anti-fraud provisions of the federal securities laws, to what extent, if any, would the proposed rule impact liquidity and market quality in securities traded? Please explain. To what extent, if any, might the proposed rule result in short squeezes? What costs, if any, would the potential for short squeezes have on the efficiency of the market?
- To what extent, if any, would the proposed rule induce short sellers to execute trades in overseas markets?

IV. General Request for Comment

The Commission seeks comment generally on all aspects of the proposed rule. Commenters are requested to provide empirical data to support their views and arguments related

to proposed Rule 10b-21. In addition to the questions posed above, commenters are welcome to offer their views on any other matter raised by the proposed rule. 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 if accompanied by alternative suggestions to our proposals where appropriate.

V. Paperwork Reduction Act

Proposed Rule 10b-21 does not contain a "collection of information" requirement within the meaning of the Paperwork Reduction Act of 1995.[45] 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.

VI. Consideration of Costs and Benefits of the Proposed Amendments

The Commission is considering the costs and benefits of proposed Rule 10b-21. The Commission is sensitive to these costs and benefits, and encourages commenters to discuss any additional costs or benefits beyond those discussed here, as well as any reductions in costs. In particular, the 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 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 rule.

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[45] 44 U.S.C. 3501 et seq.

A. Benefits

Proposed Rule 10b-21 is intended to address abusive "naked" short selling and fails to deliver. The proposed rule is aimed at short sellers, including broker-dealers acting for their own accounts, who deceive broker-dealers, participants of a registered clearing agency, or purchasers about their intention or ability to deliver securities in time for settlement and that fail to deliver securities by settlement date. Among other things, proposed Rule 10b-21 would target short sellers who deceive their broker-dealers about their source of borrowable shares for purposes of complying with Regulation SHO's "locate" requirement.[46] The proposed rule would also apply to sellers who misrepresent to their broker-dealers that they own the shares being sold.[47]

A seller misrepresenting its short sale locate source or ownership of shares may intend to fail to deliver securities in time for settlement and, therefore, engage in abusive "naked" short selling. As noted above, although abusive "naked" short selling is not defined in the federal securities laws, it refers generally to selling short without having stock available for delivery and intentionally failing to deliver stock within the standard three-day settlement cycle.[48] Such short selling may or may not be part of a scheme to manipulate the price of a security. Although "naked" short selling as part of a manipulative scheme is always illegal under the general anti-fraud provisions of the federal securities laws, including Rule 10b-5 under the Exchange Act,[49] proposed Rule 10b-21 would highlight the specific liability of persons that deceive specified persons about their intention or ability to deliver securities in time for settlement, including persons that deceive their broker-dealer about their locate source or ownership of

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[46] See 17 CFR 242.203(b)(1).

[47] Proposed Rule 10b-21.

[48] See supra note 2.

[49] 17 CFR 240.10b-5.

shares and that fail to deliver securities by settlement date. We believe that a rule specifying the illegality of these activities would focus the attention of market participants on such activities. The proposed rule would also highlight that the Commission believes such deceptive activities are detrimental to the markets and would provide a measure of predictability for market participants.

All sellers of securities should promptly deliver, or arrange for delivery of, securities to the respective buyer and all buyers of securities have a right to expect prompt delivery of securities purchased. Thus, the proposal takes direct aim at an activity that may create fails to deliver. Those fails can have a negative effect on shareholders, potentially depriving them of the benefits of ownership, such as voting and lending. They also may create a misleading impression of the market for an issuer's securities. As noted above, issuers and investors have expressed concerns about fails to deliver in connection with "naked" short selling. For example, in response to proposed amendments to Regulation SHO in 2006[50] designed to further reduce the number of persistent fails to deliver in certain equity securities by eliminating Regulation SHO's "grandfather" provision, and limiting the duration of the rule's options market maker exception, the Commission received a number of comments that expressed concerns about "naked" short selling and extended delivery failures.[51]

To the extent that fails to deliver might be indicative of manipulative "naked" short selling, which could be used as a tool to drive down a company's stock price,[52] such fails to deliver may undermine the confidence of investors.[53] These investors, in turn, may be reluctant

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50 See 2006 Regulation SHO Proposed Amendments.

51 See, e.g., letters from Overstock; TASER, Royce; Read; DeVivo; Akhtar.

52 See supra note 27.

53 See supra note 28.

to commit capital to an issuer they believe to be subject to such manipulative conduct.[54] In addition, issuers may believe that they have suffered unwarranted reputational damage due to investors' negative perceptions regarding fails to deliver in the issuer's security.[55] Any unwarranted reputational damage caused by fails to deliver might have an adverse impact on the security's price.[56]

Thus, to the extent that fails to deliver might create a misleading impression of the market for an issuer's securities, the proposed rule would benefit investors and issuers by taking direct aim at an activity that may create fails to deliver. In addition, to the extent that "naked" short selling and fails to deliver result in an unwarranted decline in investor confidence about a security, the proposed rule should improve investor confidence about the security. In addition, the proposed rule could lead to greater certainty in the settlement of securities which should strengthen investor confidence in that process.

The proposed rule could result in broker-dealers having greater confidence that their customers have obtained a valid locate source and, therefore, that shares are available for delivery on settlement date. Thus, the proposed rule would aid broker-dealers in complying with the locate requirement of Regulation SHO and, thereby, potentially reduce fails to deliver. The proposed rule also may provide additional encouragement for broker-dealers to deliver shares by settlement date and, therefore, result in a reduction in fails to deliver. In addition, to the extent that sales of threshold securities do not result in fails to deliver, the proposed rule would reduce

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[54] See supra note 29.

[55] See supra note 30 (discussing the fact that due to such concerns some issuers have taken actions to attempt to make transfer of their securities "custody only," thus preventing transfer of their stock to or from securities intermediaries such the DTC or broker-dealers).

[56] See supra note 31.

costs to broker-dealers because such broker-dealers would have to close-out a lesser amount of fails to deliver under Regulation SHO's close-out requirement.[57]

In addition, the proposed rule could help reduce manipulative schemes involving "naked" short selling. We solicit comment on any additional benefits that could be realized with the proposed rule, including both short-term and long-term benefits. We solicit comment regarding benefits to market efficiency, pricing efficiency, market stability, market integrity and investor protection.

B. Costs

As an aid in evaluating costs and reductions in costs associated with proposed Rule 10b-21, the Commission requests the public's views and any supporting information.

The proposed rule is intended to address abusive "naked" short selling by highlighting the liability of persons that deceive specified persons about their intention or ability to deliver securities in time for settlement, including persons that deceive their broker-dealer about their locate source or ownership of shares and that fail to deliver securities by settlement date. The Commission recognizes that the proposed rule might result in increased costs to broker-dealers to the extent that the proposed rule encourages or results in broker-dealers limiting the extent to which they rely on customer assurances in complying with the locate requirement of Regulation SHO. Because the failure to deliver securities by the date delivery is due is an element for a violation of the proposed rule, as a service to customers broker-dealers could feel an additional obligation to borrow or purchase securities to deliver on customer sales even though the broker-

[57] Rule 203(b)(3)(iii) of Regulation SHO contains a close-out requirement that applies only to broker-dealers for securities in which a substantial amount of fails to deliver have occurred, also known as "threshold securities." Specifically, Rule 203(b)(3)'s close-out requirement requires a participant of a clearing agency registered with the Commission to take immediate action to close out a fail to deliver position in a threshold security in the Continuous Net Settlement (CNS) system that has persisted for 13 consecutive settlement days by purchasing securities of like kind and quantity.

dealer did not enter into an arrangement with the customer to do so. The proposed rule could result in increased costs to customers who inadvertently fail to deliver securities because such customers, in an attempt to avoid liability under the proposed rule, might purchase or borrow securities to deliver on a sale at a time when, but for the proposed rule, the seller would have allowed the fail to deliver position to remain open.

The Commission believes that the proposed rule would not compromise investor protection. We seek data, however, supporting any potential costs associated with the proposed rule. In addition, we request specific comment on any systems changes to computer hardware and software, or surveillance costs that might be necessary to implement the proposed rule. Specifically:

- What would be the costs and benefits of the proposed rule?
- Would the proposed rule create any costs associated with systems, surveillance, or recordkeeping modifications? Would these costs justify the benefits of better ensuring compliance with the federal securities laws?
- How much would the proposed rule affect compliance costs for small, medium, and large broker-dealers (e.g., personnel or system changes)? We seek comment on the costs of compliance that may arise.

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.[58] In addition, Section 23(a)(2) of the Exchange Act requires the Commission, when adopting rules under the Exchange Act, to consider the impact such rules would have on competition.[59] 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.

Proposed Rule 10b-21 is intended to address abusive "naked" short selling and fails to deliver. The proposed rule is aimed at short sellers, including broker-dealers acting for their own accounts, who deceive specified persons, such as a broker-dealer, about their intention or ability to deliver securities in time for settlement and fail to deliver securities by settlement date. Among other things, proposed Rule 10b-21 would target short sellers who deceive their broker-dealers about their source of borrowable shares for purposes of complying with Regulation SHO's "locate" requirement.[60] The proposed rule would also apply to sellers who misrepresent to their broker-dealers that they own the shares being sold.[61]

Although "naked" short selling as part of a manipulative scheme is always illegal under the general anti-fraud provisions of the federal securities laws, including Rule 10b-5 under the Exchange Act,[62] proposed Rule 10b-21 would highlight the liability of persons that deceive specified persons about their intention or ability to deliver securities in time for settlement, including persons that deceive their broker-dealer about their locate source or ownership of shares and that fail to deliver securities by settlement date. We believe that a rule highlighting

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[58] 15 U.S.C. 78c(f).

[59] 15 U.S.C. 78w(a)(2).

[60] See 17 CFR 242.203(b)(1).

[61] Proposed Rule 10b-21.

[62] 17 CFR 240.10b-5.

the illegality of these activities would focus the attention of market participants on such activities. The proposed rule would also provide a measure of predictability for market participants. We believe proposed Rule 10b-21 would have minimal impact on the promotion of price efficiency. We seek comment regarding whether proposed Rule 10b-21 may adversely impact liquidity, disrupt markets, or unnecessarily increase risks or costs to customers.

In addition, we believe that the proposed rule would have minimal impact on the promotion of capital formation. The perception that abusive "naked" short selling is occurring in certain securities can undermine the confidence of investors. These investors, in turn, may be reluctant to commit capital to an issuer they believe to be subject to such manipulative conduct. We believe that any such effect on capital formation is limited by the relatively few securities from corporate issuers that persist on the Regulation SHO threshold list[63] and the fact that this persistence does not necessarily indicate abusive "naked" short selling or a deleterious effect on the cost of capital for the issuer.

In the 2006 Proposing Release, we sought comment on whether the proposed amendments to Regulation SHO would promote capital formation, including whether the proposed increased short sale restrictions would affect investors' decisions to invest in certain equity securities. In response, commenters expressed concern about the potential impact of "naked" short selling on capital formation claiming that "naked" short selling causes a drop in an issuer's stock price that may limit the issuer's ability to access the capital markets.[64] Thus, to the extent that "naked" short selling and fails to deliver result in an unwarranted decline in investor

[63] On an average day over a nine month period from May 1, 2007 to January 31, 2008, approximately 50 securities had persisted on the threshold list for more than 17 days and had fails to deliver of 10,000 shares or more. However, the majority of these securities are exchange traded funds which suggests that only a small number of corporate issuers are potentially affected.

[64] See, e.g., letter from Feeney.

confidence about a security, the proposed rule should improve investor confidence about the security. We note, however, that persistent fails to deliver exist in only a small number of securities and may be a signal of overvaluation rather than undervaluation of a security's price.[65] In addition, we believe that the proposed rule could lead to greater certainty in the settlement of securities which should strengthen investor confidence in the settlement process.

We also believe that proposed Rule 10b-21 would not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. By specifying that abusive "naked" short selling is a fraud, the Commission believes the proposed rule would promote competition by providing the industry with guidance regarding the liability of sellers that deceive specified persons about their intention or ability to deliver securities in time for settlement, including persons that deceive their broker-dealer about their locate sources or share ownership and that fail to deliver securities by settlement date. The Commission requests specific comment on whether the proposed rule would 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,"[66] 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:

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[65] Persistent fails to deliver may be symptomatic of an inadequate supply of shares in the equity lending market. If short sellers are unable to short sell due to their inability to borrow shares, their opinions about the fundamental value of the security may not be fully reflected in a security's price, which may lead to overvaluation.

[66] 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).

- 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 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.

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"),[67] regarding the proposed rule.

A. Reasons for the Proposed Action

Proposed Rule 10b-21 is intended to address fails to deliver associated with abusive "naked" short selling. While "naked" short selling as part of a manipulative scheme is already illegal under the general anti-fraud provisions of the federal securities laws, proposed Rule 10b-21 would specify that it is a fraud for any person to submit an order to sell a security if such person deceives a broker-dealer, participant of a registered clearing agency, or purchaser about its intention or ability to deliver securities on the date delivery is due and such person fails to deliver securities on or before the date delivery is due. Thus, the proposed rule would highlight the liability of persons that deceive specified persons about their intention or ability to deliver

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[67] 5 U.S.C. 603.

securities in time for settlement, including persons that deceive their broker-dealer about their locate source or ownership of shares.

B. Objectives

Proposed Rule 10b-21 is aimed at short sellers, including broker-dealers acting for their own accounts, who deceive specified persons, such as a broker or dealer, about their intention or ability to deliver securities in time for settlement and that fail to deliver securities by settlement date. We believe that a rule highlighting the illegality of these activities would focus the attention of market participants on such activities. The proposed rule would also underscore that the Commission believes such deceptive activities are detrimental to the markets and would provide a measure of predictability for market participants.

All sellers of securities should promptly deliver, or arrange for delivery of, securities to the respective buyer and all buyers of securities have a right to expect prompt delivery of securities purchased. Thus, the proposal takes direct aim at an activity that may create fails to deliver. Those fails can have a negative effect on shareholders, potentially depriving them of the benefits of ownership, such as voting and lending. They also may create a misleading impression of the market for an issuer's securities. Proposed Rule 10b-21 would also aid broker-dealers in complying with the locate requirement of Regulation SHO and, thereby, potentially reduce fails to deliver. In addition, the proposed rule could help reduce manipulative schemes involving "naked" short selling.

C. Legal Basis

Pursuant to the Exchange Act and, particularly, Sections 2, 3(b), 6, 9(h), 10, 11A, 15, 15A, 17, 17A, 19 and 23(a) thereof, 15 U.S.C. 78b, 78c(b), 78f, 78i(h), 78j, 78k-1, 78o, 78o-3,

78q, 78q-1, 78s and 78w(a), the Commission is proposing a new anti-fraud rule, Rule 10b-21, to address fails to deliver associated with abusive "naked" short selling.

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[68] 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 2006, the Commission estimates that there were approximately 894 broker-dealers that qualified as small entities as defined above.[69]

Any business, however, regardless of industry, could be subject to the proposed amendments if it effects a short or long 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 rule is intended to address abusive "naked" short selling by highlighting the liability of persons that deceive specified persons about their intention or ability to deliver securities in time for settlement, including persons that deceive their broker-dealer about their

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68 17 CFR 240.0-10(c)(1).

69 These numbers are based on OEA's review of 2006 FOCUS Report filings reflecting registered broker-dealers. This number does not include broker-dealers that are delinquent on FOCUS Report filings.

locate source or ownership of shares and that fail to deliver securities by settlement date. The Commission believes that the proposed rule could impose new or additional reporting, recordkeeping, or compliance costs on any affected party, including broker-dealers, that are small entities. To comply with Regulation SHO, small broker-dealers needed to modify their systems and surveillance mechanisms to comply with Regulation SHO's locate, marking and delivery requirements. Thus, any systems and surveillance mechanisms necessary for broker-dealers to comply with the proposed rule should already be in place. We believe that any necessary additional systems and surveillance changes, in particular changes by sellers who are not broker-dealers, would be similar to the changes incurred by broker-dealers when Regulation SHO was implemented.

We solicit comment on what new recordkeeping, reporting or compliance requirements may arise as a result of this proposed rule.

F. Duplicative, Overlapping or Conflicting Federal Rules

The Commission believes that there are no federal rules that duplicate or conflict with the proposed rule. "Naked" short selling as part of a manipulative scheme is always illegal under the general anti-fraud provisions of the federal securities laws, including Rule 10b-5 under the Exchange Act,[70] and, therefore, overlap to a certain extent with the proposed rule. Proposed Rule 10b-21 would highlight the specific liability of persons that deceive specified persons about their intention or ability to deliver securities in time for settlement, including persons that deceive their broker-dealer about their locate source or ownership of shares and that fail to deliver securities by settlement date. We believe that a rule highlighting the illegality of these activities would focus the attention of market participants on such activities. The proposed rule

[70] 17 CFR 240.10b-5.

would also highlight that the Commission believes such deceptive activities are detrimental to the markets and would provide a measure of predictability for market participants.

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 entities. Pursuant to Section 3(a) of the RFA,[71] 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.

A primary goal of proposed Rule 10b-21 is to address abusive “naked” short selling. While "naked" short selling as part of a manipulative scheme is always illegal under the general anti-fraud provisions of the federal securities laws, Rule 10b-21 would specify that it is a fraud for any person to submit an order to sell a security if such person deceives a broker-dealer, participant of a registered clearing agency, or purchaser about its intention or ability to deliver the security on the date delivery is due and such person fails to deliver the security on or before the date delivery is due. The proposed rule is aimed at short sellers, including broker-dealers acting for their own accounts, who deceive specified persons, such as a broker or dealer, about their intention or ability to deliver securities in time for settlement and who do not deliver securities by settlement date. Among other things, proposed Rule 10b-21 would target short sellers who deceive their broker-dealers about their source of borrowable shares for purposes of

[71] 5 U.S.C. 603(c).

complying with Regulation SHO's "locate" requirement.[72] The proposed rule would also apply to sellers who misrepresent to their broker-dealers that they own the shares being sold.

We believe that imposing different compliance requirements, and possibly a different timetable for implementing compliance requirements, for small entities would undermine the Commission's goal of addressing abusive "naked" short selling and fails to deliver. In addition, we have concluded similarly that it would not be consistent with the primary goal of the proposed rule to further clarify, consolidate, or simplify the proposed rule for small entities. Finally, the proposed rule 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 rule; and (ii) the existence or nature of the potential impact of the proposed rule on small entities. Those comments should specify costs of compliance with the proposed rule, and suggest alternatives that would accomplish the objective of the proposed rule.

X. Statutory Authority

Pursuant to the Exchange Act and, particularly, Sections 2, 3(b), 6, 9(h), 10, 11A, 15, 15A, 17, 17A, 19 and 23(a) thereof, 15 U.S.C. 78b, 78c(b), 78f, 78i(h), 78j, 78k-1, 78o, 78o-3, 78q, 78q-1, 78s and 78w(a), the Commission is proposing a new anti-fraud rule, Rule 10b-21, to address abusive "naked" short selling.

List of Subjects in 17 CFR Part 240

Brokers, Fraud, Reporting and recordkeeping requirements, Securities.

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[72] See 17 CFR 242.203(b)(1).

Text of the Proposed Rule Amendments

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

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

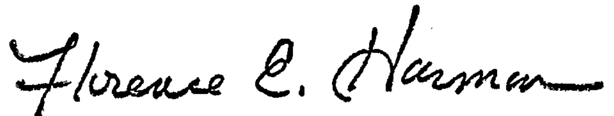
1. The authority citation for part 240 continues to read, in part, as follows:

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. Add § 240.10b-21 to read as follows:

§ 240.10b-21 Deception in connection with a seller's ability or intent to deliver securities on the date delivery is due.

It shall constitute a "manipulative or deceptive device or contrivance" as used in section 10(b) of this Act for any person to submit an order to sell a security if such person deceives a broker or dealer, a participant of a registered clearing agency, or a purchaser about its intention or ability to deliver the security on the date delivery is due, and such person fails to deliver the security on or before the date delivery is due.



By the Commission.

Florence E. Harmon
Deputy Secretary

Dated: March 17, 2008

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 57516 / March 18, 2008

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2800 / March 18, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12993

In the Matter of **ROBERT T. BASSMAN, CPA,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted against Robert T. Bassman ("Respondent" or "Bassman") pursuant to Rule 102(e)(3)(i) of the Commission's Rules of Practice.[1]

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the

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

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

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

III.

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

1. Bassman, age 48, is and has been a certified public accountant licensed to practice in the State of Michigan. He served as Assistant Controller of Lason, Inc. ("Lason") from September 1996 to 1997 and as Controller from 1997 until October 2000.

2. Lason was, at all relevant times, a Delaware corporation with its principal place of business in Troy, Michigan. Lason was engaged in the business of data management, copying, document imaging and mail sorting. At all relevant times, Lason's common stock was registered with the Commission pursuant to Section 12(b) of the Securities Exchange Act of 1934 ("Exchange Act"), and traded on the NASDAQ National Market.

3. On March 7, 2008, a final judgment was entered against Bassman, permanently enjoining him from future violations of Sections 17(a)(1), 17(a)(2), and 17(a)(3) of the Securities Act of 1933, Sections 10(b) and 13(b)(5) of the Exchange Act and Rules 10b-5, 13b2-1 and 13b2-2 thereunder, and aiding and abetting violations of Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 thereunder, in the civil action entitled Securities and Exchange Commission v. Gary L. Monroe, et al., Civil Action Number 03-71840, in the United States District Court for the Eastern District of Michigan. Bassman was also ordered to pay $240,761.70 in disgorgement and prejudgment interest, but payment of all but $35,000.00 in disgorgement was waived and no civil money penalty was imposed based on sworn representations made by Bassman in his Statement of Financial Condition.

4. The Commission's complaint alleged, among other things, that Bassman, at the direction of the former President, Chief Financial Officer and Chief Operating Officer of Lason, engaged in a fraudulent scheme which resulted in Lason filing materially false and misleading financial statements in the company's annual report on Form 10-K for the fiscal year ended December 31, 1998, and in the company's quarterly reports on Form 10-Q for the first and third quarters of fiscal year 1999. The Complaint alleged that Bassman engaged in a number of improper accounting practices that materially increased Lason's annual and quarterly revenue and net income in a departure from generally accepted accounting principles ("GAAP"). These practices included, among other things, recognizing revenue on forgiven debt that should have been used to reduce goodwill, recognizing revenue from an uncollectible invoice, and recognizing revenue from unsupportable work in process estimates. In addition, the complaint alleged that

Bassman failed to disclose information in response to questions by Lason's independent auditors about certain of Lason's fraudulent revenue recognition practices.

IV.

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

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

A. Bassman is suspended from 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;

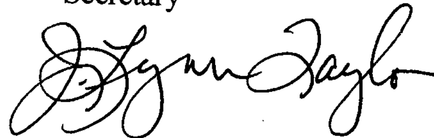
(c) Respondent has resolved all disciplinary issues with the Board, and has complied with all terms and conditions of any sanctions imposed by the Board (other than reinstatement by the Commission); and

(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 ACT OF 1933
Release No. 8903 / March 18, 2008

SECURITIES EXCHANGE ACT OF 1934
Release No. 57517 / March 18, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-11293

In the Matter of

RUBIN INVESTMENT GROUP, INC.,
SCOTT HALPERIN,
DANIEL RUBIN,
ANDREW SAKSA, and
ROBERT LOMONACO,

Respondents.

ORDER MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, AND SECTIONS 15(b) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934 AS TO ANDREW SAKSA

I.

On October 2, 2003, the Securities and Exchange Commission ("Commission") instituted public administrative and cease-and-desist proceedings pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), and Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against Andrew Saksa ("Saksa" or "Respondent").

II.

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

III.

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

Summary

1. These proceedings arise out of two fraudulent schemes to improperly acquire and promote the stock of two publicly-traded companies, Marx Toys & Entertainment Corp. ("MRXT") and The Classica Group, Inc. ("Classica"). In exchange for acquiring a large amount of purportedly unrestricted stock, illegally issued pursuant to Form S-8 registration statements filed by Classica and MRXT, Saksa and others improperly promoted and manipulated the share price of Classica and MRXT stock.

Respondent

2. **Saksa**, 41 years old, resides in Altamonte Springs, Florida. During the relevant time, Saksa was director of mergers and acquisitions at Rubin Investment Group ("RIG"), a purported investment bank. Saksa was associated with various broker-dealers from 1989 to 2000. On August 18, 2001, Saksa was censured and barred for a period of two and a half years from membership by the NYSE Division of Enforcement for, among other things, soliciting customers to invest in outside business ventures without the knowledge or consent of his member organization.

Other Relevant Person and Entities

3. **MRXT** is a Nevada corporation, with executive offices located in Sebring, Ohio, that purports to be in the business of selling collectible action figures and play sets through the Internet and via telemarketing. During the relevant time period, MRXT's common stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act, and trades in MRXT's common stock shares were quoted on the OTC Bulletin Board. MRXT's stock traded for under $5 per share and was a penny stock as defined by Rule 3a51-1 of the Exchange Act.

4. **Classica** is a New York corporation, headquartered in Sayreville, New Jersey, that purports to engage in two principal businesses. The first is designing, building, and selling of microwave heat processing equipment for pasteurization, sterilization, drying, and sanitizing in the food and pharmaceutical industries. The second is producing and importing specialty cheeses and Italian foods. During the relevant time period, Classica's common stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act, and trades in Classica's common stock shares were quoted on the NASDAQ Small Cap Market. Classica's stock traded for

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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.

under $5 per share and was a penny stock as defined by Rule 3a51-1 of the Exchange Act.

5. **RIG** is a California corporation that had offices in New York, New York, Los Angeles, California and Lake Helen, Florida. RIG purports to be an investment bank, and is not registered with the Commission.

Background

6. In or around August 2003, MRXT filed a Form S-8 Registration Statement with the Commission, purporting to register shares issuable pursuant to a stock option plan. The stock option plan states that it "is intended to provide valuable incentive for our employees by providing an opportunity for investment in our Common Stock, as an inducement for such individuals to remain with us, thereby encouraging them to increase their efforts to make the our [sic] business more successful."

7. In or around August 2003, MRXT and RIG entered into an agreement ("MRXT Agreement"), whereby RIG would provide "merger and acquisition advisory and consulting services" to MRXT in exchange for discounted shares of MRXT stock. MRXT issued to RIG approximately 6.8 million shares of stock and, to others, approximately 1.2 million shares. The shares were registered pursuant to MRXT's Form S-8 Registration Statement.

8. In or around August 2003, Classica filed a Form S-8 Registration Statement with the Commission, purporting to register shares issuable pursuant to a stock option plan. The stock option plan states that it "is intended to provide valuable incentive for our employees by providing an opportunity for investment in our Common Stock, as an inducement for such individuals to remain with us, thereby encouraging them to increase their efforts to make the our [sic] business more successful."

9. In or around August 2003, Classica entered into a purported "merger and acquisition advisor agreement" with RIG ("Classica Agreement") for the stated purpose of "possibly effecting an acquisition of or other business combination with one or more companies" in exchange for discounted shares of Classica stock. At the same time, Classica issued RIG approximately 1.8 million shares of stock, registered pursuant to Classica's Form S-8 Registration Statement.

10. In exchange for MXRT and Classica stock, Saksa and others at RIG manipulated upward the price of the companies' stock. Saksa did this, in part, to pump Classica's stock price above a certain price limitation that existed at that time for issuers listed on the NASDAQ, to create profits from the inflated market, and to generate more business for RIG.

11. Despite the terms of the MRXT and Classica Agreements, the terms of MRXT's and Classica's Form S-8 registration statements filed with the Commission, and

the requirements of Commission Form S-8,[2] Saksa knew: that RIG was a corporate entity, not a natural person, and therefore RIG was barred from receiving Form S-8 shares; that RIG did not intend to provide *bona fide* services to MRXT or Classica; and that RIG and others engaged in efforts both to promote MRXT and Classica to potential investors and to raise capital for the issuers in exchange for the discounted Form S-8 shares RIG received. Saksa also knew that RIG and others engaged in efforts to artificially inflate the price of MRXT's and Classica's stock in exchange for the Form S-8 shares, and that the Form S-8 registration statements contained or incorporated by reference materially false or misleading statements and omissions which concealed the true nature of RIG's mission and the attendant compensation.

12. Through his conduct, Respondent participated in the offering of common stock of MRXT and Classica, "penny stocks" as that term is used in Section 15(b)(6) and as defined by Section 3(a)(51) of the Exchange Act and Rule 3a51-1 thereunder.

13. As a result of the conduct described above, Respondent willfully violated, and caused the violation of, Sections 5(a) and 5(c) of the Securities Act, which prohibit the offer and sale of securities through the mails or in interstate commerce, unless a registration statement is filed or in effect as to such securities or unless an exemption from registration is available. Respondent also willfully violated, and caused the violation of, Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent conduct in the offer or sale of securities or in connection with the purchase or sale of securities.

Undertaking

Saksa undertakes to continue to provide cooperation to the Commission and its staff in its investigation and litigation related to the matters described herein. Specifically, Saksa undertakes to: upon reasonable request by the Commission or its staff, and on reasonable notice, and without service of a subpoena, he will provide documents or other information, and accept service and take all reasonable actions to make himself available to testify truthfully at any interview, investigative testimony, deposition, at any judicial proceeding related to this Order, and at any administrative proceeding arising as a result of the Commission's investigation relating to the matters described herein. This provision shall not be construed to waive Saksa's applicable attorney-client, work product or other privileges recognized under federal law, if asserted timely and in good faith. In determining whether to accept Saksa's Offer, the Commission has considered Saksa's undertaking.

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[2] Form S-8 is available for the issuance of stock to consultants only if the following conditions are met: (i) the consultant is a natural person, (ii) the consultant provides *bona fide* services to the registrant; and (iii) the services are not in connection with the offer or sale of securities in a capital-raising transaction, and do not directly or indirectly promote or maintain a market for the registrant's securities. See General Instruction A.1(a) to Form S-8.

IV.

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

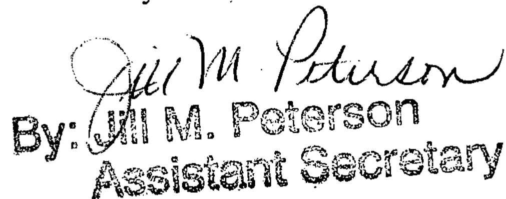
Accordingly, pursuant to Section 8A of the Securities Act, and Sections 15(b) and 21C of the Exchange Act, it is hereby ORDERED that:

A. Respondent Saksa cease and desist from committing or causing any violations and any future violations of Sections 5(a), 5(c), and 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

B. Respondent Saksa be, and hereby is, barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

By the Commission.

Nancy M. Morris
Secretary



UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 8904 / March 18, 2008

SECURITIES EXCHANGE ACT OF 1934
Release No. 57518 / March 18, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-11293

In the Matter of RUBIN INVESTMENT GROUP, INC., SCOTT HALPERIN, DANIEL RUBIN, ANDREW SAKSA, and ROBERT LOMONACO, Respondents.	ORDER MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, AND SECTIONS 15(b) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934 AS TO ROBERT LOMONACO

I.

On October 2, 2003, the Securities and Exchange Commission ("Commission") instituted public administrative and cease-and-desist proceedings pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), and Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against Robert LoMonaco ("LoMonaco" or "Respondent").

II.

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

Summary

1. These proceedings arise out of a fraudulent scheme to improperly acquire and promote the stock of a publicly-traded company, Marx Toys & Entertainment Corp. ("MRXT"). In exchange for acquiring a large amount of purportedly unrestricted stock illegally issued pursuant to a Form S-8 registration statement filed by MRXT, certain stock promoters improperly promoted and manipulated the share price of MRXT stock. LoMonaco, MRXT's CEO in September 2003, knew of and assisted in facilitating the scheme.

Respondent

2. **LoMonaco**, 60 years old, resides in Monmouth Beach, New Jersey. He was appointed chief executive officer of MRXT on or about September 11, 2003.

Other Relevant Person and Entities

3. **Scott Halperin ("Halperin")**, 45 years old, resides in Manalapan, New Jersey. He is the former chairman of the board for "stereoscape.com, inc." which was the predecessor company to MRXT.

4. **MRXT** is a Nevada corporation, with executive offices located in Sebring, Ohio, that purports to be in the business of selling collectible action figures and play sets through the Internet and via telemarketing. During the relevant time period, MRXT's common stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act, and trades in MRXT's common stock shares were quoted on the OTC Bulletin Board. MRXT's stock traded for under $5 per share and was a penny stock as defined by Rule 3a51-1 of the Exchange Act.

5. **Rubin Investment Group ("RIG")** is a California corporation with offices in New York, New York, Los Angeles, California and Lake Helen, Florida. RIG purports to be an investment bank, and is not registered with the Commission.

Background

6. In or around August 2003, Halperin caused MRXT to file a Form S-8 Registration Statement with the Commission, purporting to register shares issuable pursuant to a stock option plan. The stock option plan states that it "is intended to

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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.

provide valuable incentive for our employees by providing an opportunity for investment in our Common Stock, as an inducement for such individuals to remain with us, thereby encouraging them to increase their efforts to make the our [sic] business more successful."

7. In or around August 2003, at Halperin's direction, MRXT and RIG entered into an agreement ("MRXT Agreement"), whereby RIG would provide "merger and acquisition advisory and consulting services" to MRXT in exchange for discounted shares of MRXT stock. MRXT issued to RIG approximately 6.8 million shares of stock and, to Halperin and others, approximately 1.2 million shares. The shares were registered pursuant to MRXT's Form S-8 Registration Statement.

8. LoMonaco, who became MRXT's chief executive officer in September 2003, knew that Halperin engaged RIG and others to inflate MRXT's stock price, and LoMonaco negotiated with RIG to obtain the funding that RIG promised to MRXT in exchange for the purportedly unrestricted stock RIG received. In addition, LoMonaco promised that he would pay Halperin a kickback from MRXT for having procured RIG's investment in the company.

9. Despite the terms of the MRXT Agreement, the terms of MRXT's Form S-8 registration statement filed with the Commission, and the requirements of Commission Form S-8,[2] LoMonaco, MRXT's chief executive officer, knew: that RIG was a corporate entity, not a natural person, and therefore RIG was barred from receiving Form S-8 shares; that RIG did not intend to provide *bona fide* services to MRXT; and that RIG and others engaged in efforts both to promote MRXT to potential investors and to raise capital for MRXT in exchange for the discounted Form S-8 shares RIG received. LoMonaco also knew that RIG and others engaged in efforts to artificially inflate the price of MRXT's stock in exchange for the Form S-8 shares, and that the Form S-8 registration statements contained or incorporated by reference materially false or misleading statements and omissions which concealed the true nature of RIG's mission and the attendant compensation.

10. Through his conduct, Respondent participated in the offering of common stock of MRXT, a "penny stock" as that term is used in Section 15(b)(6) and as defined by Section 3(a)(51) of the Exchange Act and Rule 3a51-1 thereunder

11. As a result of the conduct described above, Respondent willfully violated, and caused the violation of, Section 17(a) of the Securities Act, Section 10(b) of the

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2 Form S-8 is available for the issuance of stock to consultants only if the following conditions are met: (i) the consultant is a natural person, (ii) the consultant provides *bona fide* services to the registrant; and (iii) the services are not in connection with the offer or sale of securities in a capital-raising transaction, and do not directly or indirectly promote or maintain a market for the registrant's securities. <u>See</u> General Instruction A.1(a) to Form S-8.

Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent conduct in the offer or sale of securities or in connection with the purchase or sale of securities.

Undertaking

LoMonaco undertakes to continue to provide cooperation to the Commission and its staff in its investigation and litigation related to the matters described herein. Specifically, LoMonaco undertakes to: upon reasonable request by the Commission or its staff, and on reasonable notice, and without service of a subpoena, he will provide documents or other information, and accept service and take all reasonable actions to make himself available to testify truthfully at any interview, investigative testimony, deposition, at any judicial proceeding related to this Order, and at any administrative proceeding arising as a result of the Commission's investigation relating to the matters described herein. This provision shall not be construed to waive LoMonaco's applicable attorney-client, work product or other privileges recognized under federal law, if asserted timely and in good faith. In determining whether to accept LoMonaco's Offer, the Commission has considered LoMonaco's undertaking.

IV.

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

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

A. Respondent LoMonaco cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

B. Respondent LoMonaco be, and hereby is, barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

C. Pursuant to Section 21C(f) of the Exchange Act, Respondent LoMonaco be, and hereby is, barred from acting as a director or officer of any issuer having a class of securities registered with the Commission pursuant to Section 12 of the Exchange Act or required to file reports pursuant to Section 15(d) of the Exchange Act.

By the Commission.

Nancy M. Morris
Secretary

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 240 and 249

[Release No. 34-57526; File No. S7-06-07]

RIN 3235-AJ80

Proposed Rule Changes of Self-Regulatory Organizations

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission ("Commission") is adopting rule amendments to require Self-Regulatory Organizations ("SROs") that submit proposed rule changes pursuant to Section 19(b)(7)(A) of the Securities Exchange Act of 1934 ("Act") to file these rule changes electronically. In addition, the Commission is adopting rule amendments to require SROs to post all such proposed rule changes on their Web sites. Together, the amendments are designed to expand the electronic filing by SROs of proposed rule changes, making it more efficient and cost effective, and to harmonize the process of filings made under Section 19(b)(7)(A) with that for filings made by SROs under Section 19(b)(1) of the Act.

EFFECTIVE DATE: **[insert date 30 days after publication in the Federal Register].**

FOR FURTHER INFORMATION CONTACT: John Roeser, Assistant Director, at (202) 551-5630, Michou Nguyen, Special Counsel, at (202) 551-5634, or Sherry Moore, Paralegal, at (202) 551-5549, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-6628.

SUPPLEMENTARY INFORMATION:

I. Introduction

On February 23, 2007, the Commission proposed to require SROs that submit proposed rule changes pursuant to Section 19(b)(7)(A) of the Act[1] to file these rule changes electronically.[2] The Commission proposed amending Rule 19b-7 and Form 19b-7 to: (1) require SROs to file proposed rule changes submitted pursuant to Section 19(b)(7)(A) of the Act electronically, rather than in paper format; and (2) require SROs to post all such proposed rule changes on their Web sites. The Commission also proposed making certain conforming changes to Rule 19b-4 and Form 19b-4.

Under Section 19(b)(7) of the Act and Rule 19b-7 thereunder, securities futures exchanges registered with the Commission under Section 6(g) of the Act and associations registered with the Commission under Section 15A(k) of the Act[3] for the limited purpose of regulating activities of members who are registered as broker-dealers in security futures products[4] are required to file certain categories of proposed rule changes with the Commission.[5] These proposed rule changes are published for comment and may take

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1 15 U.S.C. 78s(b)(7)(A).

2 Securities Exchange Act Release No. 55341 (February 23, 2007), 72 FR 9412 (March 1, 2007) ("Electronic 19b-7 Proposing Release").

3 15 U.S.C. 78o-1(k).

4 See Section 15(b)(11) of the Act. 15 U.S.C. 78o(b)(11).

5 Section 19(b)(7) of the Act. 15 U.S.C. 78s(b)(7). Specifically, under Section 19(b)(7), these SROs submit those proposed rule changes that relate to higher margin levels, fraud or manipulation, recordkeeping, reporting, listing standards, or decimal pricing for security futures products, sales practices for security futures products for persons who effect transactions in security futures products, or rules effectuating the SRO's obligation to enforce the securities laws.

effect: (1) when a written certification has been filed with the Commodity Futures Trading Commission ("CFTC") under Section 5c(c) of the Commodity Exchange Act; (2) when the CFTC determines that review of the proposed rule change is not necessary; or (3) when the CFTC approves the proposed rule change.[6] Rule 19b-7 and Form 19b-7 under the Act set forth the process for SROs to file proposed rule changes under Section 19(b)(7) of the Act.

Currently, SROs are required to electronically file proposed rule changes submitted to the Commission under Section 19(b)(1) of the Act.[7] SROs are also required to post such proposed rule changes on their Web sites.[8]

Proposed rule changes submitted by SROs under Section 19(b)(7) of the Act, in contrast, are submitted to the Commission in paper.[9] In addition, SROs are not currently required to post proposed rule changes filed under Section 19(b)(7) on their Web sites. The Commission proposed to amend Rule 19b-7 and Form 19b-7 to require electronic filing and Web posting of proposed rule changes filed under Section 19(b)(7) of the Act. These proposals were designed to conform to the requirements already in place for proposed rule changes filed pursuant to Rule 19b-4 and Form 19b-4.

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6 Section 19(b)(7)(B) of the Act. 15 U.S.C. 78s(b)(7)(B). Proposed rule changes that relate to margin, except for those that result in higher margin levels, must be filed pursuant to Sections 19(b)(1) of the Act. 15 U.S.C. 78s(b)(1).

7 17 CFR 240.19b-4. See Securities Exchange Act Release No. 50486 (October 4, 2004), 69 FR 60287 (October 8, 2004) (File No. S7-18-04) ("Electronic 19b-4 Adopting Release").

8 17 CFR 240.19b-4(l).

9 See Securities Exchange Act Release No. 44692 (August 13, 2001), 66 FR 43721 (August 20, 2001) (Paper Form 19b-7 Adopting Release).

The Commission received two comment letters in response to its request for comments.[10] The commenters were generally supportive of the proposed amendments but offered a few suggestions for refinements to the proposal. In addition, commenters commended the Commission's efforts to improve the rule filing process and make it less costly and more efficient. One commenter also offered suggestions relating to matters outside the scope of this rulemaking.[11] The Commission has determined to adopt the amendments substantially as proposed, with modifications to address the comments of the NFA and with some clarifications.

II. Amendments

A. Electronic Filing

The Commission proposed to amend Rule 19b-7 and Form 19b-7 to require that Form 19b-7, and any amendments thereto, be submitted electronically to the Commission. The Commission is adopting these amendments as proposed.

Based on the Commission's experience receiving electronic Rule 19b-4 filings from SROs, the Commission believes that requiring SROs to file proposed rule changes on Form 19b-7 electronically will have many benefits. First, the Commission believes electronic filing will reduce the amount of time required by SROs to submit SRO rule filings by eliminating paper delivery, photocopying, and distribution. Under the current system, SROs send paper copies of proposed rule changes on Form 19b-7 to the

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10 See letters to Nancy M. Morris, Secretary, Commission, from: Thomas W. Sexton, Vice President and General Counsel, National Futures Association ("NFA"), dated April 23, 2007 ("NFA Letter") and James J. Angel, Ph.D., CFA, Associate Professor of Finance, McDonough School of Business, Georgetown University, dated April 30, 2007 ("Angel Letter").

11 See Angel Letter, supra note 10 at 1-2.

Commission via messenger, overnight delivery, or U.S. mail. Electronic filing will reduce costs for the SROs[12] because the SROs will no longer incur costs for delivery of paper filings or for the SRO staff time currently devoted to preparing filing packages. The Commission also will benefit from reducing the personnel time currently associated with manually processing paper filings.

Second, electronic filing will allow for a more efficient use of Commission resources by integrating the SRO electronic filing technology with SRO Rule Tracking System ("SRTS"), the internal Commission database that tracks these filings, enabling Commission staff to more easily monitor and process proposed rule changes. Pertinent information regarding proposed rule changes, as well as amendments, will be captured automatically by SRTS. As a result, Commission staff will be able to monitor electronically the progress of proposed rule changes filed on Form 19b-7 from initial receipt through final disposition and thereby enhance its management of the rule filing process.

As of 5:30 p.m. Eastern Daylight Saving Time on **[insert date 29 days after publication in the Federal Register]**, the Commission will no longer accept SRO proposed rule changes in paper format. Beginning at 9:00 a.m. Eastern Daylight Saving Time on **[insert date 30 days after publication in the Federal Register]**, SROs will be required to file all Forms 19b-7 and any amendments to Forms 19b-7 electronically, according to the procedures and in the format described in Rule 19b-7 and Form 19b-7, as amended. SROs will gain access to a secure Web site known as the EFFS, which

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12 See infra notes 65-69 and accompanying text.

enables authorized individuals at the SRO to file proposed rule changes with the Commission electronically.[13] Proposed rule changes will be deemed filed on the business day the Commission receives the proposed rule change electronically, provided the Commission receives the filing before 5:30 p.m. Eastern Standard Time or Eastern Daylight Saving Time, whichever is in effect at the time of filing, and it is filed in accordance with Rule 19b-7 and Form 19b-7, as amended. The Commission has eliminated the requirement that SROs submit multiple, paper copies of proposed rule changes.[14]

As had been proposed, the adopted amendment to Form 19b-7 requires SROs to file their proposed rule changes with an electronic signature.[15] Form 19b-7 requires that a filing be signed on the SRO's behalf by a person "duly authorized" to sign a proposed rule change.[16] Each duly authorized signatory will be required to obtain a "digital ID,"

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13 The SRO will determine which individuals would be supplied with User IDs and passwords to access the secure Web site. See infra note 17 and accompanying text.

14 Occasionally, an SRO may find it necessary to file documents that cannot be submitted electronically, such as comment letters submitted to the Exchange before filing, or other exhibits. In addition, it may not be appropriate to require proprietary and other information subject to a request for confidential treatment to be filed electronically. Accordingly, the amendments to Rule 19b-7 and Form 19b-7 will retain the flexibility to permit portions of a rule filing to be made in paper form under limited circumstances. For example, the Commission will permit SROs to file materials for which confidential treatment is requested in paper format.

15 The Commission notes that the Electronic Signatures in Global and National Commerce Act, 15 U.S.C. 7001, et seq. does not apply in this regard.

16 The Commission is clarifying on amended Form 19b-7 that this individual must be an officer of the SRO, who has been authorized by the SRO's governing body to sign proposed rule changes on behalf of the SRO. See Instruction E to Form 19b-7.

which provides both the Commission and the SRO with assurances of the authenticity and integrity of the electronically-submitted Form 19b-7.[17] In addition, each signatory will be required to manually sign a hard copy of the Form 19b-7, authenticating, acknowledging, or otherwise adopting his or her electronic signature that is attached to or logically associated with the filing. In accordance with Rule 17a-1 under the Act,[18] the SRO is required to retain that manual signature page of the rule filing, authenticating the signatory's electronic signature, for not less than five years after the Form 19b-7 is filed with the Commission and, upon request, furnish a copy of it to the Commission or its staff.[19]

One commenter suggested that the Commission use its exemptive authority to eliminate the requirement that SROs file proposed rule changes with the Commission pursuant to Section 19(b)(7) of the Act.[20] The Commission believes that this comment is

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17 A digital ID, sometimes called a "digital certificate," is a file on the computer that identifies the user. Computers can use a digital ID to create a digital signature that verifies both that the message originated from a specific person and that the message has not been altered either intentionally or accidentally. The user obtains a digital ID from a "Certificate Authority" ("CA") for a modest sum (currently approximately $20 per year). When the SRO electronically sends the Form 19b-7 to the Commission, the digital ID will encrypt the data through a system that uses "key pairs." With key pairs, the SRO's software application uses one key to encrypt the document. When the Commission receives the SRO's electronic document, the Commission's software will use a matching key to decrypt the document.

18 17 CFR 240.17a-1.

19 See Rule 19b-7(d). These requirements are substantially consistent with the requirements for Form 19b-4 filings, which were adapted from Section 232.302 of Regulation S-T, 17 CFR 232.302 for EDGAR filers.

20 See Angel Letter, supra note 10 at 1.

outside the scope of the proposed amendments and therefore is not making any changes to the proposal in this regard.

B. Posting of Rule 19b-7 Proposed Rule Changes on SRO Web sites

The Commission also proposed to amend Rule 19b-7 to require each SRO to post proposed rule changes filed pursuant to that Rule, and any amendments thereto, on its public Web site no later than two business days after filing with the Commission. The Commission also proposed to require SROs to continue to post such proposed rule changes until 60 days after the SRO files a written certification with the CFTC, the CFTC determines that review of the proposed rule change is not necessary, or the CFTC approves the proposed rule change. The Commission is adopting these amendments as proposed.

The Commission believes the Web site posting requirement provides interested persons with easy access to proposed rule changes, while at the same time providing SROs with sufficient time to comply with the posting requirement.[21] Based on the Commission's experience with respect to SROs' obligation to post proposed rule changes under Rule 19b-4, the Commission believes that the two business day timeframe strikes an appropriate balance between promoting the public interest of having proposed rule changes posted quickly and the need for the SROs to have adequate time to perform the technological tasks necessary to post the proposed rule change.[22] The Commission

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21 The complete proposed rule change will also be available electronically in the Commission's Public Reference Room.

22 An SRO controls the timing of filing proposed rule changes and amendments and can assure that its technology staff is prepared to post the proposed rule change on

believes all market participants, investors, and other interested parties should have access to SRO proposed rule changes filed with the Commission, and any amendments, as soon as practicable. Moreover, the Commission believes that Web site accessibility of SRO proposed rule changes filed under Section 19(b)(7) of the Act will: (1) provide interested persons with faster access to proposed rule changes; (2) facilitate the ability of interested persons to comment on the proposals; (3) save SRO resources currently used to monitor the Commission's Public Reference Room for competitors' proposed rule changes; and (4) enhance the transparency of the rule filing process by providing ready access to proposed rule changes and facilitating public comment on them.

The Commission is also adopting as proposed amendments requiring SROs to remove proposed rule changes filed under Section 19(b)(7) of the Act that are deemed not properly filed and returned to SROs or withdrawn by SROs from their Web sites within two business days from the Commission's notification to the SRO that such proposed rule change was not properly filed,[23] or of the SRO's withdrawal of the proposed rule change.

The NFA requested clarification on whether it could keep proposed rule changes on its Web site for longer than the 60-day period provided in the proposed rule, and whether it could maintain on its Web site the letter submitted to the CFTC in connection with a proposed rule change that it withdraws from filing with the Commission or is

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the SRO's public Web site within two business days of filing with the Commission.

23 A screen within EFFS will indicate that a rule filing has not been properly filed and has been returned to the SRO.

notified was not properly filed. NFA also noted that leaving the letter submitted to the CFTC on the NFA Web site may provide useful historical information regarding NFA rule changes or other matters.[24] In this regard, the Commission notes that the amended rule only establishes minimum periods for which an SRO must post its proposed rule changes. An SRO may maintain a Form 19b-7 filing on its Web site after the 60-day period has ended. In addition, Rule 19b-7 does not apply to any filing other than those made under Section 19(b)(7)(A). Thus, an SRO may post on its Web site submissions to the CFTC or other materials, as it chooses.

Finally, Dr. Angel, suggested that all SROs be required to describe the status of rule filings (e.g., "effective," "under review at the Commission," "rejected," "superseded by a new proposal," etc.) on their Web sites.[25] In addition, Dr. Angel suggested that the Commission require SROs to post all filings submitted to the Commission, including Form 1 and Form PILOT, and that the Commission require alternative trading systems to post their Forms ATS on their respective Web sites.[26] The Commission believes these suggestions are outside the scope of the proposed amendments, which relate exclusively to electronic filing by securities futures exchanges under Section 19(b)(7) of the Act, and therefore is not modifying the proposal in response to these comments.[27]

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24 See NFA Letter, supra note 10 at 2.

25 See Angel Letter, supra note 10 at 1.

26 See Angel Letter, supra note 10 at 2.

27 The Commission notes that it proposed to require SROs to post amendments to their Form 1s on their Web sites. See Securities Release Act No. 50699 (November 18, 2004), 69 FR 71126 (December 8, 2004). The Commission has not taken action on this proposal.

C. Requirement to Update Rule Text on SRO Web Sites

Currently, Rule 19b-4(m) under the Act[28] requires all SROs to post and maintain on their Web sites a complete and accurate copy of their rules. In addition, an SRO must update its Web site to reflect rule changes within two business days after being notified of the Commission's approval of a proposed rule change filed pursuant to Section 19(b)(2) of the Act or of the Commission's notice of a proposed rule change filed pursuant to 19(b)(3)(A) or 19(b)(7) of the Act. As adopted, all SROs will continue to be required to post and maintain a complete and accurate copy of their rules and to update their Web sites to reflect their proposed rule changes.

1. New Paragraph (g) of Rule 19b-7

The Commission proposed to add paragraph (g) to Rule 19b-7 to move the requirement that an SRO filing a proposed rule change under Section 19(b)(7): (1) post and maintain a current and complete version of its rules on its Web site; and (2) update the rules posted on its Web site within two days after a rule change becomes effective.[29] The Commission is adopting new paragraph (g) to Rule 19b-7 as proposed, with certain minor changes to reflect comments from the NFA.[30]

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28 17 CFR 240.19b-4(m).

29 Section 19(b)(7)(B) of the Act requires a proposed rule change filed with the Commission under Section 19(b)(7) of the Act to be filed concurrently with the CFTC. Such proposed rule change is effective upon filing of a written certification with the CFTC, upon a determination by the CFTC that review of the proposed rule change is not necessary, or upon approval of the proposed rule change by the CFTC. 15 U.S.C. 78s(b)(7)(B).

30 Dr. Angel suggested that the Commission require SROs to post their rulebooks on their Web site in one Adobe pdf file for ease of searching. See Angel Letter, supra note 10 at 1. While the Commission encourages the SROs to employ

The NFA asked the Commission to modify the proposed language in Rule 19b-7(g) so that an SRO's obligation to update its rules on its Web site would apply no sooner than two days after the SRO's receipt of notice from the CFTC that it had determined that review of the proposal was not necessary or that it had approved the proposal.[31] The NFA states that the CFTC does not have an electronic filing system and, therefore, the NFA does not always receive immediate notification of CFTC action.

In response to the NFA's comment, the Commission is amending Rule 19b-7(g) to require an SRO to update its Web site to reflect rule changes filed under Section 19(b)(7) within two business days of the later of: (1) the Commission's notice of the proposed rule change; or (2) the filing by the SRO of a certification with the CFTC under Section 5c(c) of the Commodities Exchange Act, receipt of notice from the CFTC that it has determined that review of such proposed rule change is not necessary, or receipt of notice from the CFTC that it has approved such proposed rule change. The Commission believes these changes are appropriate because they do not impose an obligation on an SRO to update its Web site until the SRO has notice of the CFTC action and no sooner than SROs are obligated to update their rule text for proposals submitted pursuant to Section 19(b)(3)(A) of the Act, which are effective upon filing with the Commission.

2. Amendments to Paragraph (m) of Rule 19b-4

The Commission also proposed to make a conforming change to Rule

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technology on their Web sites which facilitates research of their rules, the Commission does not believe it is necessary or appropriate to require SROs to use a particular application to publish their rules.

31 See NFA Letter, supra note 10 at 2-3.

19b-4 to remove the requirement in paragraph (m) that SROs update their Web sites to reflect proposed rule changes filed pursuant to Section 19(b)(7) of the Act. As discussed above, the Commission has moved this requirement to Rule 19b-7. The Commission is adopting the conforming changes to Rule 19b-4 as proposed.[32]

In addition, in response to comments from the NFA, the Commission is modifying Rule 19b-4(m) as it applies to an exchange registered with the Commission under Section 6(g) or a limited purpose national securities association registered under Section 15A(k) with regard to the period within which it must update its rule text on its Web site. An Exchange registered with the Commission under Section 6(g) of the Act[33] or a limited purpose national securities association registered under Section 15A(k) of the Act,[34] may be required to file certain proposed rule changes under Section 19(b)(2) of the Act. Such proposed rule changes do not become effective until: (1) the Commission approved the proposal; and (2) the SRO filed with the CFTC a written certification, the CFTC determined that review of the proposed rule change is not necessary, or the CFTC approved the proposed rule change. Accordingly, the final rule the Commission is adopting provides that an exchange that is registered with the Commission under Section 6(g) of the Act or a limited purpose national securities association registered under Section 15A(k) of the Act, is required to update its rule text on its Web site to reflect rule changes filed under Section 19(b)(2) of the Act within two business days of the later of:

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32 See Rule 19b-4(m)(2). The final rule also clarifies that the two-day time period is business days.

33 15 U.S.C. 78f(g).

34 15 U.S.C. 78o-1(k).

(1) the Commission's approval of the proposed rule change; or (2) the SRO's filing of a written certification with the CFTC under Section 5c(c) of the Commodity Exchange Act, notice from the CFTC that it has determined that review of the proposed rule change is not necessary, or notice from the CFTC that it has approved the proposed rule change.[35]

The Commission believes these modifications to the proposal are appropriate because they reflect the practical effect of the fact that exchanges registered under Section 6(g) of the Act and national securities association registered under Section 15A(k) of the Act are also regulated by the CFTC. Under this dual regulatory scheme, proposed rule changes must become effective under both the Act and the CEA. The final rule makes clear that such an SRO's obligation to update its Web site to reflect rule changes arises only after such rule changes have become effective under both the Act and the CEA.

D. Form 19b-7 Amendments

1. Form 19b-7 Amendments

The Commission proposed to amend the instructions to Form 19b-7 to eliminate the requirement to submit nine paper copies and instead to require electronic filing of Form 19b-7. The Commission is adopting this amendment as proposed. To access the secure Internet site for Web-based filing of the Form 19b-7, an SRO will submit to the Commission an External Application User Authentication Form ("EAUF") to register each individual at the SRO who will be submitting Forms 19b-7 on behalf of the SRO. Upon receipt and verification of the information in the EAUF process, the Commission

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[35] See Rule 19b-4(m)(3).

will issue each such person a User ID and Password to permit access to the Commission's secure Web site. As Form 19b-7 will be electronic, initially the authorized user at an SRO will access a screen containing a filing template, referenced as Page 1, in which it can identify the SRO, enter a brief description of the proposed rule change, and enter a brief description of the SRO governing body action approval.[36] The SRO will provide contact information and place the electronic signature of a duly authorized officer on this Page 1 initial screen.[37] The second screen of the electronic Form 19b-7 will provide the SRO with a means to attach the proposed rule change and related exhibits in Microsoft Word format.[38] EAUF users will have electronic access to a mechanism to fulfill the requirements of the Form, as adapted for electronic filing.[39] Finally, the SRO will use the electronic Form 19b-7 to amend or withdraw a rule filing pending with the Commission.

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36 The authorized user also will be able to indicate if there will be a separate filing of any hard copy exhibits that are unable to be submitted electronically.

37 As noted supra notes 15-17, and accompanying text, a person that is a "duly authorized officer" at the SRO will be required to place his or her "electronic signature" on the Form 19b-7 before it is transmitted electronically to the Commission.

38 An SRO may also submit Exhibits 2, 3, and 5 in another acceptable electronic format, including Microsoft Excel, Microsoft PowerPoint, Adobe Acrobat, or Corel WordPerfect, if Microsoft Word is not available to the SRO or the document is not compatible with Microsoft Word.

39 For example, the SRO will click separate boxes on the second screen to attach documents containing the various exhibits; notices, written comments, transcripts, other communications; form, report, or questionnaire; proposed rule text; CFTC certification; the completed notice of the proposed rule change for publication in the Federal Register; and, marked copies of amendments if applicable.

The Commission also proposed a number of changes to Form 19b-7, unrelated to electronic filing, that are modeled after certain provisions in Form 19b-4, which the Commission believed would facilitate an SRO's proper filing of Form 19b-7. The Commission is adopting the changes to Form 19b-7 substantially as proposed. For example, the format of the Instructions to Form 19b-7 will be organized according to the sections currently used for Form 19b-4 Instructions, instead of the combination of questions and titles that serve as subject heads in the existing Instructions to Form 19b-7 currently. The amended Form 19b-7 will require the SRO to describe the purpose of the proposed rule change in sufficient detail to enable the public to provide meaningful public comment.[40] The Form 19b-7 will direct the SRO to relevant sections of the Act that are appropriate for discussion in the Statutory Basis section of the Form 19b-7 and will clarify that a mere assertion that the proposed rule change is consistent with the Act is not sufficient to describe why the proposed rule change is consistent with the Act. The amended Form 19b-7 will also provide updated instructions related to the solicitation of comments from interested persons regarding the proposed rule change. These updated instructions will include the new address where interested parties may direct comments to Form 19b-7 filings in hard copy and describe the manner in which comments may be submitted on the Commission Web site.

The changes to Form 19b-7 will alter the way that the Exhibits are organized and the Instructions to such Exhibits are presented. For example, the amended Instructions will direct an SRO to include the completed notice of the proposed rule change ("Form

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40 See also General Instructions for Form 19b-4, which establish a similar requirement for Form 19b-4.

19b-7 Notice" or "Notice") as Exhibit 1, whereas such notice is not assigned to an Exhibit in the existing Form 19b-7. The instructions for the Form 19b-7 Notice will be amended to include more detailed guidance on the current requirement that the Notice must be formatted to comply with the requirements for Federal Register publication. For example, the amended Instructions will provide guidance regarding Federal Register requirements relating to margin spacing, page numbering, and line spacing.

The subject of existing Exhibit 1, relating to communications with third parties on the subject of the proposed rule change, will move to Exhibit 2. The guidance in the existing Instructions to Exhibit 2 will be replaced, in Exhibit 3, with more detailed guidance as to how the SRO should present forms, reports, and questionnaires that the SRO proposes to use to implement the terms of the proposed rule change. The requirement to include the text of the proposed rule change will remain in Exhibit 4, but the requirement for the SRO to describe the anticipated effect of the proposed rule change would have on the application of other rules of the SRO will move to Section II(A)(1)(b) of the Form 19b-7 Notice.

The Commission is adopting as proposed, a requirement that an SRO submitting a Form 19b-7 attach, in Exhibit 5, a document reflecting the certificate of effectiveness of a proposed rule change, an SRO's request or the CFTC's determination that review of the proposed rule change is not necessary, or an SRO's request for CFTC approval or an indication from the CFTC that the proposed rule change has been approved. Page 1 of Form 19b-7 will provide a space for SROs to indicate which of these actions, noted in the preceding sentence, has been taken by the SRO or the CFTC. After further consideration of the issue, the Commission is modifying Page 1 to provide greater specificity as to the

status of the effectiveness of the proposed rule change. Accordingly, Page 1 will have separate boxes for the SRO to mark indicating whether it is attaching a copy of its request that the CFTC determine that review of the proposed rule change is not necessary or a copy of the CFTC's determination that review of the proposed rule change is not necessary. Similarly, an SRO will be able to mark separate boxes indicating whether the SRO is attaching a document reflecting the SRO's request that the CFTC approve the proposed rule change or to indicate that the SRO is attaching the CFTC's approval of the proposed rule change. Page 1 will also indicate that the SRO may submit more than one document in Exhibit 5.

As amended, the Instructions to Form 19b-7 describe circumstances under which an SRO must file an amendment to a proposed rule change and the procedures an SRO must follow when submitting an amendment electronically. The Instructions for Form 19b-7 state, in relevant part, that if "any information on this form or exhibit thereto is or becomes inaccurate before the proposed rule change becomes effective, the [SRO] shall file amendments correcting any such inaccuracy." This instruction, for example, will require an SRO to file an amended Exhibit 5 when the SRO receives notice from the CFTC that review of the proposed rule change is not necessary or that the CFTC has approved the proposed rule change, if the SRO receives such notice following the submission of the original proposed rule change.

The Commission believes that the changes to Form 19b-7, which are designed generally to conform to the updated Form 19b-4, will promote uniformity among SRO proposed rule change filings. This uniformity should facilitate SROs' compliance with the rule filing requirements under Section 19(b) and the Commission's review of

proposed rule changes. The changes are also expected to facilitate a speedy migration to electronic filing for SROs submitting proposed rule changes under Section 19(b)(7).

As noted above, the Commission recognizes that in rare circumstances SROs may be unable to file certain documents electronically with the Commission. Therefore, under these limited circumstances, the Commission would consider whether to allow SROs to file documents in paper format within five days of the electronic filing of all other required documents.[41] In the Electronic 19b-7 Proposing Release, the Commission solicited comment on whether there would be a need for an exception to the electronic filing requirement of Exhibit 5 to Form 19b-7. In response, the NFA suggested that while an explicit exception from the electronic filing requirement of Exhibit 5 was not necessary, the Commission should reserve the general exemptive authority to allow paper filings for all or part of a rule filing in unusual situations.[42] The Commission believes that the proposed rule changes filed pursuant to Section 19(b)(7) of the Act are usually not so time-sensitive that failure to file them with the Commission on a particular date will result in negative consequences to SROs, their members, or investors. In the rare situation where an SRO can demonstrate to the Commission that its inability to file a proposed rule change electronically on that particular date will cause harm to the SRO, its members, or investors, the Commission would consider appropriate relief. In such emergency situations, the Commission could consider an SRO's exemption request from

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[41] This exception from electronic filing would not apply to Page 1 to Form 19b-7 or Exhibits 1 and 4 thereto but would only be applicable to Exhibits 2 and 3, and any documents filed pursuant to a request for confidential treatment pursuant to the Freedom of Information Act, 5 U.S.C. 552.

[42] See NFA Letter at 2.

the electronic rule filing requirements of Section 19(b) of the Act pursuant to Rule 0-12 of the Act[43] and Section 36(a)(1) of the Act[44] "to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors." In making such findings, the Commission generally would consider important the existence of factors such as: (1) an extended electronic outage at the SRO facility or at the Commission; (2) a pressing need for implementation of the proposed rule change; and (3) a failure of back-up facilities. The Commission notes that SROs, in their business continuity planning, should ensure that they have appropriate back-up facilities to accommodate electronic filing of proposed rule changes. Accordingly, the Commission is adopting the rule as originally proposed, without a specific exception to permit SROs to file Exhibit 5 on paper.

2. Accurate, Consistent, and Complete Forms 19b-7

The Commission firmly believes that, to provide the public with a meaningful opportunity to comment, a proposed rule change must be accurate, consistent, and complete. Form 19b-7 states that the form, including the exhibits, is intended to elicit information necessary for the public to provide meaningful comment on the proposed rule change and for the Commission to determine whether abrogation of the proposal is appropriate because it unduly burdens competition or efficiency, conflicts with the securities laws, or is inconsistent with the public interest and protection of investors.[45]

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43 17 CFR 240.0-12.

44 15 U.S.C. 78mm(a)(1).

45 Section 19(b)(7)(C) of the Act grants to the Commission, after consultation with the CFTC, the authority to summarily abrogate a proposed rule change that has

The SRO must provide all the information called for by the form, including the exhibits, and must present the information in a clear and comprehensible manner.

Currently, Commission staff devotes significant time to processing proposed rule changes, reviewing them for accuracy and completeness, and preparing them for publication. SRO staff must ensure that the filings: (1) contain a properly completed Form 19b-7; (2) contain a clear and accurate statement of the authority for, and basis and purpose of, such rule change, including the impact on competition; (3) contain a summary of any written comments received by the SRO; (4) contain the proper certification submitted to the CFTC, any other appropriate determination made by the CFTC that a review of the proposed rule change is not necessary, or an indication that the CFTC has approved the proposed rule change; and (5) describe the impact of the proposed rule change on the existing rules of the SRO, including any other rules proposed to be amended. As described in the current Form 19b-7, filings that do not comply with the foregoing are deemed not filed and returned to the SRO. Under these amendments the Commission is adopting, electronically filed proposed rule changes that do not comply with the foregoing will continue to be returned to the SRO, but in electronic format, and, consistent with current practice, will be deemed not filed with the Commission until all required information has been provided.

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taken effect pursuant to Section 19(b)(7)(B) of the Act if it appears to the Commission that such a rule change unduly burdens competition or efficiency, conflicts with the securities laws, or is inconsistent with the public interest and the protection of investors.

E. Amendments to Form 19b-4

The Commission proposed to clarify on Form 19b-4 that an individual who signs the Form 19b-4 digitally must be an officer authorized by the SRO's governing body to sign proposed rule changes on behalf of the SRO. Accordingly, the Commission proposed to amend Page 1 of Form 19b-4 to add the word "officer" to follow the phrase "duly authorized" in the Signature Box appearing on that page.[46] The Commission notes that this change does not create any new obligation. Section F of the Instructions to Form 19b-4 provides that a "duly authorized officer" sign Form 19b-4 submissions, but the word "officer" was inadvertently omitted from the signature box when the electronic Form 19b-4 was adopted.[47] The Commission is adopting this amendment as proposed.

F. Date of Effectiveness of the Proposal

One commenter requested a 30 day delay before implementation of the proposed amendments.[48] The Commission believes that the SROs will benefit from an effective date that provides them with time to familiarize themselves with the EFFS and to make the technological changes to the procedures for updating their Web sites necessary to comply with the new obligations under this proposal. Accordingly, these amendments will become effective on **[insert date 30 days after publication in the Federal Register]**, 30 days following publication in the Federal Register.

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46 The proposed amendment to Form 19b-4 is attached as Appendix B.

47 See Electronic 19b-4 Adopting Release, supra note 7.

48 See NFA Letter at 3.

III. Paperwork Reduction Act

Certain provisions of the amendments to Rule 19b-7 and Form 19b-7 and Rule 19b-4 and Form 19b-4 contain "collection of information requirements" within the meaning of the Paperwork Reduction Act of 1995.[49] Accordingly, the Commission submitted the information to the Office of Management and Budget ("OMB") for review revisions to the current collection of information titled "Rule 19b-7 Under the Securities Exchange Act of 1934" (OMB Control No. 3235-0553). The Commission also submitted revisions to the current collection of information titled "Form 19b-7 Under the Securities Exchange Act of 1934" (OMB Control No. 3235-0553). In addition, the Commission has submitted revisions to the current collection of information titled "Rule 19b-4 Under the Securities Exchange Act of 1934" (OMB Control No. 3235-0045). Finally, the Commission submitted revisions to the current collection of information titled "Form 19b-4 Under the Securities Exchange Act of 1934" (OMB Control No. 3235-0045). 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. In the Electronic 19b-7 Proposing Release, the Commission solicited comments on the collection of information requirements, but received no response to the solicitation. Accordingly, the Commission is making no adjustments to the burden estimates provided in the Electronic 19b-7 Proposing Release.[50]

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[49] 44 U.S.C. 3501 et seq.

[50] See supra note 2, 72 FR 9412, 9418.

A. Summary of Collection of Information

Prior to these amendments, Rule 19b-7 required an SRO that proposes to add, delete, or amend its rules relating to certain subjects[51] to submit such proposed rule change to the Commission on Form 19b-7. Form 19b-7 required the respondent: (1) to state the purpose of the proposed rule change; (2) to state the authority and statutory basis for the proposed rule change; (3) to describe the proposal's impact on competition; (4) to provide a summary of any written comments on the proposed rule change received by the SRO; and (5) to describe the date upon which the proposed rule change becomes effective and provide supporting documentation relevant to the effectiveness date. The amendments add a requirement to Form 19b-7 that an SRO provide on Page 1 of Form 19b-7 more information about a staff member prepared to answer questions about the filing, such as the SRO staff member's title, email address and fax number. The amendments also require Web site posting of all proposed rule changes, and any amendments thereto. In addition, the amendments codify in Rule 19b-7 the requirement previously located in Rule 19b-4(m) that SROs submitting Form 19b-7 post a current and complete set of their rules on their Web sites. In response to a commenter's concerns, the Commission modified the amendment so that a security futures exchange or a limited purpose national securities association will be required to update its Web site within two business days after it files a written certification with the CFTC under Section 5c(c) of the Commodities Exchange Act, within two business days after the SRO's receipt of notice from the CFTC that it has determined that review of the proposed rule change is

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51 See 15 U.S.C. 78f(g)(4)(B)(i) and 78o-3(k)(3)(A).

not necessary, or within two business days after the SRO receives an indication from the CFTC that it has approved the proposed rule change, or within two business days of the Commission's notice of the proposed rule change, if such notice occurs after the CFTC certification, determination, or approval. The amendments also clarify that a mere assertion that the proposed rule change is consistent with the Act is not sufficient to describe why the proposed rule change is consistent with the Act. Rule 19b-4(m) will continue to require SROs to update their rules on their Web sites to reflect proposed rule changes filed pursuant to Section 19(b)(2) and 19(b)(3)(A) of the Act. Proposed Rule 19b-7(g) will require SROs to update their rule texts on their Web sites to reflect rule changes filed pursuant to Section 19(b)(7) of the Act following the Commission's notice of such proposed rule change, within two business days after such rule change takes effect. All SROs that file Form 19b-4 and Form 19b-7 currently post this information on their Web sites. Therefore, SROs will not be required to provide additional information to comply with proposed Rule 19b-7(g) and current Rule 19b-4(m).

B. Use of Information

The information provided via EAUF, as required by the amendments to Form 19b-7, will be used by the Commission to verify the identity of the individual representing the SRO and provide such individual access to a secure Commission Web site for filing of the Form 19b-7. The amendment will require that SROs post their proposed rule changes filed pursuant Section 19(b)(7) of the Act on their Web sites, so that these proposals could be viewed by the general public, SRO members, competing SROs, other market participants, and Commission staff. The information will enable interested parties to more easily access SRO rules and rule filings, which will facilitate

public comment on proposed SRO rules. In addition, SRO staff, members, industry participants, and Commission staff will utilize the accurate and current version of SRO rules that are posted on the SRO Web site to facilitate compliance with such rules.

C. Respondents

There are currently five SROs[52] registered with the Commission as national securities exchanges under Section 6(g) of the Act or as a national securities association registered with the Commission under Section 15A(k) of the Act subject to the collection of information for Rule 19b-7, though that number may vary owing to the consolidation of SROs or the introduction of new entities. In a fiscal year, these respondents filed an average of 12 rule change proposals and 3 amendments to those proposed rule change proposals, for an average of 15 filings per fiscal year that are subject to the current collection of information.[53] Of the 12 proposed rule changes filed by SROs, all 12 ultimately became effective because the SROs did not withdraw any proposed rule changes.

D. Total Annual Reporting and Recordkeeping Burden

1. Background

The amendments to Rule 19b-7 and Form 19b-7 are designed to modernize the SRO rule filing process and to make the process more efficient by conserving both SRO

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52 The Board of Trade of the City of Chicago, Inc. ("CBOT"), Chicago Mercantile Exchange, Inc. ("CME"), CBOE Futures Exchange LLC ("CFE"), NFA, and OneChicago LLC ("OC").

53 Since the implementation of the CFMA in 2001 to September 30, 2006, SROs have filed 62 proposed rule changes pursuant to Section 19(b)(7) of the Act and 13 amendments.

and Commission resources. Rule 19b-7 and Form 19b-7 are amended to require SROs to electronically file their proposed rule changes. Form 19b-7 is revised to accommodate electronic submission. In addition, SROs will be required to post on their Web sites proposed rule changes submitted on Form 19b-7 to the Commission and amendments thereto. A conforming amendment codifies in Rule 19b-7 the current requirement in Rule 19b-4(m) for SROs to maintain a current and complete set of their rules on their Web site.

2. Rule 19b-7 and Form 19b-7

The Commission does not expect that the amendments to Rule 19b-7 and Form 19b-7 relating to electronic filing of proposed rule changes and amendments will impose any material upfront cost on SROs. The technology for electronic filing will be Web-based; therefore, the SROs are not expected to have any material upfront technology expenditures for electronic filing because all SROs currently have access to the Internet.

However, each SRO will be required to obtain a digital ID from a certificating authority. The Commission estimates the annual cost of the ID to be approximately $20 for each SRO.[54] The Commission estimates that each SRO will purchase five such digital IDs for its staff. Thus, the annual cost of the ID for all SROs is expected to be approximately $500 (5 SROs x $20 x 5). The Commission included these estimates in its proposal and received no comments on them.

In addition, the Commission believes that SROs may incur some costs associated with training their personnel about the procedures for submitting proposed rule changes

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[54] This estimate is based upon the $19.95 price displayed for the ID on VeriSign's Web site as of October 2, 2007.

electronically via EFFS. However, the Commission believes that such costs will be one-time costs and relatively insubstantial since the SROs are already familiar with the information required in filing a proposed rule change with the Commission and will be required to submit the same information they currently submit in electronic form under these amendments. Based on the experience of the Commission staff in training SROs for the implementation of electronic Form 19b-4 filings, the Commission estimates that each SRO will spend approximately two hours training each staff member who will use the EFFS to submit the proposed rule changes electronically. Accordingly, the Commission estimates that the upfront cost of training SRO staff members to use EFFS will be 50 hours (5 SROs x 2 hours x 5 staff members). The Commission included these estimates in its proposal and received no comments on them.

An SRO rule change proposal is generally filed with the Commission after an SRO's staff has obtained approval from its Board. The time required to complete a filing varies significantly and is difficult to separate from the time an SRO spends in developing internally the proposed rule change. However, the Commission estimates that 15.5 hours is the amount of time required to complete an average rule filing using present Form 19b-7.[55] This figure includes an estimated 11.5 hours of in-house legal work and four hours of clerical work. The amount of time required to prepare amendments varies because some amendments are comprehensive, while other amendments are submitted in the form of a one-page letter. The Commission estimates that, under current rules, seven hours is the amount of time required to prepare an amendment to the rule proposal. This

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[55] See Electronic 19b-7 Proposing Release, supra note 2.

figure includes an estimated two hours of in-house legal work and five hours of clerical work. The Commission included these estimates in its proposal and received no comments on them.

Based upon the experience of electronic filing of proposed rule changes on Form 19b-4, the Commission expects that an electronic Form 19b-7 and new requirements to Form 19b-7 will reduce by three hours the amount of SRO clerical time required to prepare the average proposed rule change and by four hours for an amendment thereto. The Commission does not believe that the new instruction specifying that an SRO describe the purpose of the proposed rule change in sufficient detail to enable the Commission to determine whether abrogation is appropriate will add any additional burden to the Form 19b-7 filing process because the existing Instructions to Form 19b-7 already required that all information in the Form must be presented in a manner which will enable the Commission to make such a determination. The Commission does not believe that the additional contact information of an SRO staff member on Page 1 of the Form will add any measurable burden to an SRO submitting a Form 19b-7, because the information is so readily accessible to the party submitting the filing. The Commission does not believe that requiring the SROs to indicate on Page 1 of Form 19b-7 whether the CFTC has determined that review of the proposed rule change is not necessary or that the CFTC has approved the proposed rule change, as proposed herein, will create any addition burden to the SROs because the SROs are already required to indicate such information in Exhibit 1 to Form 19b-7. With the proposed electronic filing, the Commission staff estimates that 12.5 hours is the amount of time that will be required to complete an average rule filing and that three hours is the amount of time required to

complete an average amendment. These figures reflect the three hours in savings in clerical hours that would result from the use of an electronic form for rule filings and four hours for amendments.[56] The Commission estimates that the reporting burden for filing rule change proposals and amendments with the Commission under the proposed amendments will be 159 hours (12 rule change proposals x 12.5 hours + 3 amendments x 3 hours). The Commission included these estimates in its proposal and received no comments on them.

3. Posting of Proposed Rule Changes filed under Rule 19b-7 on SRO Web sites

The amendments also require SROs to post proposed rule changes filed under Rule 19b-7, and any amendments thereto, on their Web sites. The Commission estimates that 30 minutes is the amount of time that will be required to post a proposed rule on an SRO's Web site and that 30 minutes is the amount of time that will be required to post an amendment on an SRO's Web site.[57] The Commission estimates that the reporting burden for posting rule change proposals and amendments on the SRO Web sites will be approximately eight hours (12 rule change proposals x 0.5 hours + 3 amendments x 0.5 hours). The Commission included these estimates in its proposal and received no comments on them.

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[56] The SROs' four hour time savings would result from the elimination of tasks, such as making multiple copies of the Form 19b-7 and amendments, arranging for couriers, and making follow-up telephone calls to ensure Commission receipt.

[57] This estimate is based on information from the Commission's Office of Information Technology.

4. SRO Rule Text

Currently, all SROs are required to post their current rules on their Web sites pursuant to Rule 19b-4(m). The Commission estimates, based upon its analysis in the Electronic 19b-4 Adopting Release, that the amount of the time required to update an SRO's rule text on its Web site after a proposed rule change becomes effective to be four hours. Proposed rule changes submitted under Section 19(b)(7)(A) become effective an average of 12 times a year. Therefore, the Commission estimates that the reporting burden for updating the posted SRO rules on the SRO Web site will be 48 hours (12 proposed rule changes submitted pursuant to Section 19(b)(7)(A) x 4 hours). The Commission included these estimates in its proposal and received no comments on them.

The amendment will move the burden associated with complying with this provision from Rule 19b-4(m) to Rule 19b-7(g). Based upon the Commission's reporting burden estimate described above, the Commission estimates that the amendments will reduce the burden associated with SROs' compliance with the requirement provided in Rule 19b-4 that SROs post current and complete rule text on their Web sites and update that rule text after it changes following the effectiveness of a proposed rule change by 48 hours annually and increase the corresponding burden for compliance with Rule 19b-7 by 48 hours. The Commission anticipates that the amendments to Rule 19b-7(g) proposed herein, relating to the timing of updates to SRO rules do not impact the compliance burden for this rule. The Commission included these estimates in its proposal and received no comments on them.

In addition, in response to comments from the NFA, the Commission is also modifying Rule 19b-4(m) as it applies to an exchange registered with the Commission

under Section 6(g) or a limited purpose national securities association registered under Section 15A(k). In its comment letter, the NFA noted that receipt of notification of CFTC action is not always immediate and requested that the Commission change the period within which an exchange registered with the Commission under Section 6(g) or a limited purpose national securities association registered under Section 15A(k) is required to update its Web site to be based on receipt of CFTC action and not the date the CFTC action occurs.[58] In response to this comment, Rule 19b-7(g) will now will require that an exchange registered with the Commission under Section 6(g) or a limited purpose national securities association registered under Section 15A(k) to update its rule text on its Web site to reflect rule changes filed under Section 19(b)(2) of the Act within two business day of the later of: (1) Commission approval of the proposed rule change; or (2) the SRO's filing of a written certification with the CFTC under Section 5c(c) of the Commodities Exchange Act, notice from the CFTC that it has determined that review of the proposed rule change is not necessary, or notice from the CFTC that it has approved the proposed rule change. The Commission does not believe this amendment will create any additional burden to SROs because the all SROs are already required to update their Web sites following the Commission's approval of rule changes submitted to the Commission pursuant to Section 19(b)(2) of the Act.

5. Total Annual Reporting Burden

The Commission estimates that the total annual reporting burden under the proposed rule will be 167 hours (159 hours for filing proposed rule changes and

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[58] See NFA Letter, supra note 10 at 2-3.

amendments + 8 hours for posting proposed rule changes and amendments on the SROs' Web sites + 48 hours for posting and updating complete sets of SRO rule text pursuant to Rule 19b-7 – 48 hours for posting and updating complete sets of SRO rule text pursuant to Rule 19b-4).

In addition to the 167 hour annual burden, the Commission believes that SROs may incur some costs associated with training their personnel about the procedures for submitting proposed rule changes electronically and submission of the information via EFFS. However, the Commission believes that such costs will be one-time costs and relatively insubstantial since the SROs are already familiar with the information required in filing a proposed rule change with the Commission and will be required to submit the information (already required to be submitted) electronically under this proposal. The Commission estimates that each SRO will spend approximately two hours training each staff member who will use the EFFS to submit the proposed rule changes electronically. Accordingly, the Commission estimates that the upfront cost of training SRO staff members to use EFFS will be 50 hours (5 SROs x 2 hours x 5 staff members).

The Commission does not expect that the amendments with regard to electronic filing will impose any material additional costs on SROs. Instead, the Commission believes that the amendments to Rule 19b-7 and Form 19b-7, on balance, will reduce paperwork costs related to the submission of SRO proposed rule changes. The technology for electronic filing will be Web-based; therefore, the SROs are not expected to have any technology expenditures for electronic filing because all SROs currently have access to the Internet.

As previously stated, the SROs may incur costs of eight hours annually to post on their Web site their proposed rules, and amendments thereto, no later than two business days after filing with by the Commission. With regard to posting of and updating of accurate and complete text of SRO final rules, the Commission believes that the amendments will increase the burden associated with complying Rule 19b-7 by 48 hours and reduce the burden associated with complying with Rule 19b-4 by 48 hours. In addition, the Commission does not anticipate that SROs will incur any additional costs in complying with the change to Form 19b-4, which adds the word "officer" to the Signature Box because the addition of the word simply provides transparency to an obligation that already exists.[59] Accordingly, the Commission does not believe that SROs will incur any additional costs in posting this information on their Web sites.

E. Retention Period of Recordkeeping Requirements

The SROs will be required to retain records of the collection of information (the manually signed signature page of the Form 19b-7) for a period of not less than five years, the first two years in an easily accessible place, according to the current recordkeeping requirements set forth in Rule 17a-1 under the Act.[60] The SROs will be required to retain proposed rule changes, and any amendments, on their Web sites until 60 days after effectiveness of the proposed rule that is filed with both the Commission and the CFTC or within two business days of withdrawal of the proposed rule change or notification that it is

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59 See Section F of the Instructions to Form 19b-4.

60 SROs may also destroy or otherwise dispose of such records at the end of five years according to Rule 17a-5 under the Act. 17 CFR 240.17a-5.

improperly filed.[61] The SRO will be required at all times to maintain an accurate and up-to-date copy of all of its rules on its Web site.[62]

F. Collection of Information is Mandatory

Any collection of information pursuant to the amendments to Rule 19b-7 and Form 19b-7 to require electronic filing with the Commission of SRO proposed rule changes will be a mandatory collection of information filed with the Commission as a means for the Commission to review, and, as required, take action with respect to SRO proposed rule changes. Any collection of information pursuant to amendments to require Web site posting by the SROs of their proposed and final rules will also be a mandatory collection of information.

G. Responses to Collection of Information Will Not Be Kept Confidential

Other than information for which an SRO requests and obtains confidential treatment in accordance with the provisions of 5 U.S.C. 522, the collection of information pursuant to amendments to Rule 19b-7 and Form 19b-7 under the Act will not be confidential and will be publicly available.[63]

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61 See Rule 19b-7(f).

62 See Rule 19b-7(g).

63 Consistent with applicable law, proposed SRO rule changes containing proprietary or otherwise sensitive information may be accorded confidential treatment, including requests submitted pursuant to the protection afforded for such information in the Freedom of Information Act, 5 U.S.C. 552.

IV. Costs and Benefits of the Rulemaking

In the Electronic 19b-7 Proposing Release, the Commission identified certain costs and benefits of the amendments to Rule 19b-7 and Form 19b-7.[64] As noted, the Commission estimates that the total annual paperwork reporting burden under the proposed rule will be 167 hours. The Commission, however, believes that there will be an overall reduction of costs based on the amendments.[65] The Commission received one comment letter relating to the cost and benefits of the proposed amendments.[66] The commenter expressed its belief that the amendment will reduce the costs and burdens associated with compliance with Rule 19b-7 and Form 19b-7. Thus, after careful consideration, the Commission is not modifying its costs and benefits analysis from that presented in the Electronic 19b-7 Proposing Release[67] and believes that the benefits of the amendments justify the costs that they will impose.

A. Benefits

The amendments are designed to modernize the filing, receipt, and processing of SRO proposed rule changes and to make the SRO rule filing process more efficient by conserving both SRO and Commission resources. The Commission believes that the changes to Rule 19b-7 and Form 19b-7 will permit SROs to file proposed rule changes

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64 See supra note 2, 72 FR 9412, 9418.

65 As noted in the Paperwork Reduction Act analysis, the Commission staff based this total reporting burden of 159 hours for filing proposed rule changes and amendments + 8 hours for posting proposed rule changes and amendments on the SROs' Web sites + 48 hours for posting and updating complete sets of SRO rule text pursuant to Rule 19b-7 – 48 hours for posting and updating complete sets of SRO rule text pursuant to Rule 19b-4.

66 See NFA Letter, supra note 10.

67 See Proposing Release, supra note 2 at 27-30.

with the Commission more quickly and economically. For example, SROs are currently required to pay for delivery costs of multiple paper copies to the Commission and incur costs associated with monitoring the Commission's Public Reference Room for competitors' rule filings. Requiring SROs to electronically file proposed rule changes under Rule 19b-7 is expected to reduce expenses associated with clerical time, postage, and copying and to increase the speed, accuracy, and availability of information beneficial to investors, other SROs, and financial markets.

The Commission does not expect that the amendments will impose additional costs on SROs. Instead, the Commission believes that the amendments to Rule 19b-7 and Form 19b-7, on balance, will reduce costs related to the submission of SRO proposed rule changes. The technology for electronic filing will be Web-based; therefore, the SRO is not expected to have any material increase in technology expenditures for electronic filing because all SROs currently have access to the Internet. Accordingly, the Commission believes that the amendments to Rule 19b-7 and Form 19b-7, by requiring the SROs to submit proposed rule changes electronically, will reduce their costs.

Because Commission staff will no longer manually process the receipt and distribution of SRO rule filings submitted on Form 19b-7, electronic filing will also expedite the Commission's receipt of SRO proposed rule changes filed under Rule 19b-7 and provide the SROs with the certainty that the Commission has received the proposed rule changes and has captured pertinent information about the rule changes in SRTS. Based on the Commission's experience with electronic filing of Form 19b-4, the Commission believes that integrating this electronic filing technology with SRTS will

also enhance the Commission's ability to monitor and process SRO proposed rule changes filed on Form 19b-7.

Moreover, requiring SROs to post proposed rule changes filed under Rule 19b-7 on their Web sites no later than two business days after filing with the Commission is designed to increase availability of SRO proposed rules and thereby facilitate the ability of interested parties to comment on proposed rule changes. For instance, the posting of these proposed rule changes will provide the public with access to the filings on the SROs' Web sites and thereby reduce the burden on SRO and Commission staff related to providing information about proposed rule changes to interested parties. The Commission believes that the posting of the proposed rule changes submitted on Form 19b-7 will also save SRO resources that are currently being used to monitor the Commission's Public Reference Room for competitors' proposed rule changes.

B. Costs

As previously noted, the Commission estimates that the annual paperwork reporting costs will be 167 hours under the proposed rule. The Commission believes that SROs may incur some costs associated with training their personnel about the procedures for submitting proposed rule changes electronically and submission of the information via EFFS. However, the Commission believes that such costs will be one-time costs and insubstantial since the SROs are already familiar with the information required in filing a proposed rule change with the Commission and will be required to submit the same information electronically under these amendments. In the Electronic 19b-7 Proposing Release, the Commission estimated that the total amount of one-time costs that SROs will incur in training personnel how to use EFFS is 50 hours and received no comments on

this estimate. The Commission believes that the SROs may also incur some minimal costs (currently $20 per year) associated with purchasing digital IDs for each duly authorized officer electronic signatories.[68] The Commission also believes that the SROs will have to make temporary adjustments to their recordkeeping procedures since the SROs will be required to print out the Form 19b-7 signature block, manually sign proposed rule changes, and retain the manual signature for not less than five years. However, there are not expected to be additional costs associated with such recordkeeping as SROs are currently required to retain the Form 19b-7 for not less than five years.

Moreover, the Commission believes that the requirement that SROs post proposed rule changes on their Web sites will impose some but not substantial costs on most SROs. The Commission notes that no new costs will be associated with posting a current and complete version of their rules on their Web site because currently all SROs promptly post this information on their Web sites pursuant to Rule 19b-4(m). In addition, the Commission does not anticipate that SROs will incur any material additional costs in complying with the change to Form 19b-4, which adds the word "officer" to the Signature Box because the addition of the word simply provides transparency to an obligation that already exists.[69] Therefore, at all times, each SRO must maintain a current and complete set of its rules to facilitate compliance with this requirement.

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68 In the Electronic 19b-7 Proposing Release, the Commission estimated that each SRO will purchase five of their staff such digital IDs. Thus, the annual cost of the digital ID for all SROs will be $500 (5 SROs x $20 x 5). The Commission received no comments on this estimate.

69 See Section F of the Instructions to Form 19b-4.

Accordingly, the Commission does not believe that SROs will incur substantial costs in simply posting this information on their Web sites because they are already required to do so.

V. Consideration of the Burden on Competition, Promotion of Efficiency, and Capital Formation

Section 3(f) of the Act[70] 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 will promote efficiency, competition, and capital formation. In addition, Section 23(a)(2) of the Act[71] 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.

In the Electronic 19b-7 Proposing Release, the Commission considered how the proposed amendments to Rule 19b-7 and Form 19b-7 would impact competition among SROs, and whether they would promote efficiency and capital formation.[72] The Commission requested comment on the competitive or anticompetitive effects of the amendments to Rule 19b-7 and Form 19b-7 on any market participants if adopted as proposed. The Commission also requested comment on what impact the amendments, if adopted, would have on efficiency and capital formation. The Commission requested

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70 15 U.S.C. 78c(f).

71 15 U.S.C. 78w(a)(2).

72 See supra note 1, 72 FR 9412, 9419.

commenters to provide empirical data to support their views. The NFA and Dr. Angel both commented that they believed that the proposal would increase the efficiency of the 19b-7 rule filing process.[73]

The amendments are intended to modernize the receipt and review of SRO proposed rule changes and to make the SRO rule filing process more efficient by conserving both SRO and Commission resources. As a result of the new requirement to file proposed rule changes electronically, the Commission anticipates that SROs will save time and resources currently devoted to corresponding under a paper-based system. As discussed in further detail in Section IV ("Costs and Benefits of the Rulemaking"), the Commission anticipates that SROs will save staff time in the preparation and transmission of Form 19b-7 as well as associated preparation and delivery costs.

The amendments also are intended to improve the transparency of the SRO rule filing process and facilitate access to current and complete sets of SRO rules. The Commission believes that the Web site posting of rule filings submitted on Form 19b-7 will promote competition among SROs because they will be able to determine the proposed rules of their competitors more easily. Further, because the proposal does not impact a significant number of businesses or investors, the Commission believes it will have minimal impact on capital formation.

VI. Regulatory Flexibility Act Certifications

The Commission has certified, pursuant to Section 605(b) of the Regulatory

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[73] See Angel Letter and NFA Letter, supra note 10.

Flexibility Act,[74] that the amendments to Rule 19b-7 and Form 19b-7 and Rule 19b-4 and Form 19b-4 will not have a significant economic impact on a substantial number of small entities. This certification, including the reasons supporting the certification, was incorporated into the Electronic 19b-7 Proposing Release.[75] The Commission solicited comments as to the nature of any impact on small entities. No comments were received.

VII. Statutory Basis and Text of Proposed Amendments

The amendments to Rule 19b-7 and Form 19b-7 under the Act are being adopted pursuant to 15 U.S.C. 78a et seq., particularly sections 3(b), 6, 15A, 19(b), and 23(a) of the Act.

List of Subjects in 17 CFR Parts 240, and 249

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 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.

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74 5 U.S.C. 605(b).

75 See supra note 2, 72 FR 9412, 9419-20.

* * * * *

2. Section 240.19b-4 is amended by revising paragraph (m) to read as follows:

§ 240.19b-4 Filings with respect to proposed rule changes by self-regulatory organizations.

* * * * *

(m) (1) Each self-regulatory organization shall post and maintain a current and complete version of its rules on its Web site.

(2) A self-regulatory organization, other than a self-regulatory organization that is registered with the Commission under section 6(g) of the Act (15 U.S.C. 78f(g)) or pursuant to section 15A(k) of the Act (15 U.S.C. 78o-1(k)), shall update its Web site to reflect rule changes filed pursuant to section 19(b)(2) of the Act (15 U.S.C. 78s(b)(2)) within two business days after it has been notified of the Commission's approval of a proposed rule change, and to reflect rule changes filed pursuant to section 19(b)(3)(A) of the Act (15 U.S.C. 78s(b)(3)(A)) within two business days of the Commission's notice of such proposed rule change.

(3) A self-regulatory organization that is registered with the Commission under section 6(g) of the Act (15 U.S.C. 78f(g)) or pursuant to section 15A(k) of the Act (15 U.S.C. 78o-1(k)), shall update its Web site to reflect rule changes filed pursuant to section 19(b)(2) of the Act by two business days after the later of:

(A) Notification that the Commission has approved a proposed rule change; and

(B) (i) The filing of a written certification with the Commodity Futures Trading Commission under section 5c(c) of the Commodity Exchange Act (7 U.S.C. 7a-2(c));

(ii) Receipt of notice from the Commodity Futures Trading Commission that it has determined that review of the proposed rule change is not necessary; or

(iii) Receipt of notice from the Commodity Futures Trading Commission that it has approved the proposed rule change.

(4) If a rule change is not effective for a certain period, the self-regulatory organization shall clearly indicate the effective date in the relevant rule text.

* * * * *

3. Section 240.19b-7 is amended by:

a. Adding a preliminary note;

b. Revising paragraphs (a) and (b)(1); and

c. Adding paragraphs (d), (e), (f) and (g)

The additions and revisions read as follows:

§240.19b-7 Filings with respect to proposed rule changes submitted pursuant to Section 19(b)(7) of the Act.

Preliminary Note: A self-regulatory organization also must refer to Form 19b-7 (17 CFR 249.822) for further requirements with respect to the filing of proposed rule changes.

(a) Filings with respect to proposed rule changes by a self-regulatory organization submitted pursuant to section 19(b)(7) of the Act (15 U.S.C. 78s(b)(7)) shall be made electronically on Form 19b-7 (17 CFR 249.822).

(b) ***

(1) A completed Form 19b-7 (17 CFR 249.822) is submitted electronically; and

* * * * *

(d) Filings with respect to proposed rule changes by a self-regulatory organization submitted on Form 19b-7 (17 CFR 249.822) electronically shall contain an electronic signature. For the purposes of this section, the term electronic signature means an electronic entry in the form of a magnetic impulse or other form of computer data compilation of any letter or series of letters or characters comprising a name, executed, adopted or authorized as a signature. The signatory to an electronically submitted rule filing shall manually sign a signature page or other document, in the manner prescribed by Form 19b-7, authenticating, acknowledging or otherwise adopting his or her signature that appears in typed form within the electronic filing. Such document shall be executed before or at the time the rule filing is electronically submitted and shall be retained by the filer in accordance with 17 CFR 240.17a-1.

(e) If the conditions of this section and Form 19b-7 (17 CFR 249.822) are otherwise satisfied, all filings submitted electronically on or before 5:30 p.m. Eastern Standard Time or Eastern Daylight Saving Time, whichever is currently in effect, on a business day, shall be deemed filed on that business day, and all filings submitted after 5:30 p.m. Eastern Standard Time or Eastern Daylight Saving Time, whichever is currently in effect, shall be deemed filed on the next business day.

(f) The self-regulatory organization shall post the proposed rule change, and any amendments thereto, submitted on Form 19b-7 (17 CFR 249.822), on its Web site within two business days after the filing of the proposed rule change, and any amendments thereto, with the Commission. Unless the self-regulatory organization withdraws the proposed rule change or is notified that the proposed rule change is not properly filed,

such proposed rule change and amendments shall be maintained on the self-regulatory organization's Web site until 60 days after:

(1) The filing of a written certification with the Commodity Futures Trading Commission under section 5c(c) of the Commodity Exchange Act (7 U.S.C. 7a-2(c));

(2) The Commodity Futures Trading Commission determines that review of the proposed rule change is not necessary; or

(3) The Commodity Futures Trading Commission approves the proposed rule change; and

(4) In the case of a proposed rule change, or any amendment thereto, that has been withdrawn or not properly filed, the self-regulatory organization shall remove the proposed rule change, or any amendment, from its Web site within two business days of notification of improper filing or withdrawal by the self-regulatory organization of the proposed rule change.

(g)(1) Each self-regulatory organization shall post and maintain a current and complete version of its rules on its Web site.

(2) The self-regulatory organization shall update its Web site to reflect rule changes filed pursuant to section 19(b)(7) of the Act (15 U.S.C. 78s(b)(7)), by two business days after the later of:

(A) The Commission's notice of such proposed rule change; and

(B)(i) The filing of a written certification with the Commodity Futures Trading Commission under section 5c(c) of the Commodity Exchange Act (7 U.S.C. 7a-2(c));

(ii) Receipt of notice from the Commodity Futures Trading Commission that it has determined that review of the proposed rule change is not necessary; or

(iii) Receipt of notice from the Commodity Futures Trading Commission that it has approved the proposed rule change.

(3) If a rule change is not effective for a certain period, the self-regulatory organization shall clearly indicate the effective date in the relevant rule text.

PART 249 - FORMS, SECURITIES EXCHANGE ACT OF 1934

4. 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.

5. Section 249.822 is revised to read as follows:

§249.822 Form 19b-7, for electronic filing with respect to proposed rule changes by self-regulatory organizations under Section 19(b)(7)(A) of the Securities Exchange Act of 1934.

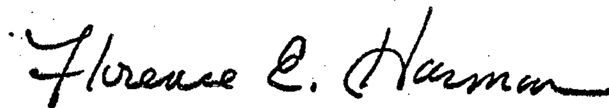
This form shall be used by self-regulatory organizations, as defined in section 3(a)(25) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(25)), to file electronically proposed rule changes with the Commission pursuant to section 19(b)(7) of the Act (15 U.S.C. 78s(b)(7)) and §240.19b-7 of this chapter.

6. Form 19b-7 (referenced in §249.822) is revised to read as follows:

[Note: Form 19b-7 is attached as Appendix A to this document.]

[Note: The text of Form 19b-7 will not appear in the Code of Federal Regulations.]

By the Commission.



Florence E. Harmon
Deputy Secretary

Date: March 19, 2008

APPENDIX A

GENERAL INSTRUCTIONS FOR FORM 19b-7

A. Use of the Form

All self-regulatory organization proposed rule changes submitted pursuant to Section 19(b)(7) of the Securities Exchange Act of 1934 ("Act"), shall be filed electronically through the Electronic Form Filing System ("EFFS"), a secure Web site operated by the Commission. This form shall be used for filings of proposed rule changes by all self-regulatory organizations pursuant to Section 19(b)(7) of the Act. National securities exchanges registered pursuant to Section 6(g) of the Act and limited purpose national securities associations registered pursuant to Section 15A(k) of the Act are self-regulatory organizations for purposes of this form.

B. Need for Careful Preparation of the Completed Form, Including Exhibits

This form, including the exhibits, is intended to elicit information necessary for the public to provide meaningful comment on the proposed rule change and for the Commission to determine whether abrogation of the proposal is appropriate because it unduly burdens competition or efficiency, conflicts with the securities laws, or is inconsistent with the public interest and the protection of investors. The self-regulatory organization must provide all the information called for by the form, including the exhibits, and must present the information in a clear and comprehensible manner.

The proposed rule change shall be considered filed with the Commission on the date on which the Commission receives the proposed rule change if the filing complies with all requirements of this form. Any filing that does not comply with the requirements of this form may be returned to the self-regulatory organization at any time before the

issuance of the notice of filing. Any filing so returned shall for all purposes be deemed not to have been filed with the Commission. See also Rule 0-3 under the Act (17 CFR 240.0-3).

C. Documents Comprising the Completed Form

The completed form filed with the Commission shall consist of the Form 19b-7 Page 1, numbers and captions for all items, responses to all items, and exhibits required in Instruction H. In responding to an item, the completed form may omit the text of the item as contained herein if the response is prepared to indicate to the reader the coverage of the item without the reader having to refer to the text of the item or its instructions. Each filing shall be marked on the Form 19b-7 with the initials of the self-regulatory organization, the four-digit year, and the number of the filing for the year (i.e., SRO-YYYY-XX). If the self-regulatory organization is filing Exhibit 2 or 3 via paper, the exhibits must be filed within 5 business days of the electronic submission of all other required documents.

D. Amendments

If information on this form or exhibit thereto is or becomes inaccurate before the proposed rule change becomes effective, the self-regulatory organization shall file amendments correcting any such inaccuracy. Amendments shall be filed as specified in Instruction E.

Amendments to a filing shall include the Form 19b-7 Page 1 marked to number consecutively the amendments, numbers and captions for each amended item, amended response to the item, and required exhibits. The amended description in Section II. A. 1. of Exhibit 1 shall explain the purpose of the amendment and, if the amendment changes

the purpose of or basis for the proposed rule change, the amended response shall also provide a revised purpose and basis statement for the proposed rule change. Exhibit 1 shall be re-filed if there is a material change from the immediately preceding filing in the language of the proposed rule change or in the information provided.

If the amendment alters the text of an existing rule, the amendment shall include the text of the existing rule, marked in the manner described in Section I. of Exhibit 1 using brackets to indicate words to be deleted from the existing rule and underscoring to indicate words to be added. The purpose of this marking requirement is to maintain a current copy of how the text of the existing rule is being changed.

If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission staff's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e., partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

If, after the rule change is filed but before it becomes effective, the self-regulatory organization receives or prepares any correspondence or other communications reduced to writing (including comment letters) to and from such self-regulatory organization concerning the proposed rule change, the communications shall be filed as Exhibit 2. If information in the communication makes the rule change filing inaccurate, the filing shall be amended to correct the inaccuracy. If such communications cannot be filed electronically in accordance with Instruction E, the communications shall be filed in accordance with Instruction F.

E. Signature and Filing of the Completed Form

All proposed rule changes, amendments, extensions, and withdrawals of proposed rule changes shall be filed through the EFFS. In order to file Form 19b-7 through EFFS, self-regulatory organizations must request access to the SEC's External Application Server by completing a request for an external account user ID and password for the use of the External Application User Authentication Form.

Initial requests will be received by contacting the Division of Trading and Markets Administrator located on our Web site (http://www.sec.gov). An e-mail will be sent to the requestor that will provide a link to a secure Web site where basic profile information will be requested.

A duly authorized officer of the self-regulatory organization shall electronically sign the completed Form 19b-7 as indicated on Page 1 of the Form. In addition, a duly authorized officer of the self-regulatory organization shall manually sign one copy of the completed Form 19b-7, and the manually signed signature page shall be maintained pursuant to Section 17 of the Act.

F. Procedures for Submission of Paper Documents for Exhibits 2 and 3

To the extent that Exhibit 2 or 3 cannot be filed electronically in accordance with Instruction E, four copies of Exhibit 2 or 3 shall be filed with the Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-6628. Page 1 of the electronic Form 19b-7 shall accompany paper submissions of Exhibit 2 or 3. If the self-regulatory organization is filing Exhibit 2 or 3 via paper, they must be filed within five days of the electronic filing of all other required documents.

G. Withdrawals of Proposed Rule Changes

If a self-regulatory organization determines to withdraw a proposed rule change, it must complete Page 1 of the Form 19b-7 and indicate by selecting the appropriate check box to withdraw the filing.

H. Exhibits

List of exhibits to be filed, as specified in Instructions C and D:

Exhibit 1. Completed Notice of Proposed Rule Change for publication in the Federal Register. It is the responsibility of the self-regulatory organization to prepare Items I, II and III of the notice. Leave a 1-inch margin at the top, bottom, and right hand side, and a 1 ½ inch margin at the left hand side. Number all pages consecutively. Double space all primary text and single space lists of items, quoted material when set apart from primary text, footnotes, and notes to tables. Amendments to Exhibit 1 should be filed in accordance with Instructions D and E.

Exhibit 2. (a) Copies of notices issued by the self-regulatory organization soliciting comment on the proposed rule change and copies of all written comments on the proposed rule change received by the self-regulatory organization (whether or not comments were solicited), presented in alphabetical order, together with an alphabetical listing of such comments. If such notices and comments cannot be filed electronically in accordance with Instruction E, the notices and comments shall be filed in accordance with Instruction F.

(b) Copies of any transcript of comments on the proposed rule change made at any public meeting or, if a transcript is not available, a copy of the summary of comments on the proposed rule change made at such meeting. If such transcript of comments or

summary of comments cannot be filed electronically in accordance with Instruction E, the transcript of comments or summary of comments shall be filed in accordance with Instruction F.

(c) Any correspondence or other communications reduced to writing (including comment letters and e-mails) concerning the proposed rule change prepared or received by the self-regulatory organization. All correspondence or other communications should be presented in alphabetical order together with an alphabetical listing of the authors, and shall be filed in accordance with Instruction E. If such communications cannot be filed electronically in accordance with Instruction E, the communications shall be filed in accordance with Instruction F.

(d) If after the proposed rule change is filed but before it becomes effective, the self-regulatory organization prepares or receives any correspondence or other communications reduced to writing (including comment letters and e-mails) to and from such self-regulatory organization concerning the proposed rule change, the communications shall be filed in accordance with Instruction E. All correspondence or other communications should be presented in alphabetical order together with an alphabetical listing of the authors. If such communications cannot be filed electronically in accordance with Instruction E, the communications shall be filed in accordance with Instruction F.

Exhibit 3. If any form, report, or questionnaire is

(a) proposed to be used in connection with the implementation or operation of the proposed rule change, or

(b) prescribed or referred to in the proposed rule change,

then the form, report, or questionnaire must be attached and shall be considered as part of the proposed rule change. If completion of the form, report or questionnaire is voluntary or is required pursuant to an existing rule of the self-regulatory organization, then the form, report, or questionnaire, together with a statement identifying any existing rule that requires completion of the form, report, or questionnaire, shall be attached as Exhibit 3. If the form, report, or questionnaire cannot be filed electronically in accordance with Instruction E, the documents shall be filed in accordance with Instruction F.

Exhibit 4. The self-regulatory organization must attach as Exhibit 4 proposed changes to its rule text. Changes in, additions to, or deletions from, any existing rule shall be set forth with brackets used to indicate words to be deleted and underscoring used to indicate words to be added. Exhibit 4 shall be considered part of the proposed rule change.

Exhibit 5. The self-regulatory organization must attach one of the following:

Certificate of Effectiveness of Proposed Rule Change: Attach a copy of the certification submitted to the CFTC pursuant to Section 5c(c) of the Commodity Exchange Act.

CFTC Request or Determination that Review of the Proposed Rule Change is Not Necessary: Attach a copy of any request submitted to the CFTC for determination that review of the proposed rule change is not necessary and any indication from the CFTC that it has determined that review of the proposed rule change is not necessary.

Request for CFTC Approval of Proposed Rule Change: Attach a copy of any request submitted to the CFTC for approval of the proposed rule change and any indication received from the CFTC that the proposed rule change has been approved.

OMB APPROVAL	
OMB Number:	3235-0553
Expires:	June 30, 2010
Estimated average burden hours per response	17.7

Page 1 of [ ]

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
Form 19b-7

File No. SR - [ ] - [ ]

Amendment No. [ ]

Proposed Rule Change by [Select SRO]

Pursuant to Rule 19b-7 under the Securities Exchange Act of 1934

Initial ☐ Amendment ☐ Withdrawal ☐

Exhibit 2 Sent As Paper Document ☐ Exhibit 3 Sent As Paper Document ☐

Description

Provide a brief description of the proposed rule change (limit 250 characters).

Contact Information

Provide the name, telephone number and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the proposed rule change.

First Name [ ] Last Name [ ]

Title [ ]

E-mail [ ]

Telephone [ ] Fax [ ]

SRO Governing Body Action

Describe action on the proposed rule change taken by the members or board of directors or other governing body of the SRO (limit 250 characters).

Signature

Pursuant to the requirements of the Securities Exchange Act of 1934,

has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized officer.

Date [ ]

By [ ]

(Name) (Title)

NOTE: Clicking the button at right will digitally sign and lock this form. A digital signature is as legally binding as a physical signature, and once signed, this form cannot be changed.

Digitally Sign and Lock Form

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

For complete Form 19b-7 instructions please refer to the EFFS website.

Exhibit 1- Notice of Proposed Rule Change

Add Remove View

The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal.

The Notice section of this Form 19b-7 must comply with the guidelines for publication in the Federal Register, as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC and CFTC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases and Commodities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)

Exhibit 2- Notices, Written Comments, Transcripts, Other Communications

Add Remove View

Exhibit Sent As Paper Document

☐

Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction E, they shall be filed in accordance with Instruction F.

Exhibit 3 - Form, Report, or Questionnaire

Add Remove View

Exhibit Sent As Paper Document

☐

Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change. If such documents cannot be filed electronically in accordance with Instruction E, they shall be filed in accordance with Instruction F.

Exhibit 4 - Proposed Rule Text

Add Remove View

The self-regulatory organization must attach as Exhibit 4 proposed changes to rule text. Exhibit 4 shall be considered part of the proposed rule change.

Exhibit 5 - Date of Effectiveness of Proposed Rule Change

The self-regulatory ogranization must attach one of the following:

☐ CFTC Certification

☐ CFTC Request that Review of Proposed Rule Change is not Necessary

☐ Request for CFTC Approval of Proposed Rule Change

☐ CFTC Determination that Review of Proposed Rule Change is not Necessary

☐ Indication of CFTC Approval of Proposed Rule Change

Exhibit Sent As Paper Document

☐

Partial Amendment

Add Remove View

If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission staff's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

Information To Be Included in the Completed Exhibit 1

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34-   ; File No. SR-[SRO Name]-[YYYY]-[XX])

SELF-REGULATORY ORGANIZATIONS; [SRO Name]; Proposed Rule Change Relating to [brief description of the subject matter of the proposed rule change].

Pursuant to Section 19(b)(7) of the Securities Exchange Act of 1934 ("Act"),[76] notice is hereby given that on [date[77]], the [name of self-regulatory organization] filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change described in Items I, II, and III below, which Items have been prepared by the self-regulatory organization. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons. [Name of self-regulatory organization] also has filed this proposed rule change concurrently with the Commodity Futures Trading Commission ("CFTC"). [Section 19(b)(7)(B) provides that a proposed rule change may take effect upon the occurrence of one of three events. The self-regulatory organization should include one of the following sentences, whichever is applicable:]

The [name of self-regulatory organization] filed a written certification with the CFTC under Section 5c(c) of the Commodity Exchange Act on [date]; or

---

[76] 15 U.S.C. 78s(b)(7).

[77] To be completed by the Commission. This date will be the date on which the Commission receives the proposed rule change filing if the filing complies with all requirements of this form. See General Instructions for Form 19b-7.

The [name of self-regulatory organization] on [date], has requested that the CFTC make a determination that review of the proposed rule change of the [self-regulatory organization] is not necessary. The CFTC has [made such determination on [date]]; or [has not made such determination]; or

The [name of self-regulatory organization] on [date] submitted the proposed rule change to the CFTC for approval. The CFTC [approved the proposed rule change on [date]]; or [has not approved the proposed rule change].

I. Self-Regulatory Organization's Description and Text of the Proposed Rule Change

[Supply a brief statement of the terms of substance of the proposed rule change. If the proposed rule change is relatively brief, a separate statement need not be prepared, and the text of the proposed rule change may be inserted in lieu of the statement of the terms of substance. If the proposed rule change amends an existing rule, indicate the changes in the rule by brackets for words to be deleted and underscoring for words to be added.]

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for the Proposed Rule Change

In its filing with the Commission, the self-regulatory organization included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The self-regulatory organization has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for the Proposed Rule Change

1. Purpose

[Provide a statement of the purpose of the proposed rule change. The statement must describe the text of the proposed rule change in a sufficiently detailed and specific manner as to enable the public to provide meaningful comment on the proposal. At a minimum, the statement should:]

(a) [Describe the reasons for adopting the proposed rule change, any problems the proposed rule change is intended to address, the manner in which the proposed rule change will resolve those problems, the manner in which the proposed rule change will affect various persons (e.g. brokers, dealers, issuers, and investors), and any significant problems known to the self-regulatory organization that persons affected are likely to have in complying with the proposed rule change; and]

(b) [Describe how the proposed rule change relates to existing rules of the self-regulatory organization. If the self-regulatory organization reasonably expects that the proposed rule change will have any direct effect, or significant indirect effect, on the application of any other rule of the self-regulatory organization, set forth the designation or title of any such rule and describe the anticipated effect of the proposed rule change on the application of such other rule. Include the file numbers for prior filings with respect to any existing rule specified.]

2. Statutory Basis

[Explain why the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to the self-regulatory organization. A

mere assertion that the proposed rule change is consistent with those requirements is not sufficient. Certain limitations that the Act imposes on self-regulatory organizations are summarized in the notes that follow.

NOTE 1. National Securities Exchanges. Under Section 6 of the Act, rules of a national securities exchange may not permit unfair discrimination between customers, issuers, brokers, or dealers, and may not regulate, by virtue of any authority conferred by the Act, matters not related to the purposes of the Act or the administration of the self-regulatory organization.

NOTE 2. Limited Purpose National Securities Associations. Under Section 15A(k) of the Act, rules of a national securities association registered for the limited purpose of regulating the activities of members who are registered as brokers or dealers in security futures products must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general to protect investors and the public interest, including rules governing sales practices and the advertising of security futures products reasonably comparable to those of other national securities associations registered pursuant to Section 15A(a) that are applicable to security futures products. The rules may not be designed to regulate, by virtue of any authority conferred by the Act, matters not related to the purposes of the Act or the administration of the association.]

B. Self-Regulatory Organization's Statement on Burden on Competition

[The information required by this section must be sufficiently detailed and specific to support the premise that the proposed rule change does not unduly burden competition. In responding to this section, the self-regulatory organization must:

- State whether the proposed rule change will have an impact on competition and, if so
  - (i) state whether the proposed rule change will impose any burden on competition or whether it will relieve any burden on, or otherwise promote, competition, and
  - (ii) specify the particular categories of persons and kinds of businesses on which any burden will be imposed and the ways in which the proposed rule change will affect them.
- Explain why any burden on competition is not undue; or, if the self-regulatory organization does not believe that the burden on competition is significant, explain why.

In providing those explanations, set forth and respond in detail to written comments as to any significant impact or burden on competition perceived by any person who has made comments on the proposed rule change to the self-regulatory organization.]

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

[If written comments were received (whether or not comments were solicited) from members of or participants in the self-regulatory organization or others, summarize the substance of all such comments received and respond in detail to any significant issues that those comments raised about the proposed rule change.

If an issue is summarized and responded to in detail under Section II.A.1. or Section II.B. of this Form 19b-7 Notice, that response need not be duplicated if appropriate cross-reference is made to the place where the response can be found. If comments were not or are not to be solicited, so state.]

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

[The self-regulatory organization shall include the following with the applicable phrase on the proposed rule change's effectiveness:]

The proposed rule change has become effective on [insert date of filing of written certification with the CFTC under Section 5c(c) of the Commodity Exchange Act; or the date of determination by the CFTC that review of the proposed rule change is not necessary; or the date of approval of the proposed rule change by the CFTC]. [or]

The proposed rule change is not effective because the CFTC [has not determined that review of the proposed rule changes is not necessary or has not approved the proposed rule change].

At any time within 60 days of the date of effectiveness of the proposed rule change, the Commission, after consultation with the CFTC, may summarily abrogate the proposed rule change and require that the proposed rule change be refiled in accordance with the provisions of Section 19(b)(1) of the Act.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with 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/sro.shtml); or

- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-[SRO]-[YYYY]-[XX] on the subject line.

Paper comments:

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

All submissions should refer to File Number SR-[SRO]-[YYYY]-[XX]. 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, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. Copies of such filing also will be available for inspection and copying at the principal office of the [SRO]. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available. All

submissions should refer to File Number SR-[SRO]-[YYYY]-[XX] and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[1]

Secretary

1 17 CFR 200.30-3(a)(73).

APPENDIX B

OMB APPROVAL	
OMB Number:	3235-0045
Expires:	June 30, 2010
Estimated average burden hours per response:	23.2

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
Form 19b-4

File No. SR - -
Amendment No.

Proposed Rule Change by Select SRO

Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934

Initial ☐ Amendment ☐ Withdrawal ☐

Section 19(b)(2) ☐ Section 19(b)(3)(A) ☐ Section 19(b)(3)(B) ☐

Rule

☐ 19b-4(f)(1) ☐ 19b-4(f)(4)
☐ 19b-4(f)(2) ☐ 19b-4(f)(5)
☐ 19b-4(f)(3) ☐ 19b-4(f)(6)

Pilot ☐ Extension of Time Period for Commission Action ☐ Date Expires

Exhibit 2 Sent As Paper Document ☐ Exhibit 3 Sent As Paper Document ☐

Description

Provide a brief description of the proposed rule change (limit 250 characters).

Contact Information

Provide the name, telephone number and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the proposed rule change.

First Name Last Name
Title
E-mail
Telephone Fax

Signature

Pursuant to the requirements of the Securities Exchange Act of 1934,

has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized officer.

Date
By

(Name) (Title)

NOTE: Clicking the button at right will digitally sign and lock this form. A digital signature is as legally binding as a physical signature, and once signed, this form cannot be changed.

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

For complete Form 19b-4 instructions please refer to the EFFS website.

Form 19b-4 Information Add Remove View	The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.
Exhibit 1 - Notice of Proposed Rule Change Add Remove View	The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)
Exhibit 2 - Notices, Written Comments, Transcripts, Other Communications Add Remove View Exhibit Sent As Paper Document ☐	Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.
Exhibit 3 - Form, Report, or Questionnaire Add Remove View Exhibit Sent As Paper Document ☐	Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.
Exhibit 4 - Marked Copies Add Remove View	The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.
Exhibit 5 - Proposed Rule Text Add Remove View	The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change.
Partial Amendment Add Remove View	If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

March 20, 2008

IN THE MATTER OF CERTAIN COMPANIES QUOTED ON THE PINK SHEETS: **NeoTactix Corporation** **Graystone Park Enterprises, Inc.** **Younger America, Inc.** File No. 500-1	ORDER OF SUSPENSION OF TRADING

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of the issuers listed below. As set forth below for each issuer, questions have arisen regarding the adequacy and accuracy of publicly disseminated information concerning, among other things: (1) the companies' current financial condition, (2) the companies' management, (3) the companies' business operations, and/or (4) stock promoting activity.

1. **NeoTactix Corporation** is a Nevada company with offices in Irvine, California. Questions have arisen regarding the adequacy and accuracy of statements in the company's press releases and promotional videos concerning the company's management, operations, current financial condition, transactions involving the issuance of the company's shares, and concerning stock promoting activity.

2. **Graystone Park Enterprises, Inc.** is a Colorado company with offices in Orlando, Florida. Questions have arisen regarding the adequacy and accuracy of press releases, promotional videos, and statements on the company's website concerning the company's current financial condition, operations, management, and concerning stock promoting activity.

3. **Younger America, Inc.** is a Nevada company with offices in Ft. Lauderdale, Florida. Questions have arisen regarding the adequacy and accuracy of press releases and promotional videos concerning the company's current financial condition, operations, management, transactions involving the issuance of the company's shares, and concerning stock promoting activity.

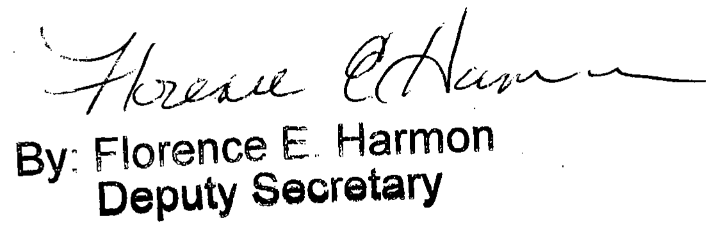
The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the companies listed above.

28 of 35

Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the companies listed above is suspended for the period from 9:30 a.m. EDT on March 20, 2008, through 11:59 p.m. EDT, on April 3, 2008.

By the Commission.

Nancy M. Morris
Secretary



By: Florence E. Harmon
Deputy Secretary

Commissioner Atkins Disapproved

SECURITIES AND EXCHANGE COMMISSION

17 CFR Ch. II

[Release Nos. 33-8905, 34-57544, IA-2723, IC-29198, File No. S7-09-08]

Regulatory Flexibility Agenda

AGENCY: Securities and Exchange Commission.

ACTION: Semiannual regulatory agenda.

SUMMARY: The Securities and Exchange Commission is publishing an agenda of its rulemaking actions pursuant to the Regulatory Flexibility Act (RFA) (Pub. L. No. 96-354, 94 Stat. 1164) (Sep. 19, 1980). Information in the agenda was accurate on March 21, 2008, the day on which the Commission's staff completed compilation of the data. To the extent possible, rulemaking actions by the Commission since that date have been reflected in the agenda. The Commission invites questions and public comment on the agenda and on the individual agenda entries. The Commission is now printing in the **Federal Register**, along with our preamble, only those agenda entries for which we have indicated that preparation of a Regulatory Flexibility Act analysis is required. The Commission's complete RFA agenda will be available online at www.reginfo.gov.

DATES: Comments should be received on or before June 30, 2008.

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

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/other.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-09-08 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 No. S7-09-08. 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/other.shtml). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street NE., Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Anne Sullivan, Office of the General Counsel, 202-551-5019.

SUPPLEMENTARY INFORMATION: The RFA requires each Federal agency, during April and October of each year, to publish in the **Federal Register** an agenda identifying rules that the agency expects to consider in the next twelve months that are likely to have a significant economic impact on a substantial number of small entities (5 U.S.C. 602(a)). The RFA specifically provides that publication of the agenda does not preclude an agency from considering or acting on any matter not included in the agenda and that an agency is not required to consider or act on any matter that is included in the agenda (5 U.S.C. 602(d)). Actions that do not have an estimated date are placed in the long-term category; the Commission may nevertheless act on items in that category within the next 12 months. The agenda includes new entries, entries carried over from prior publications, and rulemaking actions that have been completed (or withdrawn) since publication of the last agenda.

The following abbreviations for the acts administered by the Commission are used in the agenda:

"Securities Act"--Securities Act of 1933

"Exchange Act"--Securities Exchange Act of 1934

"Investment Company Act"--Investment Company Act of 1940

"Investment Advisers Act"--Investment Advisers Act of 1940

The Commission invites public comment on the agenda and on the individual agenda entries.

By the Commission.

Nancy M. Morris

Secretary

Dated: March 21, 2008

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 57548 / March 24, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12996

In the Matter of **RANDGOLD & EXPLORATION COMPANY, LIMITED,** **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 Randgold & Exploration Company, Limited ("Randgold" 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.

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III.

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

A. Randgold (CIK No. 1033217) is a South African corporation headquartered in Johannesburg, South Africa. Randgold owns interests in several South African companies, certain prospecting rights, and other assets. Randgold's ordinary shares and its American Depositary Shares ("ADSs") have been registered under Section 12(g) of the Exchange Act since 1997. Randgold's ordinary shares were traded on the JSE Limited, a South African securities exchange, until they were suspended on August 1, 2005, for failure to timely complete audited financial statements. Randgold's American Depositary Receipts ("ADRs") were traded on the NASDAQ National Market until they were delisted on September 21, 2005, for failure to file a Form 20-F with the Commission for the year ended December 31, 2004. Randgold's ADRs are currently quoted and traded on the "Pink Sheets."

B. Randgold has failed to comply with Section 13(a) of the Exchange Act and Rule 13a-1 thereunder, while its ordinary shares and ADSs were registered with the Commission, in that Randgold has not filed an Annual Report on Form 20-F since July 15, 2004 (as amended on April 4, 2005).

IV.

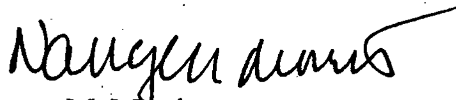
Section 12(j) of the Exchange Act provides as follows:

> 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 or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security the registration of which has been and is suspended or revoked pursuant to the preceding sentence.

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

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

By the Commission.



Nancy M. Morris
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 57552 / March 25, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12997

In the Matter of HOLLINGER 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 Hollinger Inc. ("Hollinger Inc." 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.

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III.

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

A. Hollinger Inc. is a publicly held Canadian corporation based in Toronto, Ontario, Canada. Hollinger Inc. is traded on the Toronto Stock Exchange and is a foreign private issuer registered with the Commission. Hollinger Inc. has two classes of shares registered with the Commission pursuant to Section 12(g) of the Exchange Act: Retractable Common Stock registered on June 21, 1999, and Series II Preference Shares registered on April 2, 1998.

B. Hollinger Inc. has failed to comply with Section 13(a) of the Exchange Act and Rule 13a-1 thereunder while its Retractable Common Stock and Series II Preference Shares were registered with the Commission in that it has been not filed an Annual Report on Form 20-F since June 27, 2003, amended on September 17, 2003, for any fiscal period subsequent to its fiscal year ending December 31, 2002.

IV.

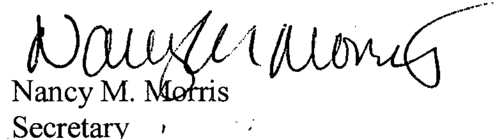
Section 12(j) of the Exchange Act provides as follows:

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 or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security the registration of which has been and is suspended or revoked pursuant to the preceding sentence.

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

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

By the Commission.



Nancy M. Morris
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 57563 / March 26, 2008

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2805 / March 26, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-11911

In the Matter of Steven H. Barry, CPA	ORDER GRANTING APPLICATION FOR REINSTATEMENT TO APPEAR AND PRACTICE BEFORE THE COMMISSION AS AN ACCOUNTANT

On April 26, 2005, Steven H. Barry ("Barry") was denied the privilege of appearing or practicing as an accountant before the Commission as a result of settled public administrative proceedings instituted by the Commission against Barry pursuant to Rule 102(e) of the Commission's Rules of Practice.[1] Barry consented to the entry of the April 26, 2005 order without admitting or denying the findings therein. This order is issued in response to Barry's application for reinstatement to practice before the Commission as an accountant.

Barry served as the engagement partner for Deloitte & Touche LLP's audit of Just for Feet, Inc.'s financial statements for the fiscal year ended January 30, 1999. Barry reasonably should have known that the financial statements had not been prepared in accordance with GAAP, but nonetheless issued, with others, an unqualified audit report that represented that the financial statements were free from material misstatements and were presented in conformity with GAAP and that the auditors had adhered to GAAS when the audit was performed. Barry did not comply with GAAS in the conduct of the audit and engaged in improper professional conduct within the meaning of Rule 102(e)(1)(ii) of the Commission's Rules of Practice through repeated instances of unreasonable conduct.

Barry has met all of the conditions set forth in the original order and, in his capacity as an independent accountant, has stated that he will comply with all requirements of the Commission and the Public Company Accounting Oversight Board, including, but not limited to all

[1] *See* Accounting and Auditing Enforcement Release No. 2238 dated April 26, 2005. Barry was permitted, pursuant to the order, to apply for reinstatement after two years upon making certain showings.

requirements relating to registration, inspections, concurring partner reviews and quality control standards. In his capacity as a preparer or reviewer, or as a person responsible for the preparation or review, of financial statements of a public company to be filed with the Commission, Barry attests that he will undertake to have his work reviewed by the independent audit committee of any company for which he works, or in some other manner acceptable to the Commission, while practicing before the Commission in this capacity.

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

On the basis of the information supplied, representations made, and undertakings agreed to by Barry, it appears that he has complied with the terms of the April 26, 2005 order denying him the privilege of appearing or practicing before the Commission as an accountant, that no information has come to the attention of the Commission relating to his character, integrity, professional conduct or qualifications to practice before the Commission that would be a basis for adverse action against him pursuant to Rule 102(e) of the Commission's Rules of Practice, and that Barry, by undertaking to have his work reviewed by the independent audit committee of any company for which he works, or in some other manner acceptable to the Commission, in his practice before the Commission as a preparer or reviewer of financial statements required to be filed with the Commission, and that Barry, by undertaking to comply with all requirements of the Commission and the Public Company Accounting Oversight Board, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews and quality control standards, in his practice before the Commission as an independent accountant has shown good cause for reinstatement. Therefore, it is accordingly,

ORDERED pursuant to Rule 102(e)(5)(i) of the Commission's Rules of Practice that Steven H. Barry, CPA is hereby reinstated to appear and practice before the Commission as an accountant.

By the Commission.

Nancy M. Morris
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

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

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

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 57560 / March 26, 2008

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2804 / March 26, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-9516

In the Matter of Lynn R. Michl, CPA	ORDER GRANTING APPLICATION FOR REINSTATEMENT TO APPEAR AND PRACTICE BEFORE THE COMMISSION AS AN ACCOUNTANT RESPONSIBLE FOR THE PREPARATION OR REVIEW OF FINANCIAL STATEMENTS REQUIRED TO BE FILED WITH THE COMMISSION

On December 23, 1997, Lynn R. Michl, CPA ("Michl") was denied the privilege of appearing or practicing as an accountant before the Commission as a result of settled public administrative proceedings instituted by the Commission against him pursuant to Rule 102(e) of the Commission's Rules of Practice.[1] Michl consented to the entry of the order without admitting or denying the findings therein. This order is issued in response to Michl's application for reinstatement to appear and practice before the Commission as an accountant responsible for the preparation or review of financial statements required to be filed with the Commission.

During 1992, 1993 and the first half of 1994, the Commission found that, while Michl was serving as CFO, Terrano Corporation ("Terrano") improperly recorded sales of certain software enhancement modules that were not yet available for use. In the course of the audits of Terrano's financial statements for fiscal 1992 and 1993, Michl provided Terrano's independent auditor with management representation documents which falsely stated that the software enhancement modules were available for delivery. In addition, during the same time period, Terrano improperly recorded, as software revenue and accounts receivable, sales of software that was available for delivery, but which had not been delivered at the time the revenue and accounts receivable were recorded. Michl either knew or should have known that revenue and accounts receivable on these sales had been improperly recorded. Based on the foregoing, Michl engaged in improper professional conduct and willfully violated the provisions of the Federal securities

[1] *See* Accounting and Auditing Enforcement Release No. 999 dated December 23, 1997. Michl was permitted, pursuant to the order, to apply for reinstatement after five years upon making certain showings.

laws and the rules thereunder within the meaning of Rule 102(e) of the Commission's Rules of Practice.

In his capacity as a preparer or reviewer, or as a person responsible for the preparation or review, of financial statements of a public company to be filed with the Commission, Michl attests that he will undertake to have his work reviewed by the independent audit committee of any company for which he works, or in some other manner acceptable to the Commission, while practicing before the Commission in this capacity. Michl is not, at this time, seeking to appear or practice before the Commission as an independent accountant. If he should wish to resume appearing and practicing before the Commission as an independent accountant, he will be required to submit an application to the Commission showing that he has complied and will comply with the terms of the original order in this regard. Therefore, the denial of Michl's privilege of appearing and practicing before the Commission as an independent accountant continues in effect until the Commission determines that a sufficient showing has been made in this regard in accordance with the terms of the original order.

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

On the basis of information supplied, representations made, and undertakings agreed to by Michl, it appears that he has complied with the terms of the December 23, 1997 order denying him the privilege of appearing or practicing before the Commission as an accountant, that no information has come to the attention of the Commission relating to his character, integrity, professional conduct or qualifications to practice before the Commission that would be a basis for adverse action against him pursuant to Rule 102(e) of the Commission's Rules of Practice, and that Michl, by undertaking to have his work reviewed by the independent audit committee of any company for which he works, or in some other manner acceptable to the Commission, in his practice before the Commission as a preparer or reviewer of financial statements required to be filed with the Commission, has shown good cause for reinstatement. Therefore, it is accordingly,

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

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

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

By the Commission.

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. 8906 / March 27, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13000

In the Matter of JPMORGAN CHASE & CO., Respondent.	ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), against JPMorgan Chase & Co. ("Respondent").

II.

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

III.

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

Respondent

1. JPMorgan Chase & Co., a Delaware corporation headquartered in New York, is a financial holding company created by the December 2000 merger of JP Morgan & Co. with The Chase Manhattan Corporation, and the July 2004 merger of JPMorgan Chase & Co. with Bank

[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.

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One Corporation. JPMorgan Chase & Co.'s securities are registered with the Commission pursuant to Section 12(b) of the Securities Exchange Act of 1934 ("Exchange Act") and are listed for trading on the New York Stock Exchange (symbol: "JPM").

Related Parties

Bank One Corp.

2. Bank One Corporation, formerly a Delaware corporation headquartered in Chicago, was at all times relevant a financial holding company. During the relevant period, Bank One Corporation's common stock was registered with the Commission pursuant to Section 12(b) of the Exchange Act and listed for trading on the New York Stock Exchange (symbol: "ONE"). Bank One Corporation merged with JPMorgan Chase & Co. in July 2004. As a result of the merger, Bank One Corporation no longer exists. JPMorgan Chase & Co. is the successor in interest to Bank One Corporation for purposes of this action.

National Century Financial Enterprises

3. National Century Financial Enterprises, Inc. ("NCFE") was incorporated in Ohio in December 1990. During the relevant period, NCFE was a privately held Ohio corporation headquartered in Dublin, Ohio. NCFE is now defunct.

4. During the relevant period, NCFE organized and owned several special-purpose subsidiary programs, including NPF VI and NPF XII, both of which were Ohio corporations.

Overview

5. This case concerns negligent conduct by Bank One, N.A. ("Bank One") and JPMorgan Chase Bank, N.A. ("JPMorgan Chase") as asset-backed indenture trustees (the "indenture trustees" or "asset-backed indenture trustees") for certain special-purpose subsidiaries ("program" or "programs") of National Century Financial Enterprises, Inc. ("NCFE"), formerly a Dublin, Ohio healthcare financing company, during the approximate period 1999-2002 (the "relevant period").

6. During the relevant period, the NCFE programs offered and sold nearly $3.5 billion in asset-backed notes to qualified institutional buyers. NCFE and the programs collapsed in November 2002 when investors and others discovered that NCFE had made large improper transfers among program accounts and caused collateral shortfalls. The collapse caused investor losses of approximately $2.6 billion.

7. The NCFE programs purchased medical account receivables from health-care providers and issued asset-backed notes that securitized those receivables. In private placement memoranda ("PPMs") through which the NCFE programs offered the notes, NCFE represented to investors that NCFE would use the proceeds from the note offerings primarily for the purchase of healthcare account receivables and that the programs would maintain specified balances ("Specified Balances") for two separate reserve accounts and an Equity Account ("Reserve Accounts") that would be held by the indenture trustees. While NCFE used some investor funds to purchase healthcare account receivables, NCFE used a substantial portion of the private

placement proceeds and Reserve Account funds to make either unsecured loans or loans secured by collateral other than healthcare account receivables, contrary to NCFE's representations to investors and contrary to the requirements of the master trust indentures ("indentures") that governed NCFE's note offerings.

8. A principal feature of the scheme that allowed NCFE to hide investor losses was the transfer of huge amounts of Reserve Account funds on or around the first and last business day of every month ("Month-End Transfers"). The indentures required that the programs maintain Specified Balances in the Reserve Accounts totaling approximately 17% of the value of the outstanding notes issued by the program. However, even though the indenture trustees for the NCFE programs had the ability to look at the balances in the Reserve Accounts at any time, the indentures only required the programs to report on the balances in Reserve Accounts as of one day of the month, called the "Monthly Payment Date." The largest program for which JPMorgan Chase served as asset-backed indenture trustee was reported on by NCFE and tested by JPMorgan Chase as of the last business day of the month. The largest program for which Bank One served as asset-backed indenture trustee was reported on by NCFE and tested by Bank One as of the first business day of the month. As a result of this structure, NCFE was able to kite large amounts of funds back and forth between the programs to make it appear that the programs were maintaining the Specified Balances. In fact, NCFE was consistently and severely depleting the balances in these Reserve Accounts without telling investors.

9. At the instruction of NCFE, Bank One and JPMorgan Chase made Reserve Account transfers that contradicted NCFE's representations to investors about how the Reserve Accounts would be used and contravened the requirements of the indentures regarding the Reserve Accounts. Among other things, pursuant to NCFE's instructions, Bank One and JPMorgan Chase made the Month-End Transfers that helped NCFE mask substantial and growing Reserve Account shortfalls.

10. The Month-End Transfers were large, recurring, and contrary to the requirements of the indentures. In participating in the Month-End Transfers that were contrary to the requirements of the indentures, Bank One and JPMorgan Chase were negligent and should have known that NCFE was misusing the Month-End Transfers.

NCFE's Basic Business

11. NCFE's programs were set out in a series of agreements (the "program agreements") between the programs, healthcare providers, and investors, including, among other things, the indentures. NCFE included the indentures as part of offering materials to prospective investors in the asset-backed notes issued by the programs.

12. The indentures allowed the programs to engage only in one type of business activity: the purchase of "eligible" medical account receivables of a hospital, physicians' group, or other healthcare provider on a weekly basis. The programs purchased the receivables at a price equal to 97% of the receivables' estimated collectible value. In most instances, the value of an "eligible receivable" was limited to the insured portion of a receivable for which medical services had already been rendered. Before purchasing a receivable, the programs required detailed billing information from the healthcare provider, including the insurance or government

payor, diagnosis code, billing date, patient account number, and patient discharge date. The program agreements required NCFE to review that information once each week and purchase only those receivables that were deemed eligible.

13. With limited exceptions, the indentures prohibited the programs from engaging in transactions with NCFE or any NCFE subsidiary, including any other program.

14. Under the indentures, the programs contractually engaged another NCFE subsidiary, National Premier Financial Services, to act as the servicer ("Servicer") for the programs.

15. From 1991 through 2002, the NCFE programs issued over $17 billion in asset-backed bonds or notes through private placements. When the company collapsed in November 2002, NCFE had over $3 billion in notes outstanding.

16. While NCFE conducted numerous programs during its existence, the largest programs by far during the relevant period were the programs NPF VI and NPF XII. During 1999-2002, NPF VI and NPF XII collectively engaged in 15 separate note issuances worth nearly $3.5 billion.

Reserve Accounts

17. The program agreements contained safeguards to protect investors from loss. One of the significant safeguards for investors was the requirement in the indentures that the programs maintain three specific Reserve Accounts with the asset-backed indenture trustees. Various provisions of the indentures collectively required that the Reserve Accounts hold, in aggregate, approximately 17% of the value of the outstanding notes issued by the program at all times. The three Reserve Accounts were called the "Equity Account,"[2] "Seller Credit Reserve Account,"[3] and "Offset Reserve Account."[4]

Investor Reports

18. The asset-backed indenture trustees received monthly investor reports from the Servicer, a wholly owned subsidiary of NCFE. The monthly investor reports presented a regular "snapshot" of each program's financial performance. The investor reports included, among other things, information on the amounts in the Reserve Accounts as of a certain day of the month, referred to in the reports as the "Determination Date." For the NPF VI program, the

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[2] The Equity Account served as the account through which the program paid principal and interest to investors and paid indenture trustee fees.

[3] The Seller Credit Reserve Account served as a reserve account in the event that an eligible receivable purchased by the program became a defaulted receivable. A defaulted receivable included any receivable for which more than 180 days had passed since the date the receivable was billed.

[4] The Offset Reserve Account served as a reserve account in the event that an eligible receivable purchased by the program became a rejected receivable. A rejected receivable included any receivable as to which the seller had breached a representation about the receivable.

Determination Date was the last business day of every month, meaning that the investor reports for the NPF VI program reported the amounts in the NPF VI Reserve Accounts as of the last business day of every month. For the NPF XII program, meanwhile, the Determination Date was the first business day of every month, meaning that the investor reports for the NPF XII program reported the amounts in the NPF XII Reserve Accounts as of the first business day of every month. The investor reports did not report on the amounts in the Reserve Accounts as of any other days of the month other than the Determination Date.

19. Although the indentures only required that the Servicer distribute the investor report to the indenture trustees and to the ratings agencies that rated the program notes, NCFE routinely distributed the investor reports to existing and prospective investors.

The Asset-Backed Indenture Trustees' Role

20. During the relevant period (1999-2002), either Bank One or JPMorgan Chase served as asset-backed indenture trustees for all of the NCFE programs. During the relevant period, Bank One served as indenture trustee for the NPF XII program (as well as for two much smaller programs, NPF WL and NPF LP), and JPMorgan Chase served as indenture trustee for the NPF VI program (as well as for a much smaller program, NPF XI). Bank One and JPMorgan Chase received revenues from the NCFE programs by collecting several different types of fees from the programs.

21. Under the indentures, deposits into and disbursements out of the trust accounts generally were required to be made by written instruction to the indenture trustee to make the deposit or disbursement. With respect to the Equity Account, the indentures required that the indenture trustee adhere to the indentures' restrictions on disbursements from the Equity Account, which included a restriction on disbursements from the Equity Account on any day of the month other than on the Monthly Payment Date of any funds held in the Equity Account as of the last Monthly Payment Date. The Monthly Payment Date was the first business day of every month.

22. Additionally, the indentures required the asset-backed indenture trustees to review the investor reports issued by the programs, and, based on the investor reports, determine whether the program held the Specified Balance for the Equity Account ("Equity Account Specified Balance") as of the Monthly Payment Date. An event of default occurred if a program did not hold the Equity Account Specified Balance as of the Monthly Payment Date or within a cure period of seven days after the Monthly Payment Date. If an event of default was "continuing," then the indentures required that the indenture trustee serve notice on the Servicer of an event of default by the program. If the Servicer failed to demonstrate within one business day that no such event of default had occurred, then the indentures required that the asset-backed indenture trustee also declare a principal amortization event, which resulted in an immediate wind-down of the program.

23. With respect to the Seller Credit Reserve Account and Offset Reserve Account, the indentures required the indenture trustee to follow the instructions of the Servicer in regard to deposits into and disbursements out of those accounts. However, in the indentures, the programs represented and warranted that they would maintain the Seller Credit Reserve Account Specified

Balance and Offset Reserve Account Specified Balance. If the programs materially breached this representation and warranty, then the indentures gave the indenture trustees the right, but not the duty, to declare an event of default based on any such breach of which they were aware.

NCFE's Improper Depletion and Manipulation of the Reserve Accounts

24. From at least February 1999 to October 2002, NCFE engaged in a pattern of depleting the Reserve Accounts to make unsecured loans or loans secured by ineligible collateral, then manipulating the Reserve Accounts on or around the Determination Dates to make it appear that the programs were maintaining the Specified Balances in the Reserve Accounts. NCFE's manipulation of the Reserve Accounts included not only improperly transferring funds between Reserve Accounts within a program, but also transferring funds back and forth between programs, in violation of the indentures.

25. During the relevant period, NCFE routinely depleted the Reserve Accounts to far below the Specified Balances for those accounts, contrary to NCFE's representations to prospective investors in the PPMs, and contrary to the requirements of the indentures. As an example, in March 2000, the NPF VI Equity Account Specified Balance was $68.7 million. Yet the average daily balance in the NPF VI Equity Account during March 2000 was only $36 million, with the balance dropping as low as $20.3 million. Similarly, in December 2000, the Specified Balance in the NPF VI Seller Credit Reserve Account was over $50 million, yet the average daily balance in the account in this month was only $9.2 million. At one point in this month, the balance in the NPF VI Seller Credit Reserve Account dropped to a mere $49,067.

26. Since the Determination Date for the NPF VI program fell on the last business day of the month, and the Determination Date for the NPF XII program fell on the first business day of the month, NCFE concocted a scheme to kite funds back and forth between the two programs through the Month-End Transfers to try to satisfy the Reserve Account Specified Balances on the Determination Dates for the two programs. Internal NCFE memoranda documented the scheme's mechanics.

27. For example, in an October 26, 1999 internal memo, NCFE discussed several options for satisfying the Reserve Account Specified Balances for the October 1999 Determination Dates, including:

> On Thursday, October 28, 1999, NCFE will meet the minimum compliance requirements in NPF VI and NPF XI, for which the Trustee is Chase Manhattan, by wiring approximately $36,000,000 from NPF XII to NPF VI and NPF XI. . . .
>
> On Friday, October 29, 1999, NCFE will wire the $36,000,000 from NPF VI and NPF XI back to NPF XII.

28. Similarly, in a January 2000 internal memo, NCFE discussed several options for satisfying the Reserve Account Specified Balances for the end of January 2000/beginning of February 2000 Determination Dates, including:

> Assuming there will be no anomalous cash receipts before the end of January and the Programs are funding $10 million in excess of cash collections each week, the books will be short by about $50 million on January 31, 2000. The last business day of January 2000 will be Monday, January 31, 2000. Currently, the only way to force all of the programs into compliance will be to hold month end open until February 1, 2000, for some of the trust accounts. On January 31, 2000, the Chase Manhattan Bank trust accounts (NPF VI and XI) will be tested per normal procedures. Then, on February 1, 2000, sufficient funds will be wired from the Chase accounts to the Bank One trust accounts (NPF WL, XII, and LP) in order to pass the month end requirements.

29. To mask the purpose of the Month-End Transfers, NCFE attached fictitious accounts receivable information to the transfer instructions to the asset-backed indenture trustees to give the appearance that the programs were purchasing receivables from each other, although no actual transfers of receivables between the programs occurred.

The Asset-Backed Indenture Trustees' Negligence Regarding NCFE's Depletion and Manipulation of the Reserve Accounts

30. On occasion, certain of Bank One's and JPMorgan Chase's asset-backed indenture trustee employees raised questions internally about NCFE's conduct to more senior-level indenture trustee employees. The failure of those more senior-level indenture trustee employees to adequately respond to those questions was negligent.

31. For example, in February 1999, despite its manipulation of the Reserve Accounts, NCFE did not have sufficient funds to satisfy the Specified Balances in the Reserve Accounts for the NPF VI program. Instead of issuing an investor report that identified the deficiencies, NCFE delayed issuing an investor report until late March 1999, after the program had raised $180 million in funds from a new securitization. NCFE deposited the new funds in the NPF VI Reserve Accounts and then issued an investor report falsely reporting that NCFE had satisfied the Specified Balances in the Reserve Accounts as of the last business day of February 1999.

32. The JPMorgan Chase administrator assigned to the account became aware of the false figures in the February 1999 investor report and alerted NCFE, the ratings agency, and her supervisors. JPMorgan Chase then contacted NCFE, which gave JPMorgan Chase and the ratings agency the explanation that the Reserve Account balances had been deficient in February 1999 and that as a result the February 1999 investor report had been inaccurate due to a "timing error" by NCFE personnel in failing to direct JPMorgan Chase to allocate certain funds to the Reserve Accounts.

33. In fact, as the account balances equally available to JPMorgan Chase and NCFE showed, the Reserve Accounts were woefully deficient because NCFE had depleted the accounts to below the Specified Balances, and NCFE did not have the funds to replenish them until NCFE raised new funds from a new securitization in late March 1999. JPMorgan Chase knew or should have known that the investor report did not comply with the terms of the indenture and that it had a duty to give notice of an event of default based on the program's failure to meet the

Equity Account Specified Balance as of the last business day of February 1999 and failure to cure the deficiency within the cure period, as required by the indenture.

34. Similarly, on September 1, 2000, a Bank One administrator assigned to the NCFE account sent a memo to the account executive responsible for the NCFE account regarding NCFE's August 31, 2000 funding requests. The administrator told the account executive that these funding requests resulted in "large dollar amounts taken from the deals, in which the compliance standards are not up to par." The administrator provided the account executive with evidence of NCFE's August 31, 2000 large transfers from the NPF XII and NPF WL programs, for which Bank One was indenture trustee, to the NPF VI and NPF XI programs at JPMorgan Chase, as well as the large transfers back from the programs at JPMorgan Chase to the programs at Bank One on September 1, 2000. Despite being notified of evidence of the large August 31, 2000 and September 1, 2000 Month-End Transfers involving the Reserve Accounts, the Bank One account executive took no action.

35. Bank One and JPMorgan Chase followed NCFE's instructions to make the large, recurring Month-End Transfers. As noted above, these transfers were contrary to the terms of the indentures, which required NCFE to maintain the Specified Balances in the Reserve Accounts.

Legal Analysis

36. Section 17(a)(3) of the Securities Act makes it unlawful for any person in the offer or sale of securities to engage in any transaction, practice or course of business which operates or would operate as a fraud or deceit upon the purchaser.

37. NCFE violated Section 17(a)(3) of the Securities Act by engaging in a fraudulent scheme to deplete and manipulate the Reserve Accounts, including making the Month-End Transfers.

38. Section 8A of the Securities Act provides that the Commission may issue a cease-and-desist order against a person who is "a cause of [another person's] violation, due to an act or omission the person knew or should have known would contribute to such violation . . . ."[5] Based on the conduct described above, Respondent was a cause of NCFE's violations of Section 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 JPMorgan Chase & Co.'s Offer.

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[5] A finding of negligent conduct is sufficient to establish liability for violating Section 17(a)(3) of the Securities Act. *See Aaron v. SEC*, 446 U.S. 680, 696 n.13 (1980). Where the primary violation underlying a finding that a person is "a cause of" violations does not itself require a finding of scienter, as here, the standard of liability for being a cause of such violations is negligence. *Cf. KPMG LLP v. SEC*, 289 F.3d 109, 112, 114 (D.C. Cir. 2002) (holding that the Commission, in an administrative proceeding under Section 21C, could use a negligence standard in determining whether a violation of Section 13(a) of the Exchange Act had occurred.)

Accordingly, it is hereby ORDERED that:

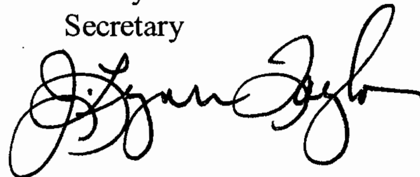
A. Pursuant to Section 8A of the Securities Act, Respondent JPMorgan Chase & Co. cease and desist from committing or causing any violations and any future violations of Section 17(a)(3) of the Securities Act.

B. IT IS FURTHER ORDERED THAT Respondent shall, within 10 days of the entry of this Order, pay disgorgement of $1,286,808.82 and prejudgment interest of $711,335.76. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. Payment shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to U.S. Bank, as paying agent for the trustee of the post-confirmation trusts ("bankruptcy trustee") created in *In re National Century Financial Enterprises, Inc.*, Case No. 02-65235 (Bankr. S.D. Ohio), for distribution on a pro rata basis solely to the injured investors in asset-backed notes issued by NPF VI and NPF XII; and (C) submitted under cover letter that identifies JPMorgan Chase & 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 Jane E. Jarcho, Chicago Regional Office, Division of Enforcement, Securities and Exchange Commission, 175 W. Jackson Blvd., Suite 900, Chicago, IL 60604. Respondent shall bear the costs of distribution of the disgorgement and prejudgment interest amounts.

C. IT IS FURTHER ORDERED THAT Respondent shall make reasonable efforts to obtain and provide to the Commission written confirmation from the bankruptcy trustee or U.S. Bank that U.S. Bank received the disgorgement and prejudgment interest amounts ordered in paragraph IV.B. above and that U.S. Bank distributed those amounts on a pro rata basis solely to the injured investors in asset-backed notes issued by NPF VI and NPF XII. This written confirmation shall be provided to Jane E. Jarcho, Chicago Regional Office, Division of Enforcement, Securities and Exchange Commission, 175 W. Jackson Blvd., Suite 900, Chicago, IL 60604.

By the Commission.

Nancy M. Morris
Secretary



By: J. Lynn Taylor
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 8907 / March 27, 2008

SECURITIES EXCHANGE ACT OF 1934
Release No. 57571 / March 27, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-13000

In the Matter of JPMORGAN CHASE & CO., Respondent.	ORDER UNDER SECTION 27A(b) OF THE SECURITIES ACT OF 1933, AND SECTION 21E(b) OF THE SECURITIES EXCHANGE ACT OF 1934, GRANTING WAIVERS OF THE DISQUALIFICATION PROVISIONS OF SECTION 27A(b)(1)(A)(ii) OF THE SECURITIES ACT OF 1933 AND SECTION 21E(b)(1)(A)(ii) OF THE SECURITIES EXCHANGE ACT OF 1934

Respondent JPMorgan Chase & Co. (the "Respondent") submitted a letter, dated January 29, 2008, requesting a waiver of the disqualification provisions of Section 27A(b)(1)(A)(ii) of the Securities Act of 1933 ("Securities Act") and Section 21E(b)(1)(A)(ii) of the Securities Exchange Act of 1934 ("Exchange Act") arising from the settlement of a cease-and-desist proceeding commenced by the Commission. On March 27, 2008, pursuant to the Respondent's Offer of Settlement, the Commission instituted an 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 against the Respondent.

The Order finds that the Respondent was a cause of National Century Financial Enterprises, Inc.'s violations of Section 17(a)(3) of the Securities Act. The Order also requires (1) Respondent to cease and desist from committing or causing any violations and any future violations of Section 17(a)(3) of the Securities Act; and (2) Respondent to pay disgorgement of $1,286,808.82 and prejudgment interest of $711,335.76.

The safe harbor provisions of Section 27A(c) of the Securities Act and Section 21E(c) of the Exchange Act are not available for any forward looking statement that is "made with respect to the business or operations of the issuer, if the issuer...during the 3-

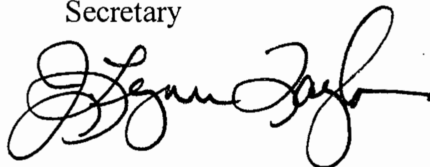
year period preceding the date on which the statement was first made…has been made the subject of a judicial or administrative decree or order arising out of a governmental action that (I) prohibits future violations of the antifraud provisions of the securities laws; (II) requires that the issuer cease and desist from violating the antifraud provisions of the securities laws; or (III) determines that the issuer violated the antifraud provisions of the securities laws[.]" Section 27A(b)(1)(A)(ii) of the Securities Act; Section 21E(b)(1)(A)(ii) of the Exchange Act. The disqualifications may be waived "to the extent otherwise provided by rule, regulation or order of the Commission." 27A(b) of the Securities Act; Section 21E(b) of the Exchange Act.

Based on the representations set forth in the Respondent's January 29, 2008 request letter, the Commission has determined that, under the circumstances, the request for a waiver of the disqualifications resulting from the entry of the Order is appropriate and should be granted.

Accordingly, **IT IS ORDERED**, pursuant to Section 27A(b) of the Securities Act and 21E(b) of the Exchange Act, that a waiver from the disqualification provisions of Section 27A(b)(1)(A)(ii) of the Securities Act and Section 21E(b)(1)(A)(ii) of the Exchange Act as to the Respondent resulting from the entry of the Order is hereby granted.

By the Commission.

Nancy M. Morris
Secretary



By: J. Lynn Taylor
Assistant Secretary

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 March 2008, 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. Commissioner Nazareth was Commissioner from August 4, 2005 to January 31, 2008.

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

ANNETTE L. NAZARETH, COMMISSIONER

KATHLEEN L. CASEY, COMMISSIONER

6 DOCUMENTS

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
March 5, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12975

In the Matter of **Machine Technology, Inc.,** **Madrona International, Inc.,** **Mangum Acquisitions Corp.,** **Magnum Sports & Entertainment, Inc.,** **Majestic Companies, Ltd.,** **Management of Environmental Solutions & Technology Corp.,** **Maple Corp.,** **Mariculture Systems, Inc.,** **Marina Capital, 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") against Respondents Machine Technology, Inc., Madrona International, Inc., Mangum Acquisitions Corp., Magnum Sports & Entertainment, Inc., Majestic Companies, Ltd., Management of Environmental Solutions & Technology Corp., Maple Corp., Mariculture Systems, Inc., and Marina Capital, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Machine Technology, Inc. ("Machine Technology") (CIK No. 320654) is a revoked New Jersey corporation located in Parsippany, New Jersey with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Machine Technology is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended May 31, 1994, which reported a $2,617,595 net loss for the prior nine months. On July 22,

1994, the company filed a Chapter 11 petition in the U.S. Bankruptcy Court for the District of New Jersey that was converted to Chapter 7 bankruptcy and the company was discharged on October 26, 2004. As of January 3, 2008, the company's common stock (symbol "MTGYQ") was quoted on the Pink Sheets, had three market makers, and was eligible for the piggyback exemption of Exchange Act Rule 15c2-11(f)(3).

2. Madrona International, Inc. ("Madrona International") (CIK No. 1080327) is a void Delaware corporation located in Bellingham, Washington with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Madrona International is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended April 30, 2001, which reported a $8,608 net loss for the prior six months.

3. Mangum Acquisition Corp. ("Mangum") (CIK No. 1113109) is a forfeited Texas corporation located in Houston, Texas with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Mangum 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 assets of $1,000 and no revenues or income for the prior three months. Mangum attempted to terminate its registration by filing a Form 15 on April 17, 2001, however the form was invalid and did not terminate Mangum's registration. Mangum disclosed that it had 1,950 shareholders of record, which makes it ineligible to terminate registration via Form 15. Moreover, because Mangum was unable to rely on any of the permitted rules identified on the Form 15 pursuant to which it could terminate registration, it altered the Form 15 and added its own category for termination called "Other: Rule 12g-(1)(B)." There is no such rule.

4. Magnum Sports & Entertainment, Inc. ("Magnum Sports") (CIK No. 1002325) is a void Delaware corporation located in New York, New York with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Magnum Sports is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 2002, which reported a $57,498 net loss for the prior three months. As of January 3, 2008, the company's common (symbol "MAGZ") stock was quoted on the Pink Sheets, had five market makers, and was eligible for the piggyback exemption of Exchange Act Rule 15c2-11(f)(3).

5. Majestic Companies, Ltd. ("Majestic Companies") (CIK No. 1083931) is a revoked Nevada corporation located in Grapevine, Texas with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Majestic Companies 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 $298,331 net loss for the prior three months. As of January 3, 2008, the company's common stock (symbol "MJXX") was traded on the over-the-counter markets.

6. Management of Environmental Solutions & Technology Corp. ("Management") (CIK No. 1062386) is a void Delaware corporation located in The Netherlands with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Management is delinquent in its periodic filings with the

Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended June 30, 2002, which reported a $233,179 net loss for the prior three months. As of January 3, 2008, the company's common stock (symbol "MESO") was quoted on the Pink Sheets, had five market makers, and was eligible for the piggyback exemption of Exchange Act Rule 15c2-11(f)(3).

7. Maple Corp. ("Maple") (CIK No. 1126565) is a revoked Nevada corporation located in Newport Beach, California with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Maple 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 no assets or revenues and net losses of $500 for the prior three months.

8. Mariculture Systems, Inc. ("Mariculture") (CIK No. 1000778) is an inactive Florida corporation located in Edmonds, Washington with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Mariculture 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 $344,868 for the prior nine months. As of January 3, 2008, the company's common stock (symbol "MCUL") was quoted on the Pink Sheets, had eight market makers, and was eligible for the piggyback exemption of Exchange Act Rule 15c2-11(f)(3).

9. Marina Capital, Inc. ("Marina Capital") (CIK No. 1027983) is an expired Utah corporation located in Salt Lake City, Utah with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Marina Capital is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2002, which reported a $674,410 net loss for the prior nine months. On March 10, 2003, the company filed a Chapter 11 petition in the U.S. Bankruptcy Court for the District of Utah that was terminated on October 16, 2006. As of January 3, 2008, the company's common stock (symbol "MARN") was traded on the over-the-counter markets.

B. DELINQUENT PERIODIC FILINGS

10. 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.

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

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

III.

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

A. Whether the allegations contained in Section II 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)].

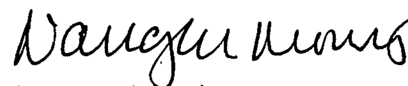
If Respondents fail to file the directed Answers, or fail to appear at a hearing after being duly notified, the Respondents may be deemed in default and the proceedings may be determined against it upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 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

Attachment

<u>Appendix 1</u>

Chart of Delinquent Filings
In the Matter of "M" Delinquent Issuers

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Machine Technology, Inc.					
	10-Q	05/31/94	07/15/94	Not filed	164
	10-K	08/31/94	11/29/94	Not filed	160
	10-Q	11/30/94	01/16/95	Not filed	158
	10-Q	02/28/95	04/14/95	Not filed	155
	10-Q	05/31/95	07/17/95	Not filed	152
	10-K	08/31/95	11/29/95	Not filed	148
	10-Q	11/30/95	01/15/96	Not filed	146
	10-Q	02/28/96	04/15/96	Not filed	143
	10-Q	05/31/96	07/15/96	Not filed	140
	10-K	08/31/96	11/29/96	Not filed	136
	10-Q	11/30/96	01/14/97	Not filed	134
	10-Q	02/28/97	04/14/97	Not filed	131
	10-Q	05/31/97	07/15/97	Not filed	128
	10-K	08/31/97	12/01/97	Not filed	123
	10-Q	11/30/97	01/14/98	Not filed	122
	10-Q	02/28/98	04/14/98	Not filed	119
	10-Q	05/31/98	07/15/98	Not filed	116
	10-K	08/31/98	11/30/98	Not filed	112
	10-Q	11/30/98	01/14/99	Not filed	110
	10-Q	02/28/99	04/14/99	Not filed	107
	10-Q	05/31/99	07/15/99	Not filed	104
	10-K	08/31/99	11/29/99	Not filed	100
	10-Q	11/30/99	01/14/00	Not filed	98
	10-Q	02/29/00	04/14/00	Not filed	95
	10-Q	05/31/00	07/17/00	Not filed	92
	10-K	08/31/00	11/29/00	Not filed	88
	10-Q	11/30/00	01/16/01	Not filed	86
	10-Q	02/28/01	04/16/01	Not filed	83
	10-Q	05/31/01	07/16/01	Not filed	80
	10-K	08/31/01	11/29/01	Not filed	76
	10-Q	11/30/01	01/14/02	Not filed	74
	10-Q	02/28/02	04/15/02	Not filed	71
	10-Q	05/31/02	07/15/02	Not filed	68
	10-K	08/31/02	11/29/02	Not filed	64

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Machine Technology, Inc.					
	10-Q	11/30/02	01/14/03	Not filed	62
	10-Q	02/28/03	04/14/03	Not filed	59
	10-Q	05/31/03	07/15/03	Not filed	56
	10-K	08/31/03	12/01/03	Not filed	51
	10-Q	11/30/03	01/14/04	Not filed	50
	10-Q	02/28/04	04/13/04	Not filed	47
	10-Q	05/31/04	07/15/04	Not filed	44
	10-K	08/31/04	11/29/04	Not filed	40
	10-Q	11/30/04	01/14/05	Not filed	38
	10-Q	02/28/05	04/14/05	Not filed	35
	10-Q	05/31/05	07/15/05	Not filed	32
	10-K	08/31/05	11/29/05	Not filed	28
	10-Q	11/30/05	01/16/06	Not filed	26
	10-Q	02/28/06	04/14/06	Not filed	23
	10-Q	05/31/06	07/17/06	Not filed	20
	10-K	08/31/06	11/29/06	Not filed	16
	10-Q	11/30/06	01/16/07	Not filed	14
	10-Q	02/28/07	04/16/07	Not filed	11
	10-Q	05/31/07	07/16/07	Not filed	8
	10-K	08/31/07	11/29/07	Not filed	4
Total Filings Delinquent	54				
Madrona International, Inc.					
	10-QSB	07/31/01	09/14/01	Not filed	78
	10-KSB	10/31/01	01/29/02	Not filed	74
	10-QSB	01/31/02	03/18/02	Not filed	72
	10-QSB	04/30/02	06/14/02	Not filed	69
	10-QSB	07/31/02	09/16/02	Not filed	66
	10-KSB	10/31/02	01/29/03	Not filed	62
	10-QSB	01/31/03	03/17/03	Not filed	60
	10-QSB	04/30/03	06/16/03	Not filed	57
	10-QSB	07/31/03	09/15/03	Not filed	54
	10-KSB	10/31/03	01/29/04	Not filed	50
	10-QSB	01/31/04	03/16/04	Not filed	48
	10-QSB	04/30/04	06/14/04	Not filed	45
	10-QSB	07/31/04	09/14/04	Not filed	42
	10-KSB	10/31/04	01/31/05	Not filed	38

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Madrona International, Inc.					
	10-QSB	01/31/05	03/17/05	Not filed	36
	10-QSB	04/30/05	06/14/05	Not filed	33
	10-QSB	07/31/05	09/14/05	Not filed	30
	10-KSB	10/31/05	01/30/06	Not filed	26
	10-QSB	01/31/06	03/17/06	Not filed	24
	10-QSB	04/30/06	06/14/06	Not filed	21
	10-QSB	07/31/06	09/14/06	Not filed	18
	10-KSB	10/31/06	01/29/07	Not filed	14
	10-QSB	01/31/07	03/19/07	Not filed	12
	10-QSB	04/30/07	06/14/07	Not filed	9
	10-QSB	07/31/07	09/14/07	Not filed	6
Total Filings Delinquent	25				
Mangum Acquisitions Corp.					
	10-KSB	12/31/00	04/02/01	Not filed	83
	10-QSB	03/31/01	05/15/01	Not filed	82
	10-QSB	06/30/01	08/14/01	Not filed	79
	10-QSB	09/30/01	11/14/01	Not filed	76
	10-KSB	12/31/01	04/01/02	Not filed	71
	10-QSB	03/31/02	05/15/02	Not filed	70
	10-QSB	06/30/02	08/14/02	Not filed	67
	10-QSB	09/30/02	11/14/02	Not filed	64
	10-KSB	12/31/02	03/31/03	Not filed	60
	10-QSB	03/31/03	05/15/03	Not filed	58
	10-QSB	06/30/03	08/14/03	Not filed	55
	10-QSB	09/30/03	11/14/03	Not filed	52
	10-KSB	12/31/03	03/30/04	Not filed	48
	10-QSB	03/31/04	05/17/04	Not filed	46
	10-QSB	06/30/04	08/16/04	Not filed	43
	10-QSB	09/30/04	11/15/04	Not filed	40
	10-KSB	12/31/04	03/31/05	Not filed	36
	10-QSB	03/31/05	05/16/05	Not filed	34
	10-QSB	06/30/05	08/15/05	Not filed	31
	10-QSB	09/30/05	11/14/05	Not filed	28
	10-KSB	12/31/05	03/31/06	Not filed	24
	10-QSB	03/31/06	05/15/06	Not filed	22

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Mangum Acquisitions Corp.					
	10-QSB	06/30/06	08/14/06	Not filed	19
	10-QSB	09/30/06	11/14/06	Not filed	16
	10-KSB	12/31/06	04/02/07	Not filed	11
	10-QSB	03/31/07	05/15/07	Not filed	10
	10-QSB	06/30/07	08/14/07	Not filed	7
	10-QSB	09/30/07	11/14/07	Not filed	4
Total Filings Delinquent	28				
Magnum Sports & Entertainment, Inc.					
	10-QSB	06/30/02	08/14/02	Not filed	67
	10-QSB	09/30/02	11/14/02	Not filed	64
	10-KSB	12/31/02	03/31/03	Not filed	60
	10-QSB	03/31/03	05/15/03	Not filed	58
	10-QSB	06/30/03	08/14/03	Not filed	55
	10-QSB	09/30/03	11/14/03	Not filed	52
	10-KSB	12/31/03	03/30/04	Not filed	48
	10-QSB	03/31/04	05/17/04	Not filed	46
	10-QSB	06/30/04	08/16/04	Not filed	43
	10-QSB	09/30/04	11/15/04	Not filed	40
	10-KSB	12/31/04	03/31/05	Not filed	36
	10-QSB	03/31/05	05/16/05	Not filed	34
	10-QSB	06/30/05	08/15/05	Not filed	31
	10-QSB	09/30/05	11/14/05	Not filed	28
	10-KSB	12/31/05	03/31/06	Not filed	24
	10-QSB	03/31/06	05/15/06	Not filed	22
	10-QSB	06/30/06	08/14/06	Not filed	19
	10-QSB	09/30/06	11/14/06	Not filed	16
	10-KSB	12/31/06	04/02/07	Not filed	11
	10-QSB	03/31/07	05/15/07	Not filed	10
	10-QSB	06/30/07	08/14/07	Not filed	7
	10-QSB	09/30/07	11/14/07	Not filed	4
Total Filings Delinquent	22				

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Majestic Companies, Ltd.					
	10-KSB	12/31/02	03/31/03	Not filed	60
	10-QSB	03/31/03	05/15/03	Not filed	58
	10-QSB	06/30/03	08/14/03	Not filed	55
	10-QSB	09/30/03	11/14/03	Not filed	52
	10-KSB	12/31/03	03/30/04	Not filed	48
	10-QSB	03/31/04	05/17/04	Not filed	46
	10-QSB	06/30/04	08/16/04	Not filed	43
	10-QSB	09/30/04	11/15/04	Not filed	40
	10-KSB	12/31/04	03/31/05	Not filed	36
	10-QSB	03/31/05	05/16/05	Not filed	34
	10-QSB	06/30/05	08/15/05	Not filed	31
	10-QSB	09/30/05	11/14/05	Not filed	28
	10-KSB	12/31/05	03/31/06	Not filed	24
	10-QSB	03/31/06	05/15/06	Not filed	22
	10-QSB	06/30/06	08/14/06	Not filed	19
	10-QSB	09/30/06	11/14/06	Not filed	16
	10-KSB	12/31/06	04/02/07	Not filed	11
	10-QSB	03/31/07	05/15/07	Not filed	10
	10-QSB	06/30/07	08/14/07	Not filed	7
	10-QSB	09/30/07	11/14/07	Not filed	4
Total Filings Delinquent	20				
Management of Environmental Solutions & Technology Corp.					
	10-QSB	09/30/02	11/14/02	Not filed	64
	10-KSB	12/31/02	03/31/03	Not filed	60
	10-QSB	03/31/03	05/15/03	Not filed	58
	10-QSB	06/30/03	08/14/03	Not filed	55
	10-QSB	09/30/03	11/14/03	Not filed	52
	10-KSB	12/31/03	03/30/04	Not filed	48
	10-QSB	03/31/04	05/17/04	Not filed	46
	10-QSB	06/30/04	08/16/04	Not filed	43
	10-QSB	09/30/04	11/15/04	Not filed	40

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Management of Environmental Solutions & Technology Corp.					
	10-KSB	12/31/04	03/31/05	Not filed	36
	10-QSB	03/31/05	05/16/05	Not filed	34
	10-QSB	06/30/05	08/15/05	Not filed	31
	10-QSB	09/30/05	11/14/05	Not filed	28
	10-KSB	12/31/05	03/31/06	Not filed	24
	10-QSB	03/31/06	05/15/06	Not filed	22
	10-QSB	06/30/06	08/14/06	Not filed	19
	10-QSB	09/30/06	11/14/06	Not filed	16
	10-KSB	12/31/06	04/02/07	Not filed	11
	10-QSB	03/31/07	05/15/07	Not filed	10
	10-QSB	06/30/07	08/14/07	Not filed	7
	10-QSB	09/30/07	11/14/07	Not filed	4
Total Filings Delinquent	21				
Maple Corp.					
	10-QSB	06/30/01	08/14/01	Not filed	79
	10-QSB	09/30/01	11/14/01	Not filed	76
	10-KSB	12/31/01	04/01/02	Not filed	71
	10-QSB	03/31/02	05/15/02	Not filed	70
	10-QSB	06/30/02	08/14/02	Not filed	67
	10-QSB	09/30/02	11/14/02	Not filed	64
	10-KSB	12/31/02	03/31/03	Not filed	60
	10-QSB	03/31/03	05/15/03	Not filed	58
	10-QSB	06/30/03	08/14/03	Not filed	55
	10-QSB	09/30/03	11/14/03	Not filed	52
	10-KSB	12/31/03	03/30/04	Not filed	48
	10-QSB	03/31/04	05/17/04	Not filed	46
	10-QSB	06/30/04	08/16/04	Not filed	43
	10-QSB	09/30/04	11/15/04	Not filed	40
	10-KSB	12/31/04	03/31/05	Not filed	36
	10-QSB	03/31/05	05/16/05	Not filed	34
	10-QSB	06/30/05	08/15/05	Not filed	31

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Maple Corp.					
	10-QSB	09/30/05	11/14/05	Not filed	28
	10-KSB	12/31/05	03/31/06	Not filed	24
	10-QSB	03/31/06	05/15/06	Not filed	22
	10-QSB	06/30/06	08/14/06	Not filed	19
	10-QSB	09/30/06	11/14/06	Not filed	16
	10-KSB	12/31/06	04/02/07	Not filed	11
	10-QSB	03/31/07	05/15/07	Not filed	10
	10-QSB	06/30/07	08/14/07	Not filed	7
	10-QSB	09/30/07	11/14/07	Not filed	4
Total Filings Delinquent	26				
Mariculture Systems, Inc.					
	10-KSB	12/31/02	03/31/03	Not filed	60
	10-QSB	03/31/03	05/15/03	Not filed	58
	10-QSB	06/30/03	08/14/03	Not filed	55
	10-QSB	09/30/03	11/14/03	Not filed	52
	10-KSB	12/31/03	03/30/04	Not filed	48
	10-QSB	03/31/04	05/17/04	Not filed	46
	10-QSB	06/30/04	08/16/04	Not filed	43
	10-QSB	09/30/04	11/15/04	Not filed	40
	10-KSB	12/31/04	03/31/05	Not filed	36
	10-QSB	03/31/05	05/16/05	Not filed	34
	10-QSB	06/30/05	08/15/05	Not filed	31
	10-QSB	09/30/05	11/14/05	Not filed	28
	10-KSB	12/31/05	03/31/06	Not filed	24
	10-QSB	03/31/06	05/15/06	Not filed	22
	10-QSB	06/30/06	08/14/06	Not filed	19
	10-QSB	09/30/06	11/14/06	Not filed	16
	10-KSB	12/31/06	04/02/07	Not filed	11
	10-QSB	03/31/07	05/15/07	Not filed	10
	10-QSB	06/30/07	08/14/07	Not filed	7
	10-QSB	09/30/07	11/14/07	Not filed	4
Total Filings Delinquent	20				

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Marina Capital, Inc.					
	10-KSB	12/31/02	03/31/03	Not filed	60
	10-QSB	03/31/03	05/15/03	Not filed	58
	10-QSB	06/30/03	08/14/03	Not filed	55
	10-QSB	09/30/03	11/14/03	Not filed	52
	10-KSB	12/31/03	03/30/04	Not filed	48
	10-QSB	03/31/04	05/17/04	Not filed	46
	10-QSB	06/30/04	08/16/04	Not filed	43
	10-QSB	09/30/04	11/15/04	Not filed	40
	10-KSB	12/31/04	03/31/05	Not filed	36
	10-QSB	03/31/05	05/16/05	Not filed	34
	10-QSB	06/30/05	08/15/05	Not filed	31
	10-QSB	09/30/05	11/14/05	Not filed	28
	10-KSB	12/31/05	03/31/06	Not filed	24
	10-QSB	03/31/06	05/15/06	Not filed	22
	10-QSB	06/30/06	08/14/06	Not filed	19
	10-QSB	09/30/06	11/14/06	Not filed	16
	10-KSB	12/31/06	04/02/07	Not filed	11
	10-QSB	03/31/07	05/15/07	Not filed	10
	10-QSB	06/30/07	08/14/07	Not filed	7
	10-QSB	09/30/07	11/14/07	Not filed	4

Total Filings Delinquent 20

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

March 5, 2008

IN THE MATTER OF Machine Technology, Inc., Magnum Sports & Entertainment, Inc., Management of Environmental Solutions & Technology Corp., and Mariculture Systems, Inc. File No. 500-1	ORDER OF SUSPENSION OF TRADING

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Machine Technology, Inc. because it has not filed any periodic reports since it filed a Form 10-Q for the period ended May 31, 1994.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Magnum Sports & Entertainment, Inc. because it has not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 2002.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Management of Environmental Solutions & Technology Corp. because it has not filed any periodic reports since it filed a Form 10-QSB for the period ended June 30, 2002.

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Mariculture Systems, Inc. because it has not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2002.

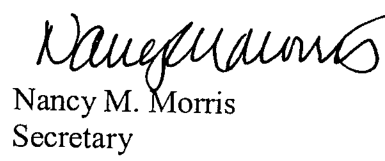
The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above-listed companies.

Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed companies is suspended for the

2 of 6

period from 9:30 a.m. EST on March 5, 2008, through 11:59 p.m. EDT on March 18, 2008.

By the Commission.



Nancy M. Morris
Secretary

Commissioner Nazareth
Not Participating

SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 57446 / March 6, 2008

Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The Retirement Systems of Alabama

I. Introduction

The Division of Enforcement has investigated whether The Retirement Systems of Alabama ("RSA") violated the federal securities laws by purchasing shares of The Liberty Corporation ("Liberty") on the basis of material, nonpublic information concerning a prospective acquisition of Liberty by Raycom Media, Inc. ("Raycom"). During discussion and negotiation of the deal, RSA received material, nonpublic information regarding Liberty and the proposed transaction. RSA then purchased 73,700 Liberty shares during the two weeks prior to the public announcement of the transaction in August 2005. After the public announcement, the price of Liberty stock rose significantly, increasing the value of RSA's Liberty shares by more than $700,000.

RSA is the retirement system for Alabama state and local employees. RSA does not engage outside professional money managers, but instead relies on an in-house investment staff to manage more than $30 billion in assets. At the time of the events described in this report, RSA had no policies, procedures, training or compliance officer to ensure its compliance with the federal securities laws.

RSA cooperated in the SEC staff's investigation. In addition, after the investigation began, RSA determined the identity of those who sold the Liberty shares that RSA purchased and offered those sellers compensation equivalent to rescission. RSA also engaged securities counsel and has implemented a compliance program that its counsel designed and recommended.

Based upon information obtained during the investigation, the Commission deems it appropriate that it issue this Report of Investigation ("Report") pursuant to Section 21(a) of the Securities Exchange Act of 1934 ("Exchange Act")[1] to emphasize the responsibilities of all investment professionals, including large public retirement systems and other public entities, under the federal securities laws and to highlight the risks they undertake when they operate without a compliance program.

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[1] Section 21(a) of the Exchange Act authorizes the Commission to investigate violations of the federal securities laws and, in its discretion, to "publish information concerning any such violations." This Report does not constitute an adjudication of any fact or issue addressed herein. RSA has consented to the issuance of this Report without admitting or denying any of the statements or conclusions herein.

II. Facts

A. Background

RSA is a state agency that administers 20 retirement funds with aggregate assets in excess of $30 billion as of September 30, 2006. Two funds, the Teachers' Retirement System and the Employees' Retirement System ("The Retirement Systems"), account for more than 90% of those assets. The Retirement Systems are defined benefit pension plans for Alabama state and local employees. Although many public pension funds employ outside investment advisers to manage at least some of their assets, RSA's 13-person in-house investment staff, along with RSA's Chief Executive Officer ("CEO"), manage all of RSA's investments. RSA's CEO has held his position since 1973, when RSA's assets were a small fraction of its current assets. The Retirement Systems have Boards of Control that are the statutory trustees of the funds. The Boards of Control, or an Investment Committee consisting of board members, must approve RSA's investment decisions. In practice, however, that authority largely has been delegated to RSA's CEO. Thus, there has been little oversight of the investment activities of RSA's CEO and staff.

At the time of the events described in this Report, RSA had no program, policy, practice or training to ensure that its investment staff understood and complied with the federal securities laws in general or insider trading laws in particular. RSA also did not have a compliance officer, and the responsibilities of its general counsel did not include oversight of RSA's investment activities.

RSA founded Raycom, a privately-held company, in 1996 and has been its primary financing source. In the Summer of 2005, Raycom's outstanding debt to RSA was approximately $2 billion, and RSA held warrants for 80% of Raycom's common stock. Raycom owned and operated television stations, as did Liberty. Raycom had previously considered a possible business combination with Liberty, but there had been no serious discussions between them.

B. Raycom-Liberty Discussions

In June 2005, a business adviser firm that had worked with Raycom and RSA in the past approached RSA about financing a Raycom acquisition of Liberty. The adviser firm was operated by two individuals (the "Advisers" or, individually, the "Adviser"), one of whom was a lawyer.[2] On June 14, they met at RSA's offices with RSA's CEO, members of RSA's investment staff, and Raycom's CEO. At that meeting, the Advisers presented their analysis that Liberty's controlling shareholders were ready to sell the company, and RSA and Raycom gave the Advisers authority to approach Liberty on their behalf.

When the Advisers contacted Liberty to begin discussions, Liberty's CEO first required assurance that RSA would finance the prospective transaction. RSA's CEO provided that assurance during a telephone conversation with Liberty's CEO on

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[2] The Advisers had ongoing business dealings with RSA through entities that RSA financed. During the preceding several years, the Advisers had received fees in at least five transactions, each involving Raycom or another media company to which RSA was the primary lender.

June 24. During that conversation, Liberty's CEO said that $1 billion was his "number." In response, RSA's CEO indicated his willingness to finance a transaction at that price.

On June 27, 2005, the Advisers and their firm entered into a written non-disclosure agreement with Liberty (the "NDA"). Under the NDA, the Advisers agreed that, prior to disclosing any of Liberty's confidential information, they would require the person(s) to whom they intended to make the disclosure to be bound by the terms of the NDA. The NDA also prohibited them from disclosing the fact of the discussions, with exceptions not applicable here. Finally, the NDA specifically set forth an acknowledgment that the Advisers were aware that the securities laws prohibit (1) trading in reliance on material, nonpublic information concerning Liberty, or a possible transaction involving Liberty, or (2) communicating such information to anyone else where reasonably foreseeable that the other person was likely to trade in reliance upon such information. On July 1, the Advisers met with Liberty officials and obtained confidential Liberty information. They also began using a code name to refer to the prospective transaction.

On July 12, 2005, the Advisers made another presentation to RSA and Raycom's CEO.[3] The Advisers distributed a hard copy presentation, with indicia that they were communicating confidential information: the code name was used as the title of the presentation booklet; the code name and "Target" were used throughout the booklet for all references to Liberty; the booklet was marked "CONFIDENTIAL"; the booklet stated that the Advisers had executed a confidentiality agreement with Liberty and that they had met "all day" with Liberty officials; and the booklet included Liberty's confidential (positive) projections and confidential financial information about many of Liberty's individual television stations. RSA neither asked to see the NDA nor inquired about its terms.[4] RSA's CEO did not believe that RSA had a duty of confidentiality because RSA had not signed a non-disclosure agreement. The RSA investment staff who attended the meeting understood that they were supposed to keep the information confidential.[5]

During the July 12 meeting, the RSA investment staff asked questions that suggested they had a negative view of the proposed Raycom-Liberty transaction. More than halfway through that meeting, when one of the Advisers (the attorney) believed RSA was losing interest in the transaction, he told RSA that no matter what it decided to do, Liberty was for sale and RSA should buy some Liberty stock and that RSA should limit its purchases to five percent of outstanding Liberty shares.[6]

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[3] This meeting also was held at RSA's offices, and RSA's CEO and the same four members of its investment staff were present. In addition, RSA's Chief Investment Officer and a college intern working for the Advisers attended the meeting; neither of those individuals had attended the June 14 meeting.

[4] RSA has a general policy of not entering into confidentiality agreements because of state public access laws.

[5] RSA investment personnel are strongly encouraged to pursue MBA degrees and Chartered Financial Analyst designations and they have some familiarity with insider trading law from their CFA training.

[6] The Adviser is certain that he made these remarks at the June 14 meeting, *i.e.*, prior to entering into the NDA with Liberty. However, the weight of the evidence is that he made the remarks at the July 12 meeting. For example, RSA's chief investment officer, who

The Adviser viewed his statement as a casual investment suggestion. The Adviser was not, and never had been, in an attorney-client relationship with RSA, although he had advised companies to which RSA was a lender. RSA did not have any basis to believe that the Adviser, even though he was an attorney, had any federal securities law experience or expertise. The Adviser did not, in fact, have such experience or expertise.

At the conclusion of the July 12 meeting, RSA and Raycom authorized the Advisers to inform Liberty that Raycom was prepared to proceed with a business combination based on a preliminary value for Liberty of $1 billion, subject to due diligence and negotiation of documentation. It was clear from the Advisers' presentation materials that $1 billion represented a substantial premium over the market price of Liberty's stock. On July 19, Raycom entered into a confidentiality agreement with Liberty, and the Advisers led extensive due diligence at Liberty's offices on July 21 and 22.[7]

On August 8, RSA's CEO received from Raycom a notice of a special meeting of Raycom's board of directors, to be held on August 15, to consider the Liberty acquisition. That notice contained a specific admonition regarding confidentiality, the federal securities laws and insider trading.[8] RSA's CEO circulated the notice to three members of RSA's investment staff, including the Chief Investment Officer, so that they would see the confidentiality and securities law warnings and not engage in any personal trading of Liberty stock or mention the proposed transaction to others. Raycom's board reacted positively to the August 15 presentation regarding the Liberty transaction, and the Advisers reported that result to RSA's CEO the following day.[9]

C. RSA's Purchases of Liberty Stock

After receiving and reviewing the August 8 notice of the upcoming special meeting of the Raycom board of directors, four weeks after the Adviser's suggestion to purchase

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attended only the July 12 meeting, heard the remarks. In any event, the Advisers failed to comply with the NDA requirement that they bind RSA to its terms.

[7] Liberty did not require RSA to execute a confidentiality agreement and did not consider, at the time, whether there was a reason to do so.

[8] The notice stated:

> For purposes of maintaining the utmost confidentiality, we code-named this company [Liberty] "5 Henry Street". To be able to view internal, non-public information about 5 Henry Street, Raycom had to execute a Confidentiality Agreement. The Confidentiality Agreement *prohibits Raycom* and its employees, officers, agents and *its directors from disclosing any confidential information* received from 5 Henry Street and *from disclosing that Raycom and 5 Henry Street have even entered into discussions of a possible transaction.* In addition, federal securities laws prohibit any person with knowledge of the proposed transaction from trading in the securities of 5 Henry Street or informing any other person of the proposed transaction who then buys or sells securities of 5 Henry Street before that information is made publicly available. (italics in original)

[9] RSA's CEO was confident of that outcome before the Raycom board met.

Liberty stock, RSA's CEO instructed RSA's Chief Investment Officer to make those purchases. RSA's CEO testified that it was probably the August 8 notice that *prompted* him to instruct the Chief Investment Officer to purchase Liberty stock. From August 10 to August 25, RSA purchased a total of 73,700 Liberty shares.[10] RSA ceased purchasing Liberty shares on August 25, after it learned that a public announcement of the transaction would likely be released later that day.

The average price of RSA's purchases of Liberty stock was $37.14 per share. After the market closed on August 25, the parties announced that Raycom had agreed to pay $47.35 per share to acquire Liberty. The following day, the price of Liberty stock rose approximately $10 per share and closed at $47.51, resulting in an increase in the value of RSA's shares of more than $700,000.[11]

RSA's purchases of Liberty stock were unusual in at least two respects. First, RSA's CEO directed the trades even though he normally was not involved in equity trading decisions. Second, Liberty's market capitalization at the time was less than $1 billion and did not satisfy the $5 billion market capitalization guidelines RSA generally used for the two funds that purchased the shares.

During the SEC staff's investigation, RSA determined the identity of those who sold the Liberty shares that RSA purchased and offered those sellers compensation equivalent to rescission.[12] To date, sellers representing more than 90% of the shares RSA purchased have accepted RSA's offer. Because they included interest, RSA's payments to the sellers exceed RSA's profits from its purchases of Liberty stock.

III. Discussion

State pension funds such as RSA are exempt from the requirements of the Investment Company Act of 1940 and the Investment Advisers Act, two federal statutes that regulate money managers.[13] However, public pension funds and their employees *are* subject to the anti-fraud provisions of the federal securities laws and Commission rules thereunder. Section 10(b) of the Exchange Act and Rule 10b-5

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[10] There is no evidence that anyone associated with RSA purchased Liberty stock for his or her personal account.

[11] RSA did not sell the shares back into the market, but realized a gain when, upon the closing of the transaction, a wholly-owned Raycom subsidiary purchased all outstanding Liberty shares, including those owned by RSA, for $47.35 per share.

[12] It was not possible for RSA to offer actual rescission because, upon the January 2006 closing, a wholly-owned subsidiary of Raycom purchased all outstanding Liberty stock and Liberty stock ceased trading.

[13] The following exclusion is found in both Section 2(b) of the Investment Company Act and Section 202(b) of the Investment Advisers Act: "No provision in this subchapter shall apply to, or be deemed to include, the United States, a State, or any political subdivision of a State, or any agency, authority, or instrumentality of any one or more of the foregoing, or any corporation which is wholly owned directly or indirectly by any one or more of the foregoing, or any officer, agent, or employee of any of the foregoing acting as such in the course of his official duty, unless such provision makes specific reference thereto."

prohibit the purchase or sale of securities on the basis of material, nonpublic information in breach of a duty of trust or confidence. That prohibition covers "insiders," those who acquire the information in the context of a relationship of trust or confidence, and persons who are "tippees" of either "insiders" or persons who have misappropriated the information. In addition, controlling persons who fail to prevent insider trading may be subject to civil penalties under Section 21A of the Exchange Act.

In issuing this Report, we observe that RSA's trading could have been prevented if RSA had adequate policies and procedures to assure compliance with the federal securities laws. Most of the RSA investment personnel involved in this matter, including its CEO, did not have a clear understanding of the securities law duties and risks implicated when they came into possession of material, nonpublic information. RSA had an in-house general counsel, but he was not responsible for securities law compliance and was not consulted before the trades. RSA had outside counsel with considerable securities law expertise, but there was no practice or procedure for the investment staff to seek advice regarding such issues. If there had been a reasonable compliance program in place at RSA at the time of the events described in this Report, RSA likely would not have purchased Liberty stock prior to the public announcement of the transaction.

We also take into consideration the following:

a. RSA has taken remedial action—including compensation of the sellers of the Liberty stock RSA purchased—that would be sought or required in an enforcement proceeding. We believe it would be appropriate here not to seek or to impose a penalty because it would be paid from Alabama public employee contributions to the funds managed by RSA, and the earnings on those contributions. Similarly, in view of RSA's adoption of a compliance program, it is appropriate under these circumstances that the Commission not impose a cease-and-desist order or seek a permanent injunction prohibiting future violations of the anti-fraud provisions of the Exchange Act.

b. RSA cooperated in the staff's investigation.

c. RSA's CEO cooperated in the staff's investigation, acknowledged error in directing RSA's purchases of Liberty stock, and authorized all remedial action described in this Report.

d. No individual profited from the conduct described in this Report.

IV. Conclusion

We issue this Report to remind investment managers, public and private, of their obligation to comply with the federal securities laws and the risks they undertake by operating without an adequate compliance program. RSA's conduct could have been prevented with appropriate policies, procedures and training.

By the Commission (Chairman Cox, Commissioner Atkins, Commissioner Casey).

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
March 7, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12985

In the Matter of

Aaro Broadband Wireless Communications, Inc., Agri Bio-Sciences, Inc., Alabaster Corp., and Alchemy Holdings, 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") against Respondents Aaro Broadband Wireless Communications, Inc., Agri Bio-Sciences, Inc., Alabaster Corp., and Alchemy Holdings, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Aaro Broadband Wireless Communications, Inc. ("Aaro") (CIK No. 47968) is a revoked Nevada corporation located in Oklahoma City, Oklahoma with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Aaro 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 $386,194 for the prior three months. As of October 18, 2007, the company's common stock (symbol "AARW") was traded on the over-the-counter markets.

2. Agri Bio-Sciences, Inc. ("Agri Bio")(CIK No. 1060212) is a void Delaware corporation located in Spring, Texas with a class of equity securities registered with the Commission pursuant to Exchange Act Sections 12(g). Agri Bio 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.

3. Alabaster Corp. ("Alabaster") (CIK No. 1102961) is a void Delaware corporation located in Houston, Texas with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Alabaster is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-SB/A registration statement on October 10, 2000, which reported a net loss of $504 for the period ended June 30, 2000.

4. Alchemy Holdings, Inc. ("Alchemy") (CIK No. 841183) is a dissolved Florida corporation located in Aventura, Florida with a class of equity securities registered with the Commission pursuant to Exchange Act Section 12(g). Alchemy is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended March 31, 1999, which reported a net loss of $267,316 for the prior six months.

B. DELINQUENT PERIODIC FILINGS

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

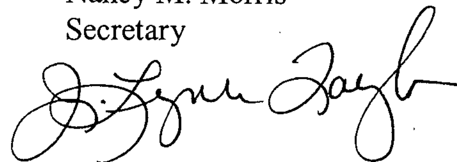
This Order shall be served forthwith upon Respondents personally or by certified, registered, or Express Mail, or by other means of verifiable delivery.

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



By: J. Lynn Taylor
Assistant Secretary

Attachment

Appendix 1

Chart of Delinquent Filings
In the Matter of Aaro Broadband Wireless Communications, Inc.

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Aaro Broadband Wireless Communications, Inc.					
	10-KSB	12/31/01	04/01/02	Not filed	71
	10-QSB	03/31/02	05/15/02	Not filed	70
	10-QSB	06/30/02	08/14/02	Not filed	67
	10-QSB	09/30/02	11/14/02	Not filed	64
	10-KSB	12/31/02	03/31/03	Not filed	60
	10-QSB	03/31/03	05/15/03	Not filed	58
	10-QSB	06/30/03	08/14/03	Not filed	55
	10-QSB	09/30/03	11/14/03	Not filed	52
	10-KSB	12/31/03	03/30/04	Not filed	48
	10-QSB	03/31/04	05/17/04	Not filed	46
	10-QSB	06/30/04	08/16/04	Not filed	43
	10-QSB	09/30/04	11/15/04	Not filed	40
	10-KSB	12/31/04	03/31/05	Not filed	36
	10-QSB	03/31/05	05/16/05	Not filed	34
	10-QSB	06/30/05	08/15/05	Not filed	31
	10-QSB	09/30/05	11/14/05	Not filed	28
	10-KSB	12/31/05	03/31/06	Not filed	24
	10-QSB	03/31/06	05/15/06	Not filed	22
	10-QSB	06/30/06	08/14/06	Not filed	19
	10-QSB	09/30/06	11/14/06	Not filed	16
	10-KSB	12/31/06	04/02/07	Not filed	11
	10-QSB	03/31/07	05/15/07	Not filed	10
	10-QSB	06/30/07	08/14/07	Not filed	7
	10-QSB	09/30/07	11/14/07	Not filed	4
Total Filings Delinquent	24				

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Agri-Bio Sciences, Inc.					
	10-KSB	12/31/00	04/02/01	Not filed	83
	10-QSB	03/31/01	05/15/01	Not filed	82
	10-QSB	06/30/01	08/14/01	Not filed	79
	10-QSB	09/30/01	11/14/01	Not filed	76
	10-KSB	12/31/01	04/01/02	Not filed	71
	10-QSB	03/31/02	05/15/02	Not filed	70
	10-QSB	06/30/02	08/14/02	Not filed	67
	10-QSB	09/30/02	11/14/02	Not filed	64
	10-KSB	12/31/02	03/31/03	Not filed	60
	10-QSB	03/31/03	05/15/03	Not filed	58
	10-QSB	06/30/03	08/14/03	Not filed	55
	10-QSB	09/30/03	11/14/03	Not filed	52
	10-KSB	12/31/03	03/30/04	Not filed	48
	10-QSB	03/31/04	05/17/04	Not filed	46
	10-QSB	06/30/04	08/16/04	Not filed	43
	10-QSB	09/30/04	11/15/04	Not filed	40
	10-KSB	12/31/04	03/31/05	Not filed	36
	10-QSB	03/31/05	05/16/05	Not filed	34
	10-QSB	06/30/05	08/15/05	Not filed	31
	10-QSB	09/30/05	11/14/05	Not filed	28
	10-KSB	12/31/05	03/31/06	Not filed	24
	10-QSB	03/31/06	05/15/06	Not filed	22
	10-QSB	06/30/06	08/14/06	Not filed	19
	10-QSB	09/30/06	11/14/06	Not filed	16
	10-KSB	12/31/06	04/02/07	Not filed	11
	10-QSB	03/31/07	05/15/07	Not filed	10
	10-QSB	06/30/07	08/14/07	Not filed	7
	10-QSB	09/30/07	11/14/07	Not filed	4

Total Filings Delinquent 28

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Alabaster Corp.					
	10-QSB	09/30/00	11/14/00	Not filed	88
	10-KSB	12/31/00	04/02/01	Not filed	83
	10-QSB	03/31/01	05/15/01	Not filed	82
	10-QSB	06/30/01	08/14/01	Not filed	79
	10-QSB	09/30/01	11/14/01	Not filed	76
	10-KSB	12/31/01	04/01/02	Not filed	71
	10-QSB	03/31/02	05/15/02	Not filed	70
	10-QSB	06/30/02	08/14/02	Not filed	67
	10-QSB	09/30/02	11/14/02	Not filed	64
	10-KSB	12/31/02	03/31/03	Not filed	60
	10-QSB	03/31/03	05/15/03	Not filed	58
	10-QSB	06/30/03	08/14/03	Not filed	55
	10-QSB	09/30/03	11/14/03	Not filed	52
	10-KSB	12/31/03	03/30/04	Not filed	48
	10-QSB	03/31/04	05/17/04	Not filed	46
	10-QSB	06/30/04	08/16/04	Not filed	43
	10-QSB	09/30/04	11/15/04	Not filed	40
	10-KSB	12/31/04	03/31/05	Not filed	36
	10-QSB	03/31/05	05/16/05	Not filed	34
	10-QSB	06/30/05	08/15/05	Not filed	31
	10-QSB	09/30/05	11/14/05	Not filed	28
	10-KSB	12/31/05	03/31/06	Not filed	24
	10-QSB	03/31/06	05/15/06	Not filed	22
	10-QSB	06/30/06	08/14/06	Not filed	19
	10-QSB	09/30/06	11/14/06	Not filed	16
	10-KSB	12/31/06	04/02/07	Not filed	11
	10-QSB	03/31/07	05/15/07	Not filed	10
	10-QSB	06/30/07	08/14/07	Not filed	7
	10-QSB	09/30/07	11/14/07	Not filed	4

Total Filings Delinquent 29

Company Name	Form Type	Period Ended	Due Date	Date Received	Months Delinquent (rounded up)
Alchemy Holdings, Inc.					
	10-K	09/30/99	12/29/99	Not filed	99
	10-Q	12/31/99	02/14/00	Not filed	97
	10-Q	03/31/00	05/15/00	Not filed	94
	10-Q	06/30/00	08/14/00	Not filed	91
	10-K	09/30/00	12/29/00	Not filed	87
	10-Q	12/31/00	02/14/01	Not filed	85
	10-Q	03/31/01	05/15/01	Not filed	82
	10-Q	06/30/01	08/14/01	Not filed	79
	10-K	09/30/01	12/31/01	Not filed	75
	10-Q	12/31/01	02/14/02	Not filed	73
	10-Q	03/31/02	05/15/02	Not filed	70
	10-Q	06/30/02	08/14/02	Not filed	67
	10-K	09/30/02	12/30/02	Not filed	63
	10-Q	12/31/02	02/14/03	Not filed	61
	10-Q	03/31/03	05/15/03	Not filed	58
	10-Q	06/30/03	08/14/03	Not filed	55
	10-K	09/30/03	12/29/03	Not filed	51
	10-Q	12/31/03	02/17/04	Not filed	49
	10-Q	03/31/04	05/17/04	Not filed	46
	10-Q	06/30/04	08/16/04	Not filed	43
	10-K	09/30/04	12/29/04	Not filed	39
	10-Q	12/31/04	02/14/05	Not filed	37
	10-Q	03/31/05	05/16/05	Not filed	34
	10-Q	06/30/05	08/15/05	Not filed	31
	10-K	09/30/05	12/29/05	Not filed	27
	10-Q	12/31/05	02/14/06	Not filed	25
	10-Q	03/31/06	05/15/06	Not filed	22
	10-Q	06/30/06	08/14/06	Not filed	19
	10-K	09/30/06	12/29/06	Not filed	15
	10-Q	12/31/06	02/14/07	Not filed	13
	10-Q	03/31/07	05/15/07	Not filed	10
	10-Q	06/30/07	08/14/07	Not filed	7
	10-K	09/30/07	12/31/07	Not filed	3
Total Filings Delinquent	33				

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 57501 / March 14, 2008

INVESTMENT ADVISERS ACT OF 1940
Release No. 2722 / March 14, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12991

In the Matter of

MARC J. BILOTTI,

Respondent.

ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Mark J. Bilotti ("Respondent").

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II.

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

III.

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

1. Bilotti, age 37, is a resident of Charlestown, Massachusetts. From 1999 through 2003, Bilotti was employed as a registered representative at the Boston, Massachusetts branch office of Prudential Securities, Inc., a registered broker-dealer and investment adviser. Bilotti was registered as a general securities representative. During the relevant period, Bilotti was a person associated with a broker or dealer and investment adviser.

2. On March 3, 2008, a final judgment was entered by consent against Bilotti, permanently enjoining him from future violations of Sections 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder in the civil action entitled Securities and Exchange Commission v. Druffner et al., Civil Action No. 03-12154-NMG in the United States District Court for District of Massachusetts.

3. The Commission's complaint alleged the following. From as early as January 2001 until September 2003, Bilotti defrauded mutual fund companies and the funds' shareholders in order to engage in market timing. Bilotti knew that the fund companies monitored activity in their funds and imposed restrictions on excessive trading. To conceal his own identity and the identities of his customers, Bilotti used numerous registered representative identification numbers and opened customer accounts under fictitious names. His use of multiple accounts and identification numbers was intended to, and did, make it more difficult for the fund companies to detect their clients' market timing, thus misleading the fund companies to process transactions they would otherwise have rejected.

IV.

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

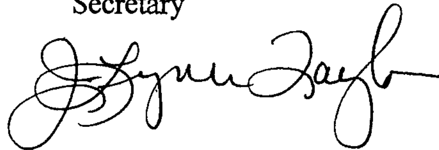
Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b)(6) of the Exchange Act and Section 203(f) of the Advisers Act, that Respondent Bilotti be, and hereby is, barred from association with any broker, dealer, or investment adviser, with the right to reapply for association after 3 years to the appropriate self-regulatory organization, or if there is none, to the Commission;

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

By the Commission.

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. 57536 / March 20, 2008

ADMINISTRATIVE PROCEEDING
File No. 3-12995

In the Matter of Bruce Chet Rothenberg, 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 Bruce Chet Rothenberg ("Rothenberg" or "Respondent").

II.

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

III.

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

1. From May to December 2004 (the "relevant period"), Rothenberg assisted Gerald and Marie Levine in locating investors and selling them shares of Nu Star Holdings, Inc., a Nevada corporation that is quoted on the Pink Sheets. Rothenberg, who held Series 7, 24 and 63 licenses, and worked as a registered representative in the early 1990s, was not a registered broker or dealer during the relevant period, nor was he associated with any broker or dealer. Rothenberg, 45, is an East Amherst, New York resident.

2. On February 21, 2008, a final judgment was entered by consent against Rothenberg, permanently enjoining him from future violations of Section 15(a)(1) of the Exchange Act, in the civil action entitled Securities and Exchange Commission v. Gerald Harold Levine, et al., Civil Action Number 2:07-CV-506-LDG (RJJ), in the United States District Court for the District of Nevada.

3. The Commission's complaint alleged, among other things, that Gerald Levine offered Rothenberg shares in Nu Star in exchange for Rothenberg's assistance in selling Nu Star shares to the public. Based on this agreement with Gerald Levine, Rothenberg approached several contacts and told them of the "opportunity" to invest in Nu Star. Rothenberg gave potential investors Nu Star press releases and its business plan, which Gerald Levine had sent to him. The Nu Star business plan contained materially false statements, such as a claim that Nu Star subsidiary Alcor had "saved Novell approximately $1,750,000," as well as claiming first year revenue of nearly $1.6 million. In addition, it contained a balance sheet that falsely stated that as of May 31, 2004, a Nu Star subsidiary had total assets of $6.83 million. Gerald Levine also told Rothenberg the share price at which Gerald Levine, through an intermediary, would sell Nu Star stock, which he claimed was at a "discount" to the market price. Based on what Gerald Levine had told him, Rothenberg offered at least one potential investor volume discounts for purchases of Nu Star stock. Rothenberg failed to inform potential investors that Gerald Levine and others had artificially inflated Nu Star's share price. Rothenberg gave the potential investors Gerald Levine's phone number. After speaking with Gerald Levine, several investors purchased shares of Nu Star. In completing these transactions, investors gave Rothenberg checks for the purchase of Nu Star shares. Between August and December 2004, the investors bought approximately 55,000 shares of Nu Star for a total of at least $149,000. After the sales closed, Gerald Levine sent Rothenberg 2,000 restricted shares of Nu Star as compensation.

IV.

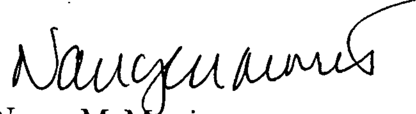
In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Rothenberg's Offer.

Accordingly, it is hereby ORDERED:

Pursuant to Section 15(b)(6) of the Exchange Act, that Respondent Rothenberg be, and hereby is, barred from association with any broker or dealer.

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